

CHARLES W. L. HILL / GARETH R. JONES

# STRATEGIC MANAGEMENT

AN INTEGRATED APPROACH



9th Edition

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# STRATEGIC MANAGEMENT THEORY

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9th Edition

# STRATEGIC MANAGEMENT THEORY

AN INTEGRATED APPROACH

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**Strategic Management Theory: An Integrated Approach, Ninth Edition**  
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Library of Congress Control Number: 2009934265

ISBN-13: 978-0-538-75107-0

ISBN-10: 0-538-75107-X

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# PREFACE

Since the eighth edition was published, this book has strengthened its position as a market leader in the Strategic Management market. This tells us that we continue to meet the expectations of existing users and attract many new users to our book. It is clear that most strategy instructors share with us a concern for our currency in the text and its examples to ensure that cutting-edge issues and new developments in strategic management are continually addressed.

Just as in the last edition, our objective in writing the ninth edition has been to maintain all that was good about prior editions. As we move steadily into the second decade of the 21st Century, we continue to refine our approach by expanding our discussion of established strategic management issues and adding new material as management trends develop to present a more complete, clear, and current account of strategic management. We believe that the result is a book that is more closely aligned with the needs of today's professors and students and with the realities of competition in the global environment.

## COMPREHENSIVE AND UP-TO-DATE COVERAGE

We have updated many of the features running throughout the chapters, including all new Opening Cases and Running Cases. For the Running Cases, Walmart is the focus corporation. In this edition, we have made no changes to the number or sequencing of our chapters. However, we have made many significant changes inside each chapter to refine and update our presentation of strategic management. Continuing real-world changes in strategic management practices such as the increased use of cost reduction strategies like global outsourcing, ethical issues, and lean production, and a continued emphasis on the business model as the driver of differentiation and competitive advantage, have led to many changes in our approach. To emphasize the importance of ethical decision making in strategic management, we have included a new marginal feature—Ethical Dilemma—that asks students to make sound management decisions while considering ethical ramifications in business.

Throughout the revision process, we have been careful to preserve the *balanced and integrated* nature of our account of strategic management. As we have continued to add new material, we have also shortened or deleted coverage of out-of-date or less important models and concepts to help students identify and focus on the core concepts and issues in the field. We have also paid close attention to retaining the book's readability.

## PRACTICING STRATEGIC MANAGEMENT: AN INTERACTIVE APPROACH

We have received a lot of positive feedback about the usefulness of the end-of-chapter exercises and assignments in the Practicing Strategic Management sections in our book. They offer a wide range of hands-on learning experiences for students. Following the Chapter Summary and Discussion Questions, each chapter contains the following exercises and assignments:

- **Small group exercise.** This short (20-minute) experiential exercise asks students to divide into groups and discuss a scenario concerning some aspect of strategic management. For example, the scenario in Chapter 11 asks students to identify the stakeholders of their educational institution and evaluate how stakeholders' claims are being and should be met.
- **Article file.** As in the last edition, this exercise requires students to search business magazines to identify a company that is facing a particular strategic management problem. For instance, students are asked to locate and research a company pursuing a low-cost or a differentiation strategy, and to describe this company's strategy, its advantages and disadvantages, and the core competencies required to pursue it. Students' presentations of their findings lead to lively class discussions.
- **Strategic management project.** In small groups, students choose a company to study for the whole semester and then analyze the company using the series of questions provided at the end of every chapter. For example, students might select Ford Motor Co. and, using the series of chapter questions, collect information on Ford's top managers, mission, ethical position, domestic and global strategy and structure, and so on. Students write a case study of their company and present it to the class at the end of the semester. In the past, we also had students present one or more of the cases in the book early in the semester, but now in our classes, we treat the students' own projects as the major class assignment and their case presentations as the climax of the semester's learning experience.
- **Closing case study.** A short closing case provides an opportunity for a short class discussion of a chapter-related theme.

In creating these exercises, it is not our intention to suggest that they should *all* be used for *every* chapter. For example, over a semester, an instructor might combine a group Strategic Management Project with five to six Article File assignments, while incorporating eight to ten Small Group Exercises in class.

We have found that our interactive approach to teaching strategic management appeals to students. It also greatly improves the quality of their learning experience. Our approach is more fully discussed in the *Instructor's Resource Manual*.

## TEACHING AND LEARNING AIDS

Taken together, the teaching and learning features of *Strategic Management* provide a package that is unsurpassed in its coverage and that supports the integrated approach that we have taken throughout the book.

## For the Instructor

- **The Instructor's Resource Manual:** Theory has been completely revised. For each chapter, we provide a clearly focused synopsis, a list of teaching objectives, a comprehensive lecture outline, teaching notes for the *Ethical Dilemma* feature, suggested answers to discussion questions, and comments on the end-of-chapter activities. Each Opening Case, Strategy in Action boxed feature, and Closing Case has a synopsis and a corresponding teaching note to help guide class discussion.
- **ExamView Test Bank** offers a set of comprehensive true/false, multiple-choice, and essay questions for each chapter in the book. The mix of questions has been adjusted to provide fewer fact-based of simple memorization items and to provide more items that rely on synthesis or application. Also, more items now reflect real or hypothetical situations in organizations. Every question is keyed to the Learning Objectives outlined in the text and includes an answer and text page reference.
- **Case Teaching Notes** include a complete list of case discussion questions as well as a comprehensive teaching note for each case, which gives a complete analysis of case issues.
- **DVD program** highlights many issues of interest and can be used to spark class discussion. It offers a compilation of footage from the Videos for Humanities video series.
- **Companion website** contains many features to aid instructors, including instructor-based PowerPoint, a DVD guide, and access to the student website.
- **WebTutor** is a web platform containing premium content such as unique web quizzes, audio summary and quiz files, lecture PowerPoint slides, and crossword puzzles for key terms from the text.

## For the Student

- **Companion Website** includes chapter summaries, learning objectives, web quizzes, glossary, and flashcards.

## ACKNOWLEDGMENTS

This book is the product of far more than two authors. We are grateful to our Acquisitions Editor, Michele Rhoades; our developmental editor, Suzanna Bainbridge; and our Marketing Manager, Nathan Anderson, for their help in developing and promoting the book and for providing us with timely feedback and information from professors and reviewers, which allowed us to shape the book to meet the needs of its intended market. We are also grateful to Jana Lewis and Tiffany Timmerman, project editors, for their adept handling of production. We are also grateful to the case authors for allowing us to use their materials. We also want to thank the departments of management at the University of Washington and Texas A&M University for providing the setting and atmosphere in which the book could be written, and the students of these universities who react to and provide input for many of our ideas. In addition, the following reviewers of this and earlier editions gave us valuable suggestions for improving the manuscript from its original version to its current form:

Ken Armstrong, *Anderson University*  
Richard Babcock, *University of San Francisco*  
Kunal Banerji, *West Virginia University*  
Kevin Banning, *Auburn University – Montgomery*  
Glenn Bassett, *University of Bridgeport*  
Thomas H. Berliner, *The University of Texas at Dallas*  
Bonnie Bollinger, *Ivy Technical Community College*  
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Eliezer Geisler, *Northeastern Illinois University*  
Gretchen Gemeinhardt, *University of Houston*  
Lynn Godkin, *Lamar University*  
Sanjay Goel, *University of Minnesota – Duluth*  
Robert L. Goldberg, *Northeastern University*  
James Grinnell, *Merrimack College*  
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Todd Hostager, *University of Wisconsin – Eau Claire*  
Graham L. Hubbard, *University of Minnesota*  
Tammy G. Hunt, *University of North Carolina at Wilmington*  
James Gaius Ibe, *Morris College*  
W. Grahm Irwin, *Miami University*  
Homer Johnson, *Loyola University – Chicago*  
Jonathan L. Johnson, *University of Arkansas – Walton College  
of Business Administration*  
Marios Katsioloudes, *St. Joseph's University*  
Robert Keating, *University of North Carolina at Wilmington*  
Geoffrey King, *California State University – Fullerton*

Rico Lam, *University of Oregon*  
Robert J. Litschert, *Virginia Polytechnic Institute and State University*  
Franz T. Lohrke, *Louisiana State University*  
Paul Mallette, *Colorado State University*  
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# 1

## STRATEGIC LEADERSHIP: MANAGING THE STRATEGY-MAKING PROCESS FOR COMPETITIVE ADVANTAGE

### LEARNING OBJECTIVES

After reading this chapter, you should be able to

- Explain what is meant by “competitive advantage”
- Discuss the strategic role of managers at different levels in an organization
- Identify the main steps in a strategic planning process
- Discuss the main pitfalls of planning and how those pitfalls can be avoided
- Outline the cognitive biases that might lead to poor strategic decisions and explain how these biases can be overcome
- Discuss the role played by strategic leaders in the strategy-making process

### Walmart’s Competitive Advantage Walmart is one of the most extraordinary success stories in business history.

Started in 1962 by Sam Walton, Walmart has grown to become the world’s largest corporation. In 2008, the discount retailer whose mantra is “everyday low prices” had sales of \$410 billion, 7,400 stores in 15 countries and 2 million employees. Some 8% of all retail sales in the United States are made at a Walmart store. Walmart is not only large; it is also very profitable. In 2008, the company earned a return on invested capital of 14.5%, better than its well-managed rivals Costco and Target, which earned

11.7% and 9.5%, respectively. As shown in Figure 1.1, Walmart has been consistently more profitable than its rivals for years, although of late its rivals have been closing the gap.

Walmart’s consistently superior profitability reflects a competitive advantage that is based on a number of strategies. Back in 1962, Walmart was one of the first companies to apply the self-service supermarket business model developed by grocery chains to general merchandise. Unlike its rivals such as Kmart and Target

### OPENING CASE





who focused on urban and suburban locations, Sam Walton's Walmart concentrated on small southern towns that were ignored by its rivals. Walmart grew quickly by pricing lower than local retailers, often putting them out of business. By the time its rivals realized that small towns could support large discount, general merchandise stores, Walmart had already preempted them. These towns, which were large enough to support one discount retailer—but not two—provided a secure profit base for Walmart.

The company was also an innovator in information systems, logistics, and human resource practices. These strategies resulted in higher productivity and lower costs than its rivals, which enabled the company to earn a high profit while charging low prices. Walmart led the way among American retailers in developing and implementing sophisticated product tracking systems by using bar code technology and checkout scanners. This information technology enabled Walmart to track what was selling and adjust its inventory accordingly so that the products found in a store matched local demand. By avoiding overstocking, Walmart did not have to hold periodic sales to shift unsold inventory. Over time, Walmart linked this information system to a nationwide network of distribution centers where inventory was stored and then shipped to stores within a 250-mile radius on a daily basis. The combination of distribution centers and information centers enabled Walmart to reduce the amount of inventory it held in stores, thereby devoting more of that valuable space to selling and reducing the amount of capital it had tied up in inventory.

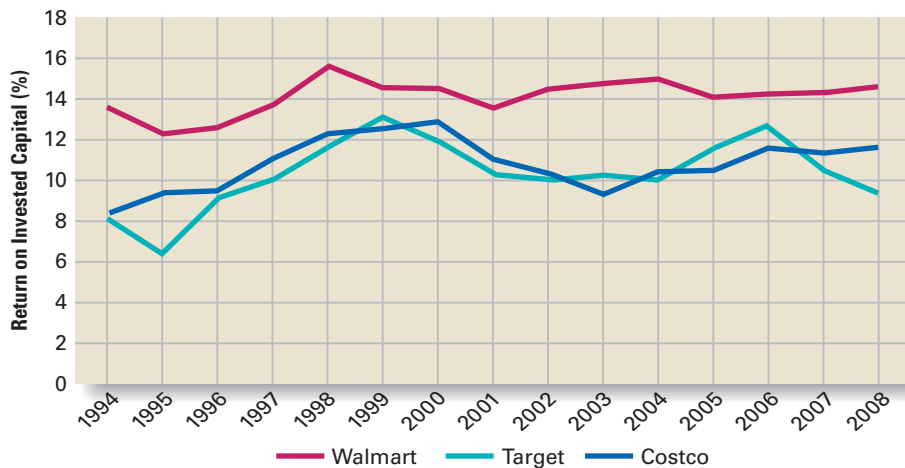
With regard to human resources, the tone was set by Sam Walton. He had a strong belief that employees should be respected and rewarded for helping to improve the profitability of the company. Underpinning this belief, Walton referred to employees as associates.

He established a profit-sharing plan for all employees and, after the company went public in 1970, a program that allowed employees to purchase Walmart stock at a discount to its market value. Walmart was rewarded for this approach by high employee productivity, which translated into lower operating costs and higher profitability.

As Walmart grew larger, the sheer size and purchasing power of the company enabled it to drive down the prices that it paid suppliers, passing on those savings to customers in the form of lower prices, which enabled Walmart to gain more market share and hence demand even lower prices. To take the sting out of the persistent demands for lower prices, Walmart shared its sales information with suppliers on a daily basis, enabling them to gain efficiencies by configuring their own production schedules to sales at Walmart.

By the 1990s, Walmart was already the largest general seller of general merchandise in America. To keep its growth going, Walmart started to diversify into the grocery business, opening 200,000-square-foot supercenter stores that sold groceries and general merchandise under one roof. Walmart also diversified into the warehouse club business with the establishment of Sam's Club. The company began expanding internationally in 1991 with its entry into Mexico.

For all its success, however, Walmart is now encountering very real limits to profitable growth. The U.S. market is approaching saturation, and growth overseas has proved more difficult than the company hoped. The company was forced to exit Germany and South Korea after losing money there and has found it tough going into several other developed nations, such as Britain. Moreover, rivals Target and Costco have continued to improve their performances and are now snapping at Walmart's heels.<sup>1</sup>

**Figure 1.1** Profitability of Walmart and Competitors

**Source:** Value Line Calculations. Data for 2008 are estimates based on three quarters.

## Overview

Why do some companies succeed while others fail? Why has Walmart been able to consistently outperform its well-managed rivals? In the airline industry, how is it that Southwest Airlines has managed to keep increasing its revenues and profits through both good times and bad, while rivals such as US Airways and United Airlines have had to seek bankruptcy protection? What explains the consistent growth and profitability of Nucor Steel, now the largest steelmaker in America, during a period when many of its once larger rivals disappeared into bankruptcy?

In this book, we argue that the strategies that a company's managers pursue have a major impact on its performance relative to its competitors. A **strategy** is a set of related actions that managers take to increase their company's performance. For most, if not all, companies, achieving superior performance relative to rivals is the ultimate challenge. If a company's strategies result in superior performance, it is said to have a competitive advantage. Walmart's strategies produced superior performance from 1994 to 2008; as a result, Walmart has enjoyed a competitive advantage over its rivals. How did Walmart achieve this competitive advantage? As explained in the opening case, it was due to the successful pursuit of a number of strategies by Walmart's managers, most notably the company's founder, Sam Walton. These strategies enabled the company to lower its cost structure, charge low prices, gain market share, and become more profitable than its rivals. (We will return to the example of Walmart several times throughout this book in a running case that examines various aspects of Walmart's strategy and performance.)

This book identifies and describes the strategies that managers can pursue to achieve superior performance and provide their company with a competitive advantage. One of its central aims is to give you a thorough understanding of the analytical techniques and skills necessary to identify and implement strategies successfully. The first step toward achieving this objective is to describe in detail what superior

performance and competitive advantage mean and to explain the pivotal roles that managers play in leading the strategy-making process.

**Strategic leadership** is about how to most effectively manage a company's strategy-making process to create competitive advantage. The strategy-making process is the process by which managers select and then implement a set of strategies that aim to achieve a competitive advantage. **Strategy formulation** is the task of selecting strategies, whereas **strategy implementation** is the task of putting strategies into action, which includes designing, delivering, and supporting products; improving the efficiency and effectiveness of operations; and designing a company's organizational structure, control systems, and culture.

By the end of this chapter, you will understand how strategic leaders can manage the strategy-making process by formulating and implementing strategies that enable a company to achieve a competitive advantage and superior performance. Moreover, readers will learn how the strategy-making process can go wrong and what managers can do to make this process more effective.

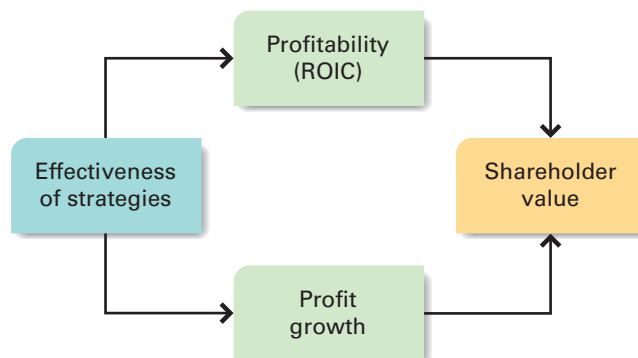
## STRATEGIC LEADERSHIP, COMPETITIVE ADVANTAGE, AND SUPERIOR PERFORMANCE

Strategic leadership is concerned with managing the strategy-making process to increase the performance of a company, thereby increasing the value of the enterprise to its owners and shareholders. As shown in Figure 1.2, to increase shareholder value, managers must pursue strategies that increase the profitability of the company and ensure that profits grow. (For more details please see the Appendix to Chapter 1 on the text companion website.) To do this, a company must be able to outperform its rivals; it must have a competitive advantage.

### Superior Performance

Maximizing shareholder value is the ultimate goal of profit-making companies for two reasons. First, shareholders provide a company with the risk capital that enables managers to buy the resources needed to produce and sell goods and services.

**Figure 1.2** Determinants of Shareholder Value





**Risk capital** is capital that cannot be recovered if a company fails and goes bankrupt. In the case of Walmart, for example, shareholders provided Sam Walton's company with the capital it used to build stores and distribution centers, invest in information systems, purchase inventory to sell to customers, and so on. Had Walmart failed, its shareholders would have lost their money; their shares would have been worthless. Thus, shareholders will not provide risk capital unless they believe that managers are committed to pursuing strategies that give them a good return on their capital investment. Second, shareholders are the legal owners of a corporation, and their shares represent a claim on the profits generated by a company. Thus, managers have an obligation to invest those profits in ways that maximize shareholder value. Of course, as explained later in this book, managers must behave in a legal, ethical, and socially responsible manner while at the same time working to maximize shareholder value.

By **shareholder value** we mean the returns that shareholders earn from purchasing shares in a company. These returns come from two sources: (1) capital appreciation in the value of a company's shares and (2) dividend payments. For example, between January 2 and December 31, 2008, the value of one share in Walmart increased from \$46.90 to \$56.06, which represents a capital appreciation of \$9.16. In addition, Walmart paid out a dividend of \$0.95 per share during 2008. Thus, if an investor had bought one share of Walmart on January 2 and held onto it for the entire year, his or her return would have been \$10.11 ( $\$9.16 + \$0.95$ ), an impressive 21.6% return on investment in a year when the stock market as a whole was down 35%! One reason Walmart's shareholders did so well during 2008 was that investors believed that managers were pursuing strategies that would both increase the long-term profitability of the company and significantly grow its profits in the future.

One way of measuring the **profitability** of a company is by the return that it makes on the capital invested in the enterprise.<sup>2</sup> The return on invested capital (ROIC) that a company earns is defined as its net profit over the capital invested in the firm (profit/capital invested). By net profit we mean net income after tax. By capital we mean the sum of money invested in the company: that is, stockholders' equity plus debt owed to creditors. Thus, profitability is the result of how efficiently and effectively managers use the capital at their disposal to produce goods and services that satisfy customer needs. A company that uses its capital efficiently and effectively makes a positive return on invested capital.

The **profit growth** of a company can be measured by the increase in net profit over time. A company can grow its profits if it sells products in markets that are growing rapidly, gains market share from rivals, increases the amount it sells to existing customers, expands overseas, or diversifies profitably into new lines of business. For example, between 1994 and 2008 Walmart increased its net profit from \$2.68 billion to \$13.8 billion. It was able to do this because the company (1) took market share from rivals, (2) established stores in nine foreign nations that collectively generated \$70 billion in sales by 2008, and (3) entered the grocery business. Due to the increase in net profit, Walmart's earnings per share increased from \$0.59 to \$3.50, making each share more valuable, and leading, in turn, to appreciation in the value of Walmart's shares.

Together, profitability and profit growth are the principal drivers of shareholder value (see the Appendix to Chapter 1 on the text companion website). To boost profitability and grow profits over time, managers must formulate and implement strategies that give their companies a competitive advantage over their rivals. Walmart's strategies have enabled the company to maintain a high level of profitability

and to simultaneously grow its profits over time. As a result, investors who purchased Walmart's stock in January 1994 when the shares were trading at \$11 would have made a return of more than 500% if they had held onto them through December 2008. By pursuing strategies that lead to high and sustained profitability and profit growth, Walmart's managers have thus rewarded shareholders for their decisions to invest in the company.

One of the key challenges managers face is to simultaneously generate high profitability and increase the profits of the company. Companies that have high profitability but whose profits are not growing will not be as highly valued by shareholders as a company that has both high profitability and rapid profit growth (see Appendix to Chapter 1 on the text companion website). At the same time, managers need to be aware that if they grow profits but profitability declines, that too will not be as highly valued by shareholders. What shareholders want to see, and what managers must try to deliver through strategic leadership, is *profitable growth*: that is, high profitability and sustainable profit growth. This is not easy, but some of the most successful enterprises of our era have achieved it, companies such as Microsoft, Google, Intel, and Walmart.

## Competitive Advantage and a Company's Business Model

Managers do not make strategic decisions in a competitive vacuum. Their company is competing against other companies for customers. Competition is a rough-and-tumble process in which only the most efficient and effective companies win out. It is a race without end. To maximize shareholder value, managers must formulate and implement strategies that enable their companies to outperform rivals and give them a competitive advantage. A company is said to have a **competitive advantage** over its rivals when its profitability is greater than the average profitability and profit growth of other companies competing for the same set of customers. The higher its profitability relative to rivals, the greater its competitive advantage will be. A company has a **sustained competitive advantage** when its strategies enable it to maintain above-average profitability for a number of years. As discussed in the opening case, Walmart had a significant and sustained competitive advantage over rivals such as Target, Costco, and Kmart between 1994 and 2008.

If a company has a sustained competitive advantage, it is likely to gain market share from its rivals and thus grow its profits more rapidly than those of rivals. In turn, competitive advantage will also lead to higher profit growth than that shown by rivals.

The key to understanding competitive advantage is appreciating how the different strategies managers pursue over time can create activities that fit together to make a company unique or different from its rivals and able to consistently outperform them. A **business model** is a manager's conception of how the set of strategies his company pursues should mesh together into a congruent whole, enabling the company to gain a competitive advantage and achieve superior profitability and profit growth. In essence, a business model is a kind of mental model, or gestalt, of how the various strategies and capital investments made by a company should fit together to generate above-average profitability and profit growth. A business model encompasses the totality of how a company will

- Select its customers.
- Define and differentiate its product offerings.
- Create value for its customers.

- Acquire and keep customers.
- Produce goods or services.
- Lower costs.
- Deliver those goods and services to the market.
- Organize activities within the company.
- Configure its resources.
- Achieve and sustain a high level of profitability.
- Grow the business over time.

The business model at discount stores such as Walmart, for example, is based on the idea that costs can be lowered by replacing a full-service retail format with a self-service format and a wider selection of products sold in a large footprint store that contains minimal fixtures and fittings. These savings are passed on to consumers in the form of lower prices, which in turn grow revenues and help the company to achieve further cost reductions from economies of scale. Over time, this business model has proved superior to the business models adopted by smaller, full-service mom and pop stores and traditional high service department stores such as Sears Roebuck and Co. The business model—known as the self-service supermarket business model—was first developed by grocery retailers in the 1950s and later refined and improved on by general merchandisers such as Walmart. More recently, the same basic business model has been applied to toys (Toys“R”Us), office supplies (Staples, Office Depot), and home improvement supplies (Home Depot and Lowes).

Walmart outperformed close rivals who adopted the same basic business model as Kmart because of key differences in strategies and because they implemented the business model more effectively. As a result, over time Walmart created unique activities that have become the foundation of its competitive advantage. For example, Walmart was one of the first retailers to make strategic investments in distribution centers and information systems, which lowered the costs of managing inventory (see the opening case). This gave Walmart a competitive advantage over rivals such as Kmart, which suffered from poor inventory controls and thus higher costs. So although Walmart and Kmart pursued similar business models, they were not identical. Key differences in the choice of strategies and the effectiveness of implementation created two unique organizations: one that attained a competitive advantage, and one that ended up with a competitive disadvantage.

The business model that managers develop may not only lead to higher profitability and thus competitive advantage at a certain point in time, but it may also help the firm to grow its profits over time, thereby maximizing shareholder value while maintaining or even increasing profitability. Thus, Walmart’s business model was so efficient and effective that it enabled the company to take market share from rivals such as Kmart, thereby growing profits over time. In addition, as alluded to earlier, Walmart was able to grow profits by applying its business model to new international markets, opening stores in nine different countries, and adding groceries to its product mix in large Walmart supercenters.

## Industry Differences in Performance

It is important to recognize that in addition to its business model and associated strategies, a company’s performance is also determined by the characteristics of the industry in which it competes. Different industries are characterized by different competitive conditions. In some, demand is growing rapidly; in others, it is contracting.



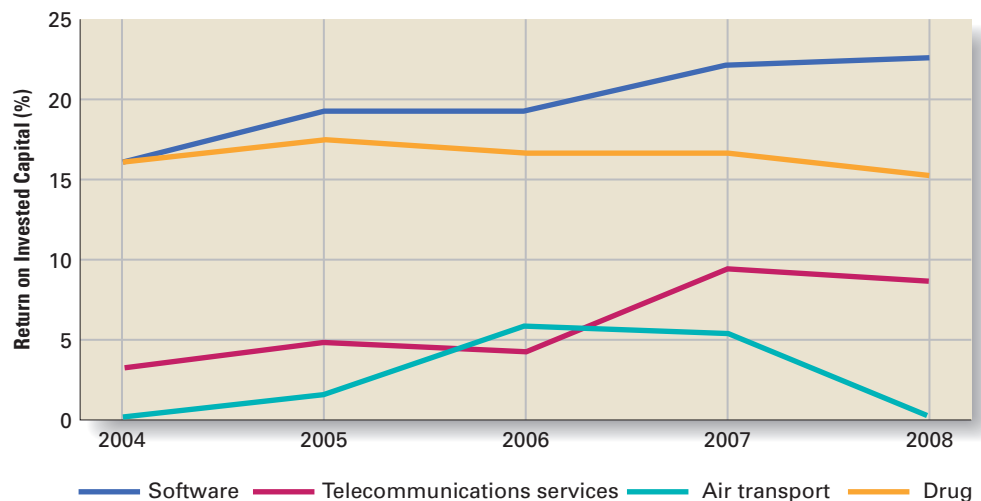
Some might be beset by excess capacity and persistent price wars, others by strong demand and rising prices. In some, technological change might be revolutionizing competition. Others might be characterized by stable technology. In some industries, high profitability among incumbent companies might induce new companies to enter the industry, and these new entrants might subsequently depress prices and profits in the industry. In other industries, new entry might be difficult, and periods of high profitability might persist for a considerable period of time. Thus, the different competitive conditions prevailing in different industries might lead to differences in profitability and profit growth. For example, average profitability might be higher in some industries and lower in other industries because competitive conditions vary from industry to industry.

Figure 1.3 shows the average profitability, measured by ROIC, among companies in several different industries between 2004 and 2008. The drug industry had a favorable competitive environment: demand for drugs was high and competition was generally not based on price. Just the opposite occurred in the air transport industry, which was extremely price competitive. Exactly how industries differ is discussed in detail in Chapter 2. For now, the important point to remember is that the profitability and profit growth of a company are determined by two main factors: its relative success in its industry and the overall performance of its industry relative to other industries.<sup>3</sup>

### Performance in Nonprofit Enterprises

A final point concerns the concept of superior performance in the nonprofit sector. By definition, nonprofit enterprises such as government agencies, universities, and charities are not in “business” to make profits. Nevertheless, they are expected to use their resources efficiently and operate effectively, and their managers set goals to

**Figure 1.3** Return on Invested Capital in Selected Industries, 2004–2008



Source: Value Line Investment Survey.

measure their performance. The performance goal for a business school might be to get its programs ranked among the best in the nation. The performance goal for a charity might be to prevent childhood illnesses in poor countries. The performance goal for a government agency might be to improve its services while not exceeding its budget. The managers of nonprofits need to map out strategies to attain these goals. They also need to understand that nonprofits compete with each other for scarce resources, just as businesses do. For example, charities compete for scarce donations, and their managers must plan and develop strategies that lead to high performance and demonstrate a track record of meeting performance goals. A successful strategy gives potential donors a compelling message about why they should contribute additional donations. Thus, planning and thinking strategically are as important for managers in the nonprofit sector as they are for managers in profit-seeking firms.

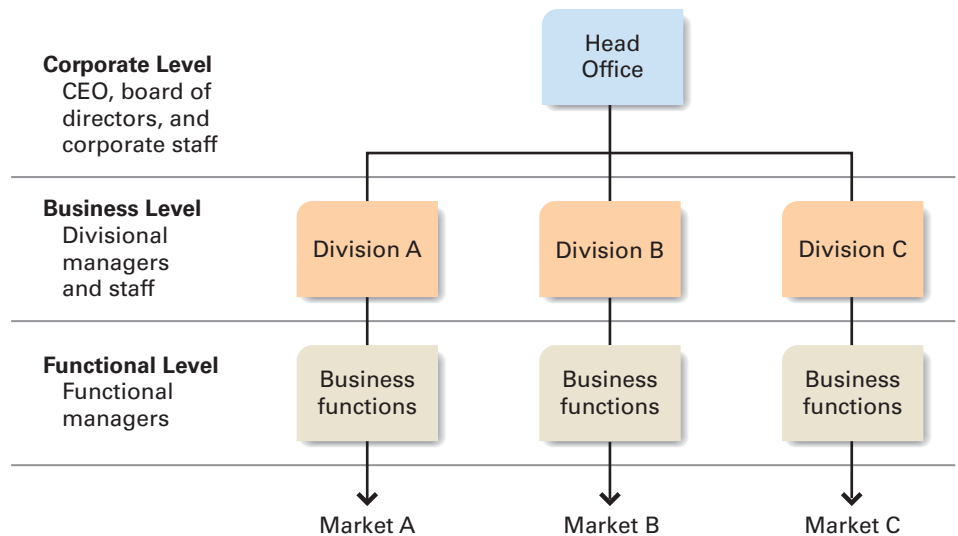
## STRATEGIC MANAGERS

Managers are the linchpins in the strategy-making process. Individual managers must take responsibility for formulating strategies to attain a competitive advantage and for putting those strategies into effect. They must lead the strategy-making process. The strategies that made Walmart so successful were not chosen by some abstract entity known as “the company”; they were chosen by the company’s founder, Sam Walton, and the managers he hired.

Walmart’s success was based in large part on how well the company’s managers performed their strategic roles. In this section, we look at the strategic roles of different managers. Later in the chapter, we discuss strategic leadership, which is how managers can effectively lead the strategy-making process.

In most companies, there are two main types of managers: **general managers** who bear responsibility for the overall performance of the company or for one of its major self-contained subunits or divisions and **functional managers** who are responsible for supervising a particular function, that is, a task, an activity, or an operation, such as accounting, marketing, research and development (R&D), information technology, or logistics.

A company is a collection of functions or departments that work together to bring a particular good or service to the market. If a company provides several different kinds of goods or services, it often duplicates these functions and creates a series of self-contained divisions (each of which contains its own set of functions) to manage each different good or service. The general managers of these divisions then become responsible for their particular product line. The overriding concern of general managers is for the health of the whole company or division under their direction; they are responsible for deciding how to create a competitive advantage and achieve high profitability with the resources and capital they have at their disposal. Figure 1.4 shows the organization of a **multidivisional company**, that is, a company that competes in several different businesses and has created a separate, self-contained division to manage each. There are three main levels of management: corporate, business, and functional. General managers are found at the first two of these levels, but their strategic roles differ depending on their spheres of responsibility.

**Figure 1.4** Levels of Strategic Management

### Corporate-Level Managers

The corporate level of management consists of the chief executive officer (CEO), other senior executives, and corporate staff. These individuals occupy the apex of decision making within the organization. The CEO is the principal general manager. In consultation with other senior executives, the role of corporate-level managers is to oversee the development of strategies for the whole organization. This role includes defining the goals of the organization, determining what businesses it should be in, allocating resources among the different businesses, formulating and implementing strategies that span individual businesses, and providing leadership for the entire organization.

Consider General Electric as an example. GE is active in a wide range of businesses, including lighting equipment, major appliances, motor and transportation equipment, turbine generators, construction and engineering services, industrial electronics, medical systems, aerospace, aircraft engines, and financial services. The main strategic responsibilities of its CEO, Jeffrey Immelt, are setting overall strategic goals, allocating resources among the different business areas, deciding whether the firm should divest itself of any of its businesses, and determining whether it should acquire any new ones. In other words, it is up to Immelt to develop strategies that span individual businesses; his concern is with building and managing the corporate portfolio of businesses to maximize corporate profitability.

It is not Immelt's specific responsibility to develop strategies for competing in the individual business areas, such as financial services. The development of such strategies is the responsibility of the general managers in these different businesses, known as business-level managers. It is, however, Immelt's responsibility to probe the strategic thinking of business-level managers to make sure that they are pursuing robust business models and strategies that will contribute toward the maximization of GE's long-run profitability, to coach and motivate those managers, to reward them for attaining or exceeding goals, and to hold them accountable for poor performance.

Corporate-level managers also provide a link between the people who oversee the strategic development of a firm and those who own it (the shareholders). Corporate-level managers, and particularly the CEO, can be viewed as the agents of shareholders.<sup>4</sup> It is their responsibility to ensure that the corporate and business strategies that the company pursues are consistent with maximizing profitability and profit growth. If they are not, then ultimately the CEO is likely to be called to account by the shareholders.

### Business-Level Managers

A **business unit** is a self-contained division (with its own functions, for example, finance, purchasing, production, and marketing departments) that provides a product or service for a particular market. The principal general manager at the business level, or the business-level manager, is the head of the division. The strategic role of these managers is to translate the general statements of direction and intent that come from the corporate level into concrete strategies for individual businesses. Whereas corporate-level general managers are concerned with strategies that span individual businesses, business-level managers are concerned with strategies that are specific to a particular business. At GE, a major corporate goal is to be first or second in every business in which the corporation competes. The general managers in each division work out for their business the details of a business model that is consistent with this objective.

### Functional-Level Managers

Functional-level managers are responsible for the specific business functions or operations (human resources, purchasing, product development, customer service, and so on) that constitute a company or one of its divisions. Thus, a functional manager's sphere of responsibility is generally confined to one organizational activity, whereas general managers oversee the operation of a whole company or division. Although they are not responsible for the overall performance of the organization, functional managers nevertheless have a major strategic role: to develop functional strategies in their area that help fulfill the strategic objectives set by business- and corporate-level managers.

In GE's aerospace business, for instance, manufacturing managers are responsible for developing manufacturing strategies consistent with corporate objectives. Moreover, functional managers provide most of the information that makes it possible for business- and corporate-level managers to formulate realistic and attainable strategies. Indeed, because they are closer to the customer than is the typical general manager, functional managers themselves may generate important ideas that subsequently become major strategies for the company. Thus, it is important for general managers to listen closely to the ideas of their functional managers. An equally great responsibility for managers at the operational level is strategy implementation: the execution of corporate- and business-level plans.

## THE STRATEGY-MAKING PROCESS

We can now turn our attention to the process by which managers formulate and implement strategies. Many writers have emphasized that strategy is the outcome of a formal planning process and that top management plays the most important role in this process.<sup>5</sup> Although this view has some basis in reality, it is not the whole story.

As we shall see later in the chapter, valuable strategies often emerge from deep within the organization without prior planning. Nevertheless, a consideration of formal, rational planning is a useful starting point for our journey into the world of strategy. Accordingly, we consider what might be described as a typical formal strategic planning model for making strategy.

## A Model of the Strategic Planning Process

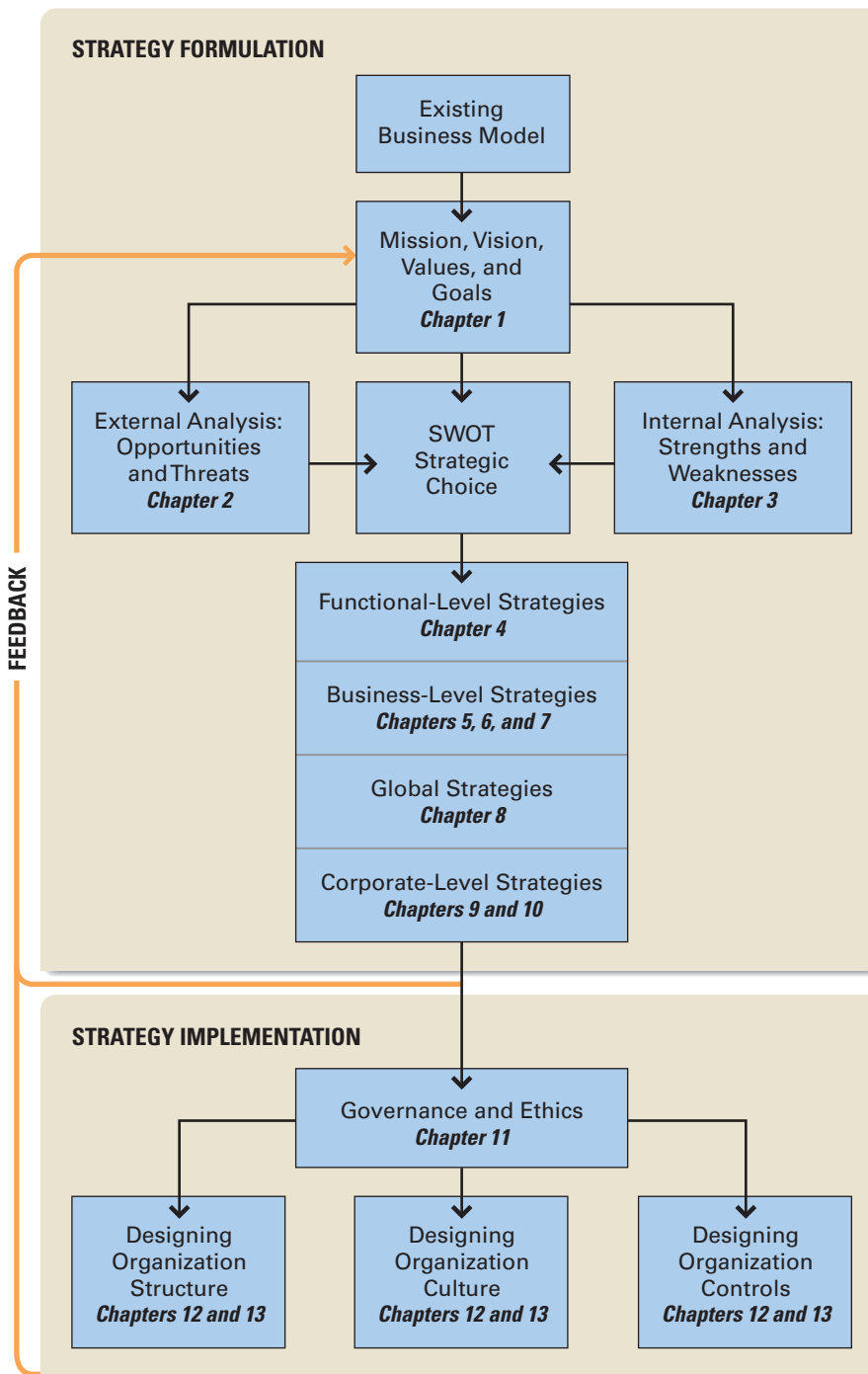
The formal strategic planning process has five main steps:

1. Select the corporate mission and major corporate goals.
2. Analyze the organization's external competitive environment to identify opportunities and threats.
3. Analyze the organization's internal operating environment to identify the organization's strengths and weaknesses.
4. Select strategies that build on the organization's strengths and correct its weaknesses in order to take advantage of external opportunities and counter external threats. These strategies should be consistent with the mission and major goals of the organization. They should be congruent and constitute a viable business model.
5. Implement the strategies.

The task of analyzing the organization's external and internal environments and then selecting appropriate strategies constitutes strategy formulation. In contrast, as noted earlier, strategy implementation involves putting the strategies (or plan) into action. This includes taking actions consistent with the selected strategies of the company at the corporate, business, and functional levels; allocating roles and responsibilities among managers (typically through the design of organizational structure); allocating resources (including capital and money); setting short-term objectives; and designing the organization's control and reward systems. These steps are illustrated in Figure 1.5 (which can also be viewed as a plan for the rest of this book).

Each step in Figure 1.5 constitutes a sequential step in the strategic planning process. At step 1, each round or cycle of the planning process begins with a statement of the corporate mission and major corporate goals. This statement is shaped by the existing business model of the company. The mission statement is followed by the foundation of strategic thinking: external analysis, internal analysis, and strategic choice. The strategy-making process ends with the design of the organizational structure and the culture and control systems necessary to implement the organization's chosen strategy. This chapter discusses how to select a corporate mission and choose major goals. Other parts of strategic planning are reserved for later chapters, as indicated in Figure 1.5.

Some organizations go through a new cycle of the strategic planning process every year. This does not necessarily mean that managers choose a new strategy each year. In many instances, the result is simply to modify or reaffirm a strategy and structure already in place. The strategic plans generated by the planning process generally look at a period of one to five years, with the plan being updated, or rolled forward, every year. In most organizations, the results of the annual strategic planning process are used as input into the budgetary process for the coming year so that strategic planning is used to shape resource allocation within the organization.

**Figure 1.5** Main Components of the Strategic Planning Process

## Mission Statement

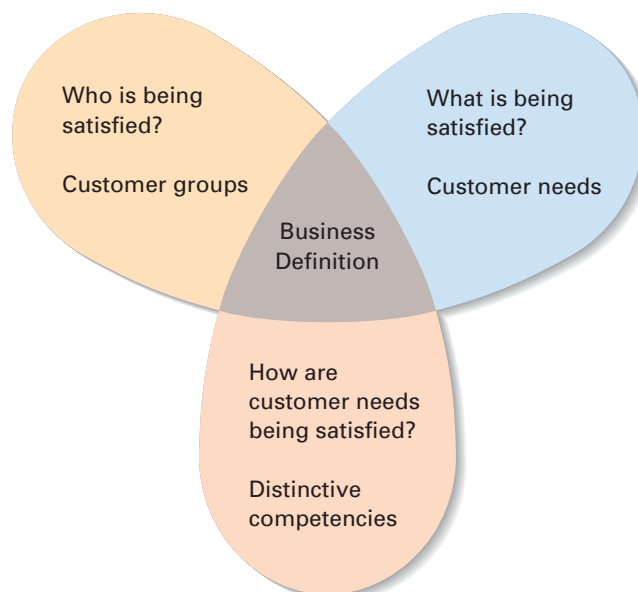
The first component of the strategic management process is crafting the organization's mission statement, which provides the framework or context within which strategies are formulated. A mission statement has four main components: a statement of the *raison d'être* of a company or organization—its reason for existence—which is normally referred to as the mission; a statement of some desired future state, usually referred to as the vision; a statement of the key values that the organization is committed to; and a statement of major goals.

**The Mission** A company's **mission** describes what the company does. For example, the mission of Kodak is to provide “customers with the solutions they need to capture, store, process, output, and communicate images—anywhere, anytime.”<sup>6</sup> In other words, Kodak exists to provide imaging solutions to consumers. This mission focuses on the customer needs that the company is trying to satisfy rather than on particular products. This is a customer-oriented rather than a product-oriented mission.

An important first step in the process of formulating a mission is to arrive at a definition of the organization's business. Essentially, the definition answers these questions: “What is our business? What will it be? What should it be?”<sup>7</sup> The responses guide the formulation of the mission. To answer the question, “What is our business?” a company should define its business in terms of three dimensions: who is being satisfied (what customer groups); what is being satisfied (what customer needs); and how customers' needs are being satisfied (by what skills, knowledge, or distinctive competencies).<sup>8</sup> Figure 1.6 illustrates these dimensions.

This approach stresses the need for a *customer-oriented* rather than a *product-oriented* business definition. A product-oriented business definition focuses on the characteristics of the products sold and the markets served, not on which kinds of

**Figure 1.6** Defining the Business



customer needs the products are satisfying. Such an approach obscures the company's true mission because a product is only the physical manifestation of applying a particular skill to satisfy a particular need for a particular customer group. In practice, that need may be served in many different ways, and a broad customer-oriented business definition that identifies these ways can safeguard companies from being caught unaware by major shifts in demand.

By helping anticipate demand shifts, a customer-oriented mission statement can also assist companies in capitalizing on changes in their environments. It can help answer the question, "What will our business be?" Kodak's mission statement—to provide "customers with the solutions they need to capture, store, process, output, and communicate images"—is a customer-oriented statement that focuses on customer needs rather than a particular product (or solution) for satisfying those needs, such as chemical film processing. For this reason, from the early 1990s on, it drove Kodak's investments in digital imaging technologies, which have replaced much of Kodak's traditional business based on chemical film processing.

The need to take a customer-oriented view of a company's business has often been ignored. History is littered with the wreckage of once-great corporations that did not define their businesses or defined them incorrectly so that ultimately they declined. In the 1950s and 1960s, many office equipment companies such as Smith Corona and Underwood defined their businesses as the production of typewriters. This product-oriented definition ignored the fact that they were really in the business of satisfying customers' information-processing needs. Unfortunately for those companies, when new technology arrived that better served customer needs for information processing (computers), demand for typewriters plummeted. The last great typewriter company, Smith Corona, went bankrupt in 1996, a victim of the success of computer-based word-processing technology.

In contrast, IBM correctly foresaw what its business would be. In the 1950s, IBM was a leader in the manufacture of typewriters and mechanical tabulating equipment using punch-card technology. However, unlike many of its competitors, IBM defined its business as providing a means for *information processing and storage*, rather than just supplying mechanical tabulating equipment and typewriters.<sup>9</sup> Given this definition, the company's subsequent move into computers, software systems, office systems, and printers was logical.

**Vision** The **vision** of a company lays out some desired future state; it articulates, often in bold terms, what the company would like to achieve. Nokia, the world's largest manufacturer of mobile (wireless) phones, has been operating with a very simple but powerful vision for some time: "If it can go mobile, it will!" This vision implied that not only would voice technology go mobile but also a host of other services based on data, such as imaging and Internet browsing. This vision led Nokia to become a leader in developing mobile handsets that not only can be used for voice communication but also take pictures, browse the Internet, play games, and manipulate personal and corporate information.

**Values** The **values** of a company state how managers and employees should conduct themselves, how they should do business, and what kind of organization they should build to help a company achieve its mission. Insofar as they help drive and shape behavior within a company, values are commonly seen as the bedrock of a company's organizational culture: the set of values, norms, and standards that control how employees work to achieve an organization's mission and goals. An



organization's culture is commonly seen as an important source of its competitive advantage.<sup>10</sup> (We discuss the issue of organization culture in depth in Chapter 12.) For example, Nucor Steel is one of the most productive and profitable steel firms in the world. Its competitive advantage is based in part on the extremely high productivity of its workforce, which the company maintains is a direct result of its cultural values, which in turn determine how it treats its employees. These values are as follows:

- “Management is obligated to manage Nucor in such a way that employees will have the opportunity to earn according to their productivity.”
- “Employees should be able to feel confident that if they do their jobs properly, they will have a job tomorrow.”
- “Employees have the right to be treated fairly and must believe that they will be.”
- “Employees must have an avenue of appeal when they believe they are being treated unfairly.”<sup>11</sup>

At Nucor, values emphasizing pay for performance, job security, and fair treatment for employees help to create an atmosphere within the company that leads to high employee productivity. In turn, this has helped to give Nucor one of the lowest cost structures in its industry, which helps to explain the company's profitability in a very price-competitive business.

In one study of organizational values, researchers identified a set of values associated with high-performing organizations that help companies achieve superior financial performance through their impact on employee behavior.<sup>12</sup> These values included respect for the interests of key organizational **stakeholders**: individuals or groups that have an interest, claim, or stake in the company, in what it does, and in how well it performs.<sup>13</sup> They include stockholders, bondholders, employees, customers, the communities in which the company does business, and the general public. The study found that deep respect for the interests of customers, employees, suppliers, and shareholders was associated with high performance. The study also noted that the encouragement of leadership and entrepreneurial behavior by mid- and lower-level managers and a willingness to support change efforts within the organization contributed to high performance. Companies that emphasize such values consistently throughout their organization include Hewlett-Packard, Walmart, and PepsiCo. The same study identified the values of poorly performing companies, values that, as might be expected, are not articulated in company mission statements: (1) arrogance, particularly to ideas from outside the company; (2) a lack of respect for key stakeholders; and (3) a history of resisting change efforts and “punishing” mid- and lower-level managers who showed “too much leadership.” General Motors was held up as an example of one such organization. According to the research, mid- or lower-level managers who showed too much leadership and initiative at GM were not promoted!

### Ethical Dilemma

You are the general manager of a home mortgage lender within a large diversified financial services firm. The firm's mission statement emphasizes the importance of acting with integrity at all times. The CEO describes this as “doing the right thing rather than trying to do all things right.” This same CEO has presented you with “nonnegotiable” challenging profitability and growth goals for the coming year. Achieving these goals may result in cash and promotion pay-offs. Missing the goals may hurt your career. Hitting those goals will require you to lower lending standards and lend money to people who are unable to meet their mortgage payments. If people default on their loans, however, your company can seize their homes and resell them, mitigating the risk. What should you do?

## MAJOR GOALS

Having stated the mission, vision, and key values, strategic managers can take the next step in the formulation of a mission statement: establishing major goals. A **goal** is a precise and measurable desired future state that a company attempts to realize. In this context, the purpose of goals is to specify with precision what must be done if the company is to attain its mission or vision.

Well-constructed goals have four main characteristics:<sup>14</sup>

1. They are precise and measurable. Measurable goals give managers a yardstick or standard against which they can judge their performance.
2. They address crucial issues. To maintain focus, managers should select a limited number of major goals to assess the performance of the company. The goals that are selected should be crucial or important ones.
3. They are challenging but realistic. They give all employees an incentive to look for ways of improving the operations of an organization. If a goal is unrealistic in the challenges it poses, employees may give up; a goal that is too easy may fail to motivate managers and other employees.<sup>15</sup>
4. They specify a time period in which the goals should be achieved, when that is appropriate. Time constraints tell employees that success requires a goal to be attained by a given date, not after that date. Deadlines can inject a sense of urgency into goal attainment and act as a motivator. However, not all goals require time constraints.

Well-constructed goals also provide a means by which the performance of managers can be evaluated.

As noted earlier, although most companies operate with a variety of goals, the central goal of most corporations is to maximize shareholder returns; doing this requires both high profitability and sustained profit growth. Thus, most companies operate with goals for profitability and profit growth. However, it is important that top managers do not make the mistake of overemphasizing current profitability to the detriment of long-term profitability and profit growth.<sup>16</sup> The overzealous pursuit of current profitability to maximize short-term ROIC can encourage such misguided managerial actions as cutting expenditures judged to be nonessential in the short run, for instance, expenditures for research and development, marketing, and new capital investments. Although cutting current expenditures increases current profitability, the resulting underinvestment, lack of innovation, and diminished marketing can jeopardize long-run profitability and profit growth.

To guard against short-run behavior, managers need to ensure that they adopt goals whose attainment will increase the long-run performance and competitiveness of their enterprises. Long-term goals are related to such issues as product development, customer satisfaction, and efficiency, and they emphasize specific objectives or targets concerning such details as employee and capital productivity, product quality, innovation, customer satisfaction, and customer service.

## External Analysis

The second component of the strategic management process is an analysis of the organization's external operating environment. The essential purpose of the external analysis is to identify strategic opportunities and threats in the organization's operating environment that will affect how it pursues its mission. Strategy in Action 1.1 describes how an analysis of opportunities and threats in the external environment led to a strategic shift at Time Inc.

Three interrelated environments should be examined when undertaking an external analysis: the industry environment in which the company operates; the country or national environment; and the wider socioeconomic or macroenvironment. Analyzing the industry environment requires an assessment of the competitive structure of the company's industry, including the competitive position of the company and its

## 1.1 STRATEGY IN ACTION

### Strategic Analysis at Time Inc.

Time Inc., the magazine publishing division of media conglomerate Time Warner, has a venerable history. Its magazine titles include *Time*, *Fortune*, *Sports Illustrated*, and *People*, all long-time leaders in their respective categories. By the mid-2000s, however, Time Inc. recognized that it needed to change its strategy. By 2005, circulation at *Time* was down by 12%; *Fortune*, by 10%; and *Sports Illustrated*, by 17%.

An external analysis revealed what was going on. The readership of Time's magazines was aging. Increasingly, younger readers were getting what they wanted from the Web. This was both a *threat* for Time Inc., because its Web offerings were not strong, and an *opportunity*, because with the right offerings Time Inc. could capture this audience. Time also realized that advertising dollars were migrating rapidly to the Web. If the company was going to hold onto its share, its Web offerings had to be every bit as good as its print offerings.

An internal analysis revealed why, despite multiple attempts, Time had failed to capitalize on the opportunities offered by the emergence of the Web. Although Time had tremendous *strengths*, including powerful brands and strong reporting, development of its Web offerings had been hindered by a serious *weakness*—an editorial culture that regarded Web publishing as a backwater. At *People*, for example, the online operation was “like a distant moon” according to managing editor Martha Nelson. Managers at Time Inc. had also been worried that Web offerings would cannibalize print offerings and help accelerate the decline of magazine circulation, with dire financial consequences for the company. As a result of this culture, efforts to move publications onto the Web underfunded or stymied by a lack of management attention and commitment.

It was Martha Nelson at *People* who, in 2003, showed the way forward for the company. Her *strategy* for overcoming the *weakness* at Time Inc. and better exploiting

*opportunities* on the Web started with merging the print and online newsrooms at *People*, thus removing the distinction between them. Then she relaunched the magazine's online site, made major editorial commitments to Web publishing, stated that original content should appear on the Web, and emphasized the importance of driving traffic to the site and earning advertising revenues. Over the next two years, page views at *People.com* increased fivefold.

Ann Moore, the CEO at Time Inc., formalized this strategy in 2005, mandating that all print offerings should follow the lead of *People.com*, integrating print and online newsrooms and investing significantly more resources in Web publishing. To drive this home, Time hired several well-known bloggers to write for its online publications. Moore's goal was to neutralize the cultural *weakness* that had hindered online efforts in the past at Time Inc. and to direct resources toward Web publishing.

In 2006, Time made another strategic move designed to exploit the opportunities associated with the Web when it started a partnership with the 24-hour news channel, CNN, putting all of its financial magazines onto a site that is jointly owned, CNNMoney.com. The site, which offers free access to *Fortune*, *Money*, and *Business 2.0*, quickly took the third spot in online financial Web sites behind Yahoo finance and MSN. This was followed with a redesigned Web site for *Sports Illustrated* that has rolled out video downloads for iPods and mobile phones.

To drive home the shift to Web-centric publishing, in 2007 Time announced another change in strategy—it would sell off 18 magazine titles that, while good performers, did not appear to have much traction on the Web. Ann Moore stated that going forward Time would be focusing its energy, resources, and investments on the company's largest and most profitable brands, brands that have demonstrated an ability to draw large audiences in digital form.

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**Sources:** A. Van Duyn, “Time Inc. Revamp to Include Sale of 18 Titles,” *Financial Times*, September 13, 2006, 24. M. Karnitsching, “Time Inc. Makes New Bid to Be Big Web Player,” *Wall Street Journal*, March 29, 2006, B1. M. Flamm, “Time Tries the Web Again,” *Crain's New York Business*, January 16, 2006, 3.

major rivals. It also requires analysis of the nature, stage, dynamics, and history of the industry. Because many markets are now global markets, analyzing the industry environment also means assessing the impact of globalization on competition within an industry. Such an analysis may reveal that a company should move some production facilities to another nation, that it should aggressively expand in emerging markets such as China, or that it should beware of new competition from emerging nations. Analyzing the macroenvironment consists of examining macroeconomic, social, government, legal, international, and technological factors that may affect the company and its industry. We look at external analysis in Chapter 2.

## Internal Analysis

Internal analysis, the third component of the strategic planning process, focuses on reviewing the resources, capabilities, and competencies of a company. The goal is to identify the strengths and weaknesses of the company. For example, as described in Strategy in Action 1.1, an internal analysis at Time Inc. revealed that while the company had strong well-known brands such as *Fortune*, *Money*, *Sports Illustrated*, and *People* (a strength), and strong reporting capabilities (another strength), it suffered from a lack of editorial commitment to online publishing (a weaknesses). We consider internal analysis in Chapter 3.

## SWOT Analysis and the Business Model

The next component of strategic thinking requires the generation of a series of strategic alternatives, or choices of future strategies to pursue, given the company's internal strengths and weaknesses and its external opportunities and threats. The comparison of strengths, weaknesses, opportunities, and threats is normally referred to as a **SWOT analysis**.<sup>17</sup> The central purpose is to identify the strategies to exploit external opportunities, counter threats, build on and protect company strengths, and eradicate weaknesses.

At Time Inc., managers saw the move of readership to the Web as both an *opportunity* that they must exploit and a *threat* to Time's established print magazines. They recognized that Time's well-known brands and strong reporting capabilities were *strengths* that would serve it well online, but an editorial culture that marginalized online publishing was a *weakness* that had to be fixed. The *strategies* that managers at Time Inc. used included merging the print and online newsrooms to remove distinctions between them; investing significant financial resources in online sites; and entering into a partnership with CNN, which already had a strong online presence.

More generally, the goal of a SWOT analysis is to create, affirm, or fine-tune a company-specific business model that will best align, fit, or match a company's resources and capabilities to the demands of the environment in which it operates. Managers compare and contrast the various alternative possible strategies against each other and then identify the set of strategies that will create and sustain a competitive advantage. These strategies can be divided into four main categories:

1. *Functional-level strategies* are directed at improving the effectiveness of operations within a company, such as manufacturing, marketing, materials management, product development, and customer service. We review functional-level strategies in Chapter 4.

2. *Business-level strategies* encompass the business's overall competitive theme, the way it positions itself in the marketplace to gain a competitive advantage, and the different positioning strategies that can be used in different industry settings, for example, cost leadership, differentiation, focusing on a particular niche or segment of the industry, or some combination of these. We review business-level strategies in Chapters 5, 6 and 7.
3. *Global strategies* address how to expand operations outside the home country to grow and prosper in a world where competitive advantage is determined at a global level. We review global strategies in Chapter 8.
4. *Corporate-level strategies* answer the primary questions: What business or businesses should we be in to maximize the long-run profitability and profit growth of the organization. How should we enter and increase our presence in these businesses to gain a competitive advantage? We review corporate-level strategies in Chapters 9 and 10.

The strategies identified through a SWOT analysis should be congruent with each other. Thus, functional-level strategies should be consistent with, or support, the company's business-level strategy and global strategy. Moreover, as we explain later in this book, corporate-level strategies should support business-level strategies. When taken together, the various strategies pursued by a company constitute a viable business model. In essence, a SWOT analysis is a methodology for choosing between competing business models and for fine-tuning the business model that managers choose. For example, when Microsoft entered the video game market with its Xbox offering, it had to settle on the best business model for competing in this market. Microsoft used a SWOT analysis to compare alternatives and settled on a "razor and razor blades" business model in which the Xbox console is priced below cost to build sales (the "razor"), while profits are made from royalties on the sale of games for the Xbox (the "blades").

## Strategy Implementation

Having chosen a set of congruent strategies to achieve a competitive advantage and increase performance, managers must put those strategies into action: strategy has to be implemented. Strategy implementation involves taking actions at the functional, business, and corporate levels to execute a strategic plan. Implementation can include, for example, putting quality improvement programs into place, changing the way a product is designed, positioning the product differently in the marketplace, segmenting the marketing and offering different versions of the product to different consumer groups, implementing price increases or decreases, expanding through mergers and acquisitions, or downsizing the company by closing down or selling off parts of the company. These and other topics are discussed in detail in Chapters 4 through 10.

Strategy implementation also entails designing the best organizational structure and the best culture and control systems to put a chosen strategy into action. In addition, senior managers need to put a governance system in place to make sure that all within the organization act in a manner that is not only consistent with maximizing profitability and profit growth but also legal and ethical. In this book, we look at the topic of governance and ethics in Chapter 11; we discuss the organizational structure, culture, and controls required to implement business-level strategies in Chapter 12;

and we present the structure, culture, and controls required to implement corporate-level strategies in Chapter 13.

## The Feedback Loop

The feedback loop in Figure 1.5 indicates that strategic planning is ongoing; it never ends. Once a strategy has been implemented, its execution must be monitored to determine the extent to which strategic goals and objectives are actually being achieved and to what degree competitive advantage is being created and sustained. This information and knowledge is passed back to the corporate level through feedback loops and becomes the input for the next round of strategy formulation and implementation. Top managers can then decide whether to reaffirm the existing business model and the existing strategies and goals or suggest changes for the future. For example, if a strategic goal proves to be too optimistic, the next time a more conservative goal is set. Or feedback may reveal that the business model is not working, so managers may seek ways to change it. In essence, this is what happened at Time Inc. (see Strategy in Action 1.1).

## STRATEGY AS AN EMERGENT PROCESS

The planning model suggests that a company's strategies are the result of a plan, the strategic planning process itself is rational and highly structured, and the process is orchestrated by top management. Several scholars have criticized the formal planning model for three main reasons: the unpredictability of the real world; the role that lower-level managers can play in the strategic management process; and the fact that many successful strategies are often the result of serendipity, not rational strategizing. They have advocated an alternative view of strategy making.<sup>18</sup>

## Strategy Making in an Unpredictable World

Critics of formal planning systems argue that we live in a world in which uncertainty, complexity, and ambiguity dominate, and in which small chance events can have a large and unpredictable impact on outcomes.<sup>19</sup> In such circumstances, they claim, even the most carefully thought-out strategic plans are prone to being rendered useless by rapid and unforeseen change. In an unpredictable world, there is a premium on being able to respond quickly to changing circumstances and to alter the strategies of the organization accordingly. The dramatic rise of Google, for example, with its business-model-based revenues earned from advertising links associated with search results (the so-called pay-per-click business model), disrupted the business models of companies that made money from online advertising. Nobody foresaw this development or planned for it, but they had to respond to it rapidly. Companies with strong online advertising presences, including Yahoo.com and Microsoft's MSN network, rapidly changed their strategies to adapt to the threat posed by Google. Specifically, both developed their own search engines and copied Google's pay-per-click business model. According to critics of formal systems, such a flexible approach to strategy making is not possible within the framework of a traditional strategic planning process, with its implicit assumption that an organization's strategies need to be reviewed only during the annual strategic planning exercise.



## Autonomous Action: Strategy Making by Lower-Level Managers

Another criticism leveled at the rational planning model of strategy is that too much importance is attached to the role of top management, particularly the CEO.<sup>20</sup> An alternative view is that individual managers deep within an organization can and often do exert a profound influence over the strategic direction of the firm.<sup>21</sup> Writing with Robert Burgelman of Stanford University, Andy Grove, the former CEO of Intel, noted that many important strategic decisions at Intel were initiated not by top managers but by the autonomous action of lower-level managers deep within Intel who, on their own initiative, formulated new strategies and worked to persuade top-level managers to alter the strategic priorities of the firm.<sup>22</sup> These strategic decisions included the decision to exit an important market (the DRAM memory chip market) and develop a certain class of microprocessors (RISC-based microprocessors) in direct contrast to the stated strategy of Intel's top managers. Another example of autonomous action, this one at Starbucks, is given in Strategy in Action 1.2.

Autonomous action may be particularly important in helping established companies deal with the uncertainty created by the arrival of a radical new technology that changes the dominant paradigm in an industry.<sup>23</sup> Top managers usually rise to preeminence by successfully executing the established strategy of the firm. Therefore, they may have an emotional commitment to the status quo and are often unable to see things from a different perspective. In this sense, they can be a conservative force that promotes inertia. Lower-level managers, however, are less likely to have the same commitment to the status quo and have more to gain from promoting new technologies and strategies. They may be the first ones to recognize new strategic opportunities and lobby for strategic change. As described in Strategy in Action 1.3, this seems to have been the case at a discount stockbroker Charles Schwab, that had to adjust to the arrival of the Web in the 1990s.

## 1.2 STRATEGY IN ACTION

### Starbucks's Music Business

Anyone who has walked into a Starbucks cannot help but notice that, in addition to various coffee beverages and food, the company also sells music CDs. Most Starbucks stores now have racks displaying about 20 CDs. Reports suggest that when Starbucks decides to carry a CD, it typically ranks among the top four retailers selling it. The interesting thing about Starbucks's entry into music retailing is that it was not the result of a formal planning process. The company's journey into music retailing started in the late 1980s when Tim Jones, then the manager of a Starbucks in Seattle's University Village, started

to bring his own tapes of music compilations into the store to play. Soon Jones was getting requests for copies from customers. Jones told this to Starbucks's CEO, Howard Schultz, and suggested that Starbucks start to sell its own music. At first, Schultz was skeptical, but, after repeated lobbying efforts by Jones, he eventually took up the suggestion. Today, Starbucks not only sells CDs, it is also moving into music downloading with its "Hear Music" Starbucks stores, where customers can listen to and burn music from Starbucks's 200,000-song online music library while sipping their coffee.

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**Source:** S. Gray and E. Smith. "Coffee and Music Create a Potent Mix at Starbucks," *Wall Street Journal*, July 19, 2005, A1.

## 1.3 STRATEGY IN ACTION

### A Strategic Shift at Charles Schwab

In the mid-1990s, Charles Schwab was the most successful discount stockbroker in the world. Over 20 years, it had gained share from full-service brokers like Merrill Lynch by offering deep discounts on the commissions charged for stock trades. Although Schwab had a nationwide network of branches, most customers executed their trades through a telephone system called Telebroker. Others used online proprietary software, Street Smart, which had to be purchased from Schwab. It was a business model that worked well; then along came E\*Trade.

E\*Trade was a discount brokerage started in 1994 by Bill Porter, a physicist and an inventor, to take advantage of the opportunity created by the rapid emergence of the World Wide Web. E\*Trade launched the first dedicated Web site for online trading. E\*Trade had no branches, no brokers, and no telephone system for taking orders; thus it had a very low-cost structure. Customers traded stocks over the company's Web site. Due to its low-cost structure, E\*Trade was able to announce a flat \$14.95 commission on stock trades, a figure significantly below Schwab's average commission, which at the time was \$65. It was clear from the outset that E\*Trade and other online brokers, such as Ameritrade, which soon followed, offered a direct threat to Schwab. Not only were their cost structures and commission rates considerably below Schwab's, but the ease, speed, and flexibility of trading stocks over the Web suddenly made Schwab's Street Smart trading software seem limited and its telephone system antiquated.

Deep within Schwab, William Pearson, a young software specialist who had worked on the development

of Street Smart, immediately saw the transformational power of the Web. Pearson believed that Schwab needed to develop its own Web-based software, and quickly. Try as he might, though, Pearson could not get the attention of his supervisor. He tried a number of other executives but found support hard to come by. Eventually he approached Anne Hennegar, a former Schwab manager who worked as a consultant to the company. Hennegar suggested that Pearson meet with Tom Seip, an executive vice president at Schwab who was known for his ability to think outside the box. Hennegar approached Seip on Pearson's behalf, and Seip responded positively, asking her to set up a meeting. Hennegar and Pearson turned up expecting to meet with just Seip, but to their surprise, in walked Charles Schwab; the chief operating officer, David Pottruck; and the vice presidents in charge of strategic planning and the electronic brokerage arena.

As the group watched Pearson's demo of how a Web-based system would look and work, they became increasingly excited. It was clear to those in the room that a Web-based system using real-time information, personalization, customization, and interactivity all advanced Schwab's commitment to empowering customers. By the end of the meeting, Pearson had received a green light to start work on the project. A year later, Schwab launched its own Web-based offering, eSchwab, which enabled Schwab clients to execute stock trades for a low flat-rate commission. eSchwab went on to become the core of the company's offering, enabling it to stave off competition from deep discount brokers like E\*Trade.

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**Sources:** John Kador, *Charles Schwab: How One Company Beat Wall Street and Reinvented the Brokerage Industry*, New York: John Wiley & Sons, 2002; Erick Schonfeld, "Schwab Puts It All Online," *Fortune*, December 7, 1998, 94–99.

### Serendipity and Strategy

Business history is replete with examples of accidental events that help to push companies in new and profitable directions. What these examples suggest is that many successful strategies are not the result of well-thought-out plans but of serendipity, that is, of stumbling across good things unexpectedly. One such example occurred at 3M in the 1960s. At that time, 3M was producing fluorocarbons for sale as coolant liquid in air conditioning equipment. One day, a researcher working with fluorocarbons in a 3M lab spilled some of the liquid on her shoes. Later that day, when she



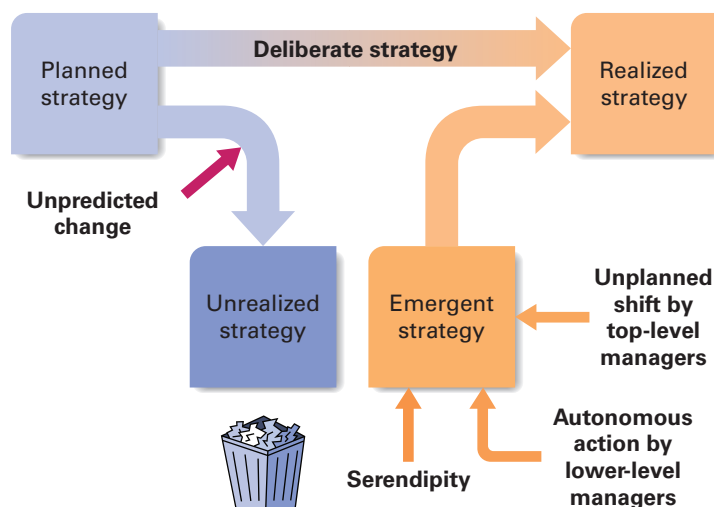
spilled coffee over her shoes, she watched with interest as the coffee formed into little beads of liquid and then ran off her shoes without leaving a stain. Reflecting on this phenomenon, she realized that a fluorocarbon-based liquid might turn out to be useful for protecting fabrics from liquid stains, and so the idea for Scotchgard was born. Subsequently, Scotchgard became one of 3M's most profitable products and took the company into the fabric protection business, an area it had never planned to participate in.<sup>24</sup>

Serendipitous discoveries and events can open all sorts of profitable avenues for a company. But some companies have missed profitable opportunities because serendipitous discoveries or events were inconsistent with their prior (planned) conception of what their strategy should be. In one of the classic examples of such myopia, a century ago, the telegraph company Western Union turned down an opportunity to purchase the rights to an invention made by Alexander Graham Bell. The invention was the telephone, a technology that subsequently made the telegraph obsolete.

## Intended and Emergent Strategies

Henry Mintzberg's model of strategy development provides a more encompassing view of what strategy actually is. According to this model, illustrated in Figure 1.7, a company's realized strategy is the product of whatever planned strategies are actually put into action (the company's deliberate strategies) and of any unplanned, or emergent, strategies. In Mintzberg's view, many planned strategies are not implemented because of unpredicted changes in the environment (they are unrealized). Emergent strategies are the unplanned responses to unforeseen circumstances. They arise from autonomous action by individual managers deep within the organization, serendipitous discoveries or events, or an unplanned strategic shift by top-level managers in response to changed circumstances. They are not the product of formal top-down planning mechanisms.

**Figure 1.7** Emergent and Deliberate Strategies



**Source:** Adapted from H. Mintzberg and A. McGugh, *Administrative Science Quarterly*, Vol. 30, No 2, June 1985.

Mintzberg maintains that emergent strategies are often successful and may be more appropriate than intended strategies. In the classic description of this process, Richard Pascale described how this was the case for the entry of Honda Motor Co. into the United States motorcycle market.<sup>25</sup> When a number of Honda executives arrived in Los Angeles from Japan in 1959 to establish a United States operation, their original aim (intended strategy) was to focus on selling 250 cc and 350 cc machines to confirmed motorcycle enthusiasts rather than 50 cc Honda Cubs, which were a big hit in Japan. Their instinct told them that the Honda 50s were not suitable for the United States market, where everything was bigger and more luxurious than in Japan.

However, sales of the 250 cc and 350 cc bikes were sluggish, and the bikes themselves were plagued by mechanical failure. It looked as if Honda's strategy was going to fail. At the same time, the Japanese executives who were using the Honda 50s to run errands around Los Angeles were attracting a lot of attention. One day, they got a call from a Sears Roebuck and Co. buyer who wanted to sell the 50 cc bikes to a broad market of Americans who were not necessarily motorcycle enthusiasts. The Honda executives were hesitant to sell the small bikes for fear of alienating serious bikers who might then associate Honda with "wimpy" machines. In the end, however, they were pushed into doing so by the failure of the 250 cc and 350 cc models.

Honda had stumbled onto a previously untouched market segment that was to prove huge: the average American who had never owned a motorcycle. Honda had also found an untried channel of distribution: general retailers rather than specialty motorcycle stores. By 1964, nearly one out of every two motorcycles sold in the United States was a Honda.

The conventional explanation for Honda's success is that the company redefined the United States motorcycle industry with a brilliantly conceived intended strategy. The fact was that Honda's intended strategy was a near disaster. The strategy that emerged did so not through planning but through unplanned action in response to unforeseen circumstances. Nevertheless, credit should be given to the Japanese management for recognizing the strength of the emergent strategy and for pursuing it with vigor.

The critical point demonstrated by the Honda example is that successful strategies can often emerge within an organization without prior planning and in response to unforeseen circumstances. As Mintzberg has noted, strategies can take root wherever people have the capacity to learn and the resources to support that capacity.

In practice, the strategies of most organizations are probably a combination of the intended (planned) and the emergent. The message for management is that it needs to recognize the process of emergence and intervene when appropriate, killing off bad emergent strategies but nurturing potentially good ones.<sup>26</sup> To make such decisions, managers must be able to judge the worth of emergent strategies. They must be able to think strategically. Although emergent strategies arise from within the organization without prior planning—that is, without going through the steps illustrated in Figure 1.5 in a sequential fashion—top management still has to evaluate emergent strategies. Such evaluation involves comparing each emergent strategy with the organization's goals, external environmental opportunities and threats, and internal strengths and weaknesses. The objective is to assess whether the emergent strategy fits the company's needs and capabilities. In addition, Mintzberg stresses that an organization's capability to produce emergent strategies is a function of the kind of corporate culture that the organization's structure and control systems foster. In other words, the different components of the strategic management process are just as important from the perspective of emergent strategies as they are from the perspective of intended strategies.

## STRATEGIC PLANNING IN PRACTICE

Despite criticisms, research suggests that formal planning systems do help managers make better strategic decisions. A study that analyzed the results of 26 previously published studies came to the conclusion that, on average, strategic planning has a positive impact on company performance.<sup>27</sup> Another study of strategic planning in 656 firms found that formal planning methodologies and emergent strategies both form part of a good strategy formulation process, particularly in an unstable environment.<sup>28</sup> For strategic planning to work, it is important that top-level managers plan not just in the context of the current competitive environment but also in the context of the future competitive environment. To try to forecast what that future will look like, managers can use scenario planning techniques to plan for different possible futures. They can also involve operating managers in the planning process and seek to shape the future competitive environment by emphasizing strategic intent.

### Scenario Planning

One reason that strategic planning may fail over the long run is that strategic managers, in their initial enthusiasm for planning techniques, may forget that the future is inherently unpredictable. Even the best-laid plans can fall apart if unforeseen contingencies occur, and that happens all the time in the real world. The recognition that uncertainty makes it difficult to forecast the future accurately led planners at Royal Dutch Shell to pioneer the scenario approach to planning.<sup>29</sup> **Scenario planning** involves formulating plans that are based on what-if scenarios about the future. In the typical scenario planning exercise, some scenarios are optimistic, and some are pessimistic. Teams of managers are asked to develop specific strategies to cope with each scenario. A set of indicators is chosen as signposts to track trends and identify the probability that any particular scenario is coming to pass. The idea is to get managers to understand the dynamic and complex nature of their environment, to think through problems in a strategic fashion, and to generate a range of strategic options that might be pursued under different circumstances.<sup>30</sup> The scenario approach to planning has spread rapidly among large companies. One survey found that more than 50% of the Fortune 500 companies use some form of scenario-planning methods.<sup>31</sup>

The oil company Royal Dutch Shell has perhaps done more than most to pioneer the concept of scenario planning, and its experience demonstrates the power of the approach.<sup>32</sup> Shell has been using scenario planning since the 1980s. Today, it uses two main scenarios to refine its strategic planning. The scenarios relate to the future demand for oil. One, called “Dynamics as Usual,” sees a gradual shift from carbon fuels such as oil to natural gas to renewable energy. The second scenario, “The Spirit of the Coming Age,” looks at the possibility that a technological revolution will lead to a rapid shift to new energy sources.<sup>33</sup> Shell is making investments that will ensure the profitability of the company whichever scenario comes to pass, and it is carefully tracking technological and market trends for signs of which scenario is becoming more likely over time.

The great virtue of the scenario approach to planning is that it can push managers to think outside the box, to anticipate what they might have to do in different situations, and to learn that the world is a complex and unpredictable place that places a premium on flexibility rather than on inflexible plans based on assumptions about the future that may turn out to be incorrect. As a result of scenario planning,

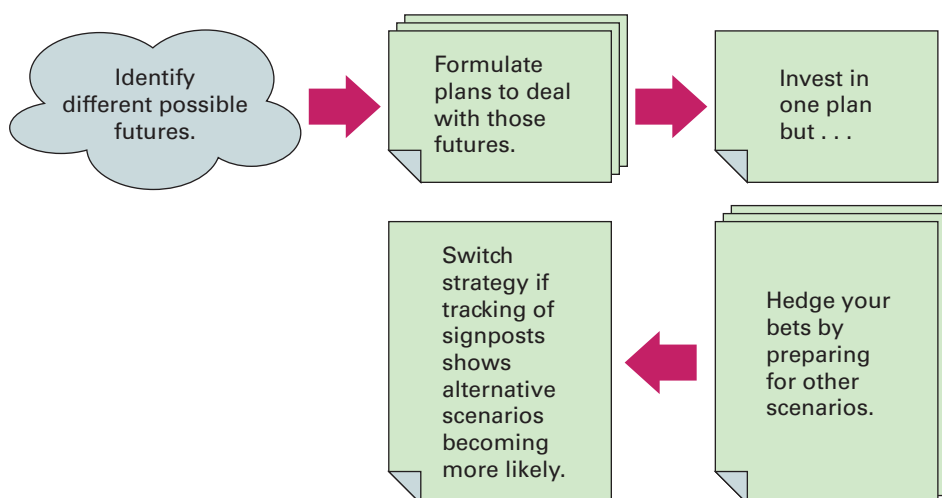
organizations might pursue one dominant strategy related to the scenario that is judged to be most likely, but they make some investments that will pay off if other scenarios come to the fore (see Figure 1.8). Thus, the current strategy of Shell is based on the assumption that the world will only gradually shift away from carbon-based fuels (its “Dynamics as Usual” scenario), but the company is also hedging its bets by investing in new energy technologies and mapping out a strategy to pursue should its second scenario come to pass.

## Decentralized Planning

A mistake that some companies have made in constructing their strategic planning process has been to treat planning as an exclusively top management responsibility. This ivory tower approach can result in strategic plans formulated in a vacuum by top managers who have little understanding or appreciation of current operating realities. Consequently, top managers may formulate strategies that do more harm than good. For example, when demographic data indicated that houses and families were shrinking, planners at GE’s appliance group concluded that smaller appliances were the wave of the future. Because they had little contact with home builders and retailers, they did not realize that kitchens and bathrooms were the two rooms that were not shrinking. Nor did they appreciate that when couples both worked, they wanted big refrigerators to cut down on trips to the supermarket. GE ended up wasting a lot of time designing small appliances with limited demand.

The ivory tower concept of planning can also lead to tensions between corporate-, business-, and functional-level managers. The experience of GE’s appliance group is again illuminating. Many of the corporate managers in the planning group were recruited from consulting firms or top-flight business schools. Many of the functional-level managers took this pattern of recruitment to mean that corporate managers did not think they were smart enough to think through strategic problems for themselves.

**Figure 1.8** Scenario Planning



They felt shut out of the decision-making process, which they believed to be unfairly constituted. Out of this perceived lack of procedural justice grew an “us-versus-them” mindset that quickly escalated into hostility. As a result, even when the planners were right, operating managers would not listen to them. For example, the planners correctly recognized the importance of the globalization of the appliance market and the emerging Japanese threat; however, operating managers, who then saw Sears Roebuck as the competition, paid them little heed. Finally, ivory tower planning ignores the important strategic role of autonomous action by lower-level managers and serendipity.

Correcting the ivory tower approach to planning requires recognizing that successful strategic planning encompasses managers at all levels of the corporation. Much of the best planning can and should be done by business- and functional-level managers who are closest to the facts; in other words, planning should be decentralized. The role of corporate-level planners should be that of facilitators who help business- and functional-level managers do the planning by setting the broad strategic goals of the organization and providing the resources required to identify the strategies that might be required to attain those goals.

## STRATEGIC DECISION MAKING

Even the best-designed strategic planning systems will fail to produce the desired results if managers do not use the information at their disposal effectively. Consequently, it is important that strategic managers learn to make better use of the information they have and understand why they sometimes make poor decisions. One important way in which managers can make better use of their knowledge and information is to understand how common cognitive biases can result in good managers making bad decisions.<sup>34</sup>

### Cognitive Biases and Strategic Decision Making

The rationality of human decision makers is bounded by our own cognitive capabilities.<sup>35</sup> We are not supercomputers, and it is difficult for us to absorb and process large amounts of information effectively. As a result, when making decisions, we tend to fall back on certain rules of thumb, or heuristics, that help us to make sense out of a complex and uncertain world. However, sometimes these rules lead to severe and systematic errors in the decision-making process.<sup>36</sup> Systematic errors are those that appear time and time again. They seem to arise from a series of **cognitive biases** in the way that human decision makers process information and reach decisions. Because of cognitive biases, many managers end up making poor strategic decisions.

A number of biases have been verified repeatedly in laboratory settings, so we can be reasonably sure that they exist and that we are all prone to them.<sup>37</sup> The **prior hypothesis bias** refers to the fact that decision makers who have strong prior beliefs about the relationship between two variables tend to make decisions on the basis of these beliefs, even when presented with evidence that their beliefs are wrong. Moreover, they tend to seek and use information that is consistent with their prior beliefs while ignoring information that contradicts these beliefs. To put this bias in a strategic context, it suggests that a CEO who has a strong prior belief that a certain strategy makes sense might continue to pursue that strategy, despite evidence that it is inappropriate or failing.

Another well-known cognitive bias, **escalating commitment**, occurs when decision makers, having already committed significant resources to a project, commit even more resources even if they receive feedback that the project is failing.<sup>38</sup> This may be an irrational response; a more logical response would be to abandon the project and move on (that is, to cut your losses and run), rather than escalate commitment. Feelings of personal responsibility for a project apparently induce decision makers to stick with a project despite evidence that it is failing.

A third bias, **reasoning by analogy**, involves the use of simple analogies to make sense out of complex problems. The problem with this heuristic is that the analogy may not be valid. A fourth bias, **representativeness**, is rooted in the tendency to generalize from a small sample or even a single vivid anecdote. This bias violates the statistical law of large numbers that says that it is inappropriate to generalize from a small sample, let alone from a single case. In many respects, the dot-com boom of the late 1990s was based on reasoning by analogy and representativeness. Prospective entrepreneurs saw some of the early dot-com companies, such as Amazon and Yahoo!, achieve rapid success, at least judged by some metrics. Reasoning by analogy from a very small sample, they assumed that any dot-com could achieve similar success. Many investors reached similar conclusions. The result was a massive wave of start-ups that jumped into the Internet space in an attempt to capitalize on the perceived opportunities. That the vast majority of these companies subsequently went bankrupt is testament to the fact that the analogy was wrong and that the success of the small sample of early entrants was no guarantee that all dot-coms would succeed.

A fifth cognitive bias is referred to as **the illusion of control**: the tendency to overestimate one's ability to control events. General or top managers seem to be particularly prone to this bias: having risen to the top of an organization, they tend to be overconfident about their ability to succeed. According to Richard Roll, such overconfidence leads to what he has termed the hubris hypothesis of takeovers.<sup>39</sup> Roll argues that top managers are typically overconfident about their ability to create value by acquiring other companies. Hence, they end up making poor acquisition decisions, often paying far too much for the companies they acquire. Subsequently, servicing the debt taken on to finance such an acquisition makes it all but impossible to make money from the acquisition.

The **availability error** is yet another common bias. The availability error arises from our predisposition to estimate the probability of an outcome based on how easy the outcome is to imagine. For example, more people seem to fear a plane crash than a car accident, and yet statistically one is far more likely to be killed in a car on the way to the airport than in a plane crash. They overweigh the probability of a plane crash because the outcome is easier to imagine, and because plane crashes are more vivid events than car crashes, which affect only small numbers of people at a time. As a result of the availability error, managers might allocate resources to a project whose outcome is easier to imagine than to one that might have the highest return.

## Techniques for Improving Decision Making

The existence of cognitive biases raises the issue of how to bring critical information to bear on the decision-making mechanism so that a company's strategic decisions are realistic and based on thorough evaluation. Two techniques known to enhance strategic thinking and counteract cognitive biases are devil's advocacy and dialectic inquiry.<sup>40</sup>



**Devil's advocacy** requires the generation of both a plan and a critical analysis of the plan. One member of the decision-making group acts as the devil's advocate, bringing out all the reasons that might make the proposal unacceptable. In this way, decision makers can become aware of the possible perils of recommended courses of action.

**Dialectic inquiry** is more complex because it requires the generation of a plan (a thesis) and a counterplan (an antithesis) that reflect plausible but conflicting courses of action.<sup>41</sup> Strategic managers listen to a debate between advocates of the plan and counterplan and then decide which plan will lead to the higher performance. The purpose of the debate is to reveal the problems with definitions, recommended courses of action, and assumptions of both plans. As a result of this exercise, strategic managers are able to form a new and more encompassing conceptualization of the problem, which then becomes the final plan (a synthesis). Dialectic inquiry can promote strategic thinking.

Another technique for countering cognitive biases is the outside view, which has been championed by Nobel Prize winner Daniel Kahneman and his associates.<sup>42</sup> The **outside view** requires planners to identify a reference class of analogous past strategic initiatives, determine whether those initiatives succeeded or failed, and evaluate the project at hand against those prior initiatives. According to Kahneman, this technique is particularly useful for countering biases, such as the illusion of control (hubris), reasoning by analogy, and representativeness. For example, when considering a potential acquisition, planners should look at the track record of acquisitions made by other enterprises (the reference class), determine if they succeeded or failed, and objectively evaluate the potential acquisition against that reference class. Kahneman argues that such a reality check against a large sample of prior events tends to constrain the inherent optimism of planners and produce more realistic assessments and plans.

## STRATEGIC LEADERSHIP

One of the key strategic roles of both general and functional managers is to use all their knowledge, energy, and enthusiasm to provide strategic leadership for their subordinates and develop a high-performing organization. Several authors have identified a few key characteristics of good strategic leaders that lead to high performance: (1) vision, eloquence, and consistency; (2) articulation of the business model; (3) commitment; (4) being well informed; (5) willingness to delegate and empower; (6) astute use of power; and (7) emotional intelligence.<sup>43</sup>

### Vision, Eloquence, and Consistency

One of the key tasks of leadership is to give an organization a sense of direction. Strong leaders seem to have clear and compelling visions of where their organizations should go, are eloquent enough to communicate these visions to others within the organization in terms that energize people, and consistently articulate their visions until they become part of the organization's culture.<sup>44</sup>

In the political arena, John F. Kennedy, Winston Churchill, Martin Luther King Jr., and Margaret Thatcher have all been described as examples of visionary leaders. Think of the impact of Kennedy's sentence, "Ask not what your country can do for you—ask what you can do for your country"; of King's "I have a dream" speech; and

of Churchill's "we will never surrender." Kennedy and Thatcher were able to use their political office to push for governmental actions that were consistent with their vision. Churchill's speech galvanized a nation to defend itself against an aggressor, and King was able to pressure the government from outside to make changes in society.

Examples of strong business leaders include Microsoft's Bill Gates; Jack Welch, the former CEO of General Electric; and Sam Walton, Walmart's founder. For years, Bill Gates' vision of a world in which there would be a Windows-based personal computer on every desk was a driving force at Microsoft. More recently, the vision has evolved into one of a world in which Windows-based software can be found on any computing device, from PCs and servers to video game consoles (Xbox), cell phones, and handheld computers. At GE, Jack Welch was responsible for articulating the simple but powerful vision that GE should be first or second in every business in which it competed or it should exit from that business. Similarly, it was Walmart founder Sam Walton who established and articulated the vision that has been central to Walmart's success: passing on cost savings from suppliers and operating efficiencies to customers in the form of everyday low prices.

## Articulation of the Business Model

Another key characteristic of good strategic leaders is their ability to identify and articulate the business model the company will use to attain its vision. A business model is a manager's conception of how the various strategies that the company pursues fit together into a congruent whole. At Dell Computer, for example, it was Michael Dell who identified and articulated the basic business model of the company: the direct sales business model. The various strategies that Dell has pursued over the years have refined this basic model, creating one that is very robust in terms of its efficiency and effectiveness. Although individual strategies can take root in many different places in an organization, and their identification is not the exclusive preserve of top management, only strategic leaders have the perspective required to make sure that the various strategies fit together into a congruent whole and form a valid and compelling business model. If strategic leaders lack clear conception of what the business model of the company is or should be, it is likely that the strategies the firm pursues will not fit together, and the result will be lack of focus and poor performance.

## Commitment

Strong leaders demonstrate their commitment to their vision and business model by actions and words, and they often lead by example. Consider Nucor's former CEO, Ken Iverson. Nucor is a very efficient steelmaker with perhaps the lowest cost structure in the steel industry. It has turned in 30 years of profitable performance in an industry where most other companies have lost money because of a relentless focus on cost minimization. In his tenure as CEO, Iverson set the example: he answered his own phone, employed only one secretary, drove an old car, flew coach class, and was proud of the fact that his base salary was the lowest of the Fortune 500 CEOs. (Iverson made most of his money from performance-based pay bonuses.) This commitment was a powerful signal to employees that Iverson was serious about doing everything possible to minimize costs. It earned him the respect of Nucor employees and made them more willing to work hard. Although Iverson has retired, his legacy lives on in the cost-conscious organizational culture that has been built at Nucor, and like all other great leaders, his impact will last beyond his tenure.



## Being Well Informed

Effective strategic leaders develop a network of formal and informal sources who keep them well informed about what is going on within their company. At Starbucks, for example, the first thing that former CEO Jim Donald did every morning was call up to 10 stores to talk to the managers and other employees and get a sense for how their stores were performing. Donald also stopped at a local Starbucks every morning on the way to work to buy his morning coffee. This allowed him to get to know individual employees very well. Donald found these informal contacts to be a very useful source of information about how the company was performing.<sup>45</sup>

Similarly, Herb Kelleher, the founder of Southwest Airlines, was able to find out much about the health of his company by dropping in unannounced on aircraft maintenance facilities and helping workers perform their tasks. Herb Kelleher would also often help airline attendants on Southwest flights, distributing refreshments and talking to customers. One frequent flyer on Southwest Airlines reported sitting next to Kelleher three times in 10 years. Each time, Kelleher asked him and others sitting nearby how Southwest Airlines was doing in a number of areas, looking for trends and spotting inconsistencies.<sup>46</sup>

Using informal and unconventional ways to gather information is wise because formal channels can be captured by special interests within the organization or by gatekeepers, managers who may misrepresent the true state of affairs to the leader. People like Donald and Kelleher who constantly interact with employees at all levels are better able to build informal information networks than leaders who closet themselves and never interact with lower-level employees.

## Willingness to Delegate and Empower

High-performance leaders are skilled at delegation. They recognize that unless they learn how to delegate effectively, they can quickly become overloaded with responsibilities. They also recognize that empowering subordinates to make decisions is a good motivation tool and often results in decisions being made by those who must implement them. At the same time, astute leaders recognize that they need to maintain control over certain key decisions. Thus, although they will delegate many important decisions to lower-level employees, they will not delegate those that they judge to be of critical importance to the future success of the organization, such as articulating the company's vision and business model.

## The Astute Use of Power

In a now classic article on leadership, Edward Wrapp noted that effective leaders tend to be very astute in their use of power.<sup>47</sup> He argued that strategic leaders must often play the power game with skill and attempt to build consensus for their ideas rather than use their authority to force ideas through; they must act as members of a coalition, or its democratic leaders, rather than as dictators. Jeffery Pfeffer has articulated a similar vision of the politically astute manager who gets things done in organizations through the intelligent use of power.<sup>48</sup> In Pfeffer's view, power comes from control over resources that are important to the organization: budgets, capital, positions, information, and knowledge. Politically astute managers use these resources to acquire another critical resource: critically placed allies who can help them attain their strategic objectives. Pfeffer stresses that one does not need to be a CEO to assemble power in an organization. Sometimes junior functional managers can build surprisingly effective power bases and use them to influence organizational outcomes.

## Emotional Intelligence

Emotional intelligence is a term that Daniel Goldman coined to describe a bundle of psychological attributes that many strong and effective leaders exhibit:<sup>49</sup>

- **Self-awareness:** the ability to understand one's own moods, emotions, and drives, as well as their effect on others
- **Self-regulation:** the ability to control or redirect disruptive impulses or moods, that is, to think before acting
- **Motivation:** a passion for work that goes beyond money or status and a propensity to pursue goals with energy and persistence
- **Empathy:** the ability to understand the feelings and viewpoints of subordinates and to take those into account when making decisions
- **Social skills:** friendliness with a purpose

According to Goldman, leaders who possess these attributes—who exhibit a high degree of emotional intelligence—tend to be more effective than those who lack these attributes. Their self-awareness and self-regulation help to elicit the trust and confidence of subordinates. In Goldman's view, people respect leaders who, because they are self-aware, recognize their own limitations and, because they are self-regulating, consider decisions carefully. Goldman also argues that self-aware and self-regulating individuals tend to be more self-confident and therefore better able to cope with ambiguity and more open to change. A strong motivation exhibited in a passion for work can also be infectious, helping to persuade others to join together in pursuit of a common goal or organizational mission. Finally, strong empathy and social skills can help leaders earn the loyalty of subordinates. Empathetic and socially adept individuals tend to be skilled at managing disputes between managers, better able to find common ground and purpose among diverse constituencies, and better able to move people in a desired direction compared to leaders who lack these skills. In short, Goldman argues that the psychological makeup of a leader matters.

## SUMMARY OF CHAPTER

1. A strategy is a set of related actions that managers take to increase their company's performance goals.
2. The major goal of a company is to maximize the returns that shareholders get from holding shares in the company. To maximize shareholder value, managers must pursue strategies that result in high and sustained profitability and also in profit growth.
3. The profitability of a company can be measured by the return that it makes on the capital invested in the enterprise. The profit growth of a company can be measured by the growth in earnings per share. Profitability and profit growth are determined by the strategies managers adopt.
4. A company has a competitive advantage over its rivals when it is more profitable than the average for all firms in its industry. It has a sustained competitive advantage when it is able to maintain above-average profitability over a number of years. In general, a company with a competitive advantage will grow its profits more rapidly than its rivals will.
5. General managers are responsible for the overall performance of the organization or for one of its major self-contained divisions. Their overriding strategic concern is for the health of the total organization under their direction.
6. Functional managers are responsible for a particular business function or operation. Although

- they lack general management responsibilities, they play a very important strategic role.
7. Formal strategic planning models stress that an organization's strategy is the outcome of a rational planning process.
  8. The major components of the strategic management process are defining the mission, vision, values, and major goals of the organization; analyzing the external and internal environments of the organization; choosing a business model and strategies that align an organization's strengths and weaknesses with external environmental opportunities and threats; and adopting organizational structures and control systems to implement the organization's chosen strategies.
  9. Strategy can emerge from deep within an organization in the absence of formal plans as lower-level managers respond to unpredicted situations.
  10. Strategic planning often fails because executives do not plan for uncertainty and ivory tower planners lose touch with operating realities.
  11. In spite of systematic planning, companies may adopt poor strategies if their decision-making processes are vulnerable to groupthink and if individual cognitive biases are allowed to intrude into the decision-making process.
  12. Devil's advocacy, dialectic inquiry, and the outside view are techniques for enhancing the effectiveness of strategic decision making.
  13. Good leaders of the strategy-making process have a number of key attributes: vision, eloquence, and consistency; ability to craft the business model; commitment; being well informed; a willingness to delegate and empower; political astuteness; and emotional intelligence.

## DISCUSSION QUESTIONS

1. What do we mean by strategy? How is a business model different from a strategy?
2. What do you think are the sources of sustained superior profitability?
3. Between 1997 and 2004, Microsoft's ROIC fell from 32% to 17.5%. Over the same period, Microsoft's profits grew from \$3.45 billion to \$11.33 billion. How can a company have declining profitability (as measured by ROIC) but growing profits? What do you think explains this situation at Microsoft? For 2004, analysts predicted that Microsoft's ROIC would jump to 35%. Why do you think this was the case? Was it due to any change in the company's strategy?
4. What are the strengths of formal strategic planning? What are its weaknesses?
5. Discuss the accuracy of the following statement: Formal strategic planning systems are irrelevant for firms competing in high-technology industries where the pace of change is so rapid that plans are routinely made obsolete by unforeseen events.
6. Pick the current or a past president of the United States and evaluate his performance against the leadership characteristics discussed in the text. On the basis of this comparison, do you think that the president was/is a good strategic leader? Why?

## PRACTICING STRATEGIC MANAGEMENT

### Small-Group Exercise: Designing a Planning System

Break up into groups of three to five each and discuss the following scenario. Appoint one group member as a spokesperson who will communicate the group's findings to the class.

You are a group of senior managers working for a fast-growing computer software company. Your product allows users to play interactive role-playing games over the Internet. In the past three years, your company has gone from a start-up enterprise with 10 employees and no revenues to a company with 250 employees and revenues of \$60 million. It has been growing so rapidly that you have not had time to create a strategic plan, but now your board of directors is telling you that they want to see a plan, and they want it to drive decision making and resource allocation at the company. They want you to design a planning process that will have the following attributes:

1. It will be democratic, involving as many key employees as possible in the process.
2. It will help to build a sense of shared vision within the company about how to continue to grow rapidly.
3. It will lead to the generation of three to five key strategies for the company.
4. It will drive the formulation of detailed action plans, and these plans will be subsequently linked to the company's annual operating budget.

Design a planning process to present to your board of directors. Think carefully about who should be included in this process. Be sure to outline the strengths and weaknesses of the approach you choose, and be prepared to justify why your approach might be superior to alternative approaches.

### Article File 1

At the end of every chapter in this book is an article file task. The task requires you to search newspapers or magazines in the library for an

example of a real company that satisfies the task question or issue.

Your first article file task is to find an example of a company that has recently changed its strategy. Identify whether this change was the outcome of a formal planning process or whether it was an emergent response to unforeseen events occurring in the company's environment.

### Strategic Management Project: Module 1

To give you practical insight into the strategic management process, we provide a series of strategic modules; one is at the end of every chapter in this book. Each module asks you to collect and analyze information relating to the material discussed in that chapter. By completing these strategic modules, you will gain a clearer idea of the overall strategic management process.

The first step in this project is to pick a company to study. We recommend that you focus on the same company throughout the book. Remember also that we will be asking you for information about the corporate and international strategy of your company as well as its structure. We strongly recommend that you pick a company for which such information is likely to be available.

There are two approaches that can be used to select a company to study, and your instructor will tell you which one to follow. The first approach is to pick a well-known company that has a lot of information written about it. For example, large publicly held companies such as IBM, Microsoft, and Southwest Airlines are routinely covered in the business and financial press. By going to the library at your university, you should be able to track down a great deal of information on such companies. Many libraries now have comprehensive Web-based electronic data search facilities such as ABI/Inform, the Wall Street Journal Index, the F&S Index, and the Nexis-Lexis databases. These enable you to identify any article that has been written in the business press on the

*(continued)*

company of your choice within the past few years. A number of non-electronic data sources are also available and useful. For example, F&S Predicts publishes an annual list of articles relating to major companies that appeared in the national and international business press. S&P Industry Surveys is also a great source for basic industry data, and Value Line Ratings and Reports contain good summaries of a firm's financial position and future prospects. Collect full financial information on the company that you pick. This information can be accessed from Web-based electronic databases such as the Edgar database, which archives all forms that publicly quoted companies must file with the Securities and Exchange Commission (SEC); for example, 10-K filings can be accessed from the SEC's Edgar database. Most SEC forms for public companies can now be accessed from Internet-based financial sites, such as Yahoo!'s finance site ([www.finance.yahoo.com/](http://www.finance.yahoo.com/)).

A second approach is to pick a smaller company in your city or town to study. Although small companies are not routinely covered in the national business press, they may be covered in the local press. More important, this approach can work well if the management of the company will agree to talk to you at length about the strategy and structure of the company. If you happen to know somebody in such a company or if you have worked there at some point, this approach can be very worthwhile. However, we do not recommend

this approach unless you can get a substantial amount of guaranteed access to the company of your choice. If in doubt, ask your instructor before making a decision. The key issue is to make sure that you have access to enough interesting information to complete a detailed and comprehensive analysis.

Your assignment for Module 1 is to choose a company to study and to obtain enough information about it to carry out the following instructions and answer the questions:

1. Give a short account of the history of the company and trace the evolution of its strategy. Try to determine whether the strategic evolution of your company is the product of intended strategies, emergent strategies, or some combination of the two.
2. Identify the mission and major goals of the company.
3. Do a preliminary analysis of the internal strengths and weaknesses of the company and the opportunities and threats that it faces in its environment. On the basis of this analysis, identify the strategies that you think the company should pursue. (You will need to perform a much more detailed analysis later in the book.)
4. Who is the CEO of the company? Evaluate the CEO's leadership capabilities.

## CLOSING CASE

### Planning for the Chevy Volt

General Motors is a company in deep trouble. As car sales in North America collapsed in 2008, GM, which had already lost money in 2007, plunged deeply into the red. With losses estimated at \$14 billion, the company was forced to go cap in hand to the government to beg for public funds to help it stave off bankruptcy. Fearing the economic consequences of a collapse of GM, the government agreed to loan funds to GM, but it insisted that the company have

a clear plan charting its way back to profitability. Ironically, such a plan was already in place at GM. At the heart of it was a potentially huge gamble on a new type of car: the Chevy Volt.

The Chevy Volt, which is scheduled for market introduction in 2010, is a compact, four-door electric car with a reserve gasoline-powered engine. The primary power source is a large lithium ion battery (lithium ion batteries are typically found in small

electric appliances such as cell phones). The battery can be charged by plugging it into a wall socket for six hours; when fully charged, it will fuel the car for 40 miles, which is less than most people's daily commute. After that, a gasoline engine kicks in, providing both drive power and recharging the lithium ion battery. GM estimates fuel economy will be over 100 miles per gallon, and charging the car overnight from a power outlet would cost about 80% less than filling it with gas at \$3 per gallon. The car will cost somewhere between \$30,000 and \$40,000; however, because it uses a battery-powered technology, buyers will be able to take \$7,500 tax credit.

The Volt was the brainchild of two men, Bob Lutz, GM's vice chairman, and Larry Burns, the head of R&D and strategic planning at GM. Although Lutz in particular had always championed large gas-hungry muscle cars, GM's planning told them that the market would probably move away from the SUVs that had been a profitable staple at GM for most of the 1990s. A number of trends were coming together to make this scenario likely.

First, oil prices, and by extension, gas prices, were increasing sharply. While driving an SUV that gets 12 miles to the gallon might make economic sense when gas was priced at \$1 a gallon, it did not for most people when gas was \$4 per gallon. GM's planning suggested that due to growing demand in developed nations, including China and India, and limited new supplies, the days of cheap oil were over. Second, global warming was becoming an increasing concern, and it seemed possible that tighter regulations designed to limit carbon emissions would be introduced in the future. As a major source of greenhouse gases, such as carbon dioxide, automobiles powered by internal combustion engines could hardly escape this trend. Third, the cost of manufacturing lithium ion batteries was falling, and new technology was promising to make them more powerful. Finally, GM's major competitor, Toyota, with its best selling hybrid, the Prius, had demonstrated that there was demand for fuel-efficient cars that utilized new battery technology (the Prius, however, uses a conventional fuel cell as opposed to a lithium ion battery).

Despite their analysis, when Lutz and Burns first proposed making the Volt in 2003, other managers at GM beat them down. For one thing, GM had already invested billions in developing fuel cells, and many in the company did not want to suddenly switch gears

and focus on lithium ion batteries instead. Besides, said the critics, technologically it would be difficult to produce a large lithium ion battery. Others were skeptical given that GM had already had one failure with an electric car, the ill-fated EV1 introduced in the 1990s. Powered by a fuel cell, the EV1 had not sold well (according to many because the company had not put its weight behind it).

By 2006, however, the tide had started to turn. Not only were oil prices surging, as predicted by the strategic planning group, but also a small Silicon Valley start-up, Tesla Motors, had announced that it would be bringing a lithium ion sports car to market. Lutz' reaction was, "if a start-up can do it, GM can too!" So Lutz and Burns formed a skunk works within GM and quickly put together a Chevy Volt concept car, which they unveiled at the 2007 Detroit auto show. The concept car gained a lot of positive feedback, and Lutz used this to argue within the company that GM needed to commit to the project. Moreover, he argued, Toyota has gaining major benefits from its Prius, both in terms of sales, and the halo effect associated with making a green car. This time Lutz and Burns were able to persuade other senior managers to back the project, and it was officially launched in early 2007 with an aggressive goal of market introduction in 2010.

### Case Discussion Questions

1. What does the Chevy Volt case tell you about the nature of strategic decision making at a large complex organization like GM?
2. What trends in the external environment favored the pursuit of the Chevy Volt project?
3. What impediments to pursuing this project do you think existed within GM?
4. The plan for the Chevy Volt seems to be based partly on the assumption that oil prices would remain high, and yet in late 2008, oil prices collapsed in the wake of a sharp global economic slowdown.
  - a. What does this tell you about the nature of strategic plans?
  - b. What do falling oil prices mean for the potential success of the Chevy Volt?
  - c. Do you think oil prices will remain low?
5. What will it take for the Chevy Volt to be a successful car? In light of your analysis, how risky do you think this venture is for GM? What are the costs of failure? What are the costs of not pursuing the project?





# 2

## EXTERNAL ANALYSIS: THE IDENTIFICATION OF OPPORTUNITIES AND THREATS

### LEARNING OBJECTIVES

After reading this chapter, you should be able to

- Review the main technique used to analyze competition in an industry environment—the five forces model
- Explore the concept of strategic groups and illustrate its implications for industry analysis
- Discuss how industries evolve over time, with reference to the industry life cycle model
- Show how trends in the macroenvironment can shape the nature of competition in an industry

### The United States Steel Industry For decades, the United States steel industry was in deep economic malaise.

The problems of the industry were numerous. Since the 1970s, on, falling trade barriers have allowed cost-efficient foreign producers to sell steel in the United States, taking market share away from once-dominant integrated steel makers, such as U.S. Steel, Bethlehem Steel, and Wheeling Pittsburg. To make matters worse for incumbents, there was also new domestic competition in the form of minimills. Minimills were small steelmakers who used electric arc furnaces to smelt scrap steel and produce steel, often at a significantly lower cost than large established companies. The average minimill was about one-tenth of the size of a large integrated mill.

If the expansion in supply from foreign companies and minimills was not enough, demand for steel was also decreasing as customers switched to substitutes, including aluminum, plastics, and composites. The combination of growing supply and shrinking demand resulted in excess capacity. Indeed, at one time, as much as 45% of the steelmaking capacity in the United States was excess to requirements. As steelmakers struggled with excess capacity, they slashed their prices to try and capture more demand and cover their fixed costs, only to be matched by rivals. The result was intense price competition and low profits. Moreover, customers for whom steel was mostly a



commodity-type input could easily switch demand from company to company, and they used this leverage to further bargain down prices. To make matters worse, established steelmakers were typically unionized. A combination of high wage rates and inflexible work rules raised labor costs, making it even more difficult to make a profit in this brutally competitive industry. Strong unions, together with the costs of closing a plant, were also impediments to reducing excess capacity in the industry.

It is not surprising, then, that the steel industry as a whole rarely made money. Many of the old integrated steelmaking companies ultimately went bankrupt, including Bethlehem Steel and Wheeling Pittsburgh. Then, in the early 2000s, things started to change. There was a surge in demand for steel from the rapidly developing economies of China, India, Russia, and Brazil. By 2004, China alone was consuming almost one-third of all steel produced worldwide, and demand there was growing by more than 20% per year. Moreover, two decades of bankruptcies and consolidation had finally removed much of the excess capacity from the industry, not just in the United States but also worldwide. In the United States, the producers that

survived the decades of restructuring were efficient enterprises with productive workforces and new technology. Finally competitive, for the first time they were able to hold their own against foreign imports. What helped was a decline in the value of the United States dollar after 2001 that made steel imports relatively more expensive and helped to create demand for steel exports *from* the United States.

As a result of this, competitive environment prices and profits surged. Hot rolled steel plate, for example, was priced at \$260 per ton in June 2003. By June 2008, it had increased to \$1,225 per ton. In 2003, U.S. Steel, the country's largest steel producer, lost \$406 million. In 2008, it made \$2 billion in net profit. Nucor Steel, long regarded as the most efficient steelmaker in the country, saw its profits increase from \$63 million to \$1.8 billion over the same period. How sustainable is this profit turnaround given the global economic slowdown that occurred in 2008? It is difficult to know for sure, but with governments around the world increasing state spending on infrastructure to try and jump-start their troubled economies, demand for steel may remain relatively strong, even in the face of a deep economic pullback.<sup>1</sup>

## Overview

Strategy formulation begins with an analysis of the forces that shape competition in the industry in which a company is based. The goal is to understand the opportunities and threats confronting the firm and to use this understanding to identify strategies that will enable the company to outperform its rivals. **Opportunities** arise when a company can take advantage of conditions in its environment to formulate and implement strategies that enable it to become more profitable. For example, as discussed in the Opening Case, the growth in infrastructure spending in developing economies such as China and India represents an *opportunity* for steelmakers to expand their sales volume by creating products for the premium segment. **Threats** arise when conditions in the external environment endanger the integrity and profitability of the company's business. For two decades, the rise of foreign competitors and minimills was a threat to established producers in the United States steel industry.



This chapter begins with an analysis of the industry environment. First, it examines concepts and tools for analyzing the competitive structure of an industry and identifying industry opportunities and threats. Second, it analyzes the competitive implications that arise when groups of companies within an industry pursue similar and different kinds of competitive strategies. Third, it explores the way an industry evolves over time and the accompanying changes in competitive conditions. Fourth, it looks at the way in which forces in the macroenvironment affect industry structure and influence opportunities and threats. By the end of the chapter, you will understand that to succeed, a company must either fit its strategy to the external environment in which it operates or be able to reshape the environment to its advantage through its chosen strategy.

## DEFINING AN INDUSTRY

An *industry* can be defined as a group of companies offering products or services that are close substitutes for each other, that is, products or services that satisfy the same basic customer needs. A company's closest competitors, its rivals, are those that serve the same basic customer needs. For example, carbonated drinks, fruit punches, and bottled water can be viewed as close substitutes for each other because they serve the same basic customer needs for refreshing and cold nonalcoholic beverages. Thus, we can talk about the soft drink industry, whose major players are Coca-Cola, PepsiCo, and Cadbury Schweppes. Similarly, desktop computers and notebook computers satisfy the same basic need that customers have for computer hardware on which to run personal productivity software; browse the Internet; send e-mail; play games; and store, display, and manipulate digital images. Thus, we can talk about the personal computer industry, whose major players are Dell, Hewlett-Packard, Lenovo (the Chinese company that purchased IBM's personal computer business), and Apple Computer.

The starting point of external analysis is to identify the industry that a company competes in. To do this, managers must begin by looking at the basic customer needs their company is serving, that is, they must take a customer-oriented view of their business as opposed to a product-oriented view (see Chapter 1). An industry is the supply side of a market, and companies in the industry are the suppliers. Customers are the demand side of a market and are the buyers of the industry's products. The basic customer needs that are served by a market define an industry's boundary. It is very important for managers to realize this, for if they define industry boundaries incorrectly, they may be caught flat-footed by the rise of competitors that serve the same basic customer needs with different product offerings. For example, Coca-Cola long saw itself as being in the soda industry—meaning carbonated soft drinks—whereas in fact it was in the soft drink industry, which includes noncarbonated soft drinks. In the mid-1990s, Coca-Cola was caught by surprise by the rise of customer demand for bottled water and fruit drinks, which began to cut into the demand for sodas. Coca-Cola moved quickly to respond to these threats, introducing its own brand of water, Dasani, and acquiring orange juice maker Minute Maid. By defining its industry boundaries too narrowly, Coca-Cola almost missed the rapid rise of the noncarbonated soft drinks segment of the soft drinks market.

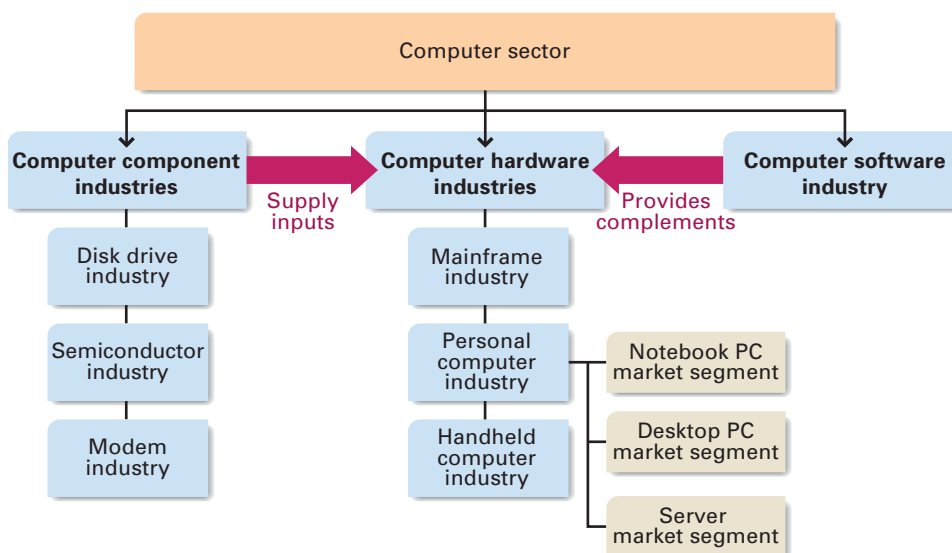
## Industry and Sector

An important distinction that needs to be made is between an industry and a sector. A sector is a group of closely related industries. For example, as illustrated in Figure 2.1, the computer sector comprises several related industries: the computer component industries (e.g., the disk drive industry, the semiconductor industry, and the modem industry), the computer hardware industries (e.g., the personal computer industry; the handheld computer industry, which includes smart phones such as the Apple iPhone; and the mainframe computer industry), and the computer software industry. Industries within a sector may be involved with each other in many different ways. Companies in the computer component industries are the suppliers of firms in the computer hardware industries. Companies in the computer software industry provide important complements to computer hardware: the software programs that customers purchase to run on their hardware. And companies in the personal, handheld, and mainframe industries are in indirect competition with each other because all provide products that are to a degree substitutes for each other.

## Industry and Market Segments

It is also important to recognize the difference between an industry and the market segments within that industry. Market segments are distinct groups of customers within a market that can be differentiated from each other on the basis of their distinct attributes and specific demands. In the beer industry, for example, there are three main segments: consumers who drink long-established, mass-market brands (e.g., Budweiser); weight-conscious consumers who drink less-filling, low-calorie mass-market brands (e.g., Coors Light), and consumers who prefer premium-priced “craft beer” offered by microbreweries and many importers. Similarly, in the personal

**Figure 2.1** The Computer Sector: Industries and Segments



computer industry, there are different segments in which customers desire desktop machines, lightweight portable machines (laptops), and servers that sit at the center of a network of personal computers (see Figure 2.1). Personal computer manufacturers recognize the existence of these different segments by producing a range of product offerings that appeal to customers in different segments. Customers in all of these different segments, however, share a common need for PCs on which to run personal software applications.

## Changing Industry Boundaries

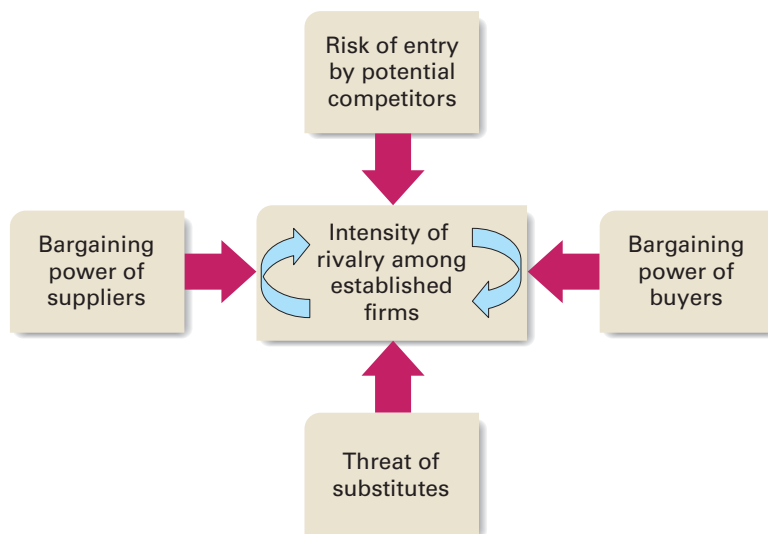
Industry boundaries may change over time as customer needs evolve or new technologies emerge that enable companies in hitherto unrelated industries to satisfy established customer needs in new ways. We have noted that during the 1990s, as consumers of soft drinks began to develop a taste for bottled water and non-carbonated fruit-based drinks, Coca-Cola found itself in direct competition, and in the same industry, with the manufacturers of bottled water and fruit-based soft drinks.

For an example of how technological change can alter industry boundaries, consider the convergence that is currently taking place between the computer and telecommunications industries. Historically, the telecommunications equipment industry has been considered a distinct entity from the computer hardware industry. However, as telecommunications equipment has moved from traditional analog technology to digital technology, so telecommunications equipment has increasingly come to resemble computers. The result is that the boundaries between these different industries are blurring. A digital wireless phone, for example, is nothing more than a small handheld computer with a wireless connection, and small handheld computers often now come with wireless capabilities, transforming them into phones. Thus, Nokia and Motorola, who manufacture wireless phones, are now finding themselves competing directly with computer companies such as Apple and Microsoft.

Industry competitive analysis begins by focusing on the overall industry in which a firm competes before market segments or sector-level issues are considered. Tools that managers can use to perform such industry analysis are discussed in the following sections: Porter's five forces model, strategic group analysis, and industry life cycle analysis.

## PORTER'S FIVE FORCES MODEL

Once the boundaries of an industry have been identified, the task facing managers is to analyze competitive forces in the industry environment to identify opportunities and threats. Michael E. Porter's well-known framework, known as the five forces model, helps managers with this analysis.<sup>2</sup> His model, shown in Figure 2.2, focuses on five forces that shape competition within an industry: (1) the risk of entry by potential competitors; (2) the intensity of rivalry among established companies within an industry; (3) the bargaining power of buyers; (4) the bargaining power of suppliers; and (5) the closeness of substitutes to an industry's products.

**Figure 2.2** Porter's Five Forces Model

**Source:** Adapted and reprinted by permission of *Harvard Business Review*. From "How Competitive Forces Shape Strategy," by Michael E. Porter, *Harvard Business Review*, March/April 1979, copyright © 1979 by the President and Fellows of Harvard College. All rights reserved.

Porter argues that the stronger each of these forces is, the more limited is the ability of established companies to raise prices and earn greater profits. Within Porter's framework, a strong competitive force can be regarded as a threat because it depresses profits. A weak competitive force can be viewed as an opportunity because it allows a company to earn greater profits. The strength of the five forces may change over time as industry conditions change. The task facing managers is to recognize how changes in the five forces give rise to new opportunities and threats and to formulate appropriate strategic responses. In addition, it is possible for a company, through its choice of strategy, to alter the strength of one or more of the five forces to its advantage. This is discussed in the following chapters.

### Risk of Entry by Potential Competitors

**Potential competitors** are companies that are not currently competing in an industry but have the capability to do so if they choose. For example, cable television companies have recently emerged as potential competitors to traditional phone companies. New digital technologies have allowed cable companies to offer telephone service over the same cables that transmit television shows.

Established companies already operating in an industry often attempt to discourage potential competitors from entering the industry because the more companies that enter, the more difficult it becomes for established companies to protect their share of the market and generate profits. A high risk of entry by potential competitors represents a threat to the profitability of established companies. But if the risk of new entry is low, established companies can take advantage of this opportunity to raise prices and earn greater returns.

The risk of entry by potential competitors is a function of the height of barriers to entry, that is, factors that make it costly for companies to enter an industry. The greater the costs that potential competitors must bear to enter an industry, the greater are the barriers to entry and the weaker this competitive force. High entry barriers may keep potential competitors out of an industry even when industry profits are high. Important barriers to entry include economies of scale, brand loyalty, absolute cost advantages, customer switching costs, and government regulation.<sup>3</sup> An important strategy is building barriers to entry (in the case of incumbent firms) or finding ways to circumvent those barriers (in the case of new entrants). We shall discuss this topic in more detail in subsequent chapters.

**Economies of Scale** Economies of scale arise when unit costs fall as a firm expands its output. Sources of economies of scale include (1) cost reductions gained through mass-producing a standardized output; (2) discounts on bulk purchases of raw material inputs and component parts; (3) the advantages gained by spreading fixed production costs over a large production volume; and (4) the cost savings associated with spreading marketing and advertising costs over a large volume of output. If the cost advantages from economies of scale are significant, a new company that enters the industry and produces on a small scale suffers a significant cost disadvantage relative to established companies. If the new company decides to enter on a large scale in an attempt to obtain these economies of scale, it has to raise the capital required to build large-scale production facilities and bear the high risks associated with such an investment. A further risk of large-scale entry is that the increased supply of products will depress prices and result in vigorous retaliation by established companies. For these reasons, the threat of entry is reduced when established companies have economies of scale.

**Brand Loyalty** Brand loyalty exists when consumers have a preference for the products of established companies. A company can create brand loyalty through continuous advertising of its brand-name products and company name, patent protection of products, product innovation achieved through company R&D programs, an emphasis on high product quality, and good after-sales service. Significant brand loyalty makes it difficult for new entrants to take market share away from established companies. Thus it reduces the threat of entry by potential competitors because they may see the task of breaking down well-established customer preferences as too costly. In the mass market segments of the beer industry, for example, the brand loyalty enjoyed by Anheuser Busch (Budweiser), Molson Coors (Coors), and SBA-Miller (Miller) is such that new entry into these segments of the industry is very difficult. Hence, most new entrants have focused on the premium segment of the industry, where established brands have less of a hold. (For an example of how a company circumvented brand-based barriers to entry in the market for carbonated soft drinks, see Strategy in Action 2.1.)

**Absolute Cost Advantages** Sometimes established companies have an **absolute cost advantage** relative to potential entrants, meaning that entrants cannot expect to match the established companies' lower cost structure. Absolute cost advantages arise from three main sources: (1) superior production operations and processes due to accumulated experience, patents, or secret processes; (2) control of particular inputs required for production, such as labor, materials, equipment, or

## 2.1 STRATEGY IN ACTION

### Circumventing Entry Barriers into the Soft Drink Industry

The soft drink industry has long been dominated by two companies—Coca-Cola and PepsiCo. By spending large sums of money on advertising and promotion, both companies have created significant brand loyalty and made it very difficult for new competitors to enter the industry and take market share away from these two giants. When new competitors do try to enter, both companies have responded by cutting prices, thus forcing the new entrant to curtail expansion plans.

However, in the late 1980s, the Cott Corporation, then a small Canadian bottling company, worked out a strategy for entering the soft drink market. Cott's strategy was deceptively simple. The company initially focused on the cola segment of the soft drink market. Cott signed a deal with Royal Crown Cola for exclusive global rights to its cola concentrate. RC Cola was a small player in the U.S. cola market. Its products were recognized as having a high quality, but RC Cola had never been able to effectively challenge Coke or Pepsi. Next, Cott signed a deal with a Canadian grocery retailer, Loblaw, to provide the retailer with its own private-label brand of cola. Priced low, the Loblaw private-label brand, known as President's Choice, was very successful and took share from both Coke and Pepsi.

Emboldened by this success, Cott decided to try to convince other retailers to carry private-label cola. To retailers, the value proposition was simple because, unlike its major rivals, Cott spent almost nothing on advertising and promotion. This constituted a major source of cost savings, which Cott passed on to retailers in the form

of lower prices. For their part, the retailers found that they could significantly undercut the price of Coke and Pepsi and still make better profit margins on private-label brands than on branded colas.

Despite this compelling value proposition, few retailers were willing to sell private-label colas for fear of alienating Coca-Cola and PepsiCo., whose products were a major draw of grocery store traffic. Cott's breakthrough came in the early 1990s when it signed a deal with Walmart to supply the retailing giant with a private-label cola called "Sam's Choice" (named after Walmart founder Sam Walton). Walmart proved to be the perfect distribution channel for Cott. The retailer was just starting to get into the grocery business, and consumers went to Walmart not to buy branded merchandise but to get low prices. As Walmart's grocery business grew, so did Cott's sales. Cott soon added other flavors to its offerings, such as lemon-lime soda, which would compete with 7Up and Sprite. Moreover, pressured by Walmart, by the late 1990s, other U.S. grocers had also started to introduce private-label sodas, often turning to Cott to supply their needs.

By 2008, Cott had grown to become a \$1.7 billion company. Cott captured more than 6% of the United States soda market, up from almost nothing a decade earlier, and held onto a 15% share of sodas in grocery stores, its core channel. The losers in this process have been Coca-Cola and PepsiCo, which are now facing the steady erosion of their brand loyalty and market share as consumers increasingly come to recognize the high quality and low price of private-label sodas.

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**Sources:** A. Kaplan, "Cott Corporation," *Beverage World*, June 15, 2004, 32; J. Popp, "2004 Soft Drink Report," *Beverage Industry*, March 2004, 13–18; L. Sparks, "From Coca-Colonization to Copy Catting: The Cott Corporation and Retailers Brand Soft Drinks in the UK and US," *Agribusiness*, March 1997, 153–127. Vol 13, Issue 2; E. Cherney, "After Flat Sales, Cott Challenges Pepsi, Coca-Cola," *Wall Street Journal*, January 8, 2003, B1, B8; Anonymous, "Cott Corporation: Company Profile," *Just-Drinks*, August 2006, 19–22; The Cott Corporation Web site, <http://www.cott.com/about/history/en>, accessed August 5, 2009.

management skills, that are limited in their supply; and (3) access to cheaper funds because existing companies represent lower risks than new entrants. If established companies have an absolute cost advantage, the threat of entry as a competitive force is weaker.

**Customer Switching Costs** Switching costs arise when it costs a customer time, energy, and money to switch from the products offered by one established company to the products offered by a new entrant. When switching costs are high, customers can be locked into the product offerings of established companies, even if new

entrants offer better products.<sup>4</sup> A familiar example of switching costs concerns the costs associated with switching from one computer operating system to another. If a person currently uses Microsoft's Windows operating system and has a library of related software applications (for example, word processing software, spreadsheet, games) and document files, it is expensive for that person to switch to another computer operating system. To effect the change, this person would have to buy a new set of software applications and convert all existing document files to run with the new system. Faced with such an expense of money and time, most people are unwilling to make the switch unless the competing operating system offers a substantial leap forward in performance. Thus, the higher the switching costs are the higher the barrier to entry is for a company attempting to promote a new computer operating system.

**Government Regulation** Historically, government regulation has constituted a major entry barrier into many industries. For example, until the mid-1990s, United States government regulation prohibited providers of long-distance telephone service from competing for local telephone service and vice versa. Other potential providers of telephone service, including cable television service companies such as Time Warner and Comcast (which could have used their cables to carry telephone traffic as well as TV signals), were prohibited from entering the market altogether. These regulatory barriers to entry significantly reduced the level of competition in both the local and long-distance telephone markets, enabling telephone companies to earn higher profits than might otherwise have been the case. All this changed in 1996 when the government deregulated the industry significantly. In the months that followed this announcement, local, long-distance, and cable TV companies all announced their intention to enter each other's markets, and a host of new players entered the market. The five forces model predicts that falling entry barriers due to government deregulation will result in significant new entry, an increase in the intensity of industry competition, and lower industry profit rates; indeed, that is what occurred.

In summary, if established companies have built brand loyalty for their products, have an absolute cost advantage with respect to potential competitors, have significant economies of scale, are the beneficiaries of high switching costs, or enjoy regulatory protection, the risk of entry by potential competitors is greatly diminished; it is a weak competitive force. Consequently, established companies can charge higher prices, and industry profits are higher. Evidence from academic research suggests that the height of barriers to entry is one of the most important determinants of profit rates in an industry.<sup>5</sup> Clearly, it is in the interest of established companies to pursue strategies consistent with raising entry barriers to secure these profits. By the same token, potential new entrants have to find strategies that allow them to circumvent barriers to entry.

## Rivalry Among Established Companies

The second of Porter's five competitive forces is the intensity of rivalry among established companies within an industry. Rivalry refers to the competitive struggle between companies in an industry to gain market share from each other. The competitive struggle can be fought using price, product design, advertising and promotional spending, direct selling efforts, and after-sales service and support. More intense rivalry implies lower prices or more spending on non-price-competitive weapons, or



both. Because intense rivalry lowers prices and raises costs, it squeezes profits out of an industry. Thus, intense rivalry among established companies constitutes a strong threat to profitability. Alternatively, if rivalry is less intense, companies may have the opportunity to raise prices or reduce spending on non-price-competitive weapons, which leads to a higher level of industry profits. The intensity of rivalry among established companies within an industry is largely a function of four factors: (1) industry competitive structure; (2) demand conditions; (3) cost conditions; and (4) the height of exit barriers in the industry.

**Industry Competitive Structure** The competitive structure of an industry refers to the number and size distribution of companies in it, something that strategic managers determine at the beginning of an industry analysis. Industry structures vary, and different structures have different implications for the intensity of rivalry. A fragmented industry consists of a large number of small or medium-sized companies, none of which is in a position to determine industry price. A consolidated industry is dominated by a small number of large companies (an oligopoly) or, in extreme cases, by just one company (a monopoly), and companies often are in a position to determine industry prices. Examples of fragmented industries are agriculture, dry cleaning, video rental, health clubs, real estate brokerage, and tanning parlors. Consolidated industries include the aerospace, soft drink, automobile, pharmaceutical, stockbrokerage, and beer industries. In the beer industry, for example, the top three firms account for 80% of industry sales.

Many fragmented industries are characterized by low entry barriers and commodity-type products that are hard to differentiate. The combination of these traits tends to result in boom-and-bust cycles as industry profits rise and fall. Low entry barriers imply that whenever demand is strong and profits are high, new entrants will flood the market, hoping to profit from the boom. The explosion in the number of video stores, health clubs, and tanning salons in the 1980s and 1990s exemplifies this situation.

Often the flood of new entrants into a booming fragmented industry creates excess capacity, so companies start to cut prices to use their spare capacity. The difficulty companies face when trying to differentiate their products from those of competitors can exacerbate this tendency. The result is a price war, which depresses industry profits, forces some companies out of business, and deters potential new entrants. For example, after a decade of expansion and booming profits, many health clubs are now finding that they have to offer large discounts to hold on to their membership. In general, the more commodity-like an industry's product is, the more vicious will be the price war. This bust part of the cycle continues until overall industry capacity is brought into line with demand (through bankruptcies), at which point prices may stabilize again.

A fragmented industry structure, then, constitutes a threat rather than an opportunity. Most booms are relatively short-lived because of the ease of new entry and will be followed by price wars and bankruptcies. Because it is often difficult to differentiate products in these industries, the best strategy for a company is to try to minimize its costs so it will be profitable in a boom and survive any subsequent bust. Alternatively, companies might try to adopt strategies that change the underlying structure of fragmented industries and lead to a consolidated industry structure in which the level of industry profitability is increased. Exactly how companies can do this is something we shall consider in later chapters.



In consolidated industries, companies are interdependent because one company's competitive actions or moves (with regard to price, quality, and so on) directly affect the market share of its rivals and thus their profitability. When one company makes a move, this generally "forces" a response from its rivals, and the consequence of such competitive interdependence can be a dangerous competitive spiral. Rivalry increases as companies attempt to undercut each other's prices or offer customers more value in their products, pushing industry profits down in the process. The fare wars that have periodically created havoc in the airline industry provide a good illustration of this process. The steel industry also suffered from similar price-cutting until 2004 (see the Opening Case).

Companies in consolidated industries sometimes seek to reduce this threat by following the prices set by the dominant company in the industry.<sup>6</sup> However, companies must be careful, for explicit face-to-face price-fixing agreements are illegal. (Tacit, indirect agreements, arrived at without direct or intentional communication, are legal.) Instead, companies set prices by watching, interpreting, anticipating, and responding to each other's behavior. However, tacit price-leadership agreements often break down under adverse economic conditions, as has occurred in the breakfast cereal industry, profiled in Strategy in Action 2.2.

**Industry Demand** The level of industry demand is a second determinant of the intensity of rivalry among established companies. Growing demand from new customers or additional purchases by existing customers tend to moderate competition by providing greater scope for companies to compete for customers. Growing demand tends to reduce rivalry because all companies can sell more without taking market share away from other companies. High industry profits are often the result. Conversely, declining demand results in more rivalry as companies fight to maintain market share and revenues (as in the breakfast cereal industry). Demand declines when customers leave the marketplace or each customer buys less. Now a company can grow only by taking market share away from other companies. Thus, declining demand constitutes a major threat, for it increases the extent of rivalry between established companies.

**Cost Conditions** The cost structure of firms in an industry is a third determinant of rivalry. In industries where fixed costs are high, profitability tends to be highly leveraged to sales volume, and the desire to grow volume can spark intense rivalry. Fixed costs are the costs that must be borne before the firm makes a single sale. For example, before they can offer service, cable TV companies have to lay cable in the ground; the cost of doing so is a fixed cost. Similarly, to offer air express service, a company like FedEx must invest in planes, package-sorting facilities, and delivery trucks, all fixed costs that require significant capital investments. In industries where the fixed costs of production are high, if sales volume is low, firms cannot cover their fixed costs and will not be profitable. Thus, they have an incentive to cut their prices and/or increase promotion spending to drive up sales volume so that they can cover their fixed costs. In situations where demand is not growing fast enough and too many companies are engaged in the same actions (cutting prices and/or raising promotion spending in an attempt to cover fixed costs), the result can be intense rivalry and lower profits. Research suggests that often the weakest firms in an industry initiate such actions, precisely because they are the ones struggling to cover their fixed costs.<sup>7</sup>

## 2.2 STRATEGY IN ACTION

### Price Wars in the Breakfast Cereal Industry

For decades, the breakfast cereal industry was one of the most profitable in the United States. The industry has a consolidated structure dominated by Kellogg's, General Mills, and Kraft Foods with its Post brand. Strong brand loyalty, coupled with control over the allocation of super-market shelf space, helped to limit the potential for new entry. Meanwhile, steady demand growth of about 3% per annum kept industry revenues expanding. Kellogg's, which accounted for more than 40% of the market share, acted as the price leader in the industry. Every year Kellogg's increased cereal prices, its rivals followed, and industry profits remained high.

This favorable industry structure started to change in the early 1990s when growth in demand slowed and then stagnated as lattes and bagels or muffins replaced cereal as the morning fare for many American adults. Soon after, the rise of powerful discounters such as Walmart, which entered the grocery industry in the early 1990s, and began to aggressively promote their own brands of cereal, priced significantly below the brand-name cereals. As the decade progressed, other grocery chains such as Kroger's started to follow suit, and brand loyalty in the industry began to decline as customers realized that a \$2.50 bag of wheat flakes from Walmart tasted about the same as a \$3.50 box of Cornflakes from Kellogg's. As sales of cheaper, store-brand cereals began to take off, supermarkets, no longer as dependent on brand names to bring traffic into their stores, began to demand lower prices from the branded cereal manufacturers.

For several years, the manufacturers of brand cereals tried to hold out against these adverse trends, but in the mid-1990s, the dam broke. In 1996, Kraft (then owned by Philip Morris) aggressively cut prices by 20% for its Post brand in an attempt to gain market share. Kellogg's soon

followed with a 19% price cut on two-thirds of its brands, and General Mills quickly did the same. The decades of tacit price collusion were officially over.

If the breakfast cereal companies were hoping that the price cuts would stimulate demand, they were wrong. Instead, demand remained flat while revenues and margins followed prices down, and Kellogg's operating margins dropped from 18% in 1995 to 10.2% in 1996, a trend experienced by the other brand cereal manufacturers.

By 2000, conditions had only worsened. Private-label sales continued to make inroads, gaining more than 10% of the market. Moreover, sales of breakfast cereals started to contract at 1% per annum. To cap it off, an aggressive General Mills continued to launch expensive price and promotion campaigns in an attempt to take share away from the market leader. Kellogg's saw its market share slip to just over 30% in 2001, behind the 31% now held by General Mills. For the first time since 1906, Kellogg's no longer led the market. Moreover, profits at all three major producers remained weak in the face of continued price discounting.

In mid-2001, General Mills finally blinked and raised prices a modest 2% in response to its own rising costs. Competitors followed, signaling perhaps that after a decade of costly price warfare, pricing discipline might once more emerge in the industry. Both Kellogg's and General Mills tried to move further away from price competition by focusing on brand extensions, such as Special K containing berries and new varieties of Cheerios. Kellogg's efforts with Special K helped the company recapture market leadership from General Mills. More importantly, the renewed emphasis on nonprice competition halted years of damaging price warfare, at least for the time being.

**Sources:** G. Morgenson, "Denial in Battle Creek," *Forbes*, October 7, 1996, 44; J. Muller, "Thinking out of the Cereal Box," *Business Week*, January 15, 2001, 54; A. Merrill, "General Mills Increases Prices," *Star Tribune*, June 5, 2001, 1D; S. Reyes, "Big G, Kellogg Attempt to Berry Each Other," *Brandweek*, October 7, 2002, 8.

**Exit Barriers** Exit barriers are economic, strategic, and emotional factors that prevent companies from leaving an industry.<sup>8</sup> If exit barriers are high, companies become locked into an unprofitable industry where overall demand is static or declining. The result is often excess productive capacity, which leads to even more intense rivalry

and price competition as companies cut prices in the attempt to obtain the customer orders needed to use their idle capacity and cover their fixed costs.<sup>9</sup> Common exit barriers include the following:

- Investments in assets such as specific machines, equipment, and operating facilities that are of little or no value in alternative uses or cannot be sold off. If a company wishes to leave the industry, it has to write off the book value of these assets.
- High fixed costs of exit, such as the severance pay, health benefits, and pensions that have to be paid to workers who are being made redundant when a company ceases to operate.
- Emotional attachments to an industry, as when a company's owners or employees are unwilling to exit from an industry for sentimental reasons or because of pride.
- Economic dependence on an industry because a company relies on a single industry for its revenue and profit.
- The need to maintain an expensive collection of assets at or above some minimum level to participate effectively in the industry.
- Bankruptcy regulations, particularly in the United States, where Chapter 11 bankruptcy provisions allow insolvent enterprises to continue operating and reorganize themselves under bankruptcy protection. These regulations can keep unprofitable assets in the industry, result in persistent excess capacity, and lengthen the time required to bring industry supply in line with demand.

As an example of the effect of exit barriers in practice, consider the express mail and parcel delivery industry. The key players in this industry, such as FedEx and UPS, rely on the delivery business entirely for their revenues and profits. They have to be able to guarantee their customers that they will deliver packages to all major localities in the United States, and much of their investment is specific to this purpose. To meet this guarantee, they need a nationwide network of air routes and ground routes, an asset that is required to participate in the industry. If excess capacity develops in this industry, as it does from time to time, FedEx cannot incrementally reduce or minimize its excess capacity by deciding not to fly to and deliver packages in, say, Miami because that proportion of its network is underused. If it did that, it would no longer be able to guarantee that it would be able to deliver packages to all major locations in the United States, and its customers would switch to some other carrier. Thus, the need to maintain a nationwide network is an exit barrier that can result in persistent excess capacity in the air express industry during periods of weak demand. Finally, both UPS and FedEx managers and employees are emotionally tied to this industry: they were first movers, in the ground and air segments of the industry, respectively; their employees are also major owners of their companies' stock; and they are dependent financially on the fortunes of the delivery business.

### The Bargaining Power of Buyers

The third of Porter's five competitive forces is the bargaining power of buyers. An industry's buyers may be the individual customers who ultimately consume

its products (its end users) or the companies that distribute an industry's products to end users, such as retailers and wholesalers. For example, while soap powder made by Procter & Gamble and Unilever is consumed by end users, the principal buyers of soap powder are supermarket chains and discount stores, which resell the product to end users. The bargaining power of buyers refers to the ability of buyers to bargain down prices charged by companies in the industry or to raise the costs of companies in the industry by demanding better product quality and service. By lowering prices and raising costs, powerful buyers can squeeze profits out of an industry. Thus, powerful buyers should be viewed as a threat. Alternatively, when buyers are in a weak bargaining position, companies in an industry can raise prices and perhaps reduce their costs by lowering product quality and service, thus increasing the level of industry profits. Buyers are most powerful in the following circumstances:

- The industry that is supplying a particular product or service is composed of many small companies and the buyers are large and few in number. These circumstances allow buyers to dominate supplying companies.
- Buyers purchase in large quantities. In such circumstances, buyers can use their purchasing power as leverage to bargain for price reductions.
- The supply industry depends on the buyers for a large percentage of its total orders.
- When switching costs are low, buyers can play off the supplying companies against each other to force down prices.
- When it is economically feasible for buyers to purchase an input from several companies at once, buyers can play off one company in the industry against another.
- When buyers can threaten to enter the industry and produce the product themselves and thus supply their own needs, this tactic will force down industry prices.

The auto component supply industry, whose buyers are large automobile manufacturers such as GM, Ford, and Toyota, is a good example of an industry in which buyers have strong bargaining power and thus a strong competitive threat. Why? The suppliers of auto components are numerous and typically small in scale; their buyers, the auto manufacturers, are large in size and few in number. Additionally, to keep component prices down, both Ford and GM have used the threat of manufacturing a component themselves rather than buying it from auto component suppliers. The automakers have used their powerful position to play off suppliers against each other, forcing down the price they have to pay for component parts and demanding better quality. If a component supplier objects, the automaker uses the threat of switching to another supplier as a bargaining tool.

Another issue is that the relative power of buyers and suppliers tends to change in response to changing industry conditions. For example, because of changes now taking place in the pharmaceutical and health care industries, major buyers of pharmaceuticals (hospitals and health maintenance organizations) are gaining power over the suppliers of pharmaceuticals and have been able to demand lower prices. The Running Case discusses how Walmart's buying power has changed over the years as the company has become larger.

# RUNNING CASE

## Walmart's Bargaining Power over Suppliers

When Walmart and other discount retailers began in the 1960s, they were small operations with little purchasing power. To generate store traffic, they depended in large part on stocking nationally branded merchandise from well-known companies such as Procter & Gamble and Rubbermaid. Because the discounters did not have high sales volume, the nationally branded companies set the price. This meant that the discounters had to look for other ways to cut costs, which they typically did by emphasizing self-service in stripped-down stores located in the suburbs where land was cheaper. (In the 1960s, the main competitors for discounters were full-service department stores such as Sears, Roebuck that were often located in downtown shopping areas.)

Discounters such as Kmart purchased their merchandise through wholesalers, who in turn bought from manufacturers. The wholesaler would come into a store and write an order, and when the merchandise arrived, the wholesaler would come in and stock the shelves, saving the retailer labor costs. However, Walmart was located in Arkansas and placed its stores in small towns. Wholesalers were not particularly interested in serving a company that built its stores in such out-of-the-way places. They would do it only if Walmart paid higher prices.

Walmart's Sam Walton refused to pay higher prices. Instead, he took his fledgling company public and used the capital raised to build a distribution center to stock merchandise. The distribution center would serve all stores within a 300-mile radius, with trucks leaving the distribution center daily to restock the stores. Because the distribution center was serving a collection of stores and thus buying in larger volumes,

Walton found that he was able to cut the wholesalers out of the equation and order directly from manufacturers. The cost savings generated by not having to pay profits to wholesalers were then passed on to consumers in the form of lower prices, which helped Walmart continue growing. This growth increased its buying power and thus its ability to demand deeper discounts from manufacturers.

Today Walmart has turned its buying process into an art form. Because 8% of all retail sales in the United States are made in a Walmart store, the company has enormous bargaining power over its suppliers. Suppliers of nationally branded products, such as Procter & Gamble, are no longer in a position to demand high prices. Instead, Walmart is now so important to Procter & Gamble that it is able to demand deep discounts from them. Moreover, Walmart has itself become a brand that is more powerful than the brands of manufacturers. People do not go to Walmart to buy branded goods; they go to Walmart for the low prices. This simple fact has enabled Walmart to bargain down the prices it pays, always passing on cost savings to consumers in the form of lower prices.

Since the early 1990s, Walmart has provided suppliers with real-time information on store sales through the use of individual stock keeping units (SKUs). These have allowed suppliers to optimize their own production processes, matching output to Walmart's demands and avoiding under- or overproduction and the need to store inventory. The efficiencies that manufacturers gain from such information are passed on to Walmart in the form of lower prices, which then passes on those cost savings to consumers.

**Sources:** "How Big Can It Grow? Wal-Mart," *Economist*, April 17, 2004, 74–76; H. Gilman, "The Most Underrated CEO Ever," *Fortune*, April 5, 2004, 242–247; K. Schaffner, "Psst! Want to Sell to Wal-Mart?" *Apparel Industry Magazine*, August 1996, 18–20.

## The Bargaining Power of Suppliers

The fourth of Porter's five competitive forces is the bargaining power of suppliers: the organizations that provide inputs into the industry, such as materials, services, and labor (which may be individuals, organizations such as labor unions, or companies that supply contract labor). The bargaining power of suppliers refers to the ability

of suppliers to raise input prices, or to raise the costs of the industry in other ways, for example, by providing poor-quality inputs or poor service. Powerful suppliers squeeze profits out of an industry by raising the costs of companies in the industry. Thus, powerful suppliers are a threat. Alternatively, if suppliers are weak, companies in the industry have the opportunity to force down input prices and demand higher-quality inputs (such as more productive labor). As with buyers, the ability of suppliers to make demands on a company depends on their power relative to that of the company. Suppliers are most powerful in the following situations:

- The product that suppliers sell has few substitutes and is vital to the companies in an industry.
- The profitability of suppliers is not significantly affected by the purchases of companies in a particular industry. In other words, the industry is not an important customer to the suppliers.
- Companies in an industry would experience significant switching costs if they moved to the product of a different supplier because a particular supplier's products are unique or different. In such cases, the company depends on a particular supplier and cannot play suppliers off against each other to reduce price.
- Suppliers can threaten to enter their customers' industry and use their inputs to produce products that would compete directly with those of companies already in the industry.
- Companies in the industry cannot threaten to enter their suppliers' industry and make their own inputs as a tactic for lowering the price of inputs.

An example of an industry in which companies are dependent on a powerful supplier is the personal computer industry. Personal computer firms are heavily dependent on Intel, the world's largest supplier of microprocessors for PCs. The industry standard for personal computers runs on Intel's microprocessor chips. Intel's competitors, such as Advanced Micro Devices (AMD), must develop and supply chips that are compatible with Intel's standard. Although AMD has developed competing chips, Intel still supplies about 85% of the chips used in PCs, primarily because only Intel has the manufacturing capacity required to serve a large share of the market. It is beyond the financial resources of Intel's competitors, such as AMD, to match the scale and efficiency of Intel's manufacturing systems. This means that while PC manufacturers can buy some microprocessors from Intel's rivals, most notably AMD, they still have to turn to Intel for the bulk of their supply. Because Intel is in a powerful bargaining position, it can charge higher prices for its microprocessors than would be the case if its competitors were more numerous and stronger (that is, if the microprocessor industry were fragmented).

## Substitute Products

The final force in Porter's model is the threat of substitute products: the products of different businesses or industries that can satisfy similar customer needs. For example, companies in the coffee industry compete indirectly with those in the tea and soft drink industries because all three serve customer needs for nonalcoholic drinks. The existence of close substitutes is a strong competitive threat because this limits the price that companies in one industry can charge for their product, and thus industry profitability. If the price of coffee rises too much relative to that of tea or soft drinks, coffee drinkers may switch to those substitutes.



If an industry's products have few enough close substitutes that substitutes are a weak competitive force, then, other things being equal, companies in the industry have opportunities to raise prices and earn additional profits. For example, there is no close substitute for microprocessors, which gives companies like Intel and AMD the ability to charge higher prices.

### A Sixth Force: Complementors

Andrew Grove, the former CEO of Intel, has argued that Porter's five forces model ignores a sixth force: the power, vigor, and competence of complementors.<sup>10</sup> Complementors are companies that sell products that add value to (complement) the products of companies in an industry because when used together, the products better satisfy customer demands. For example, the complementors to the personal computer industry are the companies that make software applications to run on those machines. The greater the supply of high-quality software applications to run on personal computers, the greater the value of personal computers to customers, creating greater demand for PCs and greater profitability for the personal computer industry.

Grove's argument has a strong foundation in economic theory, which has long argued that both substitutes and complements influence demand in an industry.<sup>11</sup> Moreover, recent research has emphasized the importance of complementary products in determining demand and profitability in many high-technology industries, such as the computer industry in which Grove made his mark.<sup>12</sup> The issue, therefore, is that when complements are an important determinant of demand for an industry's products, industry profits depend critically on there being an adequate supply of complementary products. When the number of complementors is increasing and they produce attractive complementary products, it boosts demand and profits in the industry and can open up many new opportunities for creating value. Conversely, if complementors are weak and are not producing attractive complementary products, it can be a threat that slows industry growth and limits profitability.

### Ethical Dilemma

You are a strategic analyst at a successful hotel enterprise that has been generating substantial excess cash flow. Your CEO instructed you to analyze the competitive structure of closely related industries to find one that the company could enter using your cash reserve to build a sustainable position. Your analysis, using Porter's five forces model, suggests that the highest profit opportunities are to be found in the gambling industry. You realize that it might be possible to add casinos to existing hotels, lowering entry costs into this industry. However, you personally have strong moral objections to gambling. Should your own personal beliefs influence your recommendations to the CEO?

### Porter's Model Summarized

The systematic analysis of forces in the industry environment using the Porter framework is a powerful tool that helps managers to think strategically. It is important to recognize that one competitive force often affects the others, thus all forces need to be considered and thought about when performing an industry analysis. Indeed, industry analysis leads managers to think systematically about how their strategic choices will be affected by the forces of industry competition and also about how their choices will affect the five forces and change conditions in the industry.

## STRATEGIC GROUPS WITHIN INDUSTRIES

Companies in an industry often differ significantly from each other with respect to the way they strategically position their products in the market in terms of such factors as the distribution channels they use, the market segments they serve, the quality of their products, technological leadership, customer service, pricing policy, advertising policy, and promotions. As a result of these differences, within most industries,

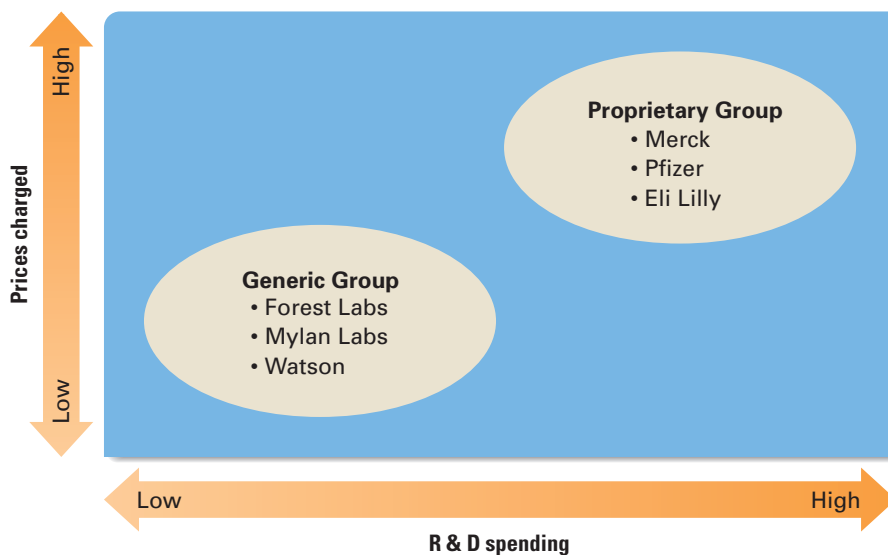


it is possible to observe groups of companies in which each company follows a business model that is similar to that pursued by other companies in the group but different from the business model followed by companies in other groups. These different groups of companies are known as strategic groups.<sup>13</sup>

Normally, the basic differences between the business models that companies in different strategic groups use can be captured by a relatively small number of strategic factors. For example, in the pharmaceutical industry, two main strategic groups stand out (see Figure 2.3).<sup>14</sup> One group, which includes such companies as Merck, Eli Lilly, and Pfizer, is characterized by a business model based on heavy R&D spending and a focus on developing new, proprietary, blockbuster drugs. The companies in this proprietary strategic group are pursuing a high-risk, high-return strategy. It is a high-risk strategy because basic drug research is difficult and expensive. Bringing a new drug to market can cost up to \$800 million in R&D money and a decade of research and clinical trials. The risks are high because the failure rate in new drug development is very high: only one out of every five drugs entering clinical trials is ultimately approved by the U.S. Food and Drug Administration. However, the strategy is also a high-return one because a single successful drug can be patented, giving the innovator a 20-year monopoly on its production and sale. This lets these proprietary companies charge a high price for the patented drug, allowing them to earn millions, if not billions, of dollars over the lifetime of the patent.

The second strategic group might be characterized as the generic drug strategic group. This group of companies, which includes Forest Labs, Mylan Labs, and Watson Pharmaceuticals, focuses on the manufacture of generic drugs: low-cost copies of drugs that were developed by companies in the proprietary group whose patents have now expired. Low R&D spending, production efficiency, and an emphasis on low prices characterize the business models of companies in this strategic group. They are pursuing low-risk, low-return strategies because they are not investing millions of dollars in R&D. The strategies are low return because the companies cannot charge high prices.

**Figure 2.3** Strategic Groups in the Pharmaceutical Industry



## Implications of Strategic Groups

The concept of strategic groups has a number of implications for the identification of opportunities and threats within an industry. First, because all the companies in a strategic group are pursuing similar business models, customers tend to view the products of such enterprises as direct substitutes for each other. Thus, a company's closest competitors are those in its strategic group, not those in other strategic groups in the industry. The most immediate threat to a company's profitability comes from rivals within its own strategic group. For example, in the retail industry, there is a group of companies that might be characterized as discounters. Included in this group are Walmart, Kmart, Target, and Fred Meyer. These companies compete most vigorously with each other, rather than with other retailers in different groups, such as Nordstrom or Gap Inc. Kmart, for example, was driven into bankruptcy in the early 2000s not because Nordstrom or Gap Inc. took business from it but because Walmart and Target gained share in the discounting group by virtue of their superior strategic execution of the discounting business model.

A second competitive implication is that different strategic groups can have a different standing with respect to each of the competitive forces; thus, each strategic group may face a different set of opportunities and threats. The risk of new entry by potential competitors, the degree of rivalry among companies within a group, the bargaining power of buyers, the bargaining power of suppliers, and the competitive force of substitute and complementary products can each be a relatively strong or weak competitive force depending on the competitive positioning approach adopted by each strategic group in the industry. For example, in the pharmaceutical industry, companies in the proprietary group have historically been in a very powerful position in relation to buyers because their products are patented and there are no substitutes. Also, rivalry based on price competition within this group has been low because competition in the industry revolves around being the first to patent a new drug (so-called patent races), not around drug prices. Thus, companies in this group have been able to charge high prices and earn high profits. In contrast, companies in the generic group have been in much weaker positions because many companies are able to produce different versions of the same generic drug after patents expire. Thus, in the generic group, products are close substitutes, rivalry has been high, and price competition has led to lower profits for this group as compared to companies in the proprietary group.

## The Role of Mobility Barriers

It follows from these two issues that some strategic groups are more desirable than other, because competitive forces open up greater opportunities and present fewer threats for those groups. Managers, after analyzing their industry, might identify a strategic group where competitive forces are weaker and higher profits can be made. Sensing an opportunity, they might contemplate changing their business models and move to compete in that strategic group. However, taking advantage of this opportunity may be difficult because of mobility barriers between strategic groups.

Mobility barriers are within-industry factors that inhibit the movement of companies between strategic groups. They include the barriers to entry into a group and the barriers to exit from a company's existing group. For example, Forest Labs would encounter mobility barriers if it attempted to enter the proprietary group in the pharmaceutical industry; it lacks R&D skills, and building these skills would be an expensive proposition. Over time, companies in different groups develop different cost structures and skills and competencies that give them different pricing options

and choices. A company contemplating entry into another strategic group must evaluate whether it has the ability to imitate, and indeed outperform, its potential competitors in that strategic group. Managers must determine if it is cost-effective to overcome mobility barriers before deciding whether the move is worthwhile.

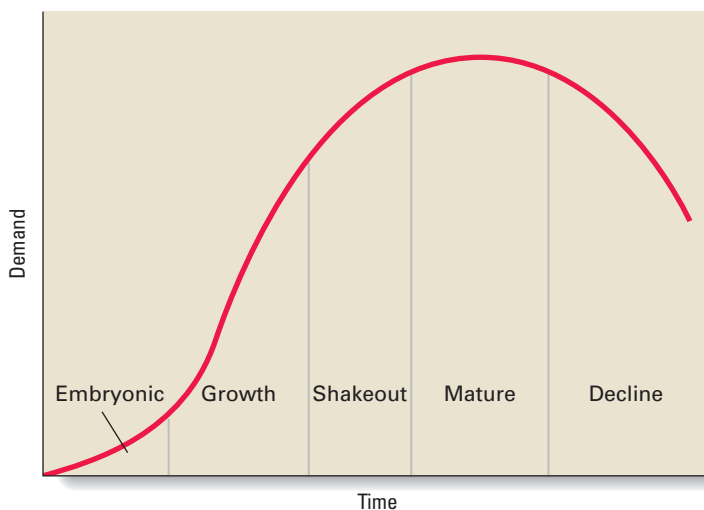
In summary, an important task of industry analysis is to determine the sources of the similarities and differences among companies in an industry and to work out the broad themes that underlie competition in an industry. This analysis often reveals new opportunities to compete in an industry by developing new kinds of products to meet the needs of customers better. It can also reveal emerging threats that can be countered effectively by changing competitive strategy. This issue is discussed in Chapters 5, 6, and 7, which examine crafting competitive strategy in different kinds of markets to build a competitive advantage over rivals and best satisfy customer needs.

## INDUSTRY LIFE CYCLE ANALYSIS

An important determinant of the strength of the competitive forces in an industry (and thus of the nature of opportunities and threats) is the changes that take place in it over time. The similarities and differences between companies in an industry often become more pronounced over time, and its strategic group structure frequently changes. The strength and nature of each of the competitive forces also change as an industry evolves, particularly the two forces of risk of entry by potential competitors and rivalry among existing firms.<sup>15</sup>

A useful tool for analyzing the effects of industry evolution on competitive forces is the industry life cycle model, which identifies five sequential stages in the evolution of an industry that lead to five distinct kinds of industry environment: embryonic, growth, shakeout, mature, and decline (see Figure 2.4). The task facing managers is to anticipate how the strength of competitive forces will change as the industry environment evolves and formulate strategies that take advantage of opportunities as they arise and that counter emerging threats.

**Figure 2.4** Stages in the Industry Life Cycle



## Embryonic Industries

An embryonic industry is just beginning to develop (e.g., personal computers and biotechnology in the 1970s, wireless communications in the 1980s, Internet retailing in the early 1990s, and nanotechnology today). Growth at this stage is slow because of such factors as buyers' unfamiliarity with the industry's product, high prices due to the inability of companies to reap any significant economies of scale, and poorly developed distribution channels. Barriers to entry tend to be based on access to key technological know-how rather than cost economies or brand loyalty. If the core know-how required to compete in the industry is complex and difficult to grasp, barriers to entry can be quite high, and established companies will be protected from potential competitors. Rivalry in embryonic industries is based not so much on price as on educating customers, opening up distribution channels, and perfecting the design of the product. Such rivalry can be intense; the company that is the first to solve design problems often has the opportunity to develop a significant market position. An embryonic industry may also be the creation of one company's innovative efforts, as happened with microprocessors (Intel), vacuum cleaners (Hoover), photocopiers (Xerox), small package express delivery (FedEx), and Internet search (Google). In such circumstances, the company has a major opportunity to capitalize on the lack of rivalry and build a strong hold on the market.

## Growth Industries

Once demand for the industry's product begins to take off, the industry develops the characteristics of a growth industry. In a growth industry, first-time demand is expanding rapidly as many new customers enter the market. Typically, an industry grows when customers become familiar with the product; prices fall because experience and economies of scale have been attained, and distribution channels develop. The United States wireless telephone industry was in the growth stage for most of the 1990s. In 1990, there were only 5 million cellular subscribers in the nation. By 2008, this figure had increased to approximately 260 million with 84% of the population owning cell phones.

Normally, the importance of control over technological knowledge as a barrier to entry has diminished by the time an industry enters its growth stage. Because few companies have yet achieved significant economies of scale or built brand loyalty, other entry barriers tend to be relatively low as well, particularly early in the growth stage. Thus, the threat from potential competitors generally is highest at this point. Paradoxically, however, high growth usually means that new entrants can be absorbed into an industry without a marked increase in the intensity of rivalry. Thus, rivalry tends to be relatively low. Rapid growth in demand enables companies to expand their revenues and profits without taking market share away from competitors. A strategically aware company takes advantage of the relatively benign environment of the growth stage to prepare itself for the intense competition of the coming industry shakeout.

## Industry Shakeout

Explosive growth cannot be maintained indefinitely. Sooner or later, the rate of growth slows, and the industry enters the shakeout stage. In the shakeout stage, demand approaches saturation levels; most of the demand is limited to replacement because there are few potential first-time buyers left.

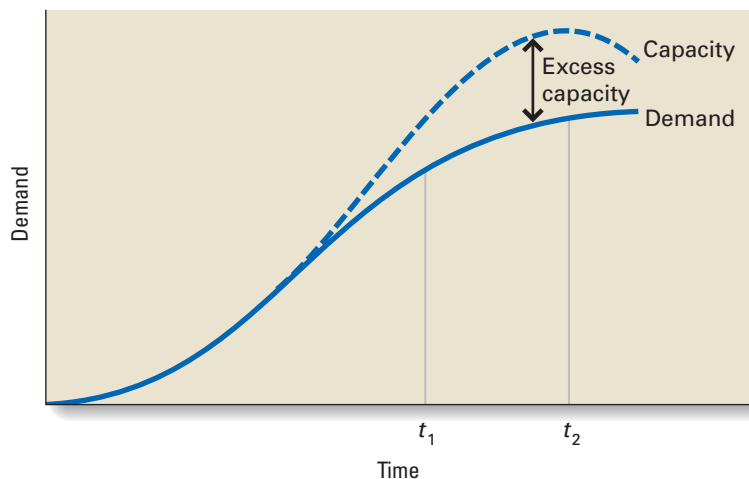
As an industry enters the shakeout stage, rivalry between companies becomes intense. Typically, companies that have become accustomed to rapid growth continue to add capacity at rates consistent with past growth. However, demand is no longer growing at historic rates, and the consequence is the emergence of excess productive capacity. This condition is illustrated in Figure 2.5, where the solid curve indicates the growth in demand over time and the broken curve indicates the growth in productive capacity over time. As you can see, past point  $t_1$ , demand growth becomes slower as the industry becomes more mature. However, capacity continues to grow until time  $t_2$ . The gap between the solid and broken lines signifies excess capacity. In an attempt to use this capacity, companies often cut prices. The result can be a price war, which drives many of the most inefficient companies into bankruptcy, which is enough to deter any new entry.

## Mature Industries

The shakeout stage ends when the industry enters its mature stage: the market is totally saturated, demand is limited to replacement demand, and growth is low or zero. What growth there is comes from population expansion that brings new customers into the market or an increase in replacement demand.

As an industry enters maturity, barriers to entry increase, and the threat of entry from potential competitors decreases. As growth slows during the shakeout, companies can no longer maintain historic growth rates merely by holding on to their market share. Competition for market share develops, driving down prices and often producing a price war, as happened in the airline and personal computer industry. To survive the shakeout, companies begin to focus on minimizing costs and building brand loyalty. The airlines, for example, tried to cut operating costs by hiring nonunion labor and build brand loyalty by introducing frequent-flyer programs. Personal computer companies have sought to build brand loyalty by providing excellent after-sales service and working to lower their cost structures. By the time an industry

**Figure 2.5** Growth in Demand and Capacity



matures, the surviving companies are those that have brand loyalty and efficient low-cost operations. Because both these factors constitute a significant barrier to entry, the threat of entry by potential competitors is often greatly diminished. High entry barriers in mature industries can give companies the opportunity to increase prices and profits—although this does not always occur.

As a result of the shakeout, most industries in the maturity stage have consolidated and become oligopolies. Examples include the beer industry, the breakfast cereal industry, and the pharmaceutical industry. In mature industries, companies tend to recognize their interdependence and try to avoid price wars. Stable demand gives them the opportunity to enter into price-leadership agreements. The net effect is to reduce the threat of intense rivalry among established companies, thereby allowing greater profitability. Nevertheless, the stability of a mature industry is always threatened by further price wars. A general slump in economic activity can depress industry demand. As companies fight to maintain their revenues in the face of declining demand, price-leadership agreements break down, rivalry increases, and prices and profits fall. The periodic price wars that occur in the airline industry seem to follow this pattern.

## Declining Industries

Eventually, most industries enter a decline stage: growth becomes negative for a variety of reasons, including technological substitution (e.g., air travel for rail travel); social changes (e.g., greater health consciousness hitting tobacco sales); demographics (e.g., the declining birthrate hurting the market for baby and child products); and international competition (e.g., low-cost foreign competition pushed the U.S. steel industry into decline for two decades until 2004—see Opening Case). Within a declining industry, the degree of rivalry among established companies usually increases. Depending on the speed of the decline and the height of exit barriers, competitive pressures can become as fierce as in the shakeout stage.<sup>16</sup> The main problem in a declining industry is that falling demand leads to the emergence of excess capacity. In trying to use this capacity, companies begin to cut prices, thus sparking a price war. The U.S. steel industry experienced these problems during the 1980s and 1990s because steel companies tried to use their excess capacity despite falling demand. The same problem occurred in the airline industry in 1990–1992, in 2001–2003, and again in 2008 as companies cut prices to ensure that they would not be flying with half-empty planes (that is, that they would not be operating with substantial excess capacity). Exit barriers play a part in adjusting excess capacity. The greater the exit barriers, the harder it is for companies to reduce capacity and the greater is the threat of severe price competition.

## Industry Life Cycle Summary

A third task of industry analysis is to identify the opportunities and threats that are characteristic of different kinds of industry environments to develop an effective business model and competitive strategy. Managers must tailor their strategies to changing industry conditions. They must learn to recognize the crucial points in an industry's development so that they can forecast when the shakeout stage of an industry might begin or when an industry might be moving into decline. This is also true at the level of strategic groups, for new embryonic groups may

emerge because of shifts in customer needs and tastes. Some groups may grow rapidly because of changes in technology, and others will decline as their customers defect.

## LIMITATIONS OF MODELS FOR INDUSTRY ANALYSIS

The competitive forces, strategic groups, and life cycle models provide useful ways of thinking about and analyzing the nature of competition within an industry to identify opportunities and threats. However, each has its limitations, and managers need to be aware of their shortcomings.

### Life Cycle Issues

It is important to remember that the industry life cycle model is a generalization. In practice, industry life cycles do not always follow the pattern illustrated in Figure 2.4. In some cases, growth is so rapid that the embryonic stage is skipped altogether. In others, industries fail to get past the embryonic stage. Industry growth can be revitalized after long periods of decline through innovation or social change. For example, the health boom brought the bicycle industry back to life after a long period of decline.

The time span of the stages can also vary significantly from industry to industry. Some industries can stay in maturity almost indefinitely if their products become basic necessities of life, as is the case for the car industry. Other industries skip the mature stage and go straight into decline, as in the case of the vacuum tube industry. Transistors replaced vacuum tubes as a major component in electronic products even though the vacuum tube industry was still in its growth stage. Still other industries may go through several shakeouts before they enter full maturity, as appears to be happening in the telecommunications industry.

### Innovation and Change

Over any reasonable length of time, in many industries competition can be viewed as a process driven by innovation.<sup>17</sup> Indeed, innovation is frequently the major factor in industry evolution and causes movement through the industry life cycle. Innovation is attractive because companies that pioneer new products, processes, or strategies can often earn enormous profits. Consider the explosive growth of Toys“R”Us, Dell Computer, and Walmart. In a variety of different ways, all of these companies were innovators. Toys“R”Us pioneered a new way of selling toys (through large discount warehouse-type stores); Dell pioneered a whole new way of selling personal computers (directly via telephone and then the Web); Walmart pioneered the low-price discount superstore concept.

Successful innovation can transform the nature of industry competition. In recent decades, one frequent consequence of innovation has been to lower the fixed costs of production, thereby reducing barriers to entry and allowing new, and smaller, enterprises to compete with large established organizations. For example, two decades ago, large integrated steel companies such as U.S. Steel, LTV, and Bethlehem Steel dominated the steel industry. The industry was a typical oligopoly, dominated by a

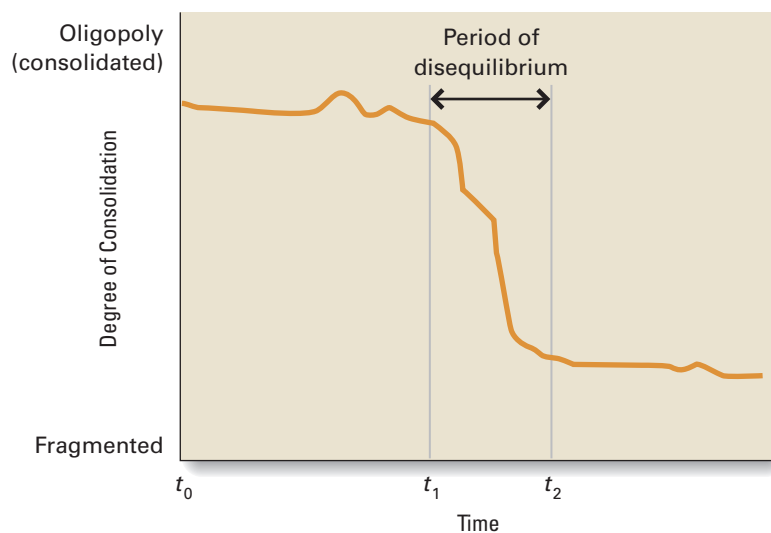


small number of large producers, in which tacit price collusion was practiced. Then along came a series of efficient minimill producers such as Nucor and Chaparral Steel, which used a new technology: electric arc furnaces. Over the past 20 years, they have revolutionized the structure of the industry. What was once a consolidated industry is now much more fragmented and price competitive. The successor company to U.S. Steel, USX, now has only a 12% market share, down from 55% in the mid-1960s. In contrast, the minimills now hold more than 40% of the market, up from 5% 20 years ago.<sup>18</sup> Thus, the minimill innovation has reshaped the nature of competition in the steel industry.<sup>19</sup> Porter's five forces model applied to the industry in 1970 would look very different from one applied in 2008 (see Opening Case for more details).

Michael Porter talks of innovations as “unfreezing” and “reshaping” industry structure. He argues that after a period of turbulence triggered by innovation, the structure of an industry once more settles down into a fairly stable pattern, and the five forces and strategic group concepts can once more be applied.<sup>20</sup> This view of the evolution of industry structure is often referred to as *punctuated equilibrium*.<sup>21</sup> The punctuated equilibrium view holds that long periods of equilibrium, when an industry's structure is stable, are punctuated by periods of rapid change when industry structure is revolutionized by innovation; there is an unfreezing and refreezing process.

Figure 2.6 shows what punctuated equilibrium might look like for one key dimension of industry structure: competitive structure. From time  $t_0$  to  $t_1$ , the competitive structure of the industry is a stable oligopoly, with a few companies sharing the market. At time  $t_1$ , a major new innovation is pioneered by either an existing company or a new entrant. The result is a period of turbulence between  $t_1$  and  $t_2$ . After a period of time, the industry settles down into a new state of equilibrium, but now the competitive structure is far more fragmented. Note that the opposite could have happened: the industry could have become more consolidated, although this seems

**Figure 2.6** Punctuated Equilibrium and Competitive Structure



to be less common. In general, innovations seem to lower barriers to entry, allow more companies into the industry, and, as a result, lead to fragmentation rather than consolidation.

During a period of rapid change when industry structure is being revolutionized by innovation, value typically migrates to business models based on new positioning strategies.<sup>22</sup> In the stockbrokerage industry, value migrated away from the full-service broker model to the online trading model. In the steel industry, the introduction of electric arc technology led to a migration of value away from large, integrated enterprises and toward small minimills. In the book-selling industry, value has migrated away from small boutique “bricks and mortar” booksellers toward large bookstore chains such as Barnes & Noble and online bookstores such as amazon.com. Because the competitive forces and strategic group models are static, they cannot adequately capture what occurs during periods of rapid change in the industry environment when value is migrating.

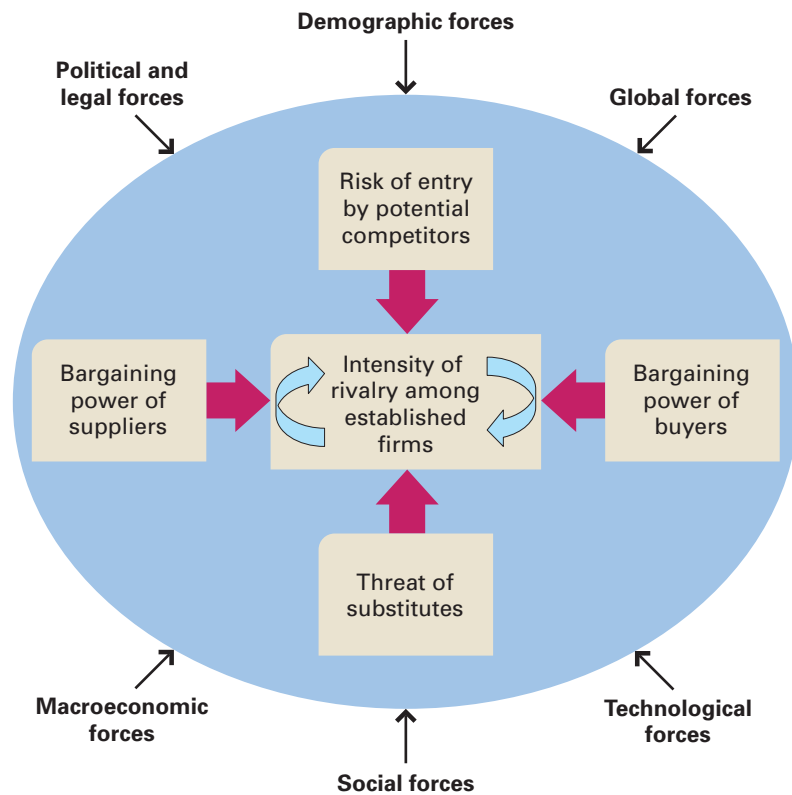
## Company Differences

Another criticism of industry models is that they overemphasize the importance of industry structure as a determinant of company performance and underemphasize the importance of variations or differences among companies within an industry or a strategic group.<sup>23</sup> As discussed in the next chapter, there can be enormous variance in the profit rates of individual companies within an industry. Research by Richard Rumelt and his associates suggests that industry structure explains only about 10% of the variance in profit rates across companies.<sup>24</sup> The implication is that individual company differences explain much of the remainder. Other studies have put the explained variance closer to 20%, which is still not a large figure.<sup>25</sup> Similarly, a growing number of studies have found only weak evidence of a link between strategic group membership and company profit rates, despite the fact that the strategic group model predicts a strong link.<sup>26</sup> Collectively, these studies suggest that the individual resources and capabilities of a company are far more important determinants of its profitability than is the industry or strategic group of which the company is a member. In other words, there are strong companies in tough industries where average profitability is low (e.g., Nucor in the steel industry), and weak companies in industries where average profitability is high.

Although these findings do not invalidate the five forces and strategic group models, they do imply that the models are only imperfect predictors of enterprise profitability. A company will not be profitable just because it is based in an attractive industry or strategic group. As we discuss in Chapters 3 and 4, more is required.

## THE MACROENVIRONMENT

Just as the decisions and actions of strategic managers can often change an industry's competitive structure, so too can changing conditions or forces in the wider macroenvironment, that is, the broader economic, global, technological, demographic, social, and political context in which companies and industries are embedded (see Figure 2.7). Changes in the forces in the macroenvironment can have a direct impact on any or all of the forces in Porter's model, thereby altering the relative strength of these forces and, with it, the attractiveness of an industry.

**Figure 2.7** The Role of the Macroevironment

## Macroeconomic Forces

Macroeconomic forces affect the general health and well-being of a nation or the regional economy of an organization, which in turn affect companies' and industries' abilities to earn an adequate rate of return. The four most important macroeconomic forces are the growth rate of the economy, interest rates, currency exchange rates, and inflation (or deflation) rates. Economic growth, because it leads to an expansion in customer expenditures, tends to produce a general easing of competitive pressures within an industry. This gives companies the opportunity to expand their operations and earn higher profits. Because economic decline (a recession) leads to a reduction in customer expenditures, it increases competitive pressures. Economic decline frequently causes price wars in mature industries.

Interest rates can determine the demand for a company's products. Interest rates are important whenever customers borrow money to finance their purchase of these products. The most obvious example is the housing market, in which mortgage rates directly affect demand. Interest rates also have an impact on the sale of autos, appliances, and capital equipment. For companies in such industries, rising interest rates are a threat and falling rates an opportunity. Interest rates are also important because they influence a company's cost of capital, and

therefore its ability to raise funds and invest in new assets. The lower that interest rates are, the lower the cost of capital for companies will be, and the more investment there will be.

Currency exchange rates define the value of different national currencies against each other. Movement in currency exchange rates has a direct impact on the competitiveness of a company's products in the global marketplace. For example, when the value of the dollar is low compared with that of other currencies, products made in the United States are relatively inexpensive, and products made overseas are relatively expensive. A low or declining dollar reduces the threat from foreign competitors while creating opportunities for increased sales overseas. The fall in the value of the dollar against several major currencies during 2004–2008 helped to make the United States steel industry more competitive.

Price inflation can destabilize the economy, producing slower economic growth, higher interest rates, and volatile currency movements. If inflation keeps increasing, investment planning becomes hazardous. The key characteristic of inflation is that it makes the future less predictable. In an inflationary environment, it may be impossible to predict with any accuracy the real value of returns that can be earned from a project five years hence. Such uncertainty makes companies less willing to invest. Their holding back in turn depresses economic activity and ultimately pushes the economy into a recession. Thus, high inflation is a threat to companies.

Price deflation also has a destabilizing effect on economic activity. If prices are falling, the real price of fixed payments goes up. This is damaging for companies and individuals with a high level of debt who must make regular fixed payments on that debt. In a deflationary environment, the increase in the real value of debt consumes more of household and corporate cash flows, leaving less for other purchases and depressing the overall level of economic activity. Although significant deflation has not been seen since the 1930s, in the 1990s it started to take hold in Japan, and in 2008 there were concerns that it might reemerge in the United States as the country plunged into a deep recession.

## Global Forces

Over the last half-century there have been enormous changes in the world economic system. We review these changes in some detail in Chapter 8 when we discuss global strategy. For now, the important points to note are that barriers to international trade and investment have tumbled, and more and more countries have enjoyed sustained economic growth. Economic growth in places like Brazil, China, and India has created large new markets for companies' goods and services and is giving companies an opportunity to grow their profits faster by entering these nations. Falling barriers to international trade and investment have made it much easier to enter foreign nations. For example, 20 years ago, it was almost impossible for a Western company to set up operations in China. Today, Western and Japanese companies are investing more than \$50 billion a year in China. By the same token, however, falling barriers to international trade and investment have made it easier for foreign enterprises to enter the domestic markets of many companies (by lowering barriers to entry), thereby increasing the intensity of competition and lowering profitability. Because of these changes, many formally isolated domestic markets have now become part of a much larger, and more competitive, global marketplace, creating a myriad of threats and opportunities for companies.

## Technological Forces

Over the last few decades, the pace of technological change has accelerated.<sup>27</sup> This has unleashed a process that has been called a “perennial gale of creative destruction.”<sup>28</sup> Technological change can make established products obsolete overnight and simultaneously create a host of new product possibilities. Thus, technological change is both creative and destructive—both an opportunity and a threat.

One of the most important impacts of technological change is that it can impact the height of barriers to entry and therefore radically reshape industry structure. For example, the Internet lowered barriers to entry into the news industry. Providers of financial news now have to compete for advertising dollars and customer attention with new Internet-based media organizations that sprang up during the 1990s and 2000s, such as TheStreet.com, the Motley Fool, Yahoo!’s financial section, and, most recently, Google news. The resulting increase in rivalry has given advertisers more choices, enabling them to bargain down the prices that they must pay to media companies.

## Demographic Forces

Demographic forces are outcomes of changes in the characteristics of a population, such as age, gender, ethnic origin, race, sexual orientation, and social class. Like the other forces in the general environment, demographic forces present managers with opportunities and threats and can have major implications for organizations. Changes in the age distribution of a population are an example of a demographic force that affects managers and organizations. Currently, most industrialized nations are experiencing the aging of their populations as a consequence of falling birth and death rates and the aging of the baby-boom generation. The aging of the population is increasing opportunities for organizations that cater to older people; the home healthcare and recreation industries, for example, are seeing an upswing in demand for their services. As the baby-boom generation from the late 1950s to the early 1960s has aged, it has created a host of opportunities and threats. During the 1980s, many baby boomers were getting married, creating an upsurge in demand for the customer appliances normally bought by newlyweds. Companies such as Whirlpool Corporation and GE capitalized on the resulting upsurge in demand for washing machines, dishwashers, dryers, and the like. In the 1990s, many of these same baby boomers were starting to save for retirement, creating an inflow of money into mutual funds and creating a boom in the mutual fund industry. In the next 20 years, many baby boomers will retire, creating a boom in retirement communities.

## Social Forces

Social forces refer to the way in which changing social mores and values affect an industry. Like the other macroenvironmental forces discussed here, social change creates opportunities and threats. One of the major social movements of recent decades has been the trend toward greater health consciousness. Its impact has been immense, and companies that recognized the opportunities early have often reaped significant gains. Philip Morris, for example, capitalized on the growing health consciousness trend when it acquired Miller Brewing Company and then redefined competition in the beer industry with its introduction of low-calorie beer (Miller Lite). Similarly, PepsiCo was able to gain market share from its rival, Coca-Cola, by

being the first to introduce diet colas and fruit-based soft drinks. At the same time, the health trend has created a threat for many industries. The tobacco industry, for example, is in decline as a direct result of greater customer awareness of the health implications of smoking.

## Political and Legal Forces

Political and legal forces are outcomes of changes in laws and regulations. They result from political and legal developments within society and significantly affect managers and companies.

Political processes shape a society's laws, which constrain the operations of organizations and managers and thus create both opportunities and threats.<sup>29</sup> For example, throughout much of the industrialized world, there has been a strong trend toward deregulation of industries previously controlled by the state and privatization of organizations once owned by the state. In the United States, deregulation of the airline industry in 1979 allowed 29 new airlines to enter the industry between 1979 and 1993. The increase in passenger-carrying capacity after deregulation led to excess capacity on many routes, intense competition, and fare wars. To respond to this more competitive task environment, airlines have had to look for ways to reduce operating costs. The development of hub-and-spoke systems, the rise of non-union airlines, and the introduction of no-frills discount service are all responses to increased competition in the airlines' task environment. Despite these innovations, the airline industry still experiences intense fare wars, which have lowered profits and caused numerous airline company bankruptcies. The global telecommunications service industry is now experiencing the same kind of turmoil following the deregulation of that industry in the United States and elsewhere.

## SUMMARY OF CHAPTER

1. An industry can be defined as a group of companies offering products or services that are close substitutes for each other. Close substitutes are products or services that satisfy the same basic customer needs.
2. The main technique used to analyze competition in the industry environment is the five forces model. The five forces are (a) the risk of new entry by potential competitors; (b) the extent of rivalry among established firms; (c) the bargaining power of buyers; (d) the bargaining power of suppliers; and (e) the threat of substitute products. The stronger each force is, the more competitive the industry and the lower the rate of return that can be earned.
3. The risk of entry by potential competitors is a function of the height of barriers to entry. The higher the barriers to entry are, the lower is the risk of entry and the greater the profits that can be earned in the industry.
4. The extent of rivalry among established companies is a function of an industry's competitive structure, demand conditions, cost conditions, and barriers to exit. Strong demand conditions moderate the competition among established companies and create opportunities for expansion. When demand is weak, intensive competition can develop, particularly in consolidated industries with high exit barriers.
5. Buyers are most powerful when a company depends on them for business but they themselves are not dependent on the company. In such circumstances, buyers are a threat.
6. Suppliers are most powerful when a company depends on them for business but they themselves are not dependent on the company. In such circumstances, suppliers are a threat.
7. Substitute products are the products of companies serving customer needs similar to the needs served by the industry being analyzed. The more similar the substitute products are to each other,

- the lower is the price that companies can charge without losing customers to the substitutes.
8. Some argue for a sixth competitive force of some significance: the power, vigor, and competence of complementors. Powerful and vigorous complementors may have a strong positive impact on demand in an industry.
  9. Most industries are composed of strategic groups: groups of companies pursuing the same or a similar strategy. Companies in different strategic groups pursue different strategies.
  10. The members of a company's strategic group constitute its immediate competitors. Because different strategic groups are characterized by different opportunities and threats, it may pay a company to switch strategic groups. The feasibility of doing so is a function of the height of mobility barriers.
  11. Industries go through a well-defined life cycle: from an embryonic stage, through growth, shake-out, and maturity, and eventually decline. Each stage has different implications for the competitive structure of the industry, and each gives rise to its own set of opportunities and threats.
  12. The five forces, strategic group, and industry life cycles models all have limitations. The five forces and strategic group models present a static picture of competition that deemphasizes the role of innovation. Yet innovation can revolutionize industry structure and completely change the strength of different competitive forces. The five forces and strategic group models have been criticized for deemphasizing the importance of individual company differences. A company will not be profitable just because it is based in an attractive industry or strategic group; much more is required. The industry life cycle model is a generalization that is not always followed, particularly when innovations revolutionize an industry.
  13. The macroenvironment affects the intensity of rivalry within an industry. Included in the macroenvironment are the macroeconomic environment, the global environment, the technological environment, the demographic and social environment, and the political and legal environment.

## DISCUSSION QUESTIONS

1. Under what environmental conditions are price wars most likely to occur in an industry? What are the implications of price wars for a company? How should a company try to deal with the threat of a price war?
2. Discuss Porter's five forces model with reference to what you know about the United States steel industry (see the Opening Case). What does the model tell you about the level of competition in this industry?
3. Identify a growth industry, a mature industry, and a declining industry. For each industry, identify the following: (a) the number and size distribution of companies; (b) the nature of barriers to entry; (c) the height of barriers to entry; and (d) the extent of product differentiation. What do these factors tell you about the nature of competition in each industry? What are the implications for the company in terms of opportunities and threats?
4. Assess the impact of macroenvironmental factors on the likely level of enrollment at your university over the next decade. What are the implications of these factors for the job security and salary level of your professors?



## PRACTICING STRATEGIC MANAGEMENT

### Small-Group Exercise: Competing with Microsoft

Break up into groups of three to five people, and discuss the following scenario. Appoint one group member as a spokesperson who will communicate your findings to the class.

You are a group of managers and software engineers at a small start-up. You have developed a revolutionary new operating system for personal computers that offers distinct advantages over Microsoft's Windows operating system: it takes up less memory space on the hard drive of a personal computer; it takes full advantage of the power of the personal computer's microprocessor and, in theory, can run software applications much faster than Windows; it is much easier to install and use than Windows; and it responds to voice instructions with an accuracy of 99.9%, in addition to input from a keyboard or mouse. The operating system is the only product offering that your company has produced.

Complete the following exercises:

1. Analyze the competitive structure of the market for personal computer operating systems. On the basis of this analysis, identify what factors might inhibit adoption of your operating system by customers.
2. Can you think of a strategy that your company might pursue, either alone or in conjunction with other enterprises, to "beat Microsoft"? What will it take to execute that strategy successfully?

### Article File 2

Find an example of an industry that has become more competitive in recent years. Identify the reasons for the increase in competitive pressure.

### Strategic Management Project: Module 2

This module requires you to analyze the industry environment in which your company is based using the information you have already gathered:

1. Apply the five forces model to the industry in which your company is based. What does this model tell you about the nature of competition in the industry?
2. Are any changes taking place in the macroenvironment that might have an impact, positive or negative, on the industry in which your company is based? If so, what are these changes, and how might they affect the industry?
3. Identify any strategic groups that might exist in the industry. How does the intensity of competition differ across these strategic groups?
4. How dynamic is the industry in which your company is based? Is there any evidence that innovation is reshaping competition or has done so in the recent past?
5. In what stage of its life cycle is the industry in which your company is based? What are the implications of this for the intensity of competition both now and in the future?
6. Is your company based in an industry that is becoming more global? If so, what are the implications of this change for competitive intensity?
7. Analyze the impact of national context as it pertains to the industry in which your company is based. Does national context help or hinder your company in achieving a competitive advantage in the global marketplace?

## CLOSING CASE

## The United States Beer Industry

Over the last few decades, the United States beer industry has been characterized by a very clear trend toward an increase in the concentration of the market. Today, some 80% of all beer consumed in the United States is produced by just three companies—Anheuser-Busch (which is now owned by InBev of Belgium), SAB-Miller, and Molson Coors—up from 57% of the market in 1980. Anheuser-Busch had almost 50% of the market in 2008, up from just 28.2% in 1980. SAB-Miller (formed in 2002 when South African Breweries merged with Miller Beer) had around 19% of the market, and Molson Coors (formed in 2005 when Canada's Molson merged with Coors) had 11% of the market.

Anheuser Busch, SAB-Miller, and Molson Coors dominate the *mass market* segment of the industry, where competition revolves around aggressive pricing, brand loyalty, distribution channels, and national advertising spending. In contrast, there is another segment in the industry, the *premium beer* segment, which is served by a large number of microbrewers and importers, the majority of which have a market share of less than 1%. The premium segment focuses on discerning buyers. Producers are engaged in the art of craft brewing. They build their brands around taste and cover higher product costs by charging much higher prices—roughly twice as much for a six pack as the mass market brewers. The microbrewers and importers have been gaining share and currently account for about 11% of the total market.

Over the last two decades, the industry has changed in a number of ways. First, consumption of beer in the United States has been gradually declining (even though consumption of premium beer has been increasing). Per capita consumption of beer peaked at 30 gallons in 1980 and fell to a low of 21.8 gallons in 2007. The decline in consumption was partly due to the growing popularity of substitutes, particularly wine and spirits. In 1994, Americans consumed 1.75 gallons of wine per capita. By 2006, that at figure

had risen 2.16 gallons. Consumption of spirits increased from 1.27 gallons per capita in 1994 to 1.34 gallons per capita over the same period.

Second, advertising spending has steadily increased, putting smaller brewers at a disadvantage. In 1975, the industry was spending \$0.18 per case on advertising; by 2002 it was spending \$0.40 per case. (These figures are in inflation adjusted or constant dollars.) Smaller mass-market brewers could not afford the expensive national TV advertising campaigns required to match the spending of the largest firms in the industry, and they saw their market share shrink as a result.

Third, due to a combination of technological change in canning and distribution and increased advertising expenditures, the size that a mass-market brewer has to attain to reap all economies of scale—called the *minimum efficient scale* of production—has steadily increased. In 1970, the minimum efficient scale of production was estimated to be 8 million barrels of beer a year, suggesting that a market share of 6.4% was required to reap significant economies of scale. By the early 2000s, the minimum efficient scale had increased to 23 million barrels, implying that a market share of 13.06% was required to reap significant economies of scale.

By the early 2000s, only 24 mass-market brewers were left in the United States, down from 82 in 1970. Among the remaining mass-market brewers, Anheuser Busch is the most consistent performer due to its superior economies of scale. The company's ROIC has been high, fluctuating in the 17% to 23% range between 1996 and 2008, while net profits grew from \$1.1 billion in 1996 to \$2 billion in 2008. In contrast, both Coors and Miller, along with most other mass market brewers, have had mediocre financial performance at best. Coors and Miller merged with Molson and SAB, respectively, in an attempt to gain economies of scale.<sup>30</sup>

### Case Discussion Questions

1. Why has the United States brewing industry become more concentrated over the last two decades?
2. Analyze the competitive structure of the industry using Porter's five forces model.
3. What are the implications of the evolving competitive structure in the brewing industry for the profitability and strategy of a smaller mass-market firm in the industry?
4. Are there different strategic groups in the industry? What are they? Do you think the nature of competition varies between groups?



# 3

## INTERNAL ANALYSIS: DISTINCTIVE COMPETENCIES, COMPETITIVE ADVANTAGE, AND PROFITABILITY

### LEARNING OBJECTIVES

After reading this chapter, you should be able to

- Discuss the source of competitive advantage
- Identify and explore the role of efficiency, quality, innovation, and customer responsiveness in building and maintaining a competitive advantage
- Explain the concept of the value chain
- Understand the link between competitive advantage and profitability
- Explain what impacts the durability of a company's competitive advantage

### Regaining McDonald's Competitive Advantage

McDonald's is an extraordinarily successful enterprise.

Started in 1955 when the legendary Ray Kroc decided to franchise the McDonald brothers' fast-food concept, McDonald's has grown into the largest restaurant chain in the world with almost 32,000 stores in 120 countries.

For decades, McDonald's success was grounded in a simple formula: give consumers value for money, good quick service, and consistent quality in a clean environment and they will come back time and time again. To deliver value for money and consistent quality, it standardized the process of order taking, making food, and service. Standardized processes raised the productivity of employees

while ensuring that customers had the same experience in any restaurant. McDonald's also developed close ties with wholesalers and food producers, managing its supply chain to reduce costs. As it became larger, its buying power enabled it to realize economies of scale in purchasing and to pass on cost savings to customers in the form of low-priced meals, which drove forward demand. And then there was the ubiquity of McDonald's; wherever people went, they could find one of their restaurants. This, coupled with the consistent experience and low prices, drove brand loyalty.



The formula worked well until the late 1990s and early 2000s. By then, McDonald's was under attack for contributing to obesity. Its low-priced, high-fat foods were dangerous, claimed the critics. The company's image was tarnished by the best-selling book, *Fast Food Nation*, and by the documentary, *Super Size Me*, which featured a journalist who rapidly gained weight by eating only McDonald's "super size" meals for a month. By 2002, sales were stagnating, and profits were falling. It seemed that McDonald's had lost its edge.

What followed was a classic corporate makeover that has enabled the company to regain its competitive advantage. First, top management was changed. Then, the emphasis was shifted. McDonald's scrapped its super-size menu and added healthier options, such as salads and apple slices. Executives mined data to see what people were eating and found that people were eating more chicken and less beef. So they emphasized chicken, adding grilled chicken sandwiches, wraps with chicken, Southern-style chicken sandwiches, and, most recently, chicken for breakfast. To be sure, the company still sells many low-cost "dollar meals" consisting of cheeseburgers and fries. Indeed, in the recessionary environment of 2008–2009, sales of dollar meals surged. However, chicken sales doubled at McDonald's between 2002 and 2008, and the company now buys more chicken than beef. The company also decided to use white chicken only, ending the speculation about the "mystery meat" in chicken McNuggets.

The company also changed its emphasis on beverages. For decades, beverages were afterthoughts at McDonald's, but executives could not help but note the rapid growth of Starbucks. In 2006, McDonald's decided to offer better coffee, including lattes. McDonald's improved the quality of its coffee by buying high-quality beans, using better equipment, and filtering its water. The company did not lose sight of the need to keep costs low and service quick, however, and has been adding coffee-making machines that produce lattes and cappuccinos in 45 seconds at the push of a button. Starbucks it is not, but for many people, a latte from the McDonald's drive-through window is good enough. Today, the machines have been installed in almost half of the stores in the United States.

The next change is in the design of the restaurants. The aging design is being phased out, to be replaced with sleek new buildings with trendy furnishings and lights, wide screen TVs, and Wi-Fi connections. The idea is to raise the perception of quality and, thereby, capture more customers.

Thus far, the changes seem to be working. Both sales and profits have been growing at a healthy clip, despite a difficult economic environment. In 2008, net profits were \$4 billion, up from \$1.7 billion in 2002, while revenues expanded from \$15.4 billion to \$24 billion. Profitability has also improved, with McDonald's return on invested capital (ROIC) increasing from 9.4% in 2002 to 18% in 2008.<sup>1</sup>

## Overview

Why, within a particular industry or market, do some companies outperform others? What is the basis of their (sustained) competitive advantage? The Opening Case provides some clues. The competitive advantage of McDonald's comes from efficiency, reliable quality, and customer responsiveness. McDonald's efficiency is due to its standardized processes, which boosts employee productivity, and its economies of scale in purchasing, both of which lower costs. Standardized processes also help



to ensure reliable quality. While McDonald's does not sell high-quality food, the quality is reliably consistent—something that consumers value. In addition, recently, McDonald's has been taking steps to raise the perceived quality of its offerings, serving healthier meals, using only white chicken meat, serving higher-quality coffee, and changing the format of its restaurants to make them more appealing. McDonald's customer responsiveness is demonstrated by its shift toward healthier meals and its decision to offer higher quality drinks, such as lattes and cappuccinos. In this manner, McDonald's responds to changes in the tastes and preferences of its customer base. As described in this chapter, efficiency, customer responsiveness, and reliable quality are three of the four main building blocks of competitive advantage. The other building block is innovation.

This chapter focuses on internal analysis, which is concerned with identifying the strengths and weaknesses of a company. Together with an analysis of a company's external environment, internal analysis gives managers the information they need to choose the business model and strategies that will enable their company to attain a sustained competitive advantage. Internal analysis is a three-step process: (1) Managers must understand the process by which companies create value for customers and profit for themselves, and they need to understand the role of resources, capabilities, and distinctive competencies in this process; (2) they need to understand how important superior efficiency, innovation, quality, and customer responsiveness are in creating value and generating high profitability; and (3) they must be able to analyze the sources of their company's competitive advantage to identify what is driving the profitability of their enterprise and where opportunities for improvement might lie. In other words, managers must be able to identify how the strengths of the enterprise boost its profitability and how any weaknesses lead to lower profitability.

Three more critical issues in internal analysis are addressed in this chapter. First, what factors influence the durability of competitive advantage? Second, why do successful companies sometimes lose their competitive advantage? Third, how can companies avoid competitive failure and sustain their competitive advantage over time?

After reading this chapter, you will understand the nature of competitive advantage and why managers need to perform internal analysis, just as they must conduct industry analysis, to achieve superior performance and profitability.

## THE ROOTS OF COMPETITIVE ADVANTAGE

A company has a *competitive advantage* over its rivals when its profitability is greater than the average profitability of all companies in its industry. It has a *sustained competitive advantage* when it is able to maintain above-average profitability over a number of years (as Walmart has done in the retail industry and McDonald's has done in the restaurant industry). The primary objective of strategy is to achieve a sustained competitive advantage, which in turn will result in superior profitability and profit growth. What are the sources of competitive advantage, and what is the link between strategy, competitive advantage, and profitability?

### Distinctive Competencies

Competitive advantage is based on distinctive competencies. **Distinctive competencies** are firm-specific strengths that allow a company to differentiate its products from those offered by rivals and/or achieve substantially lower costs than its rivals.

McDonald's, for example, has a distinctive competence in managing fast-food franchises, which leads to higher employee productivity and lower costs (see the Opening Case). Similarly, it can be argued Toyota, which is the standard outperformer in the automobile industry, has distinctive competencies in the development and operation of manufacturing processes. Toyota pioneered a whole range of manufacturing techniques, such as just-in-time inventory systems, self-managing teams, and reduced setup times for complex equipment. These competencies, collectively known as the "Toyota lean production system," helped it attain superior efficiency and product quality, the basis of its competitive advantage in the global automobile industry.<sup>2</sup> Distinctive competencies arise from two complementary sources: resources and capabilities.<sup>3</sup>

**Resources** Resources refer to the assets of a company. A company's resources can be divided into two types: tangible and intangible resources. **Tangible resources** are physical entities, such as land, buildings, plant, equipment, inventory, and money. **Intangible resources** are nonphysical entities that are created by managers and other employees, such as brand names, the reputation of the company, the knowledge that employees have gained through experience, and the intellectual property of the company, including that protected through patents, copyrights, and trademarks.

Resources are particularly *valuable* when they enable a company to create strong demand for its products, and/or to lower its costs. Toyota's valuable *tangible resources* include the equipment associated with its lean production system, much of which has been engineered specifically by Toyota for exclusive use in its factories. These valuable tangible resources allow Toyota to lower its costs, relative to its competitors. Similarly, Microsoft has a number of valuable *intangible resources*, including its brand name and the software code that underlies its Windows operating system. These valuable resources allow Microsoft to sell more of its products, relative to its competitors.

Valuable resources are more likely to lead to a sustainable competitive advantage if they are *rare*, in the sense that competitors do not possess them, and difficult for rivals to imitate; that is, if there are *barriers to imitation* (we will discuss the source of barriers to imitation in more detail later in this chapter). For example, the software code underlying Windows is rare because only Microsoft has full access to it. The code is also difficult to imitate. A rival cannot simply copy the software code underlying Windows and sell its own version of Windows because the code is protected by copyright law and copying it is illegal.

**Capabilities** Capabilities refer to a company's skills at coordinating its resources and putting them to productive use. These skills reside in an organization's rules, routines, and procedures, that is, the style or manner through which it makes decisions and manages its internal processes to achieve organizational objectives.<sup>4</sup> More generally, a company's capabilities are the product of its organizational structure, processes, control systems, and hiring systems. They specify how and where decisions are made within a company, the kind of behaviors the company rewards, and the company's cultural norms and values. (We discuss how organizational structure and control systems help a company obtain capabilities in Chapters 12 and 13.) Capabilities are intangible. They reside not so much in individuals as in the way individuals interact, cooperate, and make decisions within the context of an organization.<sup>5</sup>

Like resources, capabilities are particularly valuable if they enable a company to create strong demand for its products and/or to lower its costs. The competitive advantage of Southwest Airlines is based in large part on its capability to select,



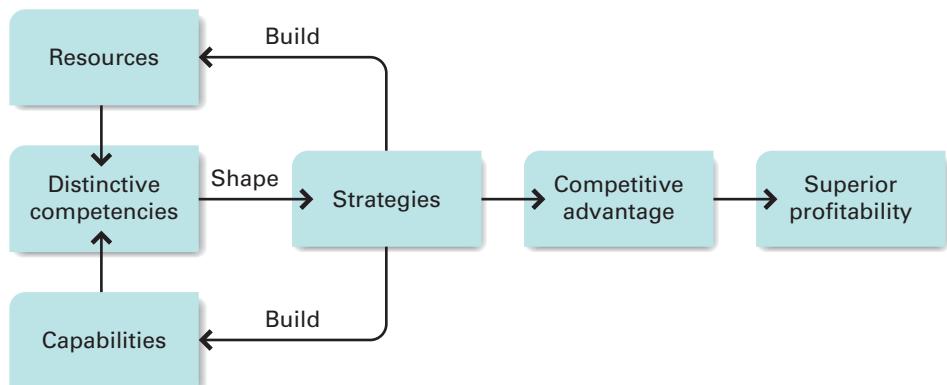
motivate, and manage its workforce in such a way that leads to high employee productivity and lower costs (like McDonald's in the Opening Case). As with resources, valuable capabilities are also more likely to lead to a sustainable competitive advantage if they are both rare and protected from copying by barriers to imitation.

**Resources, Capabilities, and Competencies** The distinction between resources and capabilities is critical to understanding what generates a distinctive competency. A company may have firm-specific and valuable resources, but unless it has the capability to use those resources effectively, it may not be able to create a distinctive competency. It is also important to recognize that a company may not need firm-specific and valuable resources to establish a distinctive competency so long as it has capabilities that no competitor possesses. For example, the steel mini-mill operator Nucor is widely acknowledged to be the most cost-efficient steelmaker in the United States. Its distinctive competency in low-cost steel-making does not come from any firm-specific and valuable resources. Nucor has the same resources (plant, equipment, skilled employees, know-how) as many other mini-mill operators. What distinguishes Nucor is its unique capability to manage its resources in a highly productive way. Specifically, Nucor's structure, control systems, and culture promote efficiency at all levels within the company.

In sum, for a company to have a distinctive competency, it must at a minimum have either (1) a firm-specific and valuable resource and the capabilities (skills) necessary to take advantage of that resource or (2) a firm-specific capability to manage resources (as exemplified by Nucor). A company's distinctive competency is strongest when it possesses both firm-specific and valuable resources and firm-specific capabilities to manage those resources.

**The Role of Strategy** Figure 3.1 illustrates the relationship of a company's strategies, distinctive competencies, and competitive advantage. Distinctive competencies shape the strategies that a company pursues, which lead to competitive advantage and superior profitability. However, it is also very important to realize that the strategies a company adopts can build new resources and capabilities or strengthen the existing resources and capabilities of the company, thereby enhancing the distinctive competencies of the enterprise. Thus, the relationship between

**Figure 3.1** Strategy, Resources, Capabilities, and Competencies



distinctive competencies and strategies is not a linear one; rather, it is a reciprocal one in which distinctive competencies shape strategies, and strategies help to build and create distinctive competencies.<sup>6</sup>

The history of the Walt Disney Company illustrates the way this process works. In the early 1980s, Disney suffered a string of poor financial years that culminated in a 1984 management shakeup when Michael Eisner was appointed CEO. Four years later, Disney's sales had increased from \$1.66 billion to \$3.75 billion, its net profits from \$98 million to \$570 million, and its stock market valuation from \$1.8 billion to \$10.3 billion. What brought about this transformation was the company's deliberate attempt to use its resources and capabilities more aggressively: Disney's enormous film library, its brand name, and its filmmaking skills, particularly in animation. Under Eisner, many old Disney classics were re-released, first in movie theaters and then on video, earning the company millions in the process. Then Eisner reintroduced the product that had originally made Disney famous: the full-length animated feature. Putting together its brand name and in-house animation capabilities, Disney produced a stream of major box office hits, including *The Little Mermaid*, *Beauty and the Beast*, *Aladdin*, *Pocahontas*, and *The Lion King*. Disney also started a cable television channel, the Disney Channel, to use this library and capitalize on the company's brand name. In other words, Disney's existing resources and capabilities shaped its strategies.

Through his choice of strategies, Eisner also developed new competencies in different parts of the business. In the filmmaking arm of Disney, for example, Eisner created a new low-cost film division under the Touchstone label, and the company had a string of low-budget box office hits. It entered into a long-term agreement with the computer animation company Pixar to develop a competency in computer-generated animated films. This strategic collaboration produced several hits, including *Toy Story* and *Monsters, Inc.* (In 2004, Disney acquired Pixar.) In sum, Disney's transformation was based not only on strategies that took advantage of the company's existing resources and capabilities but also on strategies that built new resources and capabilities such as those that underlie the company's competency in computer-generated animated films.

### Competitive Advantage, Value Creation, and Profitability

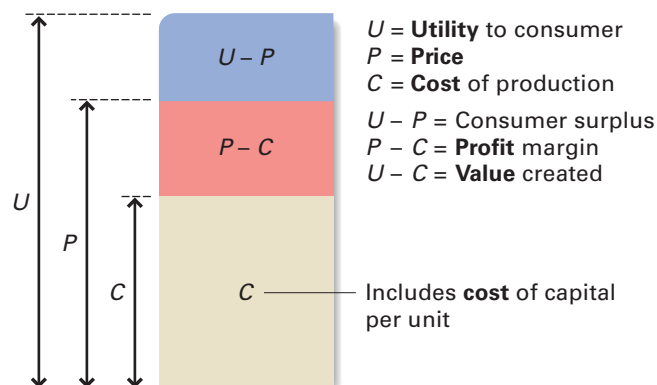
Competitive advantage leads to superior profitability. At the most basic level, how profitable a company becomes depends on three factors: (1) the value customers place on the company's products; (2) the price that a company charges for its products; and (3) the costs of creating those products. The value customers place on a product reflects the *utility* they get from a product—the happiness or satisfaction gained from consuming or owning the product. Utility must be distinguished from price. Utility is something that customers get from a product. It is a function of the attributes of the product, such as its performance, design, quality, and point-of-sale and after-sale service. For example, most customers would place a much higher utility value on a top-end Lexus car from Toyota than on a low-end basic economy car from Kia (they would value it more), precisely because they perceive the Lexus to have better performance and superior design, quality, and service. A company that strengthens the utility (or value) of its products in the eyes of customers has more pricing options: it can raise prices to reflect that utility (value) or hold prices lower to induce more customers to purchase its products, thereby expanding unit sales volume.

Whatever pricing option a company chooses, however, the price a company charges for goods or service is typically less than the utility value placed on goods or service by the customer. This is because the customer captures some of that utility in the form of what economists call a *consumer surplus*.<sup>7</sup> The customer is able to do this because the company is competing with other companies for the customer's business, so the company must charge a lower price than it could were it a monopoly supplier. Moreover, it is normally impossible to segment the market to such a degree that the company can charge each customer a price that reflects that individual's unique assessment of the utility of a product—what economists refer to as a customer's reservation price. For these reasons, the price that gets charged tends to be less than the utility value placed on the product by many customers. Nevertheless, remember the basic principle here: the more utility that consumers get from a company's products or services, the more pricing options it has.

These concepts are illustrated in Figure 3.2:  $U$  is the *average* utility value per unit of a product to a customer;  $P$  is the average price per unit that the company decides to charge for that product; and  $C$  is the average unit cost of producing that product (including actual production costs and the cost of capital investments in production systems). The company's average profit per unit is equal to  $P - C$ , and the consumer surplus is equal to  $U - P$ . In other words,  $U - P$  is a measure of the value the consumer captures, and  $P - C$  is a measure of the value the company captures. The company makes a profit so long as  $P$  is more than  $C$ , and its profitability will be greater the lower  $C$  is relative to  $P$ . Bear in mind that the difference between  $U$  and  $P$  is in part determined by the intensity of competitive pressure in the marketplace; the lower the intensity of competitive pressure is, the higher the price that can be charged relative to  $U$ , but the difference between  $U$  and  $P$  is also determined by the company's pricing choice.<sup>8</sup> As we shall see, a company may choose to keep prices low relative to volume because lower prices enable the company to sell more products, attain economies of scale, and boost its profit margin by lowering  $C$  relative to  $P$ .

Note also that the value created by a company is measured by the difference between the utility a consumer gets from the product ( $U$ ) and the costs of production ( $C$ ), that is,  $U - C$ . A company creates value by converting factors of production that cost  $C$  into a product from which customers get a utility of  $U$ . A company

**Figure 3.2** Value Creation per Unit

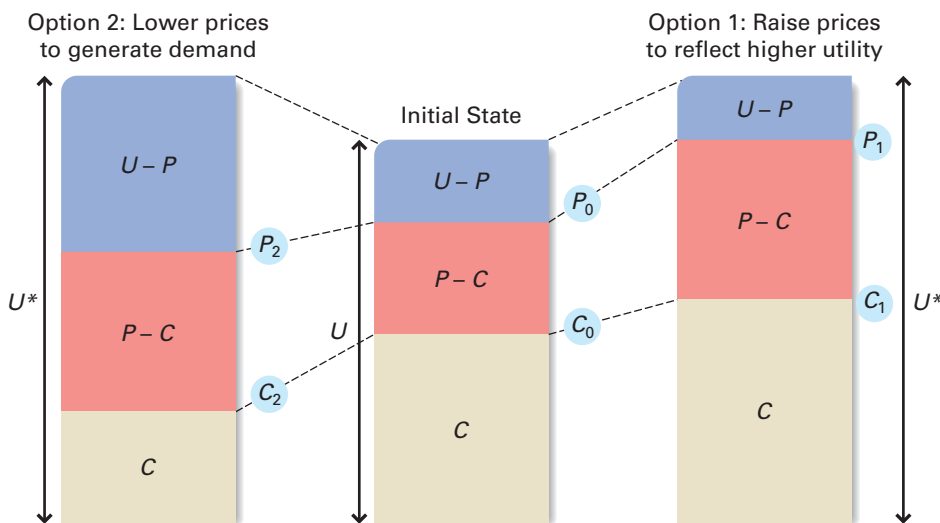


can create more value for its customers by lowering  $C$  or making the product more attractive through superior design, performance, quality, service, and the like. When customers assign a greater utility to the product ( $U$  increases), they are willing to pay a higher price ( $P$  increases). This discussion suggests that a company has a competitive advantage and high profitability when it creates more value for its customers than do rivals.<sup>9</sup>

The company's pricing options are captured in Figure 3.3. Suppose a company's current pricing option is the one pictured in the middle column of Figure 3.3. Imagine that the company decides to pursue strategies to increase the utility of its product offering from  $U$  to  $U^*$  to boost its profitability. Increasing utility initially raises production costs because the company has to spend money to increase product performance, quality, service, and other factors. Now there are two different pricing options that the company can pursue. Option 1 is to raise prices to reflect the higher utility: the company raises prices more than its costs increase, and profit per unit ( $P - C$ ) increases. Option 2 involves a very different set of choices: the company lowers prices to expand unit volume. Basically, what is happening here is that customers recognize that they are getting a great bargain because price is now much lower than utility (the consumer surplus has increased), so they rush out to buy more (demand has increased). As unit volume expands due to increased demand, the company is able to realize economies of scale and reduce its average unit costs. Although creating the extra utility initially costs more and prices are now lowered, profit margins widen because the average unit costs of production fall as volume increases and economies of scale are attained.

Managers need to understand the dynamic relationships among utility, pricing, demand, and costs and make decisions on the basis of that understanding to maximize competitive advantage and profitability. Option 2 in Figure 3.3, for example, might not be a viable strategy if demand did not increase rapidly with lower prices or if there are few economies of scale to be had by increasing volume. Managers must

**Figure 3.3** Value Creation and Pricing Options

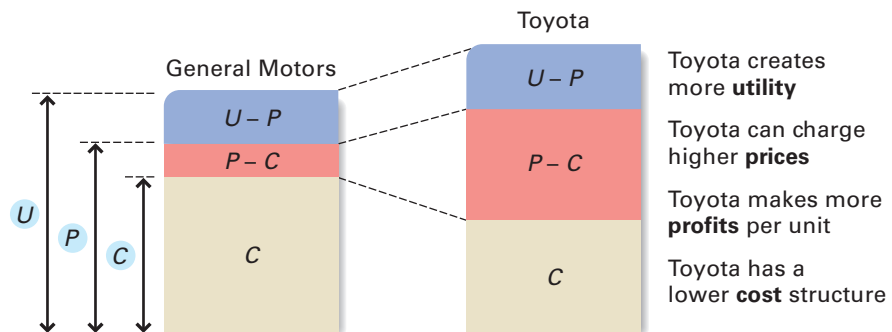


understand how value creation and pricing decisions affect demand and also how unit costs change with increases in volume. In other words, they must have a good grasp of the demand for the company's product and its cost structure at different levels of output if they are to make decisions that maximize profitability.

Consider the automobile industry. According to a 2008 study by Oliver Wyman, in 2007 Toyota made \$922 in profit on every vehicle it manufactured in North America. GM, in contrast, lost \$729 on every vehicle it made.<sup>10</sup> What accounts for the difference? First, Toyota has the best reputation for quality in the industry. According to annual surveys issued by J. D. Power and Associates, Toyota consistently tops the list in terms of quality, while GM cars are at best in the middle of the pack. The higher quality translates into a higher utility and allows Toyota to charge 5% to 10% higher prices than GM for equivalent cars. Second, Toyota has a lower cost per vehicle than GM, in part because of its superior labor productivity. For example, in Toyota's North American plants, it took an average of 30.37 employee hours to build a car, compared to 32.29 at GM plants in North America. That 1.94-hour productivity advantage translates into lower labor costs for Toyota; hence, a lower overall cost structure. Therefore, as summarized in Figure 3.4, Toyota's advantage over GM derives from greater utility ( $U$ ), which has allowed the company to charge a higher price ( $P$ ) for its cars, and from a lower cost structure ( $C$ ), which taken together implies significantly greater profitability per vehicle ( $P - C$ ).

Toyota's decisions with regard to pricing are guided by its managers' understanding of the relationship of utility, prices, demand, and costs. Given its ability to build more utility into its products, Toyota could have charged even higher prices than illustrated in Figure 3.4, but that might have led to lower sales volume, fewer economies of scale, higher unit costs, and lower profit margins. Toyota's managers have sought to find the pricing option that enables the company to maximize its profits given their assessment of demand for its products and its cost function. Thus, to create superior value, a company does not have to have the lowest cost structure in an industry or create the product with the highest utility in the eyes of customers. All that is necessary is that the gap between perceived utility ( $U$ ) and costs of production ( $C$ ) is greater than the gap attained by competitors.

**Figure 3.4** Comparing Toyota and GM



Note that Toyota has differentiated itself from General Motors by its superior quality, which allows it to charge higher prices; its superior productivity translates into a lower cost structure. Thus, its competitive advantage over General Motors is the result of strategies that have led to distinctive competencies, resulting in greater differentiation and a lower cost structure.

Indeed, at the heart of any company's business model is the combination of congruent strategies aimed at creating distinctive competencies that (1) differentiate its products in some way so that its consumers derive more utility from them, which gives the company more pricing options, and (2) result in a lower cost structure, which also gives it a broader range of pricing choices.<sup>11</sup> Achieving a sustained competitive advantage and superior profitability requires the right choices with regard to utility through differentiation and pricing given the demand conditions in the company's market and the company's cost structure at different levels of output. This issue is addressed in detail in the following chapters.

## THE VALUE CHAIN

All of the functions of a company—such as production, marketing, product development, service, information systems, materials management, and human resources—have a role in lowering the cost structure and increasing the perceived utility (value) of products through differentiation. As the first step in examining this concept, consider the value chain, which is illustrated in Figure 3.5.<sup>12</sup> The term **value chain** refers to the idea that a company is a chain of activities for transforming inputs into outputs that customers value. The transformation process involves a number of primary activities and support activities that add value to the product.

### Primary Activities

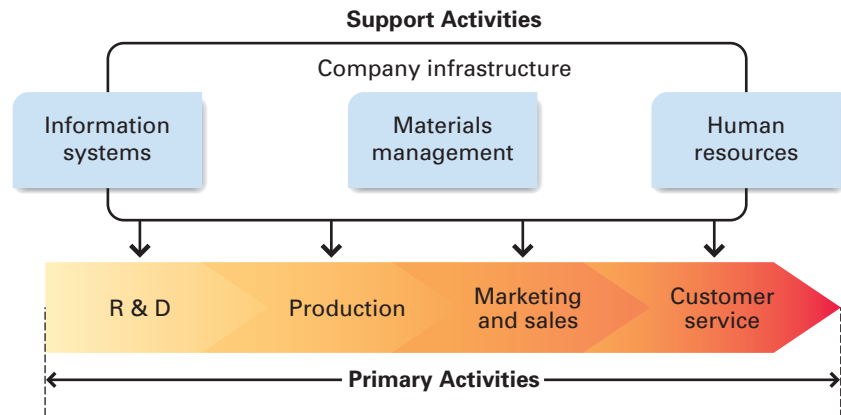
**Primary activities** have to do with the design, creation, and delivery of the product, its marketing, and its support and after-sales service. In the value chain illustrated in Figure 3.5, the primary activities are broken down into four functions: research and development, production, marketing and sales, and customer service.

**Research and Development** Research and development is concerned with the design of products and production processes. Although we think of R&D as being associated with the design of physical products and production processes in manufacturing enterprises, many service companies also undertake R&D. For example, banks compete with each other by developing new financial products and new ways of delivering those products to customers. Online banking and smart debit cards are two recent examples of the fruits of new-product development in the banking industry. Earlier examples of innovation in the banking industry were ATM machines, credit cards, and debit cards.

By creating superior product design, R&D can increase the functionality of products, which makes them more attractive to customers, thereby adding value. Alternatively, the work of R&D may result in more efficient production processes, thereby lowering production costs. Either way, the R&D function can help to lower costs or raise the utility of a product and permit a company to charge higher prices. At Intel,

### Ethical Dilemma

Your friend manages a highly profitable retailer. She attributes the principle source of competitive advantage to low labor costs, which are a result of her hiring minimum wage workers, denying worker benefits, and her consistent opposition to unionization at the company. Although she acknowledges that this approach leads to high employee turnover, she argues that the jobs are low skilled and easily refilled. Is your friend's approach to doing business ethical? Are there ways of achieving low labor costs without relying on placement of minimum wage workers? Would you counsel your friend to use an alternative approach?

**Figure 3.5** The Value Chain

for example, R&D creates value by developing ever more powerful microprocessors and helping to pioneer ever more efficient manufacturing processes (in conjunction with equipment suppliers).

It is important to emphasize that R&D is not just about enhancing the features and functions of a product; it is also about the elegance of a product's design, which can create an impression of superior value in the minds of consumers. For example, part of the success of Apple Computer's iPod player has been based on the elegance and appeal of the iPod design, which has turned this piece of electronic equipment into a fashion accessory. For another example of how design elegance can create value, see Strategy in Action 3.1, which discusses value creation at the fashion house Burberry.

**Production** Production is concerned with the creation of a good or service. For physical products, when we talk about production, we generally mean manufacturing. For services such as banking or retail operations, "production" typically takes place when the service is delivered to the customer, as when a bank makes a loan to a customer. By performing its activities efficiently, the production function of a company helps to lower its cost structure. For example, the efficient production operations of Honda and Toyota help those automobile companies achieve higher profitability relative to competitors such as General Motors. The production function can also perform its activities in a way that is consistent with high product quality, which leads to differentiation (and higher value) and lower costs.

**Marketing and Sales** There are several ways in which the marketing and sales functions of a company can help to create value. Through brand positioning and advertising, the marketing function can increase the value that customers perceive to be contained in a company's product (and thus the utility they attribute to the product). Insofar as these help to create a favorable impression of the company's product in the minds of customers, they increase utility. For example, the French company Perrier persuaded U.S. customers that slightly carbonated bottled water was worth \$1.50 per bottle rather than a price closer to the \$0.50 that it cost to collect, bottle,



## 3.1 STRATEGY IN ACTION

### Value Creation at Burberry

When Rose Marie Bravo, the highly regarded president of Saks Fifth Avenue, announced in 1997 that she was leaving to become CEO of the ailing British fashion house Burberry, people thought she was crazy. Burberry, best known as a designer of raincoats with the trademark tartan linings, had been described as an outdated, stuffy business with a fashion cachet of almost zero. When she stepped down from the Burberry position in 2006, Bravo was heralded in Britain and the United States as one of the world's best managers. During her tenure, she had engineered a remarkable turnaround, leading a transformation of Burberry into what one commentator called an "achingly hip" high-end fashion brand whose famous tartan bedecks everything from raincoats to bikinis and handbags to luggage in a riot of color from pink to blue to purple. In less than a decade, Burberry had become one of the most valuable luxury fashion brands in the world.

When asked how she achieved the transformation, Bravo explained that there was hidden brand value that was unleashed by constant creativity and innovation. Bravo hired world-class designers to redesign Burberry's tired fashion line and bought in Christopher Bailey, one

of the very best, to lead the design team. The marketing department worked closely with advertisers to develop hip ads that would appeal to a younger, well-heeled audience. The ads featured supermodel Kate Moss promoting the line, using a top fashion photographer to shoot the model wearing Burberry. Burberry exercised tight control over distribution, pulling its products from stores whose image was not consistent with the brand, and expanding its own chain of Burberry stores.

Bravo also noted that "Creativity doesn't just come from designers ... ideas can come from the sales floor, the marketing department, even from accountants, believe or not. People at whatever level they are working have a point of view and have something to say that is worth listening to." Bravo emphasized the importance of teamwork. "One of the things I think people overlook is the quality of the team. It isn't one person, and it isn't two people. It is a whole group of people—a team that works cohesively toward a goal—that makes something happen or not." She noted that her job is to build the team and then motivate them, "keeping them on track, making sure that they are following the vision."

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**Sources:** Quotes from S. Beatty, "Bass Talk: Plotting Plaid's Future," *The Wall Street Journal*, September 9, 2004, B1. Also see C. M. Moore and G. Birtwistle, "The Burberry Business Model," *International Journal of Retail and Distribution Management* 32 (2004): 412–422; M. Dickson, "Bravo's Legacy in Transforming Burberry," *Financial Times*, October 6, 2005, 22.

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and distribute the water. Perrier's marketing function essentially increased the perception of utility that customers ascribed to the product. Similarly, by helping to re-brand the company and its product offering, the marketing department at Burberry helped to create value (see Strategy in Action 3.1). Marketing and sales can also create value by discovering customer needs and communicating them back to the R&D function of the company, which can then design products that better match those needs.

**Customer Service** The role of the service function of an enterprise is to provide after-sales service and support. This function can create superior utility by solving customer problems and supporting customers after they have purchased the product. For example, Caterpillar, the U.S.-based manufacturer of heavy earth-moving equipment, can get spare parts to any point in the world within 24 hours, thereby minimizing the amount of downtime its customers have to face if their equipment malfunctions.

This is an extremely valuable support capability in an industry where downtime is expensive. It has helped to increase the utility that customers associate with Caterpillar products and, thus, the price that Caterpillar can charge for its products.

## Support Activities

The **support activities** of the value chain provide inputs that allow the primary activities to take place. These activities are broken down into four functions: materials management (or logistics), human resources, information systems, and company infrastructure (see Figure 3.5).

**Materials Management (Logistics)** The materials management (or logistics) function controls the transmission of physical materials through the value chain, from procurement through production and into distribution. The efficiency with which this is carried out can significantly lower costs, thereby creating more value. Dell has a very efficient materials management process. By tightly controlling the flow of component parts from its suppliers to its assembly plants and into the hands of consumers, Dell has dramatically reduced its inventory holding costs. Lower inventories mean lower costs and, hence, greater value creation. Another company that has benefited from very efficient materials management, the Spanish fashion company Zara, is discussed in Strategy in Action 3.2.

**Human Resources** There are a number of ways in which the human resource function can help an enterprise create more value. This function ensures that the company has the right mix of skilled people to perform its value creation activities effectively. It is also the job of the human resource function to ensure that people are adequately trained, motivated, and compensated to perform their value creation tasks. If the human resources are functioning well, employee productivity rises (which lowers costs) and customer service improves (which raises utility), thereby enabling the company to create more value.

**Information Systems** Information systems are largely electronic systems for managing inventory, tracking sales, pricing products, selling products, dealing with customer service inquiries, and so on. Information systems, when coupled with the communications features of the Internet, are holding out the promise of being able to improve the efficiency and effectiveness with which a company manages its other value creation activities. Again, Dell uses Web-based information systems to efficiently manage its global logistics network and increase inventory turnover. World-class information systems are also an aspect of Zara's competitive advantage (see Strategy in Action 3.2).

**Company Infrastructure** Company infrastructure is the company-wide context within which all the other value creation activities take place: the organizational structure, control systems, and company culture. Because top management can exert considerable influence in shaping these aspects of a company, top management should also be viewed as part of the infrastructure of a company. Indeed, through strong leadership, top management can shape the infrastructure of a company and the performance of all other value-creation activities that take place within it. A good example of this process is given in Strategy in Action 3.1, which looks at how Rose Marie Bravo helped to engineer a turnaround at Burberry.

## 3.2 STRATEGY IN ACTION

### Competitive Advantage at Zara

The fashion retailer Zara is one of Spain's fastest growing and most successful companies with sales of some \$8.5 billion and a network of 2,800 stores in 64 countries. Zara's competitive advantage centers on one thing—speed. While it takes most fashion houses six to nine months to go from design to having merchandise delivered to a store, Zara can pull off the entire process in just five weeks. This rapid response time enables Zara to quickly respond to changing fashions.

Zara achieves this by breaking many of the rules of operation in the fashion business. While most fashion houses outsource production, Zara has its own factories and keeps about half of its production in-house. Zara also has its own designers and stores. Its designers are in constant contact with the stores, not only tracking what is selling on a real-time basis through information systems but also talking to store managers once a week to get their subjective impressions of what is hot. This information supplements data gathered from other sources, such as fashion shows.

Drawing on this information, Zara's designers create approximately 40,000 new designs per year from which 10,000 are selected for production. Zara then purchases basic textiles from global suppliers but performs capital intensive production activities in its own factories. These factories use computer-controlled machinery

to cut pieces for garments. Zara does not produce in large volumes to attain economies of scale; instead it produces in small lots. Labor-intensive activities, such as sewing, are performed by subcontractors located close to Zara's factories. Zara makes a practice of having more production capacity than necessary, so that if an emerging fashion trend is spotted, the company can quickly respond by designing garments and ramping up production.

Once garments have been made, they are delivered to one of Zara's warehouses and then shipped to its stores weekly. Zara deliberately underproduces products, supplying small batches of products in hot demand before quickly shifting to the next fashion trend. Often the merchandise sells out quickly. The empty shelves in Zara stores create a scarcity value—which helps to generate demand. Customers quickly snap up products they like because they know they may soon be out of stock and not produced again.

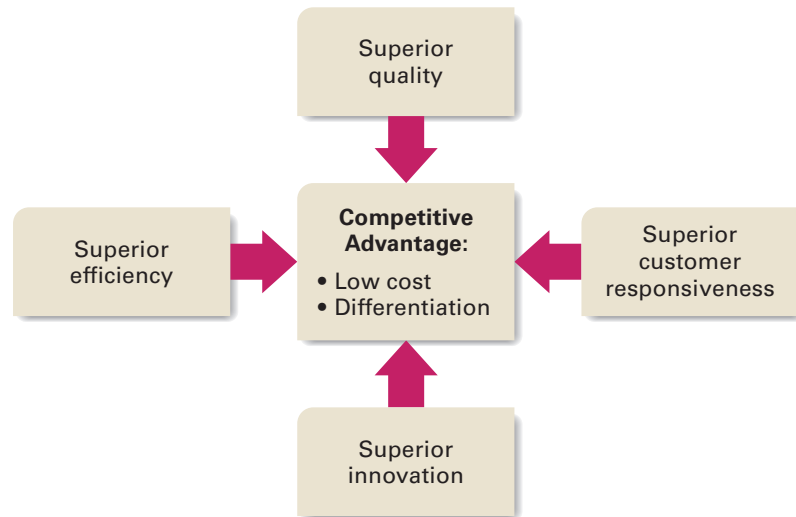
As a result of this strategy, which is supported by competencies in design, information systems, and logistics management, Zara carries fewer inventories than competitors (Zara's inventory amounts to about 10% of sales, compared to 15% at rival stores like Gap Inc. and Benetton). This means fewer price reductions to move products that have not sold and higher profit margins.

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**Source:** Staff Reporter, "Shining Examples," *The Economist: A Survey of Logistics*, June 17, 2006, 4–6; K. Capell, et al., "Fashion Conquistador," *Business Week*, September 4, 2006, 38–39; K. Ferdows, et al., "Rapid Fire Fulfillment," *Harvard Business Review* 82 (2004), 101–107.

## THE BUILDING BLOCKS OF COMPETITIVE ADVANTAGE

Four factors help a company build and sustain competitive advantage: superior efficiency, quality, innovation, and customer responsiveness. Each of these factors is the product of a company's distinctive competencies. Indeed, in a very real sense they are "generic" distinctive competencies. These generic competencies allow a company to (1) differentiate its product offering and offer more utility to its customers and (2) lower its cost structure (see Figure 3.6). These factors can be considered generic distinctive competencies because any company, regardless of its industry or the products or services it produces, can pursue them. Although they are discussed sequentially,

**Figure 3.6** Building Blocks of Competitive Advantage

they are highly interrelated, and the important ways they affect each other here should be noted. For example, superior quality can lead to superior efficiency, and innovation can enhance efficiency, quality, and responsiveness to customers.

### Efficiency

In one sense, a business is simply a device for transforming inputs into outputs. Inputs are basic factors of production, such as labor, land, capital, management, and technological know-how. Outputs are the goods and services that the business produces. The simplest measure of efficiency is the quantity of inputs that it takes to produce a given output, that is,  $\text{efficiency} = \text{outputs}/\text{inputs}$ . The more efficient a company is, the fewer the inputs required to produce a given output.

The most common measure of efficiency for many companies is employee productivity. **Employee productivity** refers to the output produced per employee. For example, if it takes GM 30 hours of employee time to assemble a car and it takes Ford 25 hours, we can say that Ford has higher employee productivity than GM and is, thus, more efficient. As long as other things are equal, such as wage rates, we can assume from this information that Ford will have a lower cost structure than GM. Thus, employee productivity helps a company attain a competitive advantage through a lower cost structure.

### Quality as Excellence and Reliability

A product can be thought of as a bundle of attributes.<sup>13</sup> The attributes of many physical products include their form, features, performance, durability, reliability, style, and design.<sup>14</sup> A product is said to have *superior quality* when customers perceive that its attributes provide them with higher utility than the attributes of products sold by rivals. For example, a Rolex watch has attributes—such as design, styling, performance, and reliability—that customers perceive as being superior to the same

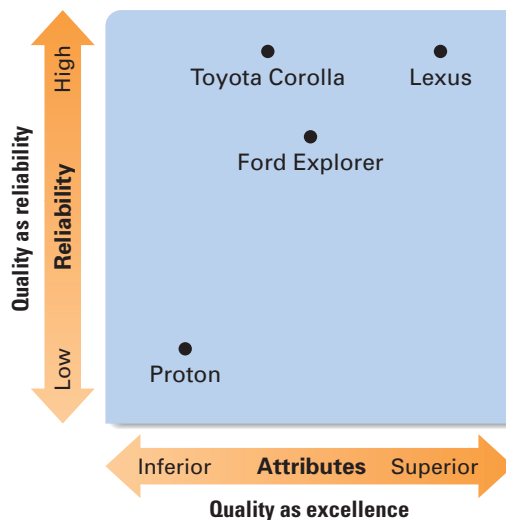
attributes in many other watches. Thus, we can refer to a Rolex as a high-quality product: Rolex has differentiated its watches by these attributes.

When customers evaluate the quality of a product, they commonly measure it against two kinds of attributes: those related to *quality as excellence* and those related to *quality as reliability*. From a quality-as-excellence perspective, the important attributes are things such as a product's design and styling, its aesthetic appeal, its features and functions, the level of service associated with the delivery of the product, and so on. For example, customers can purchase a pair of imitation leather boots for \$20 from Walmart, or they can buy a handmade pair of butter-soft leather boots from Nordstrom for \$500. The boots from Nordstrom will have far superior styling, feel more comfortable, and look much better than those from Walmart. The utility consumers will get from the Nordstrom boots will in all probability be much greater than the utility derived from the Walmart boots, but of course, they will have to pay far more for them. That is the point: when excellence is built into a product offering, consumers have to pay more to own or consume it.

With regard to quality as reliability, a product can be said to be reliable when it consistently does the job it was designed for, does it well, and rarely, if ever, breaks down. As with excellence, reliability increases the utility a consumer gets from a product and, thus, the price the company can charge for that product. Toyota's cars, for example, have the highest reliability ratings in the automobile industry, and, therefore, consumers are prepared to pay more for them than for cars that are very similar in other attributes. As we shall see, increasing product reliability has been the central goal of an influential management philosophy that came out of Japan in the 1980s, which is commonly referred to as **total quality management (TQM)**.

The position of a product against two dimensions, reliability and other attributes, can be plotted on a figure similar to Figure 3.7. For example, a Lexus has attributes—such as design, styling, performance, and safety features—that customers perceive as demonstrating excellence in quality and that are viewed as being superior to those of most other cars. Lexus is also a very reliable car. Thus, the overall

**Figure 3.7** A Quality Map for Automobiles



level of quality of the Lexus is very high, which means that the car offers consumers significant utility. This gives Toyota the option of charging a premium price for the Lexus. Toyota also produces another very reliable vehicle, the Toyota Corolla, but this product is positioned for less-wealthy customers and lacks many of the superior attributes of the Lexus. Thus, although the Corolla is also a high-quality car in the sense of being reliable, it is not as high-quality as a Lexus in the sense of being an excellent product. At the other end of the spectrum, we can find poor-quality products that have both low reliability and inferior attributes, such as poor design, performance, and styling. An example is the Proton, which is built by the Malaysian car firm of the same name. The design of the car is more than a decade old and has a dismal reputation for styling and safety. Moreover, Proton's reliability record is one of the worst of any car, according to J. D. Power.<sup>15</sup>

The concept of quality applies whether we are talking about Toyota automobiles, clothes designed and sold by Gap Inc. the customer service department of Citibank, or the ability of airlines to arrive on time. Quality is just as relevant to services as it is to goods.<sup>16</sup> The impact of high product quality on competitive advantage is twofold.<sup>17</sup> First, providing high-quality products increases the utility those products provide to customers, which gives the company the option of charging a higher price for them. In the automobile industry, for example, Toyota can charge a higher price for its cars because of the higher quality of its products.

The second impact of high quality on competitive advantage comes from the greater efficiency and the lower unit costs associated with reliable products. When products are reliable, less employee time is wasted making defective products or providing substandard services, and less time has to be spent fixing mistakes, which translates into higher employee productivity and lower unit costs. Thus, high product quality not only enables a company to differentiate its product from that of rivals, but if the product is reliable, it also lowers costs.

The importance of reliability in building competitive advantage has increased dramatically over the past decade. Indeed, so crucial is the emphasis placed on reliability by many companies that achieving high product reliability can no longer be viewed as just one way of gaining a competitive advantage. In many industries, it has become an absolute imperative for survival.

## Innovation

Innovation refers to the act of creating new products or processes. There are two main types of innovation: **product innovation** and **process innovation**. Product innovation is the development of products that are new to the world or have superior attributes to existing products. Examples are Intel's invention of the microprocessor in the early 1970s, Cisco's development of the router for routing data over the Internet in the mid-1980s, and Apple's development of the iPod in the early 2000s. **Process innovation** is the development of a new process for producing products and delivering them to customers. Examples include Toyota, which developed a range of new techniques known as the Toyota lean production system for making automobiles: just-in-time inventory systems, self-managing teams, and reduced setup times for complex equipment.

Product innovation creates value by creating new products, or enhanced versions of existing products, that customers perceive as having more utility, thus increasing the company's pricing options. Process innovation often allows a company to create more value by lowering production costs. Toyota's lean production system, for

example, helped to boost employee productivity, thus giving Toyota a cost-based competitive advantage.<sup>18</sup> Similarly, Staples' application of the supermarket business model to retail office supplies dramatically lowered the cost of selling office supplies. Staples passed on some of this cost saving to customers in the form of lower prices, which enabled the company to rapidly increase its market share.

In the long run, innovation of products and processes is perhaps the most important building block of competitive advantage.<sup>19</sup> Competition can be viewed as a process driven by innovations. Although not all innovations succeed, those that do can be a major source of competitive advantage because, by definition, they give a company something unique—something its competitors lack (at least until they imitate the innovation). Uniqueness can allow a company to differentiate itself from its rivals and charge a premium price for its product or, in the case of many process innovations, reduce its unit costs far below those of competitors.

## Customer Responsiveness

To achieve superior responsiveness to customers, a company must be able to do a better job than its competitors of identifying and satisfying its customers' needs. Customers will then attribute more utility to its products, creating a differentiation based on competitive advantage. Improving the quality of a company's product offering is consistent with achieving responsiveness, as is developing new products with features that existing products lack. In other words, achieving superior quality and innovation is integral to achieving superior responsiveness to customers.

Another factor that stands out in any discussion of responsiveness to customers is the need to customize goods and services to the unique demands of individual customers or customer groups. For example, the proliferation of soft drinks and beers can be viewed partly as a response to this trend. Automobile companies have become more adept at customizing cars to the demands of individual customers. For instance, following the lead of Toyota, Saturn builds cars to order for individual customers, letting them choose from a wide range of colors and options.

An aspect of responsiveness to customers that has drawn increasing attention is **customer response time**: the time that it takes for a good to be delivered or a service to be performed.<sup>20</sup> For a manufacturer of machinery, response time is the time it takes to fill customer orders. For a bank, it is the time it takes to process a loan or the length of time that a customer must stand in line to wait for an available teller. For a supermarket, it is the time that customers must stand in checkout lines. For a fashion retailer, it is the time required to take a new product from design to a retail store (see Strategy in Action 3.2 for a discussion of how the Spanish fashion retailer Zara minimizes this). Survey after survey has shown that slow response time is a major source of customer dissatisfaction.<sup>21</sup>

Other sources of enhanced responsiveness to customers are superior design, service, and after-sales service and support. All of these factors enhance responsiveness to customers and allow a company to differentiate itself from its less-responsive competitors. In turn, differentiation enables a company to build brand loyalty and charge premium prices for its products. Consider how much more people are prepared to pay for next-day delivery of Express Mail, as opposed to standard delivery in three to four days. In 2009, a two-page letter sent overnight by Express Mail within the United States cost about \$13, compared with 44 cents for regular mail. Thus, the price premium for express delivery (reduced response time) was \$12.60, or a premium of about 2,757% over the regular price.



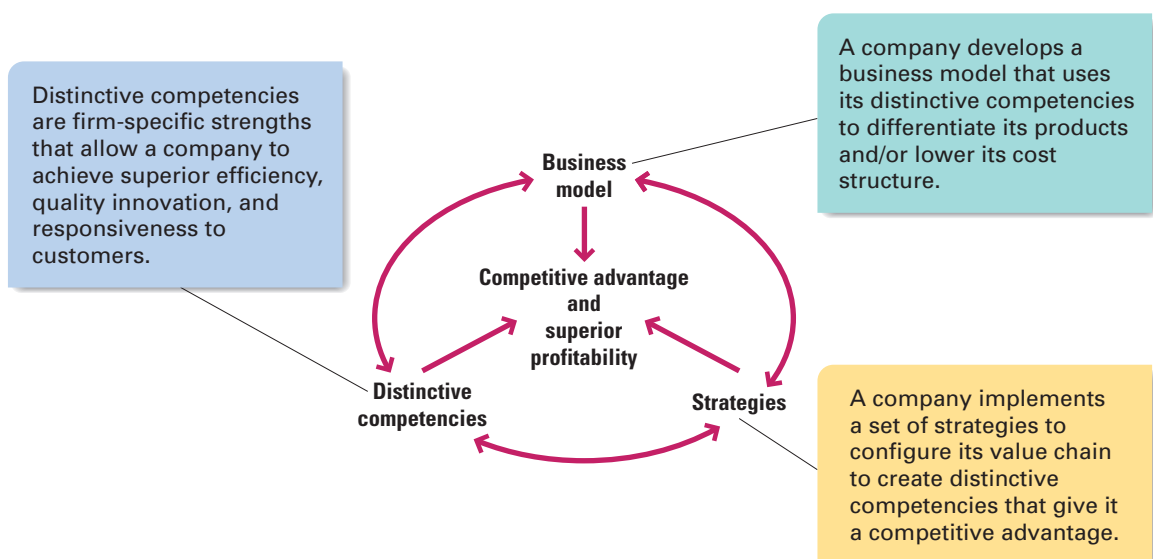
## BUSINESS MODELS, THE VALUE CHAIN, AND GENERIC DISTINCTIVE COMPETENCIES

As noted in Chapter 1, a business model is a manager's conception, or gestalt, of how the various strategies that a firm pursues fit together into a congruent whole, enabling the firm to achieve a competitive advantage. More precisely, a business model represents the way in which managers configure the value chain of the firm through strategy, as well as the investments they make to support that configuration, so that they can build the distinctive competencies necessary to attain the efficiency, quality, innovation, and customer responsiveness required to support the firm's low-cost or differentiated position, thereby achieving a competitive advantage and generating superior profitability (see Figure 3.8).

For example, the main strategic goal of Walmart is to be the lowest-cost operator offering a wide range of general merchandise in the retail industry. Walmart's business model involves offering general merchandise in a self-service supermarket type of setting. Walmart's strategies flesh out this business model and help the company to attain its strategic goal. To reduce costs, Walmart limits investments in the fittings and fixtures of its stores. One of the keys to generating sales and lowering costs in this setting is rapid inventory turnover, which is achieved through strategic investments in logistics and information systems. Walmart makes major investments in process innovation to improve the effectiveness of its information and logistics systems, which enables the company to respond to customer demands for low-priced goods when they walk in the door and to do so in a very efficient manner.

Walmart's business model is much different from that found at a retailer such as Nordstrom. Nordstrom's business model is to offer high-quality, high-priced apparel in a full-service, sophisticated setting. This implies differences in the way

**Figure 3.8** Competitive Advantage and the Value Creation Cycle



the value chain is configured. Nordstrom devotes far more attention to in-store customer service than Walmart does, which implies significant investments in its salespeople. Moreover, Nordstrom invests far more in the furnishings and fittings for its stores, as opposed to Walmart, whose stores have a basic “warehouse feel” to them. Nordstrom recaptures the costs of its investment by charging higher prices for higher-quality merchandise. Thus, even though Walmart and Nordstrom both sell apparel (Walmart is the biggest seller of apparel in the United States), their business models imply very different positioning in the marketplace and a very different configuration of value chain activities and investments.

## ANALYZING COMPETITIVE ADVANTAGE AND PROFITABILITY

If a company’s managers are to perform a good internal analysis, they need to be able to analyze the financial performance of their company, identifying how its strategies contribute (or not) to profitability. To identify strengths and weaknesses effectively, they need to be able to compare, or benchmark, the performance of their company against that of competitors and the historic performance of the company itself. This will help them determine whether (1) they are more or less profitable than competitors and whether the performance of the company has been improving or deteriorating over time; (2) their company strategies are maximizing the value being created; (3) their cost structure is out of line with those of competitors; and (4) they are using the resources of the company to the greatest effect.

As we noted in Chapter 1, the key measure of a company’s financial performance is its profitability, which captures the return that a company is generating on its investments. Although several different measures of profitability exist, such as return on assets and return on equity, many authorities on the measurement of profitability argue that ROIC is the best measure because “it focuses on the true operating performance of the company.”<sup>22</sup> (However, return on assets is very similar in formulation to return on invested capital.)

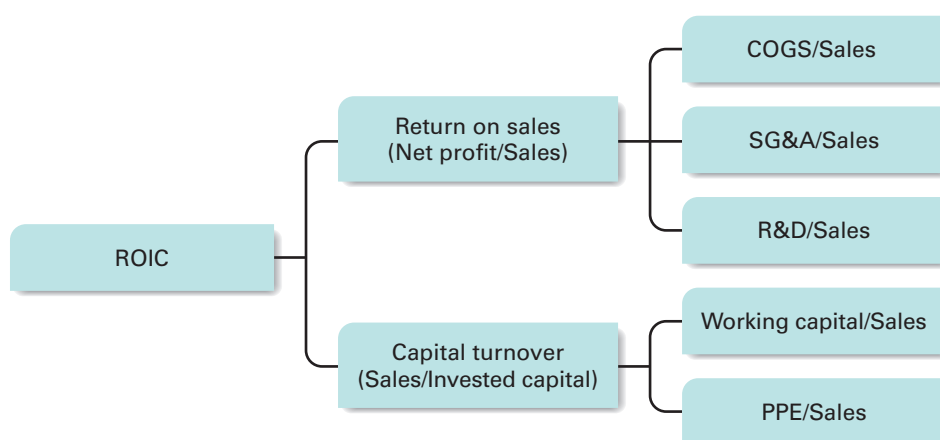
ROIC is defined as net profit over invested capital, or  $\text{ROIC} = \text{net profit} / \text{invested capital}$ . Net profit is calculated by subtracting the total costs of operating the company from its total revenues (total revenues – total costs). *Net profit* is what is left over after the government takes its share in taxes. *Invested capital* is the amount that is invested in the operations of a company: property, plant, equipment, inventories, and other assets. Invested capital comes from two main sources: interest-bearing debt and shareholders’ equity. Interest-bearing debt is money the company borrows from banks and those who purchase its bonds. Shareholders’ equity is the money raised from selling shares to the public plus earnings that the company has retained in prior years that are available to fund current investments. ROIC measures the effectiveness by which a company is using the capital funds that it has available for investment. As such, it is recognized to be an excellent measure of the value a company is creating.<sup>23</sup>

A company’s ROIC can be algebraically decomposed into two major components: return on sales and capital turnover.<sup>24</sup> Specifically:

$$\begin{aligned}\text{ROIC} &= \text{net profits} / \text{invested capital} \\ &= (\text{net profits} / \text{revenues}) \times (\text{revenues} / \text{invested capital})\end{aligned}$$

where net profits/revenues is the return on sales, and revenues/invested capital is capital turnover. Return on sales measures how effectively the company converts revenues into profits. Capital turnover measures how effectively the company employs its invested capital to generate revenues. These two ratios can be further decomposed into some basic accounting ratios, as shown in Figure 3.9 (these ratios are defined in Table 3.1).<sup>25</sup>

**Figure 3.9** Drivers of Profitability (ROIC)



**Table 3.1** Definitions of Basic Accounting Terms

Term	Definition	Source
Cost of Goods Sold (COGS)	Total costs of producing products	Income statement
Sales, General, and Administrative Expenses (SG&A)	Costs associated with selling products and administering the company	Income statement
R&D Expenses (R&D)	Research and development expenditure	Income statement
Working Capital	The amount of money the company has to “work” with in the short term: Current assets – current liabilities	Balance sheet
Property, Plant, and Equipment (PPE)	The value of investments in the property, plant, and equipment that the company uses to manufacture and sell its products; also known as <i>fixed capital</i>	Balance sheet
Return on Sales (ROS)	Net profit expressed as a percentage of sales; measures how effectively the company converts revenues into profits	Ratio
Capital Turnover	Revenues divided by invested capital; measures how effectively the company uses its capital to generate revenues	Ratio
Return on Invested Capital (ROIC)	Net profit divided by invested capital	Ratio
Net Profit	Total revenues minus total costs before tax	Income statement
Invested Capital	Interest-bearing debt plus shareholders’ equity	Balance sheet

Figure 3.9 says that a company's managers can increase ROIC by pursuing strategies that increase the company's return on sales (ROS). To increase a company's ROS, they can: pursue strategies that reduce the cost of goods sold (COGS) for a given level of sales revenues (COGS/sales); reduce the level of spending on sales force, marketing, general, and administrative expenses (SG&A) for a given level of sales revenues (SG&A/sales); and reduce research and development (R&D) spending for a given level of sales revenues (R&D/sales). Alternatively, they can increase ROS by pursuing strategies that increase sales revenues more than they increase the costs of the business, as measured by COGS, SG&A, and R&D expenses. That is, they can increase the ROS by pursuing strategies that lower costs or increase value through differentiation, thus allowing the company to increase its prices more than its costs.

Figure 3.9 also states that a company's managers can boost the profitability of their company by getting greater sales revenues from the invested capital, thereby increasing capital turnover. They do this by pursuing strategies that reduce the amount of working capital, such as the amount of capital invested in inventories, needed to generate a given level of sales (working capital/sales), and then pursuing strategies that reduce the amount of fixed capital that they have to invest in plant, property, and equipment (PPE) to generate a given level of sales (PPE/sales). That is, they pursue strategies that reduce the amount of capital that they need to generate every dollar of sales and their cost of capital. The cost of capital is part of the cost structure of a company (see Figure 3.2). Hence, strategies designed to increase capital turnover also lower the cost structure.

To see how these basic drivers of profitability help to explain what is going on in a company and identify its strengths and weaknesses, compare the financial performance of Walmart against one of its closest and more efficient competitors—Target. This is done in the following Running Case.

On the other hand, you will notice that Walmart spends significantly less on SG&A expenses as a percentage of sales than Target (18.77% versus 22.95%). There are three reasons for this as outlined on the next page.

## RUNNING CASE

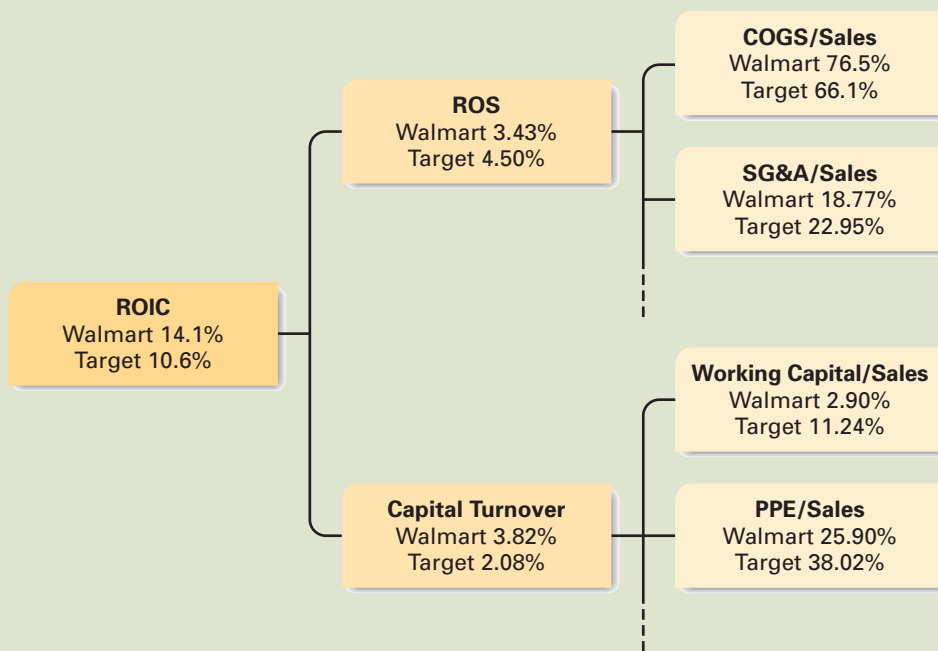
### Comparing Walmart and Target

For the financial year ending January 2008, Walmart earned a ROIC of 14.1%, while Target earned a respectable 10.6%. Walmart's superior profitability can be understood in terms of the impact of its strategies on the various ratios identified in Figure 3.9. These are summarized in Figure 3.10.

First, note that Walmart has a *lower* ROS than Target. This is because Walmart's COGS as a percentage of sales are higher than Target's (76.5% versus

66.1%). For a retailer, the COGS reflect the price that Walmart pays to its suppliers for merchandise. The lower COGS/Sales ratio implies that Walmart does not mark up prices as much as Target—its profit margin on each item sold is lower. Consistent with its long-time strategic goal, Walmart passes on the low prices it gets from suppliers to customers. Walmart's higher COGS/Sales ratio reflects its strategy of being the lowest-price retailer.

**Figure 3.10** Comparing Walmart and Target



- (1) Walmart's early strategy was to focus on small towns that could only support one discounter. In small towns, the company does not have to advertise heavily because it is not competing against other discounters.
- (2) Walmart has become such a powerful brand that the company does not need to advertise as heavily as its competitors, even when its stores are located close to them in suburban areas.
- (3) Because Walmart sticks to its low-price philosophy and manages its inventory so well, it does not usually have an overstock problem. Thus, the company does not have to hold periodic sales, nor does it have to bear the costs of promoting those sales (e.g., sending out advertisements and coupons in local newspapers). By reducing spending on sales promotions, these factors reduce Walmart's SG&A/sales ratio.

In addition, Walmart operates with a flat-organization structure that has very few layers of management between the head office and store managers (the company has no regional headquarters). This reduces administrative expenses (which are a component of SG&A), and hence, the SG&A/sales ratio. Walmart can operate with such flat structure because its information systems allow the company's top managers to monitor and control individual stores directly rather than relying on intervening layers of subordinates to do that for them.

It is when we consider the capital turnover side of the ROIC equation, however, that the financial impact of Walmart's competitive advantage in information systems and logistics becomes apparent. Walmart generates \$3.82 for every dollar of capital invested in the business, whereas Target generates only \$2.08 for every dollar of capital invested. Walmart is much more efficient in its use of capital than Target. Why?

A big reason is that Walmart has a much lower working capital/sales ratio than Target. In fact, Walmart has a *negative* ratio ( $-2.90\%$ ), while Target has a positive ratio ( $11.24\%$ ). The negative working capital ratio implies that Walmart does not need any capital to finance its day-to-day operations. In fact, Walmart is using its suppliers' capital to finance those operations. This is very unusual, but Walmart is able to do this for two reasons. First, Walmart is so powerful that it can demand and get very favorable payment terms from its suppliers. It does not have to pay for merchandise until 60 days after it is delivered. Second, Walmart turns over its inventory rapidly—7.72 times a year or every 47 days—that it typically sells merchandise *before* it has to pay its suppliers. Thus, suppliers finance Walmart's inventory and the company's short-term capital needs. Walmart's high inventory turnover is the result of strategic investments in information systems and logistics. It is these value chain activities, more than any other, that explain Walmart's competitive advantage.

Finally, note that Walmart has a significantly lower PPE/sales ratio than Target: 25.9% versus 35.02%. There are several explanations for this. First, many of Walmart's stores are still located in small towns where land is cheap, whereas most of Target's stores are located in more expensive suburban mall locations. Thus, on average, Walmart needs to spend less on a store than Target. Again, strategy has a clear impact on financial performance. Second, because Walmart turns its inventory over so rapidly, it does not need to devote as much space in stores to storing inventory. This means that more floor space can be devoted to selling merchandise. Other things being equal, this will result in a higher PPE/sales ratio. By the same token, efficient inventory management means that it needs less space at a distribution center to support a store, which again reduces total capital spending of PPE. Third, the higher PPE/sales ratio may also reflect the fact that Walmart's brand is so powerful and its commitment to low pricing so strong that store traffic is higher than at comparable discounters such as Target. The stores are simply busier. Hence, the PPE/sales ratio is higher.

In sum, Walmart's high profitability is a function of its strategy and the distinctive competencies that strategic investments have built over the years, particularly in the area of information systems and logistics. As in the Walmart example, the methodology described in this section can be a very useful tool for analyzing why and how well a company is achieving and sustaining a competitive advantage. It highlights a company's strengths and weaknesses, showing where there is room for improvement and where a company is excelling. As such, it can drive strategy formulation. Moreover, the same methodology can be used to analyze the performance of competitors, and gain a greater understanding of their strengths and weaknesses, which can in turn inform strategy.

## THE DURABILITY OF COMPETITIVE ADVANTAGE

The next question we must address is how long a competitive advantage will last once it has been created. In other words, what is the durability of competitive advantage given that other companies are also seeking to develop distinctive competencies that will give them a competitive advantage? The answer depends on three factors: barriers to imitation, the capability of competitors, and the general dynamism of the industry environment.

## Barriers to Imitation

A company with a competitive advantage will earn higher-than-average profits. These profits send a signal to rivals that the company has some valuable distinctive competency that allows it to create superior value. Naturally, its competitors will try to identify and imitate that competency, and insofar as they are successful, ultimately their increased success may whittle away the company's superior profits.<sup>26</sup>

How quickly rivals will imitate a company's distinctive competencies is an important issue because the speed of imitation has a bearing on the durability of a company's competitive advantage. Other things being equal, the more rapidly competitors imitate a company's distinctive competencies, the less durable its competitive advantage will be, and the more important it is that the company endeavor to improve its competencies to stay one step ahead of the imitators. It is important to stress that ultimately almost any distinctive competency can be imitated by a competitor. The critical issue is time: the longer it takes competitors to imitate a distinctive competency, the greater the opportunity the company has to build a strong market position and reputation with customers, which are then more difficult for competitors to attack. The longer it takes to achieve an imitation, the greater is the opportunity for the imitated company to improve on its competency or build other competencies, thereby staying one step ahead of the competition.

**Barriers to imitation** are a primary determinant of the speed of imitation. Barriers to imitation are factors that make it difficult for a competitor to copy a company's distinctive competencies; the greater the barriers to imitation, the more sustainable is a company's competitive advantage.<sup>27</sup> Barriers to imitation differ depending on whether a competitor is trying to imitate resources or capabilities.

**Imitating Resources** In general, the easiest distinctive competencies for prospective rivals to imitate tend to be those based on the possession of firm-specific and valuable tangible resources, such as buildings, plant, and equipment. Such resources are visible to competitors and can often be purchased on the open market. For example, if a company's competitive advantage is based on sole possession of efficient-scale manufacturing facilities, competitors may move fairly quickly to establish similar facilities. Although Ford gained a competitive advantage over GM in the 1920s by being the first to adopt an assembly-line manufacturing technology to produce automobiles, GM quickly imitated that innovation, competing away Ford's distinctive competency in the process. A similar process is occurring in the auto industry now, as companies try to imitate Toyota's famous production system. However, Toyota has slowed down the rate of imitation by not allowing competitors access to its latest equipment.

Intangible resources can be more difficult to imitate. This is particularly true of brand names, which are important because they symbolize a company's reputation. In the heavy earth-moving equipment industry, for example, the Caterpillar brand name is synonymous with high quality and superior after-sales service and support. Similarly, the St. Michael's brand name used by Marks & Spencer, Britain's largest clothing retailer, symbolizes high-quality but reasonably priced clothing. Customers often display a preference for the products of such companies because the brand name is an important guarantee of high quality. Although competitors might like to imitate well-established brand names, the law prohibits them from doing so.

Marketing and technological know-how are also important intangible resources and can be relatively easy to imitate. The movement of skilled marketing personnel



between companies may facilitate the general dissemination of marketing know-how. For example, in the 1970s, Ford was acknowledged as the best marketer among the big three U.S. auto companies. In 1979, it lost much of its marketing know-how to Chrysler when its most successful marketer, Lee Iacocca, joined Chrysler and subsequently hired many of Ford's top marketing people to work with him at Chrysler. More generally, successful marketing strategies are relatively easy to imitate because they are visible to competitors. Thus, Coca-Cola quickly imitated PepsiCo's Diet Pepsi brand with the introduction of its own brand, Diet Coke.

With regard to technological know-how, the patent system in theory should make technological know-how relatively immune to imitation. Patents give the inventor of a new product a 20-year exclusive production agreement; however, this is not always the case. In electrical and computer engineering, for example, it is often possible to invent "around" patents: that is, produce a product that is functionally equivalent but does not rely on the patented technology. One study found that 60% of patented innovations were successfully invented around in four years.<sup>28</sup> This suggests that, in general, distinctive competencies based on technological know-how can be relatively short-lived.

**Imitating Capabilities** Imitating a company's capabilities tends to be more difficult than imitating its tangible and intangible resources, chiefly because capabilities are based on the way in which decisions are made and processes are managed deep within a company. It is hard for outsiders to discern them.

On its own, the invisible nature of capabilities would not be enough to halt imitation; competitors could still gain insights into how a company operates by hiring people away from that company. However, a company's capabilities rarely reside in a single individual. Rather, they are the product of how numerous individuals interact within a unique organizational setting.<sup>29</sup> It is possible that no one individual within a company may be familiar with the totality of a company's internal operating routines and procedures. In such cases, hiring people away from a successful company as a way to imitate its key capabilities may not be helpful.

## Capability of Competitors

According to Pankaj Ghemawat, a major determinant of the capability of competitors to imitate a company's competitive advantage rapidly is the nature of the competitors' prior strategic commitments.<sup>30</sup> By strategic commitment, Ghemawat means a company's commitment to a particular way of doing business, that is, to developing a particular set of resources and capabilities. Ghemawat's point is that once a company has made a strategic commitment, it will have difficulty responding to new competition if doing so requires a break with this commitment. Therefore, when competitors have long-established commitments to a particular way of doing business, they may be slow to imitate an innovating company's competitive advantage. Its competitive advantage will thus be relatively durable.

The U.S. automobile industry again offers an example. From 1945 to 1975, the industry was dominated by the stable oligopoly of GM, Ford, and Chrysler, all of which geared their operations to the production of large cars, which American customers demanded at the time. When the market shifted from large cars to small, fuel-efficient ones during the late 1970s, U.S. companies lacked the resources and capabilities required to produce these cars. Their prior commitments had built the wrong kind of products for this new environment. As a result, foreign producers,

particularly the Japanese, stepped into the market breach by providing compact, fuel-efficient, high-quality, and low-cost cars. The failure of U.S. auto manufacturers to react quickly to the distinctive competency of Japanese auto companies gave the latter time to build a strong market position and brand loyalty, which subsequently have been difficult to attack.

Another determinant of the ability of competitors to respond to a company's competitive advantage is the absorptive capacity of competitors.<sup>31</sup> **Absorptive capacity** refers to the ability of an enterprise to identify, value, assimilate, and use new knowledge. For example, in the 1960s and 1970s, Toyota developed a competitive advantage based on its innovation of lean production systems. Competitors such as GM were slow to imitate this innovation, primarily because they lacked the necessary absorptive capacity. GM was a bureaucratic and inward-looking organization; thus, it was difficult for the company to identify, value, assimilate, and use the knowledge that underlies lean production systems. Indeed, long after GM had identified and understood the importance of lean production systems, it was still struggling to assimilate and use that new knowledge. Internal inertia forces can make it difficult for established competitors to respond to a rival whose competitive advantage is based on new products or internal processes, such as innovation.

Taken together, factors such as existing strategic commitments and low absorptive capacity limit the ability of established competitors to imitate the competitive advantage of a rival, particularly when that competitive advantage is based on innovative products or processes. This is why, when innovations reshape the rules of competition in an industry, value often migrates away from established competitors and toward new enterprises that are operating with new business models.

## Industry Dynamism

A dynamic industry environment is one that is changing rapidly. We examined the factors that determine the dynamism and intensity of competition in an industry in Chapter 2 when we discussed the external environment. The most dynamic industries tend to be those with a high rate of product innovation, for example, the consumer electronics industry and the personal computer industry. In dynamic industries, the rapid rate of innovation means that product life cycles are shortening, and competitive advantage can be fleeting. A company that has a competitive advantage today may find its market position outflanked tomorrow by a rival's innovation.

In the personal computer industry, the rapid increase in computing power during the past two decades has contributed to a high degree of innovation and a turbulent environment. Reflecting the persistence of innovation, in the late 1970s and early 1980s, Apple had an industry-wide competitive advantage due to its innovation. In 1981, IBM seized the advantage by introducing its first personal computer. By the mid-1980s, IBM had lost its competitive advantage to high-power "clone" manufacturers such as Compaq that had beaten IBM in the race to introduce a computer based on Intel's 386 chip. In turn, in the 1990s, Compaq subsequently lost its competitive advantage to Dell, which pioneered new low-cost ways of delivering computers to customers using the Internet as a direct-selling device.

## Summarizing Durability of Competitive Advantage

The durability of a company's competitive advantage depends on the height of barriers to imitation, the capability of competitors to imitate its innovation, and the

general level of dynamism in the industry environment. When barriers to imitation are low, capable competitors abound, and the environment is dynamic, with innovations being developed all the time, then competitive advantage is likely to be transitory. But even within such industries, companies can build a more enduring competitive advantage if they are able to make investments that build barriers to imitation.

## AVOIDING FAILURE AND SUSTAINING COMPETITIVE ADVANTAGE

How can a company avoid failure and escape the traps that have snared so many once-successful companies? How can managers build a sustainable competitive advantage? Much of the remainder of this book deals with these issues. Following, we identify several key points that set the scene for the coming discussion.

### Why Companies Fail

When a company loses its competitive advantage, its profitability falls. The company does not necessarily fail; it may just have average or below-average profitability. It can remain in this mode for a considerable time, although its resource and capital base is shrinking. Failure implies something more drastic. A failing company is one whose profitability is now substantially lower than the average profitability of its competitors; it has lost the ability to attract and generate resources, so its profit margins and invested capital are shrinking rapidly.

Why does a company lose its competitive advantage and fail? The question is particularly pertinent because some of the most successful companies of the last half-century have seen their competitive position deteriorate at one time or another. IBM, GM, American Express, Digital Equipment Corporation (DEC), and Sears, among many others, which all at one time were held up as examples of managerial excellence, have gone through periods where their financial performance was poor and they clearly lacked any competitive advantage. We explore three related reasons for failure: inertia, prior strategic commitments, and the Icarus paradox.

**Inertia** The inertia argument says that companies find it difficult to change their strategies and structures when adapting to changing competitive conditions.<sup>32</sup> IBM is a classic example of this problem. For 30 years, it was viewed as the world's most successful computer company. Then in the space of a few years, its success turned into a disaster: it lost \$5 billion in 1992, leading to layoffs of more than 100,000 employees. IBM's troubles were caused by a dramatic decline in the cost of computing power as a result of innovations in microprocessors. With the advent of powerful low-cost microprocessors, the locus of the computer market shifted from mainframes to small, low-priced personal computers, leaving IBM's huge mainframe operations with a diminished market. Although IBM had a significant presence in the personal computer market, it had failed to shift the focus of its efforts away from mainframes and toward personal computers. This failure meant deep trouble for one of the most successful companies of the 20th century. (IBM has now executed a successful turnaround with a repositioning as a provider of e-commerce infrastructure and solutions.)

One reason that companies find it so difficult to adapt to new environmental conditions seems to be the role of capabilities in causing inertia. Organizational capabilities—the way a company makes decisions and manages its processes—can be a source of competitive advantage, but they are difficult to change. IBM always emphasized close coordination among operating units and favored decision processes that stressed consensus among interdependent operating units as a prerequisite for a decision to go forward.<sup>33</sup> This capability was a source of advantage for IBM during the 1970s, when coordination among its worldwide operating units was necessary to develop, manufacture, and sell complex mainframes. But the slow-moving bureaucracy that it had spawned was a source of failure in the 1990s, when organizations had to adapt readily to rapid environmental change.

Capabilities are difficult to change because a certain distribution of power and influence is embedded within the established decision-making and management processes of an organization. Those who play key roles in a decision-making process clearly have more power. It follows that changing the established capabilities of an organization means changing its existing distribution of power and influence; those whose power and influence would diminish then resist such change. Proposals for change trigger turf battles. This power struggle and the political resistance associated with trying to alter the way in which an organization makes decisions and manages its process—that is, trying to change its capabilities—bring on inertia. This is not to say that companies cannot change. However, because change is so often resisted by those who feel threatened by it, change in most cases has to be induced by a crisis. By then, the company may already be failing, as happened at IBM.

**Prior Strategic Commitments** A company's prior strategic commitments not only limit its ability to imitate rivals but may also cause competitive disadvantage.<sup>34</sup> IBM, for instance, had major investments in the mainframe computer business, so when the market shifted, it was stuck with significant resources specialized to that particular business. IBM's manufacturing facilities were geared to the production of mainframes. Its research organization and sales force were similarly specialized. Because these resources were not well-suited to the newly emerging personal computer business, IBM's difficulties in the early 1990s were, in a sense, inevitable. Its prior strategic commitments locked it into a business that was shrinking. Shedding these resources was bound to cause hardship for all organization stakeholders.

**The Icarus Paradox** Danny Miller has postulated that the roots of competitive failure can be found in what he termed the Icarus paradox.<sup>35</sup> Icarus is a figure in Greek mythology who used a pair of wings that his father made for him to escape from an island where he was being held prisoner. He flew so well that he went higher and higher, ever closer to the sun, until the heat of the sun melted the wax that held his wings together, and he plunged to his death in the Aegean Sea. The paradox is that his greatest asset, his ability to fly, caused his demise. Miller argues that the same paradox applies to many once successful companies. According to Miller, many companies become so dazzled by their early success that they believe more of the same type of effort is the way to future success. As a result, they can become so specialized and inner-directed that they lose sight of market realities and the fundamental requirements for achieving a competitive advantage. Sooner or later, this leads to failure. For example, Miller argues that Texas Instruments and Digital Equipment Corporation (DEC), achieved early success through engineering excellence. But then they became so obsessed with engineering details that they lost sight of market realities. (The story of DEC's demise is summarized in Strategy in Action 3.3.)

## 3.3 STRATEGY IN ACTION

### The Road to Ruin at DEC

Digital Equipment Corporation (DEC) was one of the premier computer companies of the 1970s and 1980s. DEC's original success was founded on the minicomputer, a cheaper, more-flexible version of its mainframe cousins that Ken Olson and his brilliant team of engineers invented in the 1960s. DEC improved on its original minicomputers until they could not be beat for quality and reliability. In the 1970s, their VAX series of minicomputers was widely regarded as the most reliable series of computers ever produced, and DEC was rewarded by high profit rates and rapid growth. By 1990, it was number 27 on the Fortune 500 list of the largest corporations in America.

Buoyed by its success, DEC turned into an engineering monoculture—its engineers became idols; its marketing and accounting staff, however, were barely tolerated. Component specifications and design standards were all that senior managers understood. Technological fine-tuning became such an obsession that the needs of customers for smaller, more economical, user-friendly computers were ignored. DEC's personal computers, for example, bombed because they were out of touch with the needs

of customers, and the company failed to respond to the threat to its core market presented by the rise of computer workstations and client-server architecture. Indeed, Ken Olson was known for dismissing such new products. He once said, "We always say that customers are right, but they are not always right." Perhaps. But DEC, blinded by its early success, failed to remain responsive to its customers and changing-market conditions. In another famous statement, when asked about personal computers in the early 1980s, Olson said, "I can see of no reason why anybody would ever want a computer on their desk."

By the early 1990s, DEC was in deep trouble. Olson was forced out in July 1992, and the company lost billions of dollars between 1992 and 1995. It returned to profitability in 1996, primarily because of the success of a turnaround strategy aimed at reorienting the company to serve precisely those areas that Olson had dismissed. In 1998, the company was acquired by Compaq Computer Corporation (which was subsequently purchased by Hewlett Packard) and disappeared from the business landscape as an independent entity.

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**Sources:** D. Miller, *The Icarus Paradox* (New York: HarperBusiness, 1990); P. D. Llosa, "We Must Know What We Are Doing," *Fortune*, November 14, 1994, 68.

### Steps to Avoid Failure

Given that so many traps wait for companies, the question arises as to how strategic managers can use internal analysis to find them and escape them. We now look at several tactics that managers can use.

**Focus on the Building Blocks of Competitive Advantage** Maintaining a competitive advantage requires a company to continue focusing on all four generic building blocks of competitive advantage—efficiency, quality, innovation, and responsiveness to customers—and to develop distinctive competencies that contribute to superior performance in these areas. One of the messages of Miller's Icarus paradox is that many successful companies become unbalanced in their pursuit of distinctive competencies. DEC, for example, focused on engineering quality at the expense of almost everything else, including, most importantly, responsiveness to customers. Other companies forget to focus on any distinctive competency at all.

**Institute Continuous Improvement and Learning** The only constant in the world is change. Today's source of competitive advantage may soon be rapidly imitated by capable competitors or made obsolete by the innovations of a rival. In such a dynamic and fast-paced environment, the only way that a company can maintain

a competitive advantage over time is to continually improve its efficiency, quality, innovation, and responsiveness to customers. The way to do this is to recognize the importance of learning within the organization.<sup>36</sup> The most-successful companies are not those that stand still, resting on their laurels. They are those that are always seeking out ways of improving their operations and, in the process, are constantly upgrading the value of their distinctive competencies or creating new competencies. Companies such as GE and Toyota have a reputation for being learning organizations. This means that they are continually analyzing the processes that underlie their efficiency, quality, innovation, and responsiveness to customers. Their objective is to learn from prior mistakes and to seek out ways to improve their processes over time. This has enabled Toyota, for example, to continually upgrade its employee productivity and product quality, and thus stay ahead of imitators.

**Track Best Industrial Practice and Use Benchmarking** One of the best ways to develop distinctive competencies that contribute to superior efficiency, quality, innovation, and responsiveness to customers is to identify and adopt best industrial practice. Only in this way will a company be able to build and maintain the resources and capabilities that underpin excellence in efficiency, quality, innovation, and responsiveness to customers. (We discuss what constitutes best industrial practice in some depth in chapter 4.) It requires tracking the practice of other companies, and perhaps the best way to do so is through benchmarking: measuring the company against the products, practices, and services of some of its most efficient global competitors.

**Overcome Inertia** Overcoming the internal forces that are a barrier to change within an organization is one of the key requirements for maintaining a competitive advantage, and an entire chapter, Chapter 4, is spent discussing this issue. Suffice it to say that identifying barriers to change is an important first step. Once this step has been taken, implementing change requires good leadership, the judicious use of power, and appropriate changes in organizational structure and control systems.

**The Role of Luck** A number of scholars have argued that luck plays a critical role in determining competitive success and failure.<sup>37</sup> In its most extreme version, the luck argument devalues the importance of strategy altogether. Instead, it states that, in the face of uncertainty, some companies just happen to pick the correct strategy.

Although luck may be the reason for a company's success in particular cases, it is an unconvincing explanation for the persistent success of a company. Recall our argument that the generic building blocks of competitive advantage are superior efficiency, quality, innovation, and responsiveness to customers. Keep in mind also that competition is a process in which companies are continually trying to outdo each other in their ability to achieve high efficiency, superior quality, outstanding innovation, and quick responsiveness to customers. It is possible to imagine a company getting lucky and coming into possession of resources that allow it to achieve excellence on one or more of these dimensions. However, it is difficult to imagine how sustained excellence on any of these four dimensions could be produced by anything other than conscious effort, that is, by strategy. Luck may indeed play a role in success, and managers must always exploit a lucky break. However, to argue that success is entirely a matter of luck is to strain credibility. As the great banker of the early 20th century, J. P. Morgan, once said, "The harder I work, the luckier I seem to get." Managers who strive to formulate and implement strategies that lead to a competitive advantage are more likely to be lucky.



## SUMMARY OF CHAPTER

1. Distinctive competencies are the firm-specific strengths of a company. Valuable distinctive competencies enable a company to earn a profit rate that is above the industry average.
2. The distinctive competencies of an organization arise from its resources (its financial, physical, human, technological, and organizational assets) and capabilities (its skills at coordinating resources and putting them to productive use).
3. In order to achieve a competitive advantage, a company needs to pursue strategies that build on its existing resources and capabilities and formulate strategies that build additional resources and capabilities (develop new competencies).
4. The source of a competitive advantage is superior value creation.
5. To create superior value, a company must lower its costs or differentiate its product so that it creates more value and can charge a higher price or do both simultaneously.
6. Managers must understand how value creation and pricing decisions affect demand and how costs change with increases in volume. They must have a good grasp of the demand conditions in the company's market and the cost structure of the company at different levels of output if they are to make decisions that maximize the profitability of their enterprise.
7. The four building blocks of competitive advantage are efficiency, quality, innovation, and responsiveness to customers. These are generic distinctive competencies. Superior efficiency enables a company to lower its costs; superior quality allows it to charge a higher price and lower its costs; and superior customer service lets it charge a higher price. Superior innovation can lead to higher prices, particularly in the case of product innovations, or lower unit costs, particularly in the case of process innovations.
8. If a company's managers are to perform a good internal analysis, they need to be able to analyze the financial performance of their company, identifying how the strategies of the company relate to its profitability, as measured by the ROIC.
9. The durability of a company's competitive advantage depends on the height of barriers to imitation, the capability of competitors, and environmental dynamism.
10. Failing companies typically earn low or negative profits. Three factors seem to contribute to failure: organizational inertia in the face of environmental change, the nature of a company's prior strategic commitments, and the Icarus paradox.
11. Avoiding failure requires a constant focus on the basic building blocks of competitive advantage, continuous improvement, identification and adoption of best industrial practice, and victory over inertia.

## DISCUSSION QUESTIONS

1. What are the main implications of the material discussed in this chapter for strategy formulation?
2. When is a company's competitive advantage most likely to endure over time?
3. It is possible for a company to be the lowest-cost producer in its industry and simultaneously have an output that is the most valued by customers. Discuss this statement.
4. Why is it important to understand the drivers of profitability, as measured by the ROIC?
5. Which is more important in explaining the success and failure of companies: strategizing or luck?



## PRACTICING STRATEGIC MANAGEMENT

### Small-Group Exercise: Analyzing Competitive Advantage

Break up into groups of three to five people. Drawing on the concepts introduced in this chapter, analyze the competitive position of your business school in the market for business education. Then answer the following questions:

1. Does your business school have a competitive advantage?
2. If so, on what is this advantage based and is this advantage sustainable?
3. If your school does not have a competitive advantage in the market for business education, identify the inhibiting factors that are holding it back.
4. How might the Internet change the way in which business education is delivered?
5. Does the Internet pose a threat to the competitive position of your school in the market for business education or is it an opportunity for your school to enhance its competitive position? (Note that it can be both.)

### Article File 3

Find a company that has sustained its competitive advantage for more than 10 years. Identify the source of the competitive advantage and explain why it has lasted so long.

### Strategic Management Project: Module 3

This module deals with the competitive position of your company. With the information you have at your disposal, perform the following tasks and answer the questions:

1. Identify whether your company has a competitive advantage or disadvantage in its primary industry. (Its primary industry is the one in which it has the most sales.)
2. Evaluate your company against the four generic building blocks of competitive advantage: efficiency, quality, innovation, and responsiveness to customers. How does this exercise help you understand the performance of your company relative to its competitors?
3. What are the distinctive competencies of your company?
4. What role have prior strategies played in shaping the distinctive competencies of your company? What has been the role of luck?
5. Do the strategies your company is pursuing now build on its distinctive competencies? Are they an attempt to build new competencies?
6. What are the barriers to imitating the distinctive competencies of your company?
7. Is there any evidence that your company finds it difficult to adapt to changing industry conditions? If so, why do you think this is the case?

## CLOSING CASE

### Southwest Airlines

Southwest Airlines has long been one of the stand-out performers in the U.S. airline industry. It is famous for its low fares, which are often some 30% lower than those of its major rivals. These are balanced by an even lower cost structure, enabling it to record superior profitability even in bad years such as 2002, when the industry faced slumping demand in the wake of the September 11 terrorist attacks. Indeed, from 2001 to 2005, quite possibly the worst four years in the history of the airline industry, while every other major airline lost money, Southwest made money every year and earned an ROIC of 5.8%. Even in 2008, an awful year for most airlines, Southwest made a profit and earned an ROIC of 4%.

Southwest operates somewhat differently from many of its competitors. While operators like American Airlines and United Airlines route passengers through hubs, Southwest Airlines flies point-to-point, often through smaller airports. By competing in a way that other airlines do not, Southwest has found that it can capture enough demand to keep its planes full. Moreover, because it avoids many hubs, Southwest has experienced fewer delays. In the first eight months of 2008, Southwest planes arrived on schedule 80% of the time, compared to 76% at United and 74% at Continental.

Southwest flies only one type of plane, the Boeing 737. This reduces training costs, maintenance costs, and inventory costs while increasing efficiency in crew and flight scheduling. The operation is nearly ticketless, with no seat assignments, which reduces cost and back-office accounting functions. There are no meals or movies in flight, and the airline will not transfer baggage to other airlines, reducing the need for baggage handlers.

Southwest also has high employee productivity. One-way airlines measure employee productivity by the ratio of employees to passengers carried. According to figures from company 10-K statements, in 2008 Southwest had an employee-to-passenger ratio of 1 to 2,400, the best in the industry. By comparison, the ratio at United Airlines was 1 to 1,175 and, at Continental, it was 1 to 1,125.

Southwest devotes enormous attention to the people it hires. On average, the company hires only 3% of those interviewed in a year. When hiring, it emphasizes teamwork and a positive attitude. Southwest rationalizes that skills can be taught, but a positive attitude and a willingness to pitch in cannot. Southwest also creates incentives for its employees to work hard. All employees are covered by a profit-sharing plan, and at least 25% of an employee's share of the profit-sharing plan has to be invested in Southwest Airlines stock. This gives rise to a simple formula: the harder employees work, the more profitable Southwest becomes, and the richer the employees get. The results are clear. At other airlines, one would never see a pilot helping to check passengers onto the plane. At Southwest, pilots and flight attendants have been known to help clean the aircraft and check in passengers at the gate. They do this to turn around an aircraft as quickly as possible and get it into the air again because an aircraft does not make money while it is on the ground. This flexible and motivated workforce leads to higher productivity and reduces the company's need for more employees.

Because Southwest flies point-to-point rather than through congested airport hubs, there is no need for dozens of gates and thousands of employees to handle banks of flights that come in and then disperse within a two-hour window, leaving the hub empty until the next flights a few hours later. The result: Southwest can operate with far fewer employees than airlines that fly through hubs.<sup>38</sup>

### Case Discussion Questions

1. How would you characterize the business model of Southwest Airlines? How does this differ from the business model used at many other airlines, such as United and American Airlines?
2. Identify the resources, capabilities, and distinctive competencies of Southwest Airlines.
3. How do Southwest's resources, capabilities, and distinctive competencies translate into superior financial performance?
4. How secure is Southwest's competitive advantage? What are the barriers to imitation here?



# 4

## BUILDING COMPETITIVE ADVANTAGE THROUGH FUNCTIONAL-LEVEL STRATEGY

### LEARNING OBJECTIVES

After reading this chapter, you should be able to

- Explain how an enterprise can use functional-level strategies to increase its efficiency
- Explain how an enterprise can use functional-level strategies to increase its quality
- Explain how an enterprise can use functional-level strategies to increase its innovation
- Explain how an enterprise can use functional-level strategies to increase its customer responsiveness

## Productivity Improvement at United Technologies

In 2007, George David, the long-time CEO of United Technologies, retired.

David could look back on a very impressive 15 years at the helm, during which time revenues tripled while net profits rose tenfold. Today, United Technologies is a \$60 billion diversified manufacturing enterprise with businesses including jet-engine-maker Pratt & Whitney; Carrier, an air-conditioning business; and Otis Elevators.

A major source of the profit surge over the last 15 years has been productivity improvements. At the heart of these is a program known as Achieve Competitive Excellence (ACE). The program was a result of collaboration between David and a Japanese quality consultant, Yuzuru Ito, who at one time was a quality expert at Matsushita, the Japanese consumer electronics giant. David brought Ito in to figure

out why Otis Elevators performed so poorly compared to those from rival Mitsubishi. The number of times a building owner had to call a mechanic was 40 times per year for Otis products and just 0.5 times a year for those from Mitsubishi. What Ito uncovered was a range of problems ranging from bad design to poor manufacturing practices and a lack of quality control in Otis' factories. Ito explained to David how poor quality hurt employee productivity because time was wasted building defective products. Poor quality also hurt demand because customers were less likely to buy products from a company with a poor reputation for quality.

The solution to these problems at Otis included designing elevators so that they



were easier to manufacture, which led to fewer errors in the assembly process, reconfiguring the manufacturing process, and empowering factory floor employees to identify and fix quality problems. For example, by changing the placement of elevator parts, allowing assembly line workers easier access, Otis took \$300 off the cost of each elevator, which led to worldwide annual savings of \$27 million. In addition, the production processes were streamlined, requiring fewer steps, less reaching and movement for workers, and easier access to parts, all of which boosted productivity.

ACE evolved out of the experience at Otis and was subsequently rolled out company wide. The main thrust of ACE is built around the belief that every person should be involved with continuous improvement, from top executives to the most junior workers. ACE “pilots” are production line workers who learn a quality improvement process in a matter of days

and then are empowered to lead that process within their work groups. They learn to pinpoint potential problems, ranging from fundamental design flaws in a product, such as misplaced bolts, to a co-worker's fatigue from staying up with a newborn all night.

As the program was implemented across the company, the results were impressive. At Carrier, square footage assigned to manufacturing was reduced by 50%, while production rose 70%, all with 10% fewer employees. At Pratt & Whitney, dramatic improvements in the quality of jet engines were registered. The mean time between part failures in a jet engine went from 2,500 hours to 170,000 hours, a huge improvement resulting from better design and manufacturing processes. Customers noticed these quality improvements, and they increased their purchases of United Technology products, driving forward revenues and profits.<sup>1</sup>

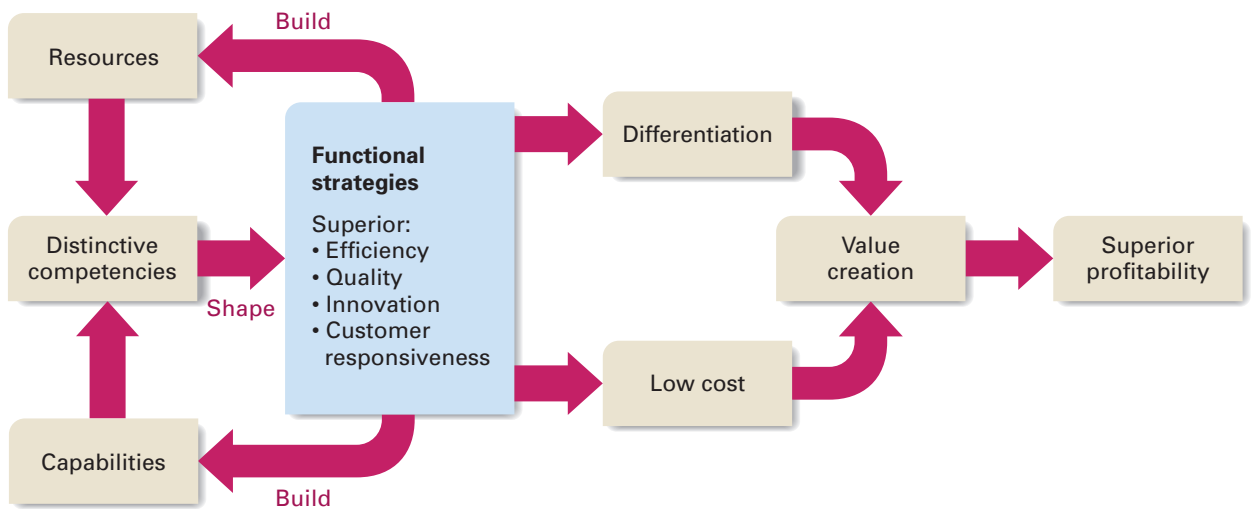
## Overview

In this chapter, we take a close look at **functional-level strategies**: those aimed at improving the effectiveness of a company's operations and, thus, its ability to attain superior efficiency, quality, innovation, and customer responsiveness.

It is important to keep in mind the relationships between functional strategies, distinctive competencies, differentiation, low cost, value creation, and profitability (see Figure 4.1). Distinctive competencies shape the functional-level strategies that a company can pursue. Managers, through their choices with regard to functional-level strategies, can build resources and capabilities that enhance a company's distinctive competencies. Note also that the ability of a company to attain superior efficiency, quality, innovation, and customer responsiveness will determine if its product offering is differentiated from that of its rivals and if it has a low cost structure. Recall that companies that increase the utility consumers get from their products through differentiation, while simultaneously lowering their cost structures, create more value than their rivals. This leads to a competitive advantage and superior profitability and profit growth.

The Opening Case illustrates some of these relationships. Managers at United Technologies pursued functional-level strategies that raised productivity, increasing the efficiency of their production processes, while also increasing the reliability of their final product offering. The superior efficiency enabled United Technologies to



**Figure 4.1** The Roots of Competitive Advantage

lower costs, while superior reliability enhanced product quality and helped to differentiate the product offerings of United Technologies, thereby boosting sales volume. The result: United Technologies created more value, and its profitability increased.

Consistent with the United Technologies example, much of this chapter is devoted to looking at the basic strategies that can be adopted at the functional level to improve competitive position. By the end of this chapter, you will understand how functional-level strategies can be used to build a sustainable competitive advantage.

## ACHIEVING SUPERIOR EFFICIENCY

A company is a device for transforming inputs (labor, land, capital, management, and technological know-how) into outputs (the goods and services produced). The simplest measure of efficiency is the quantity of inputs that it takes to produce a given output; that is,  $\text{efficiency} = \text{outputs/inputs}$ . The more efficient a company is, the fewer the inputs required to produce a given output and the lower its cost structure will be. Put another way, an efficient company has higher productivity, and therefore lower costs, than its rivals. Following, we review the steps that companies can take at the functional level to increase their efficiency and thereby lower their cost structures.

### Efficiency and Economies of Scale

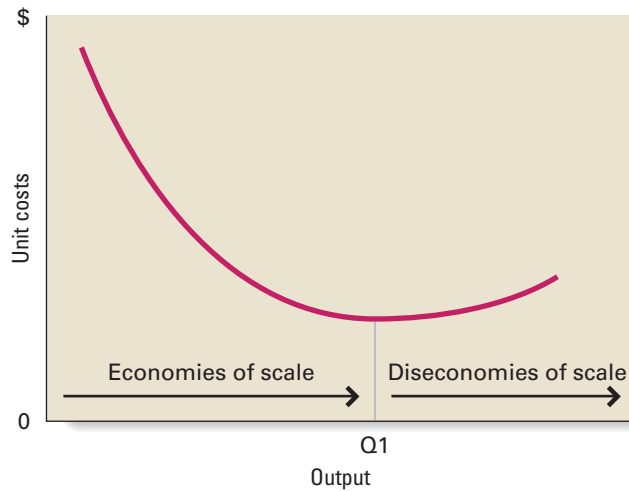
Economies of scale are unit cost reductions associated with a large scale of output. You will recall from the previous chapter that it is very important for managers to understand how the cost structure of their enterprise varies with output because this understanding should help to drive strategy. For example, if unit costs fall significantly as output is expanded—that is, if there are significant economies of scale—a company may benefit by keeping prices down and increasing volume.

One source of economies of scale is the ability to spread fixed costs over a large production volume. **Fixed costs** are costs that must be incurred to produce a product whatever the level of output; examples are the costs of purchasing machinery, setting up machinery for individual production runs, building facilities, advertising, and R&D. For example, Microsoft spent approximately \$5 billion to develop the latest version of its Windows operating system, Windows Vista. It can realize substantial scale economies by spreading the fixed costs associated with developing the new operating system over the enormous unit sales volume it expects for this system (95% of the world's 250 million personal computers use Microsoft operating systems). These scale economies are significant because of the trivial incremental (or marginal) cost of producing additional copies of Windows Vista. Once the master copy has been produced, additional CDs containing the operating system can be produced for a few cents. The key to Microsoft's efficiency and profitability (and that of other companies with high fixed costs and trivial incremental or marginal costs) is to increase sales rapidly enough that fixed costs can be spread out over a large unit volume so that substantial scale economies can be realized.

Another source of scale economies is the ability of companies producing in large volumes to achieve a greater division of labor and specialization. Specialization is said to have a favorable impact on productivity, mainly because it enables employees to become very skilled at performing particular tasks. The classic example of such economies is Ford's Model T car. The world's first mass-produced car, the Model T Ford, was introduced in 1923. Until then, Ford had made cars using an expensive hand-built craft production method. By introducing mass-production techniques, the company achieved greater division of labor (it split assembly into small, repeatable tasks) and specialization, which boosted employee productivity. Ford was also able to spread the fixed costs of developing a car and setting up production machinery over a large volume of output. As a result of these economies, the cost of manufacturing a car at Ford fell from \$3,000 to less than \$900 (in 1958 dollars).

These examples illustrate that economies of scale can boost profitability, as measured by ROIC, in a number of ways. Economies of scale exist in production, sales and marketing, and R&D, and the overall effect of realizing economies of scale is to reduce spending as a percentage of revenues on COGS, SG&A expenses, and R&D expenses, thereby boosting ROS and, by extension, ROIC (see Figure 3.9). Moreover, by making more intensive use of existing capacity, a company can increase the amount of sales generated from its PPE, thereby reducing the amount of capital it needs to generate a dollar of sales, thus increasing its capital turnover and its ROIC.

The concept of economies of scale is illustrated in Figure 4.2, which shows that as a company increases its output, unit costs fall. This process comes to an end at an output of Q1, where all scale economies are exhausted. Indeed, at outputs of greater than Q1, the company may encounter **diseconomies of scale**, which are the unit cost increases associated with a large scale of output. Diseconomies of scale occur primarily because of the increasing bureaucracy associated with large-scale enterprises and the managerial inefficiencies that can result.<sup>2</sup> Larger enterprises have a tendency to develop extensive managerial hierarchies in which dysfunctional political behavior is commonplace, information about operating matters is accidentally and deliberately distorted by the number of managerial layers through which it has to travel to reach top decision makers, and poor decisions are the result. As a result, past some point (such as Q1 in Figure 4.2), the inefficiencies that result from such

**Figure 4.2** Economies and Diseconomies of Scale

developments outweigh any additional gains from economies of scale, and unit costs start to rise as output expands.

Managers must know not only the extent of economies of scale but also where diseconomies of scale begin to occur. At Nucor for example, the realization that diseconomies of scale exist has led to a decision not to build plants that employ more than 300 individuals. The belief is that it is more efficient to build two plants, each employing 300 people, than one plant employing 600 people. Although the larger plant might theoretically be able to reap greater scale economies, Nucor's management believes that these would be swamped by the diseconomies of scale that come with larger organizational units.

## Efficiency and Learning Effects

**Learning effects** are cost savings that come from learning by doing. Labor, for example, learns by repetition how best to carry out a task. Therefore, labor productivity increases over time, and unit costs fall as individuals learn the most efficient way to perform a particular task. Equally important, management in new manufacturing facilities typically learns over time how best to run the new operation. Hence, production costs decline because of increasing labor productivity and management efficiency. Japanese companies like Toyota are noted for making learning a central part of their operating philosophy.

Learning effects tend to be more significant when a technologically complex task is repeated because there is more to learn. Thus, learning effects will be more significant in an assembly process that has 1,000 complex steps than in one with 100 simple steps. Although learning effects are normally associated with the manufacturing process, there is every reason to believe that they are just as important in service industries. For example, one famous study of learning in the context of the health care industry found that more-experienced medical providers posted significantly lower mortality rates for a number of common surgical procedures, suggesting that learning effects are at work in surgery.<sup>3</sup> The authors of this study used the



evidence to argue for establishing regional referral centers for the provision of highly specialized medical care. These centers would perform many specific surgical procedures (such as heart surgery), replacing local facilities with lower volumes and presumably higher mortality rates. Another recent study found strong evidence of learning effects in a financial institution. The study looked at a newly established document-processing unit with 100 staff members and found that, over time, documents were processed much more rapidly as the staff learned the process. Overall, the study concluded that unit costs fell every time the cumulative number of documents processed doubled.<sup>4</sup> Strategy in Action 4.1 looks at the determinants of differences in learning effects across a sample of hospitals performing cardiac surgery.

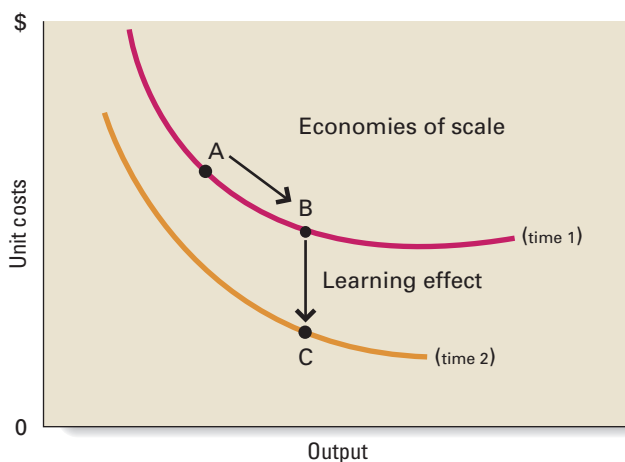
In terms of the unit cost curve of a company, although economies of scale imply a movement along the curve (say, from A to B in Figure 4.3), the realization of learning effects implies a downward shift of the entire curve (B to C in Figure 4.3) as both labor and management become more efficient over time at performing their tasks at every level of output. In accounting terms, learning effects in a production setting will reduce the COGS as a percentage of revenues, enabling the company to earn a higher ROS and ROIC.

No matter how complex the task is, however, learning effects typically die out after a limited period of time. Indeed, it has been suggested that they are really important only during the start-up period of a new process and cease after two or three years.<sup>5</sup> When changes occur to a company's production system—as a result of merger or the use of new information technology, for example—the learning process must begin again.

### Efficiency and the Experience Curve

The **experience curve** refers to the systematic lowering of the cost structure, and consequent unit cost reductions, that have been observed to occur over the life of a product.<sup>6</sup> According to the experience-curve concept, unit manufacturing costs for a product typically decline by some characteristic amount each time accumulated output of the product is doubled (accumulated output is the total output of a product

**Figure 4.3** The Impact of Learning and Scale Economies on Unit Costs



## 4.1 STRATEGY IN ACTION

### Learning Effects in Cardiac Surgery

A study carried out by researchers at the Harvard Business School tried to estimate the importance of learning effects in the case of a specific new technology for minimally invasive heart surgery that was approved by federal regulators in 1996. The researchers looked at 16 hospitals and obtained data on the operations for 660 patients. They examined how the time required to undertake the procedure varied with cumulative experience. Across the 16 hospitals, they found that average time fell from 280 minutes for the first procedure with the new technology to 220 minutes by the time a hospital had performed 50 procedures. (Note that not all of the hospitals performed 50 procedures, and the estimates represent an extrapolation based on the data.)

Next they looked at differences across hospitals. They found evidence of very large differences in learning effects. One hospital, in particular, stood out. This hospital, which they called "Hospital M," reduced its net procedure time from 500 minutes on case 1 to 132 minutes by case 50. Hospital M's 88-minute procedure time advantage over the average hospital at case 50 translated into a cost saving of approximately \$2,250 per case and allowed surgeons at the hospital to do one more revenue-generating procedure per day.

The researchers tried to find out why Hospital M was superior. They noted that all hospitals had similar state-of-the-art operating rooms and used the same set of FDA approved devices. All adopting surgeons went through

the same training courses, and all surgeons came from highly respected training hospitals. Follow-up interviews, however, suggested that Hospital M differed in how it implemented the new procedure. The team was hand-picked by the adopting surgeon to perform the surgery. It had significant prior experience working together (That was apparently a key criterion for team members.) The team trained together to perform the new surgery. Before undertaking a single procedure, they met with the operating room nurses and anesthesiologists to discuss the procedure. Moreover, the adopting surgeon mandated that the surgical team and surgical procedure was stable in the early cases. The initial team went through 15 procedures, and new members were added or substituted 20 cases before the procedures were modified. The adopting surgeon also insisted that the team meet prior to each of the first 10 cases, and they also met after the first 20 cases to debrief.

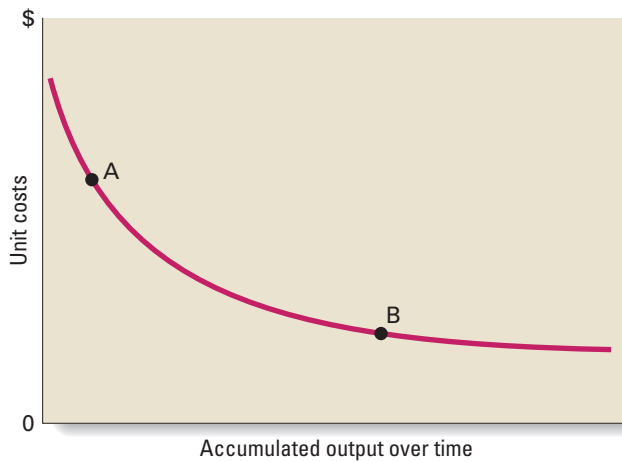
The picture that emerges is one of a core team that was selected and managed to maximize the gains from learning. Unlike other hospitals in which there was less stability of team members and procedures, and less attention to briefing, debriefing, and learning, surgeons at Hospital M both learned much faster, and ultimately achieved higher productivity than their peers in other institutions. Clearly, differences in the implementation of the new procedure were very important.

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**Source:** G. P. Pisano, R. M. J. Bohmer, and A. C. Edmondson, "Organizational Differences in Rates of Learning: Evidence from the Adoption of Minimally Invasive Cardiac Surgery," *Management Science* 47 (2001): 752–768.

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since its introduction). This relationship was first observed in the aircraft industry, in which it was found that each time the accumulated output of airframes was doubled, unit costs declined to 80% of their previous level.<sup>7</sup> Thus, the fourth airframe typically cost only 80% of the second airframe to produce; the eighth airframe only 80% of the fourth; the 16th only 80% of the eighth; and so on. The outcome of this process is a relationship between unit manufacturing costs and accumulated output similar to that illustrated in Figure 4.4. Economies of scale and learning effects underlie the experience-curve phenomenon. Put simply, as a company increases the accumulated volume of its output over time, it is able to realize both economies of scale (as volume increases) and learning effects. Consequently, unit costs and cost structure fall with increases in accumulated output.

**Figure 4.4** The Experience Curve

The strategic significance of the experience curve is clear: increasing a company's product volume and market share will lower its cost structure relative to its rivals. Thus, company B in Figure 4.4, because it is farther down the experience curve, has a cost advantage over company A because of its lower cost structure. The concept is very important in industries that mass-produce a standardized output (for example, the manufacture of semiconductor chips). A company that wishes to become more efficient and lower its cost structure must try to ride down the experience curve as quickly as possible. This means constructing efficient scale manufacturing facilities even before it has generated demand for the product and aggressively pursuing cost reductions from learning effects. It might also need to adopt an aggressive marketing strategy—cutting prices to the bone, stressing heavy sales promotions and extensive advertising to build up demand, hence, accumulating volume as quickly as possible. The need to be aware of the relationship of demand, price options, and costs noted in Chapter 3 is clear.

Once down the experience curve because of its superior efficiency, the company is likely to have a significant cost advantage over its competitors. For example, it has been argued that Intel uses such tactics to ride down the experience curve and gain a competitive advantage over its rivals in the market for microprocessors.<sup>8</sup>

However, there are three reasons why managers should not become complacent about efficiency-based cost advantages derived from experience effects. First, because neither learning effects nor economies of scale go on forever, the experience curve is likely to bottom out at some point; indeed, it must do so by definition. When this occurs, further unit cost reductions from learning effects and economies of scale will be hard to come by. Thus, in time, other companies can lower their cost structures and match the cost leader. Once this happens, a number of low-cost companies can have cost parity with each other. In such circumstances, a sustainable competitive advantage must rely on strategic factors besides the minimization of production costs by using existing technologies—factors such as better responsiveness to customers, product quality, or innovation.

Second, as noted in Chapter 2, changes that are always taking place in the external environment disrupt a company's business model, so cost advantages gained

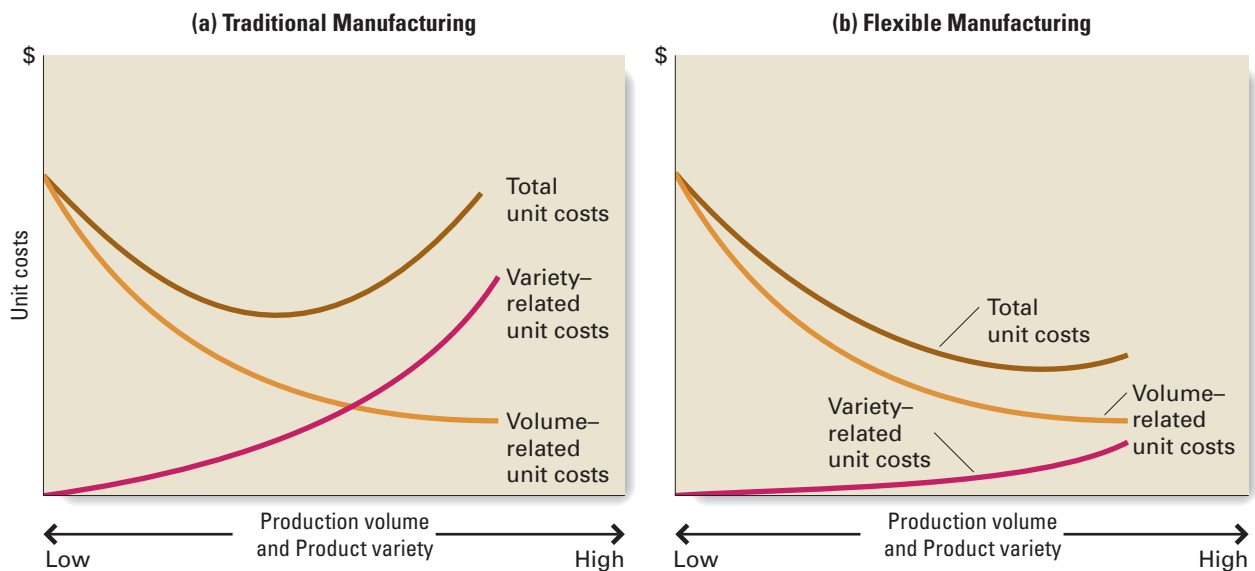
from experience effects can be made obsolete by the development of new technologies. The price of television picture tubes followed the experience-curve pattern from the introduction of television in the late 1940s until 1963. The average unit price dropped from \$34 to \$8 (in 1958 dollars) in that time. However, the advent of color TV interrupted the experience curve. To make picture tubes for color TVs, a new manufacturing technology was required, and the price of color TV tubes shot up to \$51 by 1966. Then, the experience curve reasserted itself. The price dropped to \$48 in 1968, \$37 in 1970, and \$36 in 1972.<sup>9</sup> In short, technological change can alter the rules of the game, requiring that former low-cost companies take steps to reestablish their competitive edge.

A further reason for avoiding complacency is that producing a high volume of output does not necessarily give a company a lower cost structure. Different technologies have different cost structures. For example, the steel industry has two alternative manufacturing technologies: an integrated technology, which relies on the basic oxygen furnace, and a mini-mill technology, which depends on the electric arc furnace. Whereas the basic oxygen furnace requires high volumes to attain maximum efficiency, mini-mills are cost efficient at relative low volumes. Moreover, even when both technologies are producing at their most efficient output levels, steel companies with basic oxygen furnaces do not have a cost advantage over mini-mills. Consequently, the pursuit of experience economies by an integrated company using basic oxygen technology may not bring the kind of cost advantages that a naive reading of the experience-curve phenomenon would lead the company to expect. Indeed, there have been significant periods of time when integrated companies have not been able to get enough orders to run at optimum capacity. Hence, their production costs have been considerably higher than those of mini-mills.<sup>10</sup> As we discuss next, new flexible manufacturing technologies in many industries hold out the promise of allowing small manufacturers to produce at unit costs comparable to those of large assembly-line operations.

### **Efficiency, Flexible Production Systems, and Mass Customization**

Central to the concept of economies of scale is the idea that the best way to achieve high efficiency and a lower cost structure is through the mass production of a standardized output. The tradeoff implicit in this idea is between unit costs and product variety. Producing greater product variety from a factory implies shorter production runs, which implies an inability to realize economies of scale and higher costs. That is, a wide product variety makes it difficult for a company to increase its production efficiency and thus reduce its unit costs. According to this logic, the way to increase efficiency and achieve a lower cost structure is to limit product variety and produce a standardized product in large volumes (see Figure 4.5a).

This view of production efficiency has been challenged by the rise of flexible production technologies. The term **flexible production technology**—or lean production as it is sometimes called—covers a range of technologies designed to reduce setup times for complex equipment, increase the use of individual machines through better scheduling, and improve quality control at all stages of the manufacturing process.<sup>11</sup> Flexible production technologies allow the company to produce a wider variety of end products at a unit cost that at one time could be achieved only through the mass production of a standardized output (see Figure 4.5b). Indeed, research suggests that the adoption of flexible production technologies may increase efficiency

**Figure 4.5** Tradeoff between Costs and Product Variety

and lower unit costs relative to what can be achieved by the mass production of a standardized output, while at the same time enabling the company to customize its product offering to a much greater extent than was once thought possible. The term **mass customization** has been coined to describe the ability of companies to use flexible manufacturing technology to reconcile two goals that were once thought to be incompatible: low cost and differentiation through product customization.<sup>12</sup> For an extended example of the benefits of mass customization, see Strategy in Action 4.2, which looks at mass customization at Lands' End.

Flexible machine cells are a common flexible production technology. A flexible machine cell is a grouping of various types of machinery, a common materials handler, and a centralized cell controller (a computer). Each cell normally contains four to six machines capable of performing a variety of operations but dedicated to producing a family of parts or products. The settings on the machines are computer controlled, which allows each cell to switch quickly between the production of different parts or products.

Improved capacity utilization and reductions in work in progress (that is, stockpiles of partly finished products) and waste are major efficiency benefits of flexible machine cells. Improved capacity utilization arises from the reduction in setup times and the computer-controlled coordination of production flow between machines, which eliminates bottlenecks. The tight coordination between machines also reduces work in progress. Reductions in waste are due to the ability of computer-controlled machinery to identify ways to transform inputs into outputs while producing a minimum of unusable waste material. Freestanding machines might be in use 50% of the time; the same machines when grouped into a cell can be used more than 80% of the time and produce the same end product with half the waste, thereby increasing efficiency and resulting in lower costs.

The effects of installing flexible production technology on a company's cost structure can be dramatic. Ford is currently introducing flexible production

## 4.2 STRATEGY IN ACTION

### Mass Customization at Lands' End

Years ago, almost all clothing was made to individual order by a tailor (a job shop production method). Then along came the 20th century and techniques for mass production, mass marketing, and mass selling. Production in the industry shifted toward larger volume and less variety based on standardized sizes. The benefits in terms of production cost reductions were enormous, but the customer did not always win. Offset against lower prices was the difficulty of finding clothes that fit as well as tailored clothes did. People come in a bewildering variety of shapes and sizes. Going into a store to purchase a shirt, you get to choose between just four-sizes—small, medium, large, and extra large. It is estimated the current sizing categories in clothing fit only about one-third of the population. The rest of us wear clothes in which the fit is less than ideal.

The mass production system has drawbacks for apparel manufacturers and retailers as well. Year after year, apparel firms find themselves saddled with billions of dollars in excess inventory that is either thrown away, or put on sale, because retailers had too many items of the wrong size and color. To try and solve this problem, Lands' End has been experimenting with mass customization techniques.

To purchase customized clothes from Lands' End, the customer provides information on Lands' End Web site by answering a series of 15 questions (for pants) or 25 questions (for shirts) covering nearly everything from

waist to inseam. The process takes about 20 minutes the first time through, but once the information is saved by Lands' End, it can be quickly accessed for repeat purchases. The customer information is then analyzed by an algorithm that pinpoints a person's body dimensions by taking these data points and running them against a huge database of typical sizes to create a unique, customized pattern. The analysis is done automatically by a computer that transmits the order to one of five contract manufacturer plants in the United States and elsewhere; the plant cuts and sews the garment and ships the finished product directly to the customer.

Today customization is available for most categories of Lands' End clothing. Some 40% of its online shoppers choose a customized garment over the standard-sized equivalent when they have the choice. Even though prices for customized clothes are at least \$20 higher and take about three to four weeks to arrive, customized clothing reportedly accounts for a rapidly growing percentage of Lands' End's \$500 million online business. Lands' End states that its profit margins are roughly the same for customized clothes as regular clothes, but the reductions in inventories that come from matching demand to supply account for additional cost savings. Moreover, customers who customize appear to be more loyal, with reordering rates that are 34% higher than for buyers of standard-sized clothing.

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**Sources:** J. Schlosser, "Cashing in on the New World of Me," *Fortune*, December 13, 2004, 244–249; V. S. Borland, "Global Technology in the Twenty-First Century," *Textile World*, January 2003, 42–56; <http://www.landsend.com>.

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technologies into its automotive plants around the world. These new technologies should allow Ford to produce multiple models from the same line and to switch production from one model to another much more quickly than in the past. In total, Ford hopes to take \$2 billion out of its cost structure between 2006 and 2010 through flexible manufacturing.<sup>13</sup>

More generally, in terms of the profitability framework developed in Chapter 3, flexible production technology should boost profitability (measured by ROIC) by reducing the COGS as a percentage of revenues, reducing the working capital needed to finance work-in-progress (because there is less of it), and reducing the amount of capital that needs to be invested in PPE to generate a dollar of sales (because less space is needed to store inventory).



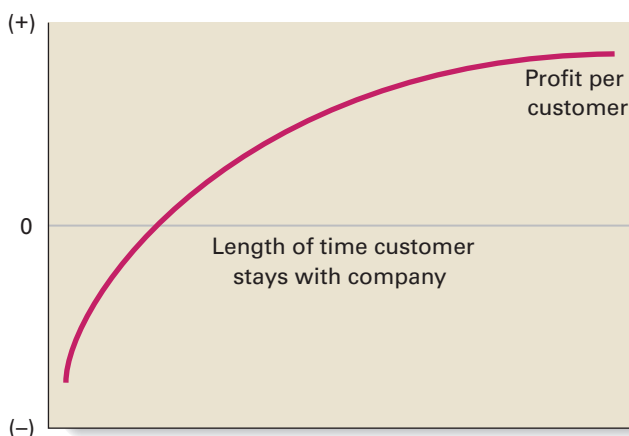
## Marketing and Efficiency

The marketing strategy that a company adopts can have a major impact on efficiency and cost structure. **Marketing strategy** refers to the position that a company takes with regard to pricing, promotion, advertising, product design, and distribution. Some of the steps leading to greater efficiency are fairly obvious. For example, riding down the experience curve to achieve a lower cost structure can be facilitated by aggressive pricing, promotions, and advertising, all of which are the task of the marketing function. Other aspects of marketing strategy have a less obvious but no less important impact on efficiency. One important aspect is the relationship of customer defection rates, cost structure, and unit costs.<sup>14</sup>

**Customer defection rates** (or “churn rates”) are the percentage of a company’s customers who defect every year to competitors. Defection rates are determined by customer loyalty, which in turn is a function of the ability of a company to satisfy its customers. Because acquiring a new customer entails certain one-time fixed costs for advertising, promotions, and the like, there is a direct relationship between defection rates and costs. The longer a company holds on to a customer, the greater is the volume of customer-generated unit sales that can be set against these fixed costs and the lower the average unit cost of each sale. Thus, lowering customer defection rates allows a company to achieve a lower cost structure.

One consequence of the defection-cost relationship is illustrated in Figure 4.6. Because of the relatively high fixed costs of acquiring new customers, serving customers who stay with a company only for a short time before switching to competitors often leads to a loss on the investment made to acquire those customers. The longer a customer stays with a company, the more the fixed costs of acquiring that customer can be spread out over repeat purchases, boosting the profit per customer. Thus, there is a positive relationship between the length of time that a customer stays with a company and profit per customer. If a company can reduce customer defection rates, it can make a much better return on its investment in acquiring customers and thereby boost its profitability. In terms of the profitability framework developed in Chapter 3,

**Figure 4.6** The Relationship between Customer Loyalty and Profit per Customer



reduced customer defection rates mean that the company needs to spend less on SG&A expenses to generate a dollar of sales revenue, which increases both return on sales and ROIC.

For an example, consider the credit card business.<sup>15</sup> Most credit card companies spend an average of \$50 to recruit a customer and set up a new account. These costs come from the advertising required to attract new customers, the credit checks required for each customer, and the mechanics of setting up an account and issuing a card. These one-time fixed costs can be recouped only if a customer stays with the company for at least two years. Moreover, when customers stay a second year, they tend to increase their use of the credit card, which raises the volume of revenues generated by each customer over time. As a result, although the credit card business loses \$50 per customer in year 1, it makes a profit of \$44 in year 3 and \$55 in year 6.

Another economic benefit of long-time customer loyalty is the free advertising that customers provide for a company. Loyal customers can dramatically increase the volume of business through referrals. A striking example is Britain's largest retailer, the clothing and food company Marks & Spencer, whose success is built on a well-earned reputation for providing its customers with high-quality goods at reasonable prices. The company has generated such customer loyalty that it does not need to advertise in Britain, a major source of cost saving.

The key message, then, is that reducing customer defection rates and building customer loyalty can be major sources of a lower cost structure. One study has estimated that a 5% reduction in customer defection rates leads to the following increases in profits per customer over average customer life: 75% in the credit card business; 50% in the insurance brokerage industry; 45% in the industrial laundry business; and 35% in the computer software industry.<sup>16</sup>

A central component of developing a strategy to reduce defection rates is to identify customers who have defected, find out why they defected, and act on that information so that other customers do not defect for similar reasons in the future. To take these measures, the marketing function must have information systems capable of tracking customer defections.

## MATERIALS MANAGEMENT, JUST-IN-TIME, AND EFFICIENCY

The contribution of materials management (logistics) in boosting the efficiency of a company can be just as dramatic as the contribution of production and marketing. Materials management encompasses the activities necessary to get inputs and components to a production facility (including the costs of purchasing inputs), through the production process, and out through a distribution system to the end user.<sup>17</sup> Because there are so many sources of cost in this process, the potential for reducing costs through more efficient materials-management strategies is enormous. For a typical manufacturing company, materials and transportation costs account for 50% to 70% of its revenues, so even a small reduction in these costs can have a substantial impact on profitability. According to one estimate, for a company with revenues of \$1 million, an ROIC of 5%, and materials-management costs that amount to 50% of sales revenues (including purchasing costs), increasing total profits by \$15,000 would require either a 30% increase in sales revenues or a

3% reduction in materials costs.<sup>18</sup> In a typical competitive market, reducing materials costs by 3% is usually much easier than increasing sales revenues by 30%.

Improving the efficiency of the materials-management function typically requires the adoption of a **just-in-time (JIT)** inventory system, which is designed to economize on inventory holding costs by having components arrive at a manufacturing plant just in time to enter the production process or to have goods arrive at a retail store only when stock is almost depleted. The major cost saving comes from increasing inventory turnover, which reduces inventory holding costs, such as warehousing and storage costs, and the company's need for working capital. For example, through efficient logistics Walmart can replenish the stock in its stores at least twice a week; many stores receive daily deliveries if they are needed. The typical competitor replenishes its stock every two weeks, so it has to carry a much higher inventory and needs more working capital per dollar of sales. Compared to its competitors, Walmart can maintain the same service levels with a lower investment in inventory, a major source of its lower cost structure. Thus, faster inventory turnover has helped Walmart achieve an efficiency-based competitive advantage in the retailing industry.<sup>19</sup>

More generally, in terms of the profitability model developed in Chapter 3, JIT inventory systems reduce the need for working capital (because there is less inventory to finance) and fixed capital to finance storage space (because there is less to store). This reduces capital needs, increases capital turnover, and, by extension, boosts the return on invested capital.

The drawback of JIT systems is that they deny companies buffer stocks of inventory. Although buffer stocks are expensive to store, they can help tide a company over shortages of inputs brought about by disruption among suppliers (for instance, a labor dispute at a key supplier) and can help a company respond quickly to increases in demand. However, there are ways around these limitations. For example, to reduce the risks linked to dependence on just one supplier for an important input, a company might decide to source inputs from multiple suppliers.

Recently, the efficient management of materials and inventory has been recast in terms of **supply-chain management**: the task of managing the flow of inputs and components from suppliers into the company's production processes to minimize inventory holding and maximize inventory turnover. One of the exemplary companies in terms of supply-chain management is Dell, whose goal is to streamline its supply chain to such an extent that it "replaces inventory with information."

## R&D Strategy and Efficiency

The role of superior R&D in helping a company achieve a greater efficiency and a lower cost structure is twofold. First, the R&D function can boost efficiency by designing products that are easy to manufacture. By cutting down on the number of parts that make up a product, R&D can dramatically decrease the required assembly time, which translates into higher employee productivity, lower costs, and higher profitability. For example, after Texas Instruments redesigned an infrared sighting mechanism that it supplies to the Pentagon, it found that it had reduced, the number of parts from 47 to 12, the number of assembly steps from 56 to 13, the time spent fabricating metal from 757 minutes per unit to 219 minutes per unit, and unit assembly time from 129 minutes to 20 minutes. The result was a substantial decline in production costs. Design for manufacturing requires close coordination between the production and R&D functions of a

company, of course. Cross-functional teams that contain production and R&D personnel who work jointly on the problem best achieve this.

The second way in which the R&D function can help a company achieve a lower cost structure is by pioneering process innovations. A process innovation is an innovation in the way production processes operate that improves their efficiency. Process innovations have often been a major source of competitive advantage. Toyota's competitive advantage is based partly on the company's invention of new flexible manufacturing processes that dramatically reduced setup times. This process innovation enabled it to obtain efficiency gains associated with flexible manufacturing systems years ahead of its competitors.

## Human Resource Strategy and Efficiency

Employee productivity is one of the key determinants of an enterprise's efficiency, cost structure, and profitability.<sup>20</sup> Productive manufacturing employees can lower COGS as a percentage of revenues, a productive sales force can increase sales revenues for a given level of expenses, and productive employees in the company's R&D function can boost the percentage of revenues generated from new products for a given level of R&D expenses. Thus, productive employees lower the costs of generating revenues, increase ROS, and by extension boost the company's ROIC. The challenge for a company's human resource function is to devise ways to increase employee productivity. Among the choices it has are using certain hiring strategies, training employees, organizing the workforce into self-managing teams, and linking pay to performance. The running case in this chapter looks at the steps Walmart has taken to boost employee productivity.

**Hiring Strategy** Many companies that are known for their productive employees devote considerable attention to hiring. Southwest Airlines hires people who have positive attitudes and work well in teams because it believes these people will work hard and interact well with customers, helping to create customer loyalty. Nucor hires people who are self-reliant and goal-oriented because its employees work in self-managing teams in which they need these qualities to perform well. As these examples suggest, it is important to make sure that the hiring strategy of the company is consistent with its own internal organization, culture, and strategic priorities. The people a company hires should have attributes that match the strategic objectives of the company.

**Employee Training** Employees are a major input into the production process. Those who are highly skilled can perform tasks faster and more accurately and are more likely to learn the complex tasks associated with many modern production methods than individuals with lesser skills. Training upgrades employee skill levels, bringing the company productivity-related efficiency gains from learning and experimentation.<sup>21</sup>

**Self-Managing Teams** The use of **self-managing teams**, whose members coordinate their own activities and make their own hiring, training, work, and reward decisions, has been spreading rapidly. The typical team comprises five to fifteen employees who produce an entire product or undertake an entire task. Team members learn all team tasks and rotate from job to job. Because a more flexible workforce is a result, team members can fill in for absent coworkers and take over managerial duties such

## RUNNING CASE

### Human Resource Strategy and Productivity at Walmart

Walmart has one of the most productive workforces of any retailer. The roots of Walmart's high productivity go back to the company's early days and the business philosophy of the company's founder, Sam Walton. Walton started off his career as a management trainee at JCPenney. There he noticed that all employees were called associates, and, moreover, that treating them with respect seemed to reap dividends in the form of high employee productivity.

When he founded Walmart, Walton decided to call all employees "associates" to symbolize their importance to the company. He reinforced this by emphasizing that at Walmart, "Our people make the difference." Unlike many managers who have stated this mantra, Walton believed it and put it into action. He believed that if he treated people well, they would return the favor by working hard, and that if he empowered them, ordinary people could work together to achieve extraordinary things. These beliefs formed the basis for a decentralized organization that operated with an open-door policy and open books. This allowed associates to see just how their store and the company were doing.

Consistent with the open-door policy, Walton continually emphasized that management needed to listen to associates and their ideas. As he noted:

The folks on the front lines—the ones who actually talk to the customer—are the only ones who really know what's going on out there. You'd better find out what they know. This really is what total quality is all about. To push responsibility down in your organization, and to force good ideas to bubble up within it, you must listen to what your associates are trying to tell you.

For all of his belief in empowerment, however, Walton was notoriously tight on pay. Walton opposed unionization, fearing that it would lead to higher pay and restrictive work rules that would sap productivity. The culture of Walmart also encouraged people to work hard. One of Walton's favorite homilies was the "sun-

down rule," which stated that one should never put off until tomorrow what can be done today. The sundown rule was enforced by senior managers, including Walton, who would drop in unannounced at a store, peppering store managers and employees with questions, but at the same time praising them for a job well done and celebrating the "heroes" who took the sundown rule to heart and did today what could have been put off for tomorrow.

The key to getting extraordinary effort out of employees, while paying them meager salaries, was to reward them with profit-sharing plans and stock-ownership schemes. Long before it became fashionable in American business, Walton was placing a chunk of Walmart's profits into a profit-sharing plan for associates, and the company put matching funds into employee stock-ownership programs. The idea was simple: reward associates by giving them a stake in the company, and they will work hard for low pay because they know they will make it up in profit sharing and stock price appreciation.

For years, this formula worked extraordinarily well, but there are now signs that Walmart's very success is creating problems. In 2008, the company had a staggering 2.1 million associates, making it the largest private employer in the world. As the company has grown, it has become increasingly difficult to hire people that Walmart has traditionally relied on—those willing to work long hours for low pay based on the promise of advancement and reward through profit sharing and stock ownership. The company has come under attack for paying its associates low wages and pressuring them to work long hours without overtime pay. Labor unions have made a concerted but so far unsuccessful attempt over time to unionize stores, and the company itself is the target of lawsuits from employees alleging sexual discrimination. Walmart claims that the negative publicity is based on faulty data, and perhaps that is right, but if the company has indeed become too big to put Walton's principles into practice, the glory days may be over.

as scheduling work and vacation, ordering materials, and hiring new members. The greater responsibility thrust on team members and the empowerment it implies are seen as motivators. (Empowerment is the process of giving lower-level employees decision-making power.) People often respond well to being given greater autonomy and responsibility. Performance bonuses linked to team production and quality targets work as an additional motivator.

The effect of introducing self-managing teams is reportedly an increase in productivity of 30% or more and a substantial increase in product quality. Further cost savings arise from eliminating supervisors and creating a flatter organizational hierarchy, which also lowers the cost structure of the company. In manufacturing companies, perhaps the most potent way to lower the cost structure is to combine self-managing teams with flexible manufacturing cells. For example, after the introduction of flexible manufacturing technology and work practices based on self-managing teams, a GE plant in Salisbury, North Carolina, increased productivity by 250% compared with GE plants that produced the same products four years earlier.<sup>22</sup>

Still, teams are no panacea; in manufacturing companies, self-managing teams may fail to live up to their potential unless they are integrated with flexible manufacturing technology. Also, teams put a lot of management responsibilities on team members, and helping team members to cope with these responsibilities often requires substantial training—a fact that many companies often forget in their rush to drive down costs, with the result that the teams do not work out as well as planned.<sup>23</sup>

**Pay for Performance** It is hardly surprising that linking pay to performance can help increase employee productivity, but the issue is not quite so simple as just introducing incentive pay systems. It is also important to define what kind of job performance is to be rewarded and how. Some of the most efficient companies in the world, mindful that cooperation among employees is necessary to realize productivity gains, link pay to group or team (rather than individual) performance. Nucor divides its workforce into teams of 30 or so, with bonus pay, which can amount to 30% of base pay, linked to the ability of the team to meet productivity and quality goals. This link creates a strong incentive for individuals to cooperate with each other in pursuit of team goals; that is, it facilitates teamwork.

## Information Systems and Efficiency

With the rapid spread of computers, the explosive growth of the Internet and corporate intranets (internal corporate computer networks based on Internet standards), and the spread of high-bandwidth fiber optics and digital wireless technology, the information systems function is moving to center stage in the quest for operating efficiencies and a lower cost structure.<sup>24</sup> The impact of information systems on productivity is wide ranging and potentially affects all other activities of a company. For example, Cisco Systems has been able to realize significant cost savings by moving its ordering and customer service functions online. The company has just 300 service agents handling all of its customer accounts, compared to the 900 it would need if sales were not handled online. The difference represents an annual saving of \$20 million a year. Moreover, without automated customer service functions, Cisco calculates that it would need at least 1,000 additional service engineers, which would cost about \$75 million.<sup>25</sup> Dell also makes extensive use of the Internet to lower its cost structure and differentiate itself from rivals.

### Ethical Dilemma

Reread the running case on Walmart then discuss the following question: Is it ethical for Walmart to pay its employees minimum wage and to oppose unionization, given that the organization also works its people very hard? Are Walmart's employment and compensation practices for lower-level employees (i.e., associates) ethical?



Like Cisco and Dell, many companies are using Web-based information systems to reduce the costs of coordination between the company and its customers and the company and its suppliers. By using Web-based programs to automate customer and supplier interactions, companies can substantially reduce the number of people required to manage these interfaces, thereby reducing costs. This trend extends beyond high-tech companies. Banks and financial service companies are finding that they can substantially reduce costs by moving customer accounts and support functions online. Such a move reduces the need for customer service representatives, bank tellers, stockbrokers, insurance agents, and others. For example, it costs an average of about \$1.07 to execute a transaction at a bank, such as shifting money from one account to another; executing the same transaction via the Internet costs \$0.01.<sup>26</sup>

Similarly, the theory behind Internet-based retailers such as amazon.com is that by replacing physical stores and their supporting personnel with an online virtual store and automated ordering and checkout processes, a company can take significant costs out of the retailing system. Cost savings can also be realized by using Web-based information systems to automate many internal company activities, from managing expense reimbursements to benefits planning and hiring processes, thereby reducing the need for internal support personnel.

## Infrastructure and Efficiency

A company's infrastructure—that is, its structure, culture, style of strategic leadership, and control system—determines the context within which all other value creation activities take place. It follows that improving infrastructure can help a company increase efficiency and lower its cost structure. Above all, an appropriate infrastructure can help foster a company-wide commitment to efficiency and promote cooperation among different functions in pursuit of efficiency goals. These issues are addressed at length in later chapters.

For now, it is important to note that strategic leadership is especially important in building a company-wide commitment to efficiency. The leadership task is to articulate a vision that recognizes the need for all functions of a company to focus on improving efficiency. It is not enough to improve the efficiency of production, or of marketing, or of R&D in a piecemeal fashion. Achieving superior efficiency requires a company-wide commitment to this goal that must be articulated by general and functional managers. A further leadership task is to facilitate the cross-functional cooperation needed to achieve superior efficiency. For example, designing products that are easy to manufacture requires that production and R&D personnel communicate; integrating JIT systems with production scheduling requires close communication between materials management and production; designing self-managing teams to perform production tasks requires close cooperation between human resources and production; and so on.

## Summary: Achieving Efficiency

Table 4.1 summarizes the primary roles that various functions must take to achieve superior efficiency. Bear in mind that achieving superior efficiency is not something that can be tackled on a function-by-function basis. It requires an organization-wide commitment and an ability to ensure close cooperation among functions. Top management, by exercising leadership and influencing the infrastructure, plays a major role in this process.



**Table 4.1** Primary Roles of Value Creation Functions in Achieving Superior Efficiency

Value Creation Function	Primary Roles
Infrastructure (leadership)	<ol style="list-style-type: none"> <li>1. Provide company-wide commitment to efficiency</li> <li>2. Facilitate cooperation among functions</li> </ol>
Production	<ol style="list-style-type: none"> <li>1. Where appropriate, pursue economies of scale and learning economics</li> <li>2. Implement flexible manufacturing systems</li> </ol>
Marketing	<ol style="list-style-type: none"> <li>1. Where appropriate, adopt aggressive marketing to ride down the experience curve</li> <li>2. Limit customer defection rates by building brand loyalty</li> </ol>
Materials management	<ol style="list-style-type: none"> <li>1. Implement JIT systems</li> <li>2. Implement supply-chain coordination</li> </ol>
R&D	<ol style="list-style-type: none"> <li>1. Design products for ease of manufacture</li> <li>2. Seek process innovations</li> </ol>
Information systems	<ol style="list-style-type: none"> <li>1. Use information systems to automate processes</li> <li>2. Use information systems to reduce costs of coordination</li> </ol>
Human resources	<ol style="list-style-type: none"> <li>1. Institute training programs to build skills</li> <li>2. Implement self-managing teams</li> <li>3. Implement pay for performance</li> </ol>

## ACHIEVING SUPERIOR QUALITY

In Chapter 3, we noted that quality can be thought of in terms of two dimensions: *quality as reliability* and *quality as excellence*. High-quality products are reliable, in the sense that they do the job they were designed for and do it well, and are also perceived by consumers to have superior attributes. We also noted that superior quality gives a company two advantages. First, a strong reputation for quality allows a company to differentiate its products from those offered by rivals, thereby creating more utility in the eyes of customers, which gives a company the option of charging a premium price for its products. Second, eliminating defects or errors from the production process reduces waste, increases efficiency, and lowers the cost structure of a company and increases its profitability. For example, reducing the number of defects in a company's manufacturing process will lower the COGS as a percentage of revenues, thereby raising the company's ROS and ROIC. In this section, we look in more depth at what managers can do to enhance the reliability and other attributes of a company's product offering.

## Attaining Superior Reliability

The principal tool that most managers now use to increase the reliability of their product offering is the Six Sigma quality-improvement methodology. The Six Sigma methodology is a direct descendant of the TQM philosophy that was widely adopted, first by Japanese companies and then by American companies, during the 1980s and early 1990s.<sup>27</sup> The TQM concept was developed by a number of American management consultants, including W. Edwards Deming, Joseph Juran, and A. V. Feigenbaum.<sup>28</sup>

Originally, these consultants won few converts in the United States. However, managers in Japan embraced their ideas enthusiastically and even named their premier annual prize for manufacturing excellence after Deming. The philosophy underlying TQM, as articulated by Deming, is based on the following five-step chain reaction:

1. Improved quality means that costs decrease because of less rework, fewer mistakes, fewer delays, and better use of time and materials.
2. As a result, productivity improves.
3. Better quality leads to higher market share and allows the company to raise prices.
4. This increases the company's profitability and allows it to stay in business.
5. Thus the company creates more jobs.<sup>29</sup>

Deming identified a number of steps that should be part of any quality-improvement program: A company should have a clear business model to specify where it is going and how it is going to get there.

1. Management should embrace the philosophy that mistakes, defects, and poor-quality materials are not acceptable and should be eliminated.
2. Quality of supervision should be improved by allowing more time for supervisors to work with employees and giving them appropriate skills for the job.
3. Management should create an environment in which employees will not fear reporting problems or recommending improvements.
4. Work standards should not only be defined as numbers or quotas but also include some notion of quality to promote the production of defect-free output.
5. Management is responsible for training employees in new skills to keep pace with changes in the workplace.
6. Achieving better quality requires the commitment of everyone in the company.

It took the rise of Japan to the top rank of economic powers in the 1980s to alert western business to the importance of the TQM concept. Since then, quality-improvement programs have spread rapidly throughout western industry. Strategy in Action 4.3 describes one of the most successful implementations of a quality-improvement process, GE's Six Sigma program.

Despite such instances of spectacular success, quality-improvement practices are not universally accepted. A study by the American Quality Foundation found that only 20% of United States companies regularly review the consequences of quality performance, compared with 70% of Japanese companies.<sup>30</sup> Another study, this one by Arthur D. Little, of 500 American companies using TQM found that only 36% believed that TQM was increasing their competitiveness.<sup>31</sup> A prime reason for this, according to the study, was that many companies had not fully understood or

## 4.3 STRATEGY IN ACTION

### GE's Six Sigma Quality Improvement Process

Six Sigma, a quality and efficiency program adopted by several major corporations, including Motorola, GE, and Allied Signal, aims to reduce defects, boost productivity, eliminate waste, and cut costs throughout a company. "Sigma" comes from the Greek letter that statisticians use to represent a standard deviation from a mean: the higher the number of sigma, the smaller the number of errors. At Six Sigma, a production process would be 99.99966% accurate, creating just 3.4 defects per million units. Although it is almost impossible for a company to achieve such perfection, several companies strive toward that goal.

GE is perhaps the most well-known adopter of Six Sigma programs. Under the direction of long-serving CEO Jack Welch, GE spent nearly \$1 billion to convert all of its divisions to the Six Sigma faith.

One of the first products that was designed from start to finish using Six Sigma processes was a \$1.25 million diagnostic computer tomography (CT) scanner, the Lightspeed, which produces rapid three-dimensional images of the human body. The new scanner captures multiple images simultaneously, requiring only 20 seconds to do full-body scans that once took three minutes—important because patients must remain perfectly still during the scan. GE spent \$50 million to run 250 separate Six Sigma analyses designed to improve the reliability and lower the manufacturing cost of the new scanner. Its efforts were rewarded when the Lightspeed's first customers soon noticed that it ran without downtime from the start, a testament to the reliability of the product.

Achieving that reliability took a lot of work. GE's engineers deconstructed the scanner into its basic

components and tried to improve the reliability of each component through a detailed step-by-step analysis. For example, the most important part of CT scanners is vacuum tubes that focus X-ray waves. The tubes that GE used in previous scanners, which cost \$60,000 each, suffered from low reliability. Hospitals and clinics wanted the tubes to operate for 12 hours a day for at least six months, but typically they lasted only half that long. Moreover, GE was scrapping some \$20 million in tubes each year because they failed preshipping performance tests, and a disturbing number of faulty tubes were slipping past inspection, only to be pronounced dead on arrival.

To try to solve the reliability problem, the Six Sigma team took the tubes apart. They knew that one problem was a petroleum-based oil used in the tube to prevent short circuits by isolating the anode, which has a positive charge, from the negatively charged cathode. The oil often deteriorated after a few months, leading to short circuits, but the team did not know why. By using statistical "what-if" scenarios on all parts of the tube, the researchers learned that the lead-based paint on the inside of the tube was adulterating the oil. Acting on this information, the team developed a paint that would preserve the tube and protect the oil. By pursuing this and other improvements, the Six Sigma team was able to extend the average life of a vacuum tube in the CT scanner from three months to over a year. Although the improvements increased the cost of the tube from \$60,000 to \$85,000, the increased cost was outweighed by the reduction in replacement costs, making it an attractive proposition for customers.

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**Sources:** C. H. Deutsch, "Six-Sigma Enlightenment," *New York Times*, December 7, 1998, 1; J. J. Barshay, "The Six-Sigma Story," *Star Tribune*, June 14, 1999, 1; D. D. Bak, "Rethinking Industrial Drives," *Electrical/Electronics Technology*, November 30, 1998, 58.

embraced the TQM concept. They were looking for a quick fix, whereas implementing a quality-improvement program is a long-term commitment.

### Implementing Reliability Improvement Methodologies

Among companies that have successfully adopted quality-improvement methodologies, certain imperatives stand out. These are discussed following in the order in which they are usually tackled in companies implementing quality-improvement programs. What needs to be stressed first, however, is that improvement in product

reliability is a cross-functional process. Its implementation requires close cooperation among all functions in the pursuit of the common goal of improving quality; it is a process that cuts across functions. The roles played by the different functions in implementing reliability improvement methodologies are summarized in Table 4.2.

First, it is important that senior managers buy into a quality-improvement program and communicate its importance to the organization. Second, if a quality-improvement program is to be successful, individuals must be identified to lead the program. Under the Six Sigma methodology, exceptional employees are identified and put through a “black belt” training course on the Six Sigma methodology. The black belts are taken from their regular job roles and assigned to work solely on Six Sigma projects for the next two years. In effect, the black belts become internal consultants and project leaders. Because they are dedicated to Six Sigma programs, the black belts are not distracted from the task at hand by day-to-day operating responsibilities. To make a black belt assignment attractive, many companies now use it as a step in a career path. Successful black belts may not return to their prior jobs after two years but instead are promoted and given more responsibility.

Third, quality-improvement methodologies preach the need to identify defects that arise from processes, trace them to their source, find out what caused them, and make corrections so that they do not recur. Production and materials

**Table 4.2** Roles Played by Different Functions in Implementing Reliability Improvement Methodologies

Infrastructure (leadership)	<ol style="list-style-type: none"> <li>1. Provide leadership and commitment to quality</li> <li>2. Find ways to measure quality</li> <li>3. Set goals and create incentives</li> <li>4. Solicit input from employees</li> <li>5. Encourage cooperation among functions</li> </ol>
Production	<ol style="list-style-type: none"> <li>1. Shorten production runs</li> <li>2. Trace defects back to the source</li> </ol>
Marketing	<ol style="list-style-type: none"> <li>1. Focus on the customer</li> <li>2. Provide customers' feedback on quality</li> </ol>
Materials management	<ol style="list-style-type: none"> <li>1. Rationalize suppliers</li> <li>2. Help suppliers implement quality-improvement methodologies</li> <li>3. Trace defects back to suppliers</li> </ol>
R&D	<ol style="list-style-type: none"> <li>1. Design products that are easy to manufacture</li> </ol>
Information systems	<ol style="list-style-type: none"> <li>1. Use information systems to monitor defect rates</li> </ol>
Human resources	<ol style="list-style-type: none"> <li>1. Institute quality-improvement training programs</li> <li>2. Identify and train “black belts”</li> <li>3. Organize employees into quality teams</li> </ol>

management typically have primary responsibility for this task. To uncover defects, quality-improvement methodologies rely upon the use of statistical procedures to pinpoint variations in the quality of goods or services. Once variations have been identified, they must be traced to their source and eliminated.

One technique that greatly helps in tracing defects to their source is reducing lot sizes for manufactured products. With short production runs, defects show up immediately. Consequently, they can be quickly traced to the source, and the problem can be addressed. Reducing lot sizes also means that when defective products are produced, their number will not be large, thus decreasing waste. Flexible manufacturing techniques can be used to reduce lot sizes without raising costs. JIT inventory systems also play a part. Under a JIT system, defective parts enter the manufacturing process immediately; they are not warehoused for several months before use. Hence, defective inputs can be quickly spotted. The problem can then be traced to the supply source and corrected before more defective parts are produced. Under a more traditional system, the practice of warehousing parts for months before they are used may mean that large numbers of defects are produced by a supplier before they enter the production process.

Fourth, another key to any quality-improvement program is to create a metric that can be used to measure quality. In manufacturing companies, quality can be measured by criteria such as defects per million parts. In service companies, with a little creativity, suitable metrics can be devised. For example, one of the metrics Florida Power & Light uses to measure quality is meter-reading errors per month.

Fifth, once a metric has been devised, the next step is to set a challenging quality goal and create incentives for reaching it. Under Six Sigma programs, the goal is 3.4 defects per million units. One way of creating incentives to attain such a goal is to link rewards, like bonus pay and promotional opportunities, to the goal.

Sixth, shop floor employees can be a major source of ideas for improving product quality, so their participation needs to be incorporated into a quality-improvement program.

Seventh, a major source of poor-quality finished goods is poor-quality component parts. To decrease product defects, a company must work with its suppliers to improve the quality of the parts they supply.

Eighth, the more assembly steps a product requires, the more opportunities there are for making mistakes. Thus, designing products with fewer parts is often a major component of any quality-improvement program.

Finally, implementing quality-improvement methodologies requires organization-wide commitment and substantial cooperation among functions. R&D must cooperate with production to design products that are easy to manufacture; marketing must cooperate with production and R&D so that customer problems identified by marketing can be acted on; human resource management has to cooperate with all the other functions of the company to devise suitable quality-training programs; and so on.

## Improving Quality as Excellence

As we stated in Chapter 3, a product is a bundle of different attributes, and reliability is just one of them, albeit an important one. Products can also be *differentiated* by attributes that collectively define product excellence. These attributes include the form, features, performance, durability, and styling of a product. In addition, a company can create quality as excellence by emphasizing attributes of the service

associated with the product, such as ordering ease, prompt delivery, easy installation, the availability of customer training and consulting, and maintenance services. Dell, for example, differentiates itself on ease of ordering (via the Web), prompt delivery, easy installation, and the ready availability of customer support and maintenance services. Differentiation can also be based on the attributes of the people in the company whom customers interact with when making a product purchase, such as their competence, courtesy, credibility, responsiveness, and communication. Singapore Airlines, for example, enjoys an excellent reputation for quality service, largely because passengers perceive their flight attendants as competent, courteous, and responsive to their needs. Thus, we can talk about the product attributes, the service attributes, and the personnel attributes associated with a company's product offering (see Table 4.3).

For a product to be regarded as high in the excellence dimension, a company's product offering must be seen as superior to that of its rivals. Achieving a perception of high quality on any of these attributes requires specific actions by managers. First, it is important for managers to collect marketing intelligence indicating which of these attributes are most important to customers. For example, consumers of personal computers may place a low weight on durability because they expect their PCs to be made obsolete by technological advances within three years, but they may place a high weight on features and performance. Similarly, ease of ordering and timely delivery may be very important attributes for customers of online booksellers (as they indeed are for customers of amazon.com), whereas customer training and consulting may be very important attributes for customers who purchase complex business-to-business software to manage their relationships with suppliers.

Second, once the company has identified the attributes that are important to customers, it needs to design its products, and the associated services, so that those attributes are embodied in the product, and it needs to make sure that personnel in the company are appropriately trained so that the correct attributes are emphasized. This requires close coordination between marketing and product development (the topic of the next section) and the involvement of the human resource management function in employee selection and training.

Third, the company must decide which of the significant attributes to promote and how best to position them in the minds of consumers, that is, how to tailor the marketing message so that it creates a consistent image in the minds of customers.<sup>32</sup>

**Table 4.3** Attributes Associated with a Product Offering

Product Attributes	Service Attributes	Associated Personnel Attributes
Form	Ordering ease	Competence
Features	Delivery	Courtesy
Performance	Installation	Credibility
Durability	Customer training	Reliability
Reliability	Customer consulting	Responsiveness
Style	Maintenance and repair	Communication



At this point, it is important to recognize that although a product might be differentiated on the basis of six attributes, covering all of those attributes in the company's communication messages may lead to an unfocused message. Many marketing experts advocate promoting only one or two central attributes to customers. For example, Volvo consistently emphasizes the safety and durability of its vehicles in all marketing messages, creating the perception in the minds of consumers (backed by product design) that Volvo cars are safe and durable. Volvo cars are also very reliable and have high performance, but the company does not emphasize these attributes in its marketing messages. In contrast, Porsche emphasizes performance and styling in all of its marketing messages; thus, a Porsche is positioned differently in the minds of consumers than a Volvo is. Both are regarded as high-quality products because both have superior attributes, but the attributes that the two companies have chosen to emphasize are very different. They are differentiated from the average car in different ways.

Finally, it must be recognized that competition does not stand still, but instead produces continual improvement in product attributes and often the development of new-product attributes. This is obvious in fast-moving high-tech industries where product features that were considered leading edge just a few years ago are now obsolete, but the same process is also at work in more stable industries. For example, the rapid diffusion of microwave ovens during the 1980s required food companies to build new attributes into their frozen food products: they had to maintain their texture and consistency while cooked in microwaves. A product could not be considered high quality unless it could do that. This speaks to the importance of having a strong R&D function in the company that can work with marketing and manufacturing to continually upgrade the quality of the attributes that are designed into the company's product offerings. Exactly how to achieve this is covered in the next section.

## ACHIEVING SUPERIOR INNOVATION

In many ways, innovation is the most important source of competitive advantage. This is because innovation can result in new products that better satisfy customer needs, can improve the quality (attributes) of existing products, or can reduce the costs of making products that customers want. The ability to develop innovative new products or processes gives a company a major competitive advantage that allows it to (1) *differentiate* its products and charge a premium price, and/or (2) *lower its cost structure* below that of its rivals. Competitors, however, attempt to imitate successful innovations and often succeed. Therefore, maintaining a competitive advantage requires a continuing commitment to innovation.

Successful new product launches are major drivers of superior profitability. Robert Cooper looked at more than 200 new product introductions and found that of those classified as successes, some 50% achieve a return on investment in excess of 33%; half have a payback period of two years or less; and half achieve a market share in excess of 35%.<sup>33</sup> Many companies have established a track record for successful innovation. Among them Sony, whose successes include the Walkman, the CD, and the PlayStation; Nokia, which has been a leader in the development of wireless phones; Pfizer, a drug company that during the 1990s and early 2000s produced eight blockbuster new drugs; 3M, which has applied its core competency

in tapes and adhesives to developing a wide range of new products; Intel, which has consistently managed to lead in the development of innovative new microprocessors to run personal computers; and Cisco Systems, whose innovations helped to pave the way for the rapid growth of the Internet.

## The High Failure Rate of Innovation

Although promoting innovation can be a source of competitive advantage, the failure rate of innovative new products is high. Research evidence suggests that only 10% to 20% of major R&D projects give rise to a commercial products.<sup>34</sup> Well-publicized product failures include Apple's Newton, a personal digital assistant, Sony's Betamax format in the video player and recorder market, and Sega's Dreamcast videogame console. Although many reasons have been advanced to explain why so many new products fail to generate an economic return, five explanations for failure appear on most lists.<sup>35</sup>

First, many new products fail because the demand for innovations is inherently uncertain. It is impossible to know prior to market introduction whether the new product has tapped an unmet customer need, and if there is sufficient market demand to justify making the product. Although good market research can reduce the uncertainty about likely future demand for a new technology, it cannot be eradicated, so a certain failure rate is to be expected.

Second, new products often fail because the technology is poorly commercialized. This occurs when there is definite customer demand for a new product, but the product is not well adapted to customer needs because of factors such as poor design and poor quality. For instance, the failure of Apple to establish a market for the Newton, a handheld personal digital system that Apple introduced in the 1990s can be traced to poor commercialization of a potentially attractive technology. Apple predicted a \$1 billion market for the Newton, but sales failed to materialize when it became clear that the Newton's handwriting software, an attribute that Apple chose to emphasize in its marketing promotions, could not adequately recognize messages written on the Newton's message pad.

Third, new products may fail because of poor positioning strategy. **Positioning strategy** is the specific set of options a company adopts for a product on four main dimensions of marketing: price, distribution, promotion and advertising, and product features. Apart from poor product quality, another reason for the failure of the Newton was poor positioning strategy. The Newton was introduced at such a high initial price (close to \$1,000) that there would probably have been few buyers even if the technology had been adequately commercialized.

Fourth, many new product introductions fail because companies often make the mistake of marketing a technology for which there is not enough demand. A company can get blinded by the wizardry of a new technology and fail to examine whether there is customer demand for the product.

Finally, companies fail when they are slow to get their products to market. The more time that elapses between initial development and final marketing—the slower the “cycle time”—the more likely it is that someone else will beat the company to market and gain a first-mover advantage.<sup>36</sup> In the car industry, GM has suffered from being a slow innovator. Its product development cycle has been about five years, compared with two to three years at Honda, Toyota, and Mazda and three to four years at Ford. Because they are based on five-year-old technology and design concepts, GM cars are already out of date when they reach the market.

## Reducing Innovation Failures

One of the most important things that managers can do to reduce the high failure rate associated with innovation is to make sure that there is tight integration between R&D, production, and marketing.<sup>37</sup> Tight cross-functional integration can help a company to ensure that:

1. Product development projects are driven by customer needs.
2. New products are designed for ease of manufacture.
3. Development costs are kept in check.
4. Time to market is minimized.
5. Close integration between R&D and marketing is achieved to ensure that product development projects are driven by the needs of customers.

A company's customers can be one of its primary sources of new product ideas. The identification of customer needs, and particularly unmet needs, can set the context within which successful product innovation takes place. As the point of contact with customers, the marketing function can provide valuable information. Moreover, integrating R&D and marketing is crucial if a new product is to be properly commercialized. Otherwise, a company runs the risk of developing products for which there is little or no demand.

Integration between R&D and production can help a company ensure that products are designed with manufacturing requirements in mind. Design for manufacturing lowers manufacturing costs and leaves less room for mistakes, which can lower costs and increase product quality. Integrating R&D and production can help lower development costs and speed products to market. If a new product is not designed with manufacturing capabilities in mind, it may prove too difficult to build, given existing manufacturing technology. In that case, the product will have to be redesigned, and both overall development costs and time to market may increase significantly. Making design changes during product planning can increase overall development costs by 50% and add 25% to the time it takes to bring the product to market.<sup>38</sup>

One of the best ways to achieve cross-functional integration is to establish cross-functional product development teams, composed of representatives from R&D, marketing, and production. The objective of a team should be to take a product development project from the initial concept development to market introduction. A number of attributes seem to be important for a product development team to function effectively and meet all its development milestones.<sup>39</sup>

First, a **heavyweight project manager**—one who has high status within the organization and the power and authority required to get the financial and human resources that the team needs to succeed—should lead the team and be dedicated primarily, if not entirely, to the project. The leader should believe in the project (a champion) and be skilled at integrating the perspectives of different functions and helping personnel from different functions work together for a common goal. The leader should also be able to act as an advocate of the team to senior management.

Second, the team should be composed of at least one member from each key function. The team members should have a number of attributes, including an ability to contribute functional expertise, high standing within their function, a willingness to share responsibility for team results, and an ability to put functional advocacy aside. It is generally preferable if core team members are 100% dedicated to the project for its duration. This makes sure that their focus is on the project, not on the ongoing work of their function.

Third, the team members should be physically co-located to create a sense of camaraderie and facilitate communication. Fourth, the team should have a clear plan and clear goals, particularly with regard to critical development milestones and development budgets. The team should have incentives to attain those goals; for example, pay bonuses when major development milestones are hit. Fifth, each team needs to develop its own processes for communication and conflict resolution. For example, one product development team at Quantum Corporation, a California-based manufacturer of disk drives for personal computers, instituted a rule that all major decisions would be made and conflicts resolved at meetings that were held every Monday afternoon. This simple rule helped the team to meet its development goals.<sup>40</sup>

Finally, there is good evidence that developing competencies in innovation requires managers to take proactive steps to learn from their experience with product development and incorporate the lessons from past successes and failures in future new product development processes.<sup>41</sup> This is easier said than done. To learn, managers need to undertake an objective postmortem of a product development project, identify key success factors and the root causes of failures, and allocate resources toward fixing failures. Leaders also need to admit their own failures if they are to encourage others to step up to the plate and identify what they did wrong. Strategy in Action 4.4 looks at how Corning learned from a prior mistake to develop a potentially promising new product.

The primary role that the various functions play in achieving superior innovation is summarized in Table 4.4. The table makes two matters clear. First, top management must bear primary responsibility for overseeing the whole development

**Table 4.4** Functional Roles for Achieving Superior Innovation

Value Creation Function	Primary Roles
Infrastructure (leadership)	<ol style="list-style-type: none"> <li>1. Manage overall project (i.e., manage the development function)</li> <li>2. Facilitate cross-functional cooperation</li> </ol>
Production	<ol style="list-style-type: none"> <li>1. Cooperate with R&amp;D on designing products that are easy to manufacture</li> <li>2. Work with R&amp;D to develop process innovations</li> </ol>
Marketing	<ol style="list-style-type: none"> <li>1. Provide market information to R&amp;D</li> <li>2. Work with R&amp;D to develop new products</li> </ol>
Materials management	No primary responsibility
R&D	<ol style="list-style-type: none"> <li>1. Develop new products and processes</li> <li>2. Cooperate with other functions, particularly marketing and manufacturing, in the development process</li> </ol>
Information systems	<ol style="list-style-type: none"> <li>1. Use information systems to coordinate cross-functional and cross-company product development work</li> </ol>
Human resources	<ol style="list-style-type: none"> <li>1. Hire talented scientists and engineers</li> </ol>

## 4.4 STRATEGY IN ACTION

### Corning: Learning from Innovation Failures

In 1998, Corning, then the world's largest supplier of fiber optic cable, decided to diversify into the development and manufacture of DNA microarrays (DNA chips). DNA chips are used to analyze the function of genes and are an important research tool in the drug development process. Corning tried to develop a DNA chip that could print all 28,000 human genes onto a set of slides. By 2000, Corning had invested more than \$100 million in the project and its first chips were on the market, but the project was a failure; in 2001 it was pulled.

What went wrong? Corning was late to market—a critical mistake. The market was dominated by Affymetrix, which had been in the businesses since the early 1990s. By 2000, Affymetrix's DNA chips were the dominant design; researchers were familiar with them, they performed well, and few people were willing to switch to chips from unproven competitors. Corning was late because it adhered to its long-established innovation processes, which were not entirely appropriate in the biological sciences. In particular, Corning's own in-house experts in the physical sciences insisted on sticking to rigorous quality standards that customers and life scientists felt were higher than necessary. These quality standards proved to be very difficult to achieve. As a result, the product launch was delayed, giving Affymetrix time

to consolidate its hold on the market. Moreover, Corning failed to give prototypes of its chips to potential customers, and, consequently, it missed incorporating some crucial features that customers wanted.

After reviewing this failure, Corning decided that going forward, it needed to bring customers into the development process earlier; it needed to hire more outside experts if it was diversifying into an area where it lacked competencies to give those experts a larger say in the development process.

The project was not a total failure, however, for through it Corning discovered a vibrant and growing market: the market for drug discovery. By combining what it had learned about drug discovery with another failed businesses, photonics, which manipulates data using light waves, Corning created a new product called Epic. Epic is a revolutionary technology for drug testing that uses light waves instead of fluorescent dyes (the standard industry practice). Epic promises to accelerate the process of testing potential drugs and saving pharmaceutical companies valuable R&D money. Unlike its DNA microarray project, Corning had 18 pharmaceutical companies test Epic before development was finalized. Corning used this feedback to refine Epic. The company believes that ultimately Epic could generate \$500 million annually.

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**Sources:** V. Govindarajan and C. Trimble, "How Forgetting Leads to Innovation," *Chief Executive*, March 2006, 46–50.  
J. McGregor, "How Failure Breeds Success," *Business Week*, July 10, 2006, 42–52.

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process. This entails both managing the development funnel and facilitating cooperation among the functions. Second, the effectiveness of R&D in developing new products and processes depends on its ability to cooperate with marketing and production.

## ACHIEVING SUPERIOR RESPONSIVENESS TO CUSTOMERS

To achieve superior responsiveness to customers, a company must give customers what they want, when they want it, and at a price they are willing to pay—so long as the company's long-term profitability is not compromised in the process. Customer

responsiveness is an important differentiating attribute that can help to build brand loyalty. Strong product differentiation and brand loyalty give a company more pricing options; the company can charge a premium price for its products or keep prices low to sell more goods and services to customers. Either way, the company that is more responsive to its customers' needs than its rivals will have a competitive advantage, all else being equal.

Achieving superior responsiveness to customers means giving customers value for money. Steps taken to improve the efficiency of a company's production process and the quality of its products should be consistent with this aim. In addition, giving customers what they want may require the development of new products with new features. In other words, achieving superior efficiency, quality, and innovation are all part of achieving superior responsiveness to customers. There are two other prerequisites for attaining this goal. First, a company has to develop competency in listening to and focusing on its customers and in investigating and identifying their needs. Second, it constantly needs to seek better ways to satisfy those needs.

### Focusing on the Customer

A company cannot be responsive to its customers' needs unless it knows what those needs are. Thus, the first step to building superior responsiveness to customers is to motivate the whole company to focus on the customer. The means to this end are demonstrating leadership, shaping employee attitudes, and using mechanisms for bringing customers into the company.

**Demonstrating Leadership** Customer focus must start at the top of the organization. A commitment to superior responsiveness to customers brings attitudinal changes throughout a company that ultimately can be built only through strong leadership. A mission statement that puts customers first is one way to send a clear message to employees about the desired focus. Another avenue is top management's own actions. For example, Tom Monaghan, the founder of Domino's Pizza, stayed close to the customers by visiting as many stores as possible every week, running some deliveries himself, insisting that other top managers do the same, and eating Domino's pizza regularly.<sup>42</sup>

**Shaping Employee Attitudes** Leadership alone is not enough to attain a superior customer focus. All employees must see the customer as the focus of their activity and be trained to focus on the customer, whether their function is marketing, manufacturing, R&D, or accounting. The objective should be to make employees think of themselves as customers—to put themselves in customers' shoes. At that point, employees will be better able to identify ways to improve the quality of a customer's experience with the company.

To reinforce this mindset, incentive systems within the company should reward employees for satisfying customers. For example, senior managers at the Four Seasons hotel chain, who pride themselves on their customer focus, like to tell the story of Roy Dymont, a doorman in Toronto who neglected to load a departing guest's briefcase into his taxi. The doorman called the guest, a lawyer, in Washington DC, who desperately needed the briefcase for a morning meeting. Dymont hopped on a plane to Washington and returned it—without first securing approval from his boss. Far from punishing Dymont for making a mistake and not checking with management before going to Washington, the Four Seasons responded by naming Dymont



Employee of the Year.<sup>43</sup> This action sent a powerful message to Four Seasons employees about the importance of satisfying customer needs.

**Bringing Customers into the Company** “Know thy customer” is one of the keys to achieving superior responsiveness to customers. Knowing the customer not only requires that employees think like customers themselves; it also demands that they listen to what their customers have to say and, as much as possible, bring them into the company. Although this may not involve physically bringing customers into the company, it does mean bringing in customers’ opinions by soliciting feedback on the company’s goods and services and by building information systems that communicate the feedback to the relevant people.

For example, consider direct-selling clothing retailer Lands’ End. Through its catalog, the Internet, and customer service telephone operators, Lands’ End actively solicits comments from its customers about the quality of its clothing and the kind of merchandise they want it to supply. Indeed, it was customers’ insistence that initially prompted the company to move into the clothing segment. Lands’ End used to supply equipment for sailboats through mail-order catalogs. However, it received so many requests from customers to include outdoor clothing in its offerings that it responded by expanding the catalog to fill this need. Soon clothing became the main business, and Lands’ End dropped the sailboat equipment. Today, the company still pays close attention to customer requests. Every month, a computer printout of customer requests and comments is given to managers. This feedback helps the company to fine-tune the merchandise it sells. Indeed, frequently new lines of merchandise are introduced in response to customer requests.<sup>44</sup>

## Satisfying Customer Needs

Once a focus on the customer is an integral part of the company, the next requirement is to satisfy the customer needs that have been identified. As already noted, efficiency, quality, and innovation are crucial competencies that help a company satisfy customer needs. Beyond that, companies can provide a higher level of satisfaction if they differentiate their products by (1) customizing them, where possible, to the requirements of individual customers and (2) reducing the time it takes to respond to or satisfy customer needs.

**Customization** Customization is varying the features of a good or service to tailor it to the unique needs or tastes of groups of customers or, in the extreme case, individual customers. Although extensive customization can raise costs, the development of flexible manufacturing technologies has made it possible to customize products to a much greater extent than was feasible 10 to 15 years ago without experiencing a prohibitive rise in cost structure (particularly when flexible manufacturing technologies are linked with Web-based information systems). For example, online retailers such as amazon.com have used Web-based technologies to develop a homepage customized for each individual user. When a customer accesses amazon.com, he or she is offered a list of recommendations for books or music to purchase based on an analysis of prior buying history, a powerful competency that gives amazon.com a competitive advantage.



The trend toward customization has fragmented many markets, particularly customer markets, into ever smaller niches. An example of this fragmentation occurred in Japan in the early 1980s when Honda dominated the motorcycle market there. Second-place Yamaha decided to go after Honda's lead. It announced the opening of a new factory that, when operating at full capacity, would make Yamaha the world's largest manufacturer of motorcycles. Honda responded by proliferating its product line and stepping up its rate of new-product introduction. At the start of what became known as the "motorcycle wars," Honda had 60 motorcycles in its product line. Over the next 18 months, it rapidly increased its range to 113 models, customizing them to ever smaller niches. Honda was able to accomplish this without bearing a prohibitive cost penalty because it has a competency in flexible manufacturing. The flood of Honda's customized models pushed Yamaha out of much of the market, effectively stalling its bid to overtake Honda.<sup>45</sup>

**Response Time** Giving customers what they want when they want it requires speed of response to customer demands. To gain a competitive advantage, a company must often respond to customer demands very quickly, whether the transaction is a furniture manufacturer's delivery of a product once it has been ordered, a bank's processing of a loan application, an automobile manufacturer's delivery of a spare part for a car that broke down, or the wait in a supermarket checkout line. We live in a fast-paced society, where time is a valuable commodity. Companies that can satisfy customer demands for rapid response build brand loyalty, differentiate their products, and can charge higher prices for them.

Increased speed often lets a company choose a premium pricing option, as the mail delivery industry illustrates. The air express niche of the mail delivery industry is based on the notion that customers are often willing to pay considerably more for overnight Express Mail as opposed to regular mail. Another example of the value of rapid response is Caterpillar, the manufacturer of heavy earth-moving equipment, who can get a spare part to any point in the world within 24 hours. Downtime for heavy construction equipment is very costly, so Caterpillar's ability to respond quickly in the event of equipment malfunction is of prime importance to its customers. As a result, many of them have remained loyal to Caterpillar despite the aggressive low-price competition from Komatsu of Japan.

In general, reducing response time requires (1) a marketing function that can quickly communicate customer requests to production; (2) production and materials-management functions that can quickly adjust production schedules in response to unanticipated customer demands; and (3) information systems that can help production and marketing in this process.

Table 4.5 summarizes the steps different functions must take if a company is to achieve superior responsiveness to customers. Although marketing plays the critical role in helping a company attain this goal, primarily because it represents the point of contact with the customer, Table 4.5 shows that the other functions also have major roles. Moreover, like achieving superior efficiency, quality, and innovation, achieving superior responsiveness to customers requires top management to lead in building a customer orientation within the company.

**Table 4.5** Primary Roles of Different Functions in Achieving Superior Responsiveness to Customers

Value Creation Function	Primary Roles
Infrastructure (leadership)	<ul style="list-style-type: none"> <li>Through leadership by example, build a company-wide commitment to responsiveness to customers</li> </ul>
Production	<ul style="list-style-type: none"> <li>Achieve customization through implementation of flexible manufacturing</li> <li>Achieve rapid response through flexible manufacturing</li> </ul>
Marketing	<ul style="list-style-type: none"> <li>Know the customer</li> <li>Communicate customer feedback to appropriate functions</li> </ul>
Materials management	<ul style="list-style-type: none"> <li>Develop logistics systems capable of responding quickly to unanticipated customer demands (JIT)</li> </ul>
R&D	<ul style="list-style-type: none"> <li>Bring customers into the product development process</li> </ul>
Information systems	<ul style="list-style-type: none"> <li>Use Web-based information systems to increase responsiveness to customers</li> </ul>
Human resources	<ul style="list-style-type: none"> <li>Develop training programs that get employees to think like customers themselves</li> </ul>

## SUMMARY OF CHAPTER

1. A company can increase efficiency through a number of steps: exploiting economies of scale and learning effects; adopting flexible manufacturing technologies; reducing customer defection rates; implementing JIT systems; getting the R&D function to design products that are easy to manufacture; upgrading the skills of employees through training; introducing self-managing teams; linking pay to performance; building a company-wide commitment to efficiency through strong leadership; and designing structures that facilitate cooperation among different functions in pursuit of efficiency goals.
2. Superior quality can help a company lower its costs, differentiate its product, and charge a premium price.
3. Achieving superior quality demands an organization-wide commitment to quality and a clear focus on the customer. It also requires metrics to measure quality goals and incentives that emphasize quality, input from employees regarding ways in which quality can be improved, a methodology for tracing defects to their source and correcting the problems that produce them, a rationalization of the company's supply base, cooperation with the suppliers that remain to implement TQM programs, products that are designed for ease of manufacturing, and substantial cooperation among functions.
4. The failure rate of new-product introductions is high because of factors such as uncertainty, poor commercialization, poor positioning strategy, slow cycle time, and technological myopia.
5. To achieve superior innovation, a company must build skills in basic and applied research; design good processes for managing development projects; and achieve close integration between the different functions of the company, primarily through the adoption of cross-functional product development teams and partly parallel development processes.

6. To achieve superior responsiveness to customers often requires that the company achieve superior efficiency, quality, and innovation.
7. To achieve superior responsiveness to customers, a company needs to give customers what they want when they want it. It must ensure a strong customer focus, which can be attained

by emphasizing customer focus through leadership; training employees to think like customers; bringing customers into the company through superior market research; customizing products to the unique needs of individual customers or customer groups; and responding quickly to customer demands.

## DISCUSSION QUESTIONS

1. How are the four generic building blocks of competitive advantage related to each other?
2. What role can top management play in helping a company achieve superior efficiency, quality, innovation, and responsiveness to customers?
3. In the long run, will adoption of Six Sigma quality-improvement processes give a company
4. In what sense might innovation be called the single most important building block of competitive advantage?

## PRACTICING STRATEGIC MANAGEMENT

### Small-Group Exercise: Identifying Excellence

Break up into groups of three to five people and appoint one group member as a spokesperson who will communicate your findings to the class.

You are the management team of a start-up company that will produce hard disc drives for the personal computer industry. You will sell your product to manufacturers of personal computers (original equipment manufacturers). The disk drive market is characterized by rapid technological change, product life cycles of only six to nine months, intense price competition, high fixed costs for manufacturing equipment, and substantial manufacturing economies of scale. Your customers, the original equipment manufacturers, issue very demanding technological specifications that your product has to comply with. They also pressure you to deliver your product on time so that it fits in with their own product introduction schedule.

1. In this industry, what functional competencies are the most important for you to build?

2. How will you design your internal processes to ensure that those competencies are built within the company?

### Article File 4

Choose a company that is widely regarded as excellent. Identify the source of its excellence and relate it to the material discussed in this chapter. Pay particular attention to the role played by the various functions in building excellence.

### Strategic Management Project: Module 4

This module deals with the ability of your company to achieve superior efficiency, quality, innovation, and responsiveness to customers. With the information you have at your disposal, answer the following questions and perform the tasks listed:

1. Is your company pursuing any of the efficiency-enhancing practices discussed in this chapter?
2. Is your company pursuing any of the quality-enhancing practices discussed in this chapter?

3. Is your company pursuing any of the practices designed to enhance innovation discussed in this chapter?
4. Is your company pursuing any of the practices designed to increase responsiveness to customers discussed in this chapter?
5. Evaluate the competitive position of your company in the light of your answers to questions 1–4. Explain what, if anything, the company needs to do to improve its competitive position.

## CLOSING CASE

### Boosting Efficiency at Matsushita

In 2000, when Kunio Nakamura became CEO of the venerable Japanese electronics giant, Matsushita, it was a company in deep trouble. Earnings had been going south for years, and the company's market capitalization had shrunk to less than half of that of long-time rival Sony. Employees were frustrated and moral was poor. By the time he retired in June 2006, Matsushita was delivering its best financial performance in more than a decade. After losing \$3.7 billion in 2002, in 2006 the company registered profits of \$1.37 billion. Moreover, earnings grew 20% to \$1.7 billion in 2007.

For a long time, the policy at Matsushita had been to allow different divisions to develop identical products, although at the end of the day typically only one division was granted the right to market a product. Early in his tenure, Nakamura put an end to this internal competition, believing that it would produce efficiency gains. He also effectively ended the long-standing practice at Matsushita of lifetime employment. He slashed the domestic workforce by 19% and reduced the number of layers in the management hierarchy. He pushed factory managers to do everything possible to raise productivity, giving them challenging productivity goals, and tying bonuses to the attainment of those goals.

Matsushita's factory in Saga, Japan, exemplifies the obsession with productivity improvements. Employees at the factory, which makes cordless phones, faxes, and security cameras, doubled productivity between 2000 and 2004 by introducing robots into the assembly line, but factory managers were not happy. An analysis of flow in the production system showed that bottlenecks on the assembly

line meant that robots sat idle for longer than they were working. So the plant's managers ripped out the assembly line conveyor belts and replaced them with clusters of robots grouped into cells. The cells allowed them to double up on slower robots to make the entire manufacturing process run more smoothly. Then they developed software to synchronize production so that each robot jumped into action as soon as the previous step was completed. If one robot broke down, the workflow could be shifted to another to do the same job.

The results were impressive. The time that it took to build products was drastically reduced. It formerly took two-and-one-half days into a production run before the first finished products came off the assembly line; now it takes as little as 40 minutes. Phones, for example, can now be assembled in one-third of the time, doubling weekly output from the same plant with the same number of employees. Shorter cycle times enabled the factory to slash inventories. Work in progress, such as partly finished products, along with components such as chipsets, keypads, and circuit boards now spent far less time in the factory.

The Saga factory is known as a "mother plant" within Matsushita. Once process improvements have been refined at a mother plant, they have to be transferred to other plants within the group as quickly as possible. There are six other plants in the Saga group in China, Malaysia, Mexico, and Britain. Most were able to quickly copy what was done at Saga and saw similar cuts in inventory and boosts in productivity.

Despite the faster pace of work, the factory employees paid close attention to product quality.

The short cycle times helped employees to identify the source of defective products and quickly fix any errors that led to quality problems. Consequently, at less than 1% of output, by 2006 defect rates were at an all time low in every factory. The reduction in waste further boosted productivity and helped the company to strengthen its reputation for producing high-quality merchandise.<sup>46</sup>

### Case Discussion Questions

1. What are the benefits of eliminating the long-standing policy at Matsushita that different divisions should be allowed to develop the same basic product? Are there any potential drawbacks of such a policy change?
2. What do you think were the benefits of lifetime employment at Matsushita? Why then did Nakamura effectively end this practice? What benefits did he realize for Matsushita by doing so?
3. What does the example of the Saga factory at Matsushita tell you about the benefits of optimizing workflow for (a) work in progress, (b) the productivity of both employees, and (c) the capital invested in plant and equipment?
4. What are the benefits to Matsushita of a reduction in defect rates?
5. What does the Matsushita example tell you about the importance of functional-level strategies for competitive advantage?
6. Matsushita is a manufacturing company. Do you think that the principles discussed in the case are as important for a service enterprise?



# BUILDING COMPETITIVE ADVANTAGE THROUGH BUSINESS-LEVEL STRATEGY

## LEARNING OBJECTIVES

After reading this chapter, you should be able to

- Explain why a company must define its business and how managers do this through their choices about which customer groups, customer needs, and distinctive competencies to pursue
- Define competitive positioning and explain the tradeoffs between differentiation, cost, and pricing options
- Identify the choices managers make to pursue a business model based on some combination of the main generic business-level strategies: cost leadership, differentiation, and focus
- Explain why each business model allows a company to outperform its rivals, reach the value creation frontier, and obtain above average profitability
- Discuss why some companies can successfully make the competitive positioning decisions that allow them to sustain their competitive advantage over time while others cannot

## Sony's Failure in Competitive Positioning

Just a few years ago, engineers at Sony turned out an average of four ideas for new products every day, and the company was the innovation leader in the consumer electronics industry.

Why? It had a policy of “self-promotion” that allowed Sony engineers to seek out projects anywhere in the company they thought they could contribute to new product innovation. Sony had hundreds of new product development teams in which its engineers churned out innovative electronics such as the Sony PlayStation, Trinitron TVs, and Walkman cassette

players that allowed it to differentiate its products from competitors and charge customers premium prices.<sup>1</sup> By the early 2000s, Sony was the most profitable company in the electronics industry, but in 2009 it warned that instead of the \$2.2 billion in profits, it expected to earn it now forecast a \$2.9 billion operating loss—its first in 14 years.<sup>2</sup>



What went wrong? Sony's Welsh-born CEO Howard Stringer who had been hired in 2006 to develop a new business model that would allow it to maintain its leading industry position had no doubt that the company's problems were due to poor competitive positioning. On the one hand, Sony had failed to develop strategies to deal with competitors that were developing new and improved technologies and sustain its differentiated position. On the other hand, it had failed to develop strategies to deal with increasing low-cost competitors from Korea and Taiwan that were offering electronic products at rock-bottom prices. Stringer claimed that despite the fact that Sony had an "unbeatable" combination of top-notch consumer electronic products, and entertainment content such as blockbuster movies, TV programs, and music, it had not managed to fuse them together into a digital package that could be easily delivered to customers online.<sup>3</sup>

On the differentiation side, Sony's reputation as the most innovative company was challenged by the rapid advances of other electronics and computer companies. Companies like Samsung, Visio, and Sharp had been much faster than Sony in developing the flat screen LCD technology that had made its Trinitron TVs obsolete. Apple had revolutionized music hardware and software with its iPod and iTunes platform that had made Sony's Walkman obsolete.<sup>4</sup> And, because Sony made more than 55% of its profits from its PlayStation business group, the performance of this division had been badly affected by the increasing popularity of Nintendo's pioneering Wii, with its innovative "interactive" features, and from Microsoft's Xbox, with its sophisticated Internet-linked console and services. Indeed, by 2009 Nintendo had sold 50 million Wiis worldwide and had become the most profitable consumer electronics company.

Why was Sony suffering from these failures in product positioning, despite the fact that it still had thousands of talented engineers continually working on developing its distinctive competence in innovation? Stringer said

frankly that the problem was because of the intense competition between Sony's different product groups that had developed over time; groups were not sharing knowledge; they were hoarding it, and Sony's position as the industry leader suffered as a result. "Too often we have been late to market with new products and this practice cannot be tolerated going forward."<sup>5</sup> Although he had made attempts to change the way Sony operated, in 2009, Stringer announced that he was changing Sony's traditional product-group decision-making to one based on speedier, top-down decision-making. He removed Ryoji Chubachi, Sony's powerful vice chairman and director of engineering, who he blamed for the slow pace of change. Stringer's goal was to force a change in Sony's competitive positioning by encouraging engineers to think about how consumers will use a new product before they focus on the product's technical capabilities when deciding which new products to invest in—to force a customer-oriented, not a product-oriented, business definition on the company.

On the cost side, however, Sony engineers' focus on technical innovation also had devastating effects on its product positioning. Stringer announced that Sony's practice of allowing its product divisions and individual engineers to champion whatever products they wished might increase innovation, but it had also resulted in a bloated cost structure that was draining the company's profits. Not only was the competition for resources between divisions for funds increasing costs, it had also led managers to ignore the need to manage the supply chain efficiently. For example, Sony was still making many components that other companies had outsourced to efficient suppliers long ago. Sony was now behind its competitors because of its higher cost structure, and Stringer changed the company's product positioning in major ways. To reduce costs, Stringer announced thousands of layoffs and plans to close 10 of its 57 factories worldwide, and he ordered divisions to outsource all





non-vital components. His top management team was instructed to conduct a top-to-bottom review of each of its business groups, from flat screen TVs to video games, to find ways to reduce operating costs and make

Sony's value-creation chain run more efficiently. On the day he announced the new loss forecast, he also announced that he was doubling Sony's cost-cutting target to \$2.8 billion by 2010.

## Overview

As the Opening Case suggests, even an industry leader like Sony can experience major problems in managing its business model successfully over time to maintain its competitive advantage. This chapter examines how a company selects, pursues, and maintains a business model that will allow it to compete effectively in an industry and increase its profitability over time. A successful business model results from business-level strategies that create a competitive advantage over rivals and achieve superior performance in an industry.

In Chapter 2, we examined how the competitive forces at work inside an industry affect its profitability. As industry forces change, so they change the profitability of an industry and, thus, the profitability of any particular business model. Industry analysis is vital in formulating a successful business model because it determines (1) how existing companies will decide to change their business-level strategies to improve the performance of their business model over time; (2) whether established companies outside an industry may decide to create a business model to enter it; and (3) whether entrepreneurs can devise a business model that will allow them to compete successfully against existing companies in an industry.

In Chapter 3, we examined how competitive advantage depends on a company developing a business model that allows it to achieve superior efficiency, quality, innovation, and customer responsiveness—the building blocks of competitive advantage. In Chapter 4, we discussed how every function must develop the distinctive competencies that allow a company to implement a business model that will lead to superior performance and competitive advantage in an industry.

In this chapter, we examine the competitive decisions involved in creating a business model that will attract and retain customers and continue to do so over time so that a company enjoys growing profitability. To create a successful business model, strategic managers must (1) formulate business-level strategies that will allow a company to attract customers away from other companies in the industry (its competitors) and (2) implement those business-level strategies, which also involves the use of functional-level strategies to increase responsiveness to customers, efficiency, innovation, and quality. As the Opening Case suggests, Sony failed to do this, and, by 2009, it was unprofitable as a result.

By the end of this chapter, you will be able to distinguish between the principal generic business models and business-level strategies that a company uses to obtain a competitive advantage over its rivals. You will also understand why, and under what circumstances, strategic leaders of companies like Sony, Apple, Nintendo, and Microsoft change their company's strategies over time to pursue different kinds of business models to try to increase their competitive advantage over industry rivals.

## COMPETITIVE POSITIONING AND THE BUSINESS MODEL

To create a successful business model, managers must choose a set of business-level strategies that work together to give a company a competitive advantage over its rivals; that is, they must optimize **competitive positioning**. As we noted in Chapter 1, to craft a successful business model, a company must first define its business, which entails decisions about (1) customer needs, or what is to be satisfied; (2) customer groups, or who is to be satisfied; and (3) distinctive competencies, or how customer needs are to be satisfied.<sup>6</sup> The decisions managers make about these three issues determine which set of strategies they formulate and implement to put a company's business model into action and create value for customers. Consequently, we need to examine the principal choices facing managers as they make these three decisions.

### Formulating the Business Model: Customer Needs and Product Differentiation

**Customer needs** are desires, wants, or cravings that can be satisfied by means of the attributes or characteristics of a product (a good or service). For example, a person's craving for something sweet can be satisfied by a box of Godiva chocolates, a carton of Ben & Jerry's ice cream, a Snickers bar, or a spoonful of sugar. Two factors determine which product a customer chooses to satisfy these needs: (1) the way a product is differentiated from other products of its type so that it appeals to customers and (2) the price of the product. All companies must differentiate their products to a certain degree to attract customers. Some companies, however, decide to offer customers low-priced products and do not engage in much product differentiation. Companies that seek to create something *unique* about their product differentiate their products to a much greater degree than others so that they satisfy customers' needs in ways other products cannot.

**Product differentiation** is the process of designing products to satisfy customers' needs. A company obtains a competitive advantage when it creates, makes, and sells a product in a way that better satisfies customer needs than its rivals do. Then the four building blocks of competitive advantage come into play, for a company's decision to pursue one or more of these building blocks determine its approach to product differentiation. If managers devise strategies to differentiate a product by innovation, excellent quality, or responsiveness to customers, they are choosing a business model based on offering customers *differentiated products*. On the other hand, if managers base their business model on finding ways to increase efficiency and reliability to reduce costs, they are choosing a business model based on offering customers *low-priced products*.

Creating unique or distinctive products can be achieved in countless different ways, which explains why there are usually many different companies competing in an industry. Distinctiveness obtained from the physical characteristics of a product commonly results from pursuing innovation or quality, such as when a company focuses on developing state-of-the-art car safety systems or on engineering a sports utility vehicle (SUV) to give it sports car-like handling, something Porsche and BMW strive to achieve. Similarly, companies might try to design their cars with features such as butter-soft, hand-sewn leather interiors, fine wood fittings, and sleek, exciting body styling to appeal to customers' psychological needs, such as a personal need for prestige and status or to declare a particular "lifestyle," something Mercedes-Benz and Lexus strive for.<sup>7</sup>

Differentiation has another important aspect. Companies that invest their resources to create something distinct or different about their products can often charge a higher or *premium* price for their product. For example, superb design or technical sophistication allows companies to charge more for their products because customers are willing to pay these higher prices. Porsche and Mercedes-Benz buyers pay a high premium price to enjoy their sophisticated vehicles, as do customers of Godiva chocolates, which retail for about \$26 a pound—much more than, say, a box of Whitman's candies or a Hershey bar.

Consider the high-price segment of the car market, in which customers are willing to pay more than \$35,000 to satisfy their needs for a “personal luxury vehicle.” In this segment, Cadillac, Mercedes-Benz, Infiniti, BMW, Jaguar, Lexus, Lincoln, Audi, Volvo, Acura, and others are engaged in a continuing battle to design the “perfect” luxury vehicle—the one that best meets the needs of those who want such a vehicle. Over time, the companies that attract the most luxury car buyers—because they have designed the cars that possess the innovative features or excellent quality and reliability these customers desire the most—are the ones that achieve a sustained competitive advantage over rivals. For example, some customers value a sporty ride and performance handling; Mercedes-Benz and BMW, because of their cutting-edge technical design, can offer this driving experience better than any other carmaker. Toyota's Lexus division is well known for the smoothness and quietness of its cars and their exceptional reliability. Lexus cars consistently outrank all other cars in published reliability rankings, and this excellence appeals to a large group of customers who appreciate these qualities. Infiniti's reputation for both sportiness and reliability has increased steadily in the 2000s as has its market share, and both Bentley and Rolls-Royce that produce prestige cars can sell all they can make. Other luxury carmakers have not fared so well. Cadillac, Lincoln, Audi, Acura, Saab, and Volvo have found it more difficult to differentiate their cars, which sometimes compare unfavorably to their rivals in terms of ride, comfort, safety, or reliability. Although these less successful companies still sell many cars, customers often find their needs better satisfied by the attributes and qualities of their rivals' cars. It is the latter that can sustain their competitive advantage over time. Even in the luxury car segment, however, carmakers must be concerned with efficiency because price affects a buying decision, even for highly differentiated products. Luxury carmakers compete to offer customers the car with the ride, performance, and features that provide them with the most value (satisfies their needs best) given the price of the car. Thus, Lexus cars are always several thousand dollars less than comparable cars, and Toyota can price these cars lower because of its low cost structure. For example, the Lexus LS460 at about \$64,000 costs at least \$20,000 less than the BMW 7 Series and Mercedes S Class, its closest rivals. Most customers are discriminating and match price to differentiation, even in the luxury car segment of the market, so BMW and Mercedes have to offer customers something that justifies their vehicles' higher prices.

At every price range in the car market—under \$15,000, from \$15,000 to \$25,000, from \$25,000 to \$35,000, and the luxury segment above \$35,000—many models of cars compete to attract customers. For each price range, a carmaker has to decide how best to differentiate a particular car model to suit the needs of customers in that price range. Typically, the more differentiated a product is, the more it will cost to design and produce, and so differentiation leads to a higher cost structure. Thus, if a carmaker is to stay within the \$15,000 to \$25,000 price range and yet design and produce a differentiated car with a competitive advantage that allows it to outperform its rivals in the same price range, its managers have to make difficult choices.

They have to forecast what features customers will most value; for example, they may decide to trade-off sporty styling to increase safety features so that the car will not cost too much to produce, which allows them to make a profit and still sell the car for less than \$25,000.

In sum, in devising a business model, strategic managers are always constrained by the need to differentiate their products against the need to keep their cost structure under control so that they can offer the product at a **competitive price**—a price that offers customers as much or more value than the products of its rivals. Companies that have built a competitive advantage through innovation, quality, and reliability can differentiate their products more successfully than their rivals. In turn, because customers perceive there is more value in their products, these companies can charge a premium price, as Sony used to be able to do.

### Formulating the Business Model: Customer Groups and Market Segmentation

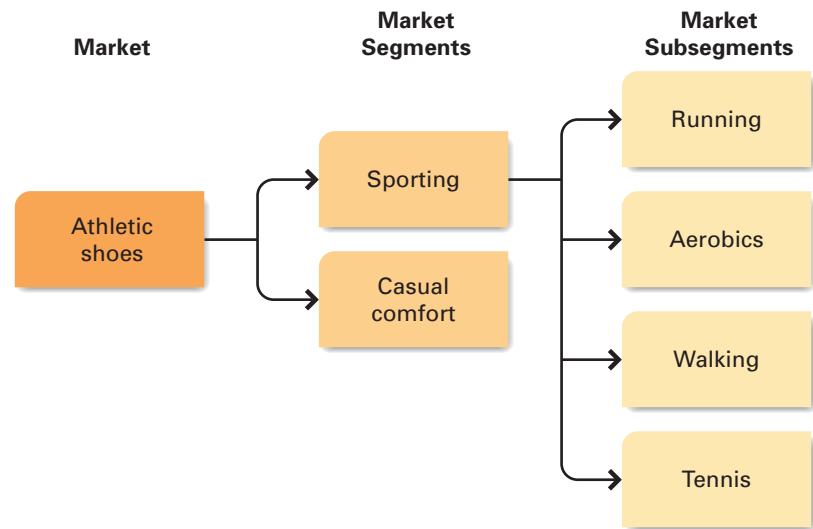
The second main choice involved in formulating a successful business model is to decide which kind of product(s) to offer to which customer group(s). Customer groups are the sets of people who share a similar need for a particular product. Because a particular product usually satisfies several different kinds of desires and needs, many different customer groups normally exist in a market. In the car market, for example, some customers need basic transportation, some desire top-of-the-line luxury, and others want the thrill of driving a sports car; these are three of the customer groups in the car market.

In the athletic shoe market, the two main customer groups are those people who use them for sporting purposes and those who like to wear them because they are casual and comfortable. Within each customer group, there are often subgroups composed of people who have an even more specific need for a product. Inside the group of people who buy athletic shoes for sporting purposes, for example, are subgroups of people who buy shoes suited to a specific kind of activity, such as running, aerobics, walking, and soccer (see Figure 5.1).

A company searching for a successful business model must group customers according to the similarities or differences in their needs to discover what kinds of products to develop for different kinds of customers. The marketing function performs research to discover a group of customers' primary need for a product, how they will use it, and their income or buying power (to determine the balance between differentiation and price). Other important attributes of a customer group are then identified that more narrowly target their specific needs. Once a group of customers who share a similar or specific need for a product has been identified, this group is treated as a market segment. Companies then decide whether to make and sell a product designed to satisfy the specific needs of this customer segment.

**Three Approaches to Market Segmentation** Market segmentation is the way a company decides to group customers, based on important differences in their needs or preferences, to gain a competitive advantage.<sup>8</sup> First, the company must segment the market according to how much customers are able and willing to pay for a particular product, such as the different price ranges for cars mentioned above. Once price has been taken into consideration, customers can be segmented according to the specific needs that are being satisfied by a particular product, such as the economy, luxury, or speed of cars mentioned earlier.

**Figure 5.1** Identifying Customer Groups and Market Segments

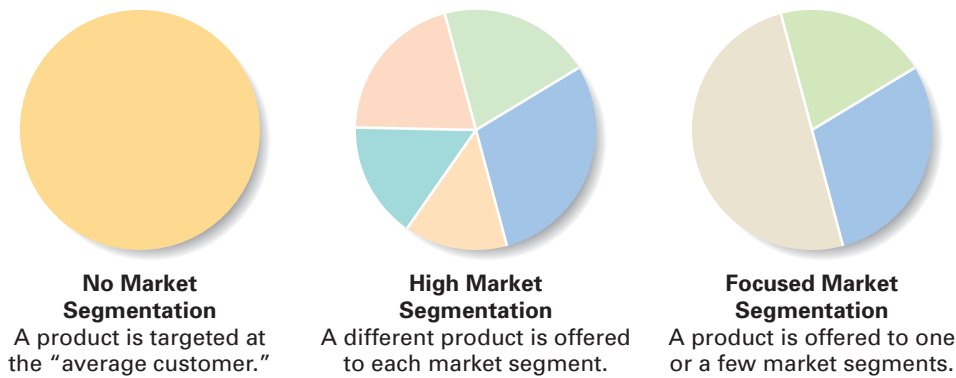


In crafting a business model, managers have to think strategically about which segments they are going to compete in and how they will differentiate their products for each segment. In other words, once market segments have been identified, a company has to decide how *responsive it should be to the needs of customers in the different segments* to obtain a competitive advantage. This decision determines a particular company's product range. There are three main approaches toward market segmentation in devising a business model (Figure 5.2):

1. First, a company might choose *not* to recognize that different market segments exist and make a product targeted at the average or typical customer. In this case, customer responsiveness is at a *minimum*, and competitive advantage is achieved through low price, not differentiation.
2. Second, a company can choose to recognize the differences between customer groups and make a product targeted toward most or all of the different market segments. In this case, customer responsiveness is *high* and products are being *customized* to meet the specific needs of customers in each group, so competitive advantage is obtained through differentiation, not low price.
3. Third, a company might choose to target just *one or two market segments* and devote its resources to developing products for customers in just these segments. In this case, it may be highly responsive to the needs of customers in only these segments, or it may offer a bare-bones product to undercut the prices charged by companies who do focus on differentiation. So, competitive advantage may be obtained through a focus on low price *or* differentiation.

Because a company's cost structure and operating costs increase when it makes a different product for each market segment rather than just one product for the whole market, why would a company devise a business model based on serving customers in multiple market segments? The answer is that although operating costs

**Figure 5.2** Three Approaches to Market Segmentation



increase, the decision to produce a range of products that are closely aligned with the needs of customers in different market segments attracts many more customers (because responsiveness to customers increases), and, therefore, sales revenues and profits increase. A car company that offers a wide range of cars customized to the needs of customers in different market segments increases the total number of cars it can sell. As long as a company’s revenues increase faster than its operating costs as its product range expands, profitability increases.

This does *not* mean that all companies should decide to produce a wide range of products aimed at each market segment. Profitability increases to the degree that there are significant differences in customer needs for a product in a particular market or industry. In some industries, like cars, customer needs differ widely. There are considerable differences in buyers’ primary needs for a car: income levels, lifestyles, ages, and so on. For this reason, major global carmakers broaden their product range and make vehicles to serve most market segments because this does increase profitability. A company that produces only a single model, compared to a company that produces 25 models, may therefore find itself at a serious competitive disadvantage.

On the other hand, in some markets customers have similar needs for a product, and so the relative price of competing products drives their buying choices. In this situation, a company that strives to gain a competitive advantage by using its resources to make and sell a single product as inexpensively as possible might be the most profitable. The average customer buys the product because it’s “OK” and good “value for the money.” This is the business model followed by companies that specialize in making a low-cost product, such as BIC, which makes low-cost razors and ballpoint pens, and Arm & Hammer, which makes baking soda. These are products that most people use in the same way. This is also the business model followed by companies like Walmart whose goal is to buy products from suppliers as cheaply as possible and then sell them to customers at the lowest possible prices. BIC and Walmart do not segment the market; they decide to serve the needs of customers who want to buy products as inexpensively as possible. Walmart promises everyday low prices and price rollbacks; BIC promises the lowest-priced razor blades that work acceptably.



The third approach to market segmentation is to target a product just at one or two market segments. To pursue this approach, a company must develop something very special or distinctive about its product to attract a large share of customers in those particular market segments. In the car market, for example, Rolls-Royce and Porsche target their products at specific market segments. Porsche, for example, targets its well-known sports cars at buyers in the high-priced sports car segment. In a similar way, specialty retailers compete for customers in a particular market segment, such as the segment composed of affluent people who can afford to buy expensive handmade clothing, or people who enjoy wearing “trendy” shoes or jeans. A retailer might also specialize in a particular style of clothing, such as western wear, beachwear, or accessories. In many markets, these are enormous opportunities for small companies to specialize in satisfying the needs of a specific market segment. Often, these companies can better satisfy their customers’ needs because they are so close to them and understand how their needs are changing over time.

Market segmentation is an evolving, ongoing process that presents considerable opportunities for strategic managers to improve their company’s business model. For example, in the car industry, savvy strategists often identify a “new” customer group whose specific needs have not been met and who have had to “satisfice” and buy a model that does not meet their needs exactly but is a reasonable compromise. Now a car company can decide to treat this group as a market segment and create a product designed to meet their specific needs, and, if it makes the right choice, it has a blockbuster product. This was the origin of the minivan; the SUV; crossover vehicles like the Honda Pilot, Toyota Scion, or Dodge Magnum; and hybrid vehicles such as Toyota’s Prius and Honda’s 2009 Insight. In the case of SUVs, many car buyers wanted a more rugged and powerful vehicle capable of carrying many passengers or towing heavy loads. They liked the comfort of a car but also the qualities of a pickup. By combining these two, carmakers created the SUV market segment. If managers make mistakes, however, and design a product for a market segment that is much smaller than they expected, the opposite can occur. After oil prices soared, United States carmakers ended production of many gas-guzzling vehicles, such as the luxury Lincoln truck and Excursion SUV, and massively reduced production of other models after customer demand collapsed; even Toyota had to temporarily suspend production of its blockbuster Tundra pickup.

### **Implementing the Business Model: Building Distinctive Competencies**

To develop a successful business model, strategic managers have to devise a set of strategies that determine (1) how to differentiate and price their product and (2) how much to segment a market and how wide a range of products to develop. Whether these strategies will result in a profitable business model now depends on a strategic manager’s ability to implement the business model, that is, to choose strategies that will create products that provide customers with the most value, while keeping the cost structure viable (because of the need to be price competitive).

In practice, this involves deciding how to invest a company’s capital to build and shape distinctive competencies that result in a competitive advantage based on superior efficiency, quality, innovation, and/or responsiveness to customers. Hence, implementing a company’s business model sets in motion *the specific set of functional-level strategies needed to create a successful differentiation and low-cost business strategy*. We discussed how functional strategies can build competitive advantage

## RUNNING CASE

### Walmart's Business Model and Competitive Positioning

As noted earlier, Walmart's business model is based on buying goods from suppliers as inexpensively as possible and then selling them to customers at the lowest possible prices. Figure 5.3 identifies strategies that Sam Walton, the company's founder, developed to allow the company to position itself to keep operating costs to a minimum so that he could offer customers everyday low prices and continuous price rollbacks. Walton chose strategies to increase efficiency, such as having low product differentiation (Walmart chooses minimal advertising and low responsiveness to customers) and targeting the mass market. His discount retail business model was based on the idea that lower costs mean lower prices.

Having devised a way to compete for customers, Walton's task was now to implement the business

model in ways that would create a low-cost structure to allow him to charge lower prices. One business-level strategy he implemented was to locate his stores in small towns where there were no low-cost competitors; a second was to find ways to manage the value chain to reduce the costs of getting products from manufacturers to customers; and a third was to design and staff store operations to increase efficiency. The task of all functional managers in logistics, materials management, sales and customer service, store management, and so on, was to implement specific functional-level strategies that supported the low-cost/low-price business model. As Figure 5.3 suggests, Walmart has made thousands of specific strategic choices to allow it to implement its low-price business model successfully.

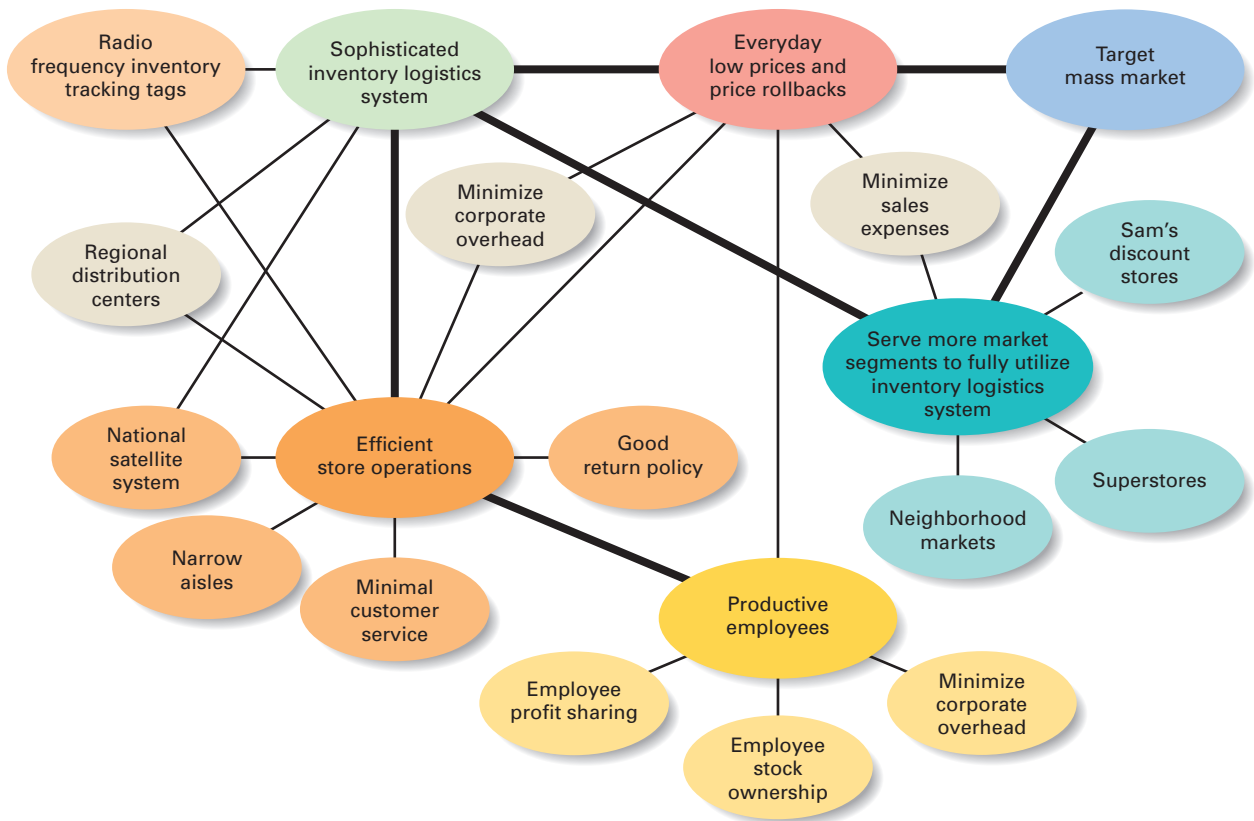
in Chapter 4. The better the fit between a company's business strategy and its functional-level strategies, the more value and profit a company creates, as the Running Case on Walmart suggests.

## COMPETITIVE POSITIONING AND BUSINESS-LEVEL STRATEGY

Figure 5.4 presents a way of thinking about the competitive positioning decisions that strategic managers make to create a successful business model.<sup>9</sup> The decision to differentiate a product increases its perceived value to the customer so that market demand for the product increases. Differentiation is expensive, however; for example, strategies to improve product quality, support a higher level of service, or increase innovation increase operating costs. Therefore, the decision to increase product differentiation also raises a company's cost structure and results in a higher unit cost. (In some cases, if increased demand for the product allows a company to make large volumes of the product and achieve economies of scale, these economies can offset some of these extra costs; this effect is showed by the dashed line in Figure 5.4.)<sup>10</sup>

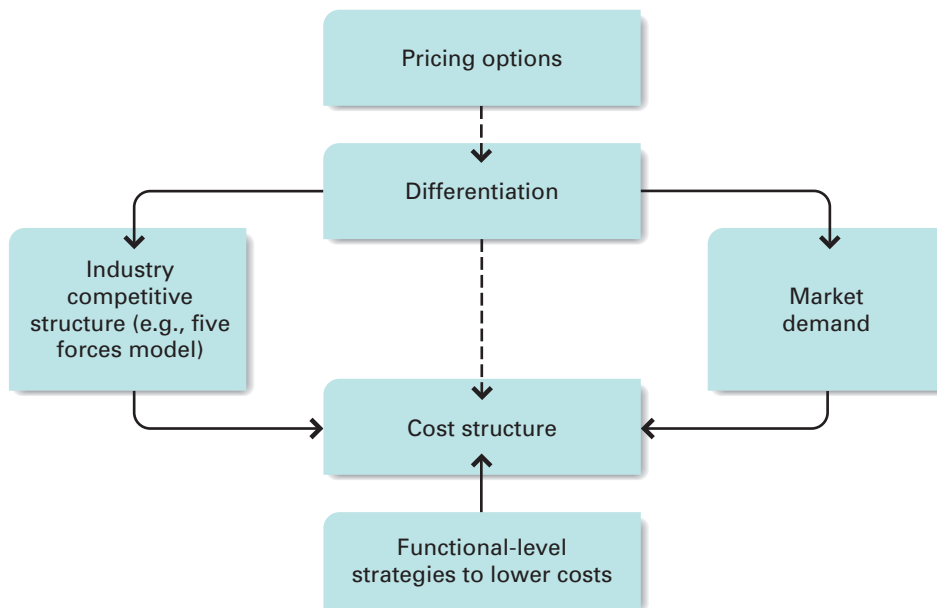
To maximize profitability, managers must choose a premium pricing option that compensates for the extra costs of product differentiation but is not so high that it chokes off the increase in expected demand (to prevent customers from deciding that the extra differentiation is not worth the higher price). Once again, to increase

### Figure 5.3 Walmart's Business Model



profitability, managers must also search for other ways to reduce the cost structure but not in ways that will harm the differentiated appeal of its products. There are many specific functional strategies a company can adopt to achieve this. For example, Nordstrom, the luxury department store retailer, differentiates itself in the retail clothing industry by providing a high-quality shopping experience with elegant store operations and a high level of customer service—all of which raise Nordstrom's cost structure. However, Nordstrom can still lower its cost structure by, for example, managing its inventories efficiently and increasing inventory turnover. Also, its strategy of being highly responsive to customers results in more customers and higher demand, which means that sales per square foot increase. This revenue enables it to make more intensive use of its facilities and salespeople, which leads to scale economies and lower costs. Thus, no matter what level of differentiation a company chooses to pursue in its business model, it always must recognize the way its cost structure will vary as a result of its choice of differentiation and the other specific strategies it adopts to lower its cost structure; in other words, *differentiation and cost structure decisions affect one another*.

The last main issue shown in Figure 5.4 concerns the impact of the industry's competitive structure on a company's differentiation, cost structure, and pricing choices. Recall that strategies are developed in an industry environment populated

**Figure 5.4** Competitive Positioning at the Business Level

**Source:** Copyright © C. W. L. Hill and G. R. Jones, "The Dynamics of Business-Level Strategy" (unpublished manuscript, 2005).

by watchful and agile competitors; therefore, one company's choice of competitive positioning is always made *with reference to those of its competitors*. If, for example, competitors start to offer products with new or improved features, a company may be forced to increase its level of differentiation to remain competitive, even if this reduces its profitability. Similarly, if competitors decide to develop products for new market segments, the company will have to follow suit or become uncompetitive. Thus, because differentiation increases costs, increasing industry competition can drive up a company's cost structure. When that happens, a company's ability to charge a premium price to cover these high costs may fall.

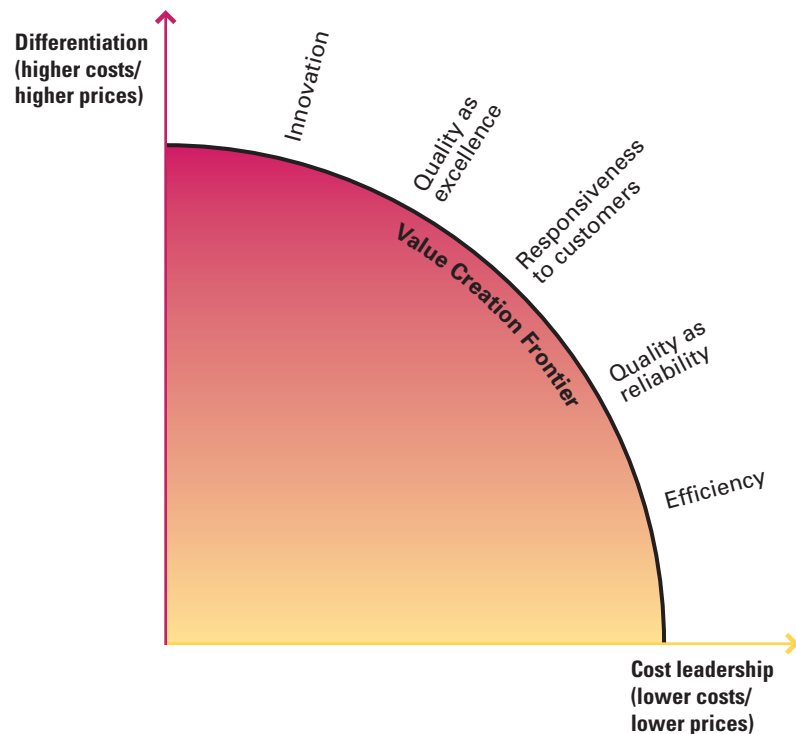
This is what happened to Sony when it lost its competitive advantage to competitors making flat screen LCD TVs and gaming consoles. Its cost structure rose, but it was unable to maintain its premium pricing, thus the result was lost profitability. Of course, its competitors, like Apple and Nintendo, experienced the opposite situation. Their innovative products, such as the iPhone and Wii, increased their cost structure, but the technological lead they obtained has allowed them to charge customers premium prices, which has made them the most profitable companies in these product markets. This is why competitive advantage can change so quickly in an industry and why it is vital to make the right product positioning choices. In sum, maximizing the profitability of a company's business model is about making the right choices with regard to value creation through differentiation, cost structure, and pricing, given the level of customer demand for its particular product and overall competitive conditions in the industry.

## COMPETITIVE POSITIONING: GENERIC BUSINESS-LEVEL STRATEGIES

As we discussed previously, a successful business model is the result of the way a company formulates and implements a set of strategies to achieve a fit between its differentiation, cost, and pricing options. Although no diagram can ever model all the complexities involved in business-level strategy decisions, Figure 5.5 represents a way to bring together the three issues involved in developing a successful business model. In the figure, the vertical and horizontal axes represent the decisions of strategic managers to position a company's products with respect to the tradeoff between differentiating products (higher costs/higher prices) and achieving the lowest cost structure or cost leadership (lower costs/lower prices). The curve connecting the axes represents the **value creation frontier**, that is, the maximum amount of value that the products of different companies in an industry can provide to customers at any one time using the different business models. Companies on the value creation frontier are those that have built and maintained the most successful business models in a particular industry over time—they have a competitive advantage and above average profitability.

As Figure 5.5 illustrates, the value creation frontier is reached by pursuing one or more of the four building blocks of competitive advantage (quality has been split into its two components), which are listed from top to bottom in terms of how much

**Figure 5.5** Competitive Positioning and the Value Creation Frontier



they can contribute to the creation of a differentiation or cost-leadership advantage. Thus innovation, a costly process that results in unique products, is nearest the differentiation axis, followed by quality as excellence, customer responsiveness, and quality as reliability; efficiency with its focus on lowering the cost structure is closest to the cost-leadership axis.

To reach the value creation frontier and so achieve above-average profitability, a company must formulate and implement a business model based on one or a combination of three generic business-level strategies: cost leadership, differentiation, and focused. A **generic business-level strategy** gives a company a specific form of competitive position and advantage vis-à-vis its rivals that results in above-average profitability.<sup>11</sup> *Generic* means that all companies can potentially pursue these strategies regardless of whether they are manufacturing, service, or nonprofit enterprises; they are also generic because they can be pursued across different kinds of industries.<sup>12</sup>

## Cost Leadership

A company pursuing a **cost-leadership** business model chooses strategies that do everything possible to lower its cost structure so it can make and sell goods or services at a lower cost than its competitors. These strategies include both functional strategies designed to improve its operating performance and competitive strategies intended to influence industry competition in its favor. In essence, a company seeks to achieve a competitive advantage and above-average profitability by developing a cost-leadership business model that positions it on the value creation frontier as close as possible to the lower costs/lower prices axis.

Two advantages accrue to a company pursuing cost leadership. First, because the company has lower costs, it will be more profitable than its closest competitors, the companies that compete for the same set of customers and charge similar low prices for their products. Second, the cost leader gains a competitive advantage because it is able to charge a *lower price* than its competitors because of its lower cost structure. Offering customers the same kind of value from a product but at a lower price attracts many more customers, so that even though the company has chosen a lower price option, the increased volume of sales will cause profits to surge. If its competitors try to get lost customers back by reducing their prices and all companies start to compete on price, the cost leader will still be able to withstand competition better than the other companies because of its lower costs. It is likely to win any competitive struggle. For these reasons, cost leaders are likely to earn above-average profits. A company becomes a cost leader when its strategic managers make the following competitive positioning decisions.

**Competitive Positioning Decisions** The cost leader chooses a low to moderate level of product differentiation relative to its competitors. Differentiation is expensive; the more a company spends resources to make its products distinctive, the more its costs rise.<sup>13</sup> The cost leader aims for a “sufficient” level of differentiation obtainable at low cost.<sup>14</sup> Walmart, for example, does not spend hundreds of millions of dollars on store design to create an attractive shopping experience as chains like Macy’s, Dillard’s, or Nordstrom’s have done. As Walmart explains in its mission statement, “We think of ourselves as buyers for our customers, and we apply our considerable strengths to get the best value for you.” Such value is not obtained by building lavish stores.<sup>15</sup> Cost leaders often wait until customers want a feature or service before providing it. For example, a cost leader like Vizio or Phillips is never



the first to offer the state-of-the-art picture or sound quality; they increase their LCD TV capabilities only when it is obvious that customers demand it—or competitors start to do it first.

The cost leader also ignores the many different market segments in an industry. It positions its products to appeal to the “average” customer to avoid the high costs of developing and selling a wide range of products tailored to the needs of different market segments. In targeting the average customer, the goal is to provide the smallest number of products that will attract the largest number of customers—something at the heart of Dell’s approach to building its PCs or Walmart’s approach to stocking its stores. Thus, although customers may not get exactly the products they want, they are attracted by their lower prices.

To implement cost leadership, the overriding goal of the cost leader must be to choose strategies to increase its efficiency and lower its cost structure compared with its rivals. The development of distinctive competencies in manufacturing, materials management, and IT is central to achieving this goal. For example, manufacturing companies that pursue a cost-leadership strategy focus on doing everything they can to continually ride down the experience curve to continuously lower cost structure. Achieving a cost-leadership position requires a company to develop skills in flexible manufacturing, adopt efficient materials-management techniques, and do all it can to increase inventory turnover and reduce the cost of goods sold. (Table 4.1 outlined the ways in which a company’s functions can be used to increase efficiency.)

Consequently, the main goal is to reduce the operating costs of the manufacturing and materials-management functions, and the other functions shape their distinctive competencies to help achieve this. The sales function, for example, may focus on capturing large, stable sets of customer orders so that manufacturing can make longer production runs and so obtain economies of scale that reduce costs. Similarly, Dell provides its online PC customers with a limited set of options to choose from so that it can provide customized PCs at a low cost.

By contrast, companies supplying services, such as retail stores like Walmart, must develop distinctive competencies in the specific functions that contribute most to their cost structure. For Walmart, this is the cost of purchasing products, so the logistics or materials-management function becomes of central importance for reducing product costs. Walmart continually takes advantage of advances in IT to lower the costs associated with transferring products from manufacturers to customers, just as Dell, the cost leader in the PC industry, uses the Internet to lower the cost of selling its computers. Another major source of cost savings in pursuing cost leadership is to choose an organizational structure and culture to implement this strategy in the most cost-efficient way. Thus, a low-cost strategy implies minimizing the number of managers in the hierarchy and the rigorous use of budgets to control production and selling costs. An interesting example of the way a company can craft a business model to become the cost leader in an industry is Ryanair, discussed in Strategy in Action 5.1.

**Competitive Advantages and Disadvantages** Porter’s five forces model, introduced in Chapter 2, explains why companies that employ each of the business models successfully reach the value creation frontier shown in Figure 5.5 and achieve a competitive advantage and above-average profitability. Recall that the five forces are threats from competitors, powerful suppliers, powerful buyers, substitute products, and new entrants. The cost leader has an advantage over industry competitors because

## 5.1 STRATEGY IN ACTION

### Ryanair Takes Control over the Sky in Europe

Ryanair, based in Dublin, Ireland, imitated and improved on the cost-leadership business model pioneered by Southwest Airlines in the United States and used it to become a leading player in the European air travel market. Ryanair's CEO, the flamboyant Michael O'Leary, copied the specific strategies Southwest had developed to cut costs and position Ryanair as the lowest-cost, lowest-priced European airline. The average cost of a Ryanair ticket within Europe is \$48, compared to \$330 on British Airways and \$277 on Lufthansa, which have long dominated the European air travel market. The result is that Ryanair now flies more passengers inside Britain than British Airways, and its share of the European market is growing as fast as it can gain access to new landing spots and buy the new planes needed to service its expanding route structure.

O'Leary also worked to improve Southwest's low-cost business model. Ryanair imitated the main elements of Southwest's model, such as using only one plane, the 737, to reduce maintenance costs, selling tickets directly to customers, and eliminating seat assignments and free in-flight meals. It also avoids high-cost airports like Heathrow and chooses smaller ones outside big cities, such as Luton, its London hub. However, to reduce airplane operating costs, O'Leary also eliminated free blankets, pillows, sodas or snacks, and even "sick" bags—perks a passenger expects to receive on a more

differentiated airline. "You get what you pay for" is Ryanair's philosophy. To implement his cost-leadership strategy, O'Leary and all employees are expected to find ways to continually shrink the operating costs that arise in performing the thousands of specific tasks needed to run an airline. Through these tactics, Ryanair has lowered its cost structure so far that no other European airline can come close to offering its low-cost fares and break even, let alone make a profit.

The other side of Ryanair's business model is to add to its revenues by getting its customers to spend as much as possible while they are on its flights. To this end, Ryanair offers snacks, meals, and a variety of drinks to encourage customers to open their wallets. In addition, to cut costs his planes have no back-seat LCD screens for viewing movies and playing games; passengers can rent a digital handheld device for \$6 a flight to watch movies and sitcoms or play games or music. 14% of its revenues come from these sources; they are so important that the airline gives away millions of its unsold seats free to customers so that it can at least generate some revenue from passengers sitting in what otherwise would be empty seats. Ryanair and Southwest have together shown that the cost-leadership business model is the only one that will work in the future and globally; all large airlines are rushing to adopt the specific strategies that will allow them to pursue it.

**Sources:** D. McGinn, "Is This Any Way to Run an Airline?" *Newsweek*, October 4, 2004, E14–19; E. Torbenson, "Budget Carriers Rule the European Skies," *Dallas Morning News*, September 22, 2004, D1. <http://www.ryanair.com>.

it has a lower cost structure. Its lower costs also mean that it will be less affected than its competitors by increases in the price of inputs if there are powerful suppliers and less affected by the lower prices it can charge if powerful buyers exist. Moreover, because cost leadership usually requires a large market share, the cost leader purchases in relatively large quantities, increasing its bargaining power over suppliers, just as Walmart does. If substitute products begin to come onto the market, the cost leader can reduce its price to compete with them and retain its market share. Finally, the leader's cost advantage constitutes a barrier to entry because other companies are unable to enter the industry and match the leader's low costs or prices. The cost leader is therefore relatively safe as long as it can maintain its low-cost advantage.

The principal dangers of the cost-leadership approach arise when competitors are able to develop new strategies that lower their cost structure and beat the cost leader at its own game. For instance, if technological change makes experience-curve

economies obsolete, new companies may apply lower-cost technologies that give them a cost advantage. The steel mini-mills discussed in Chapter 4 pursued this strategy to obtain a competitive advantage. Competitors may also obtain a cost advantage from labor-cost savings. Global competitors located in countries overseas often have very low labor costs; wage costs in the United States are roughly 600% more than they are in Malaysia, China, or Mexico. Most United States companies now assemble their products abroad as part of their low-cost strategy; many are forced to do so simply to compete and stay in business.

Competitors' ability to imitate the cost leader's methods easily is another threat to the cost-leadership strategy. For example, companies in China routinely take apart the electronic products of Japanese companies like Sony and Panasonic to see how they are designed and assembled. Then, using inexpensive Chinese-made components and domestic labor, they manufacture clones of these products and flood the United States market with lower-priced flat screen TVs, laptops, and mobile phones.

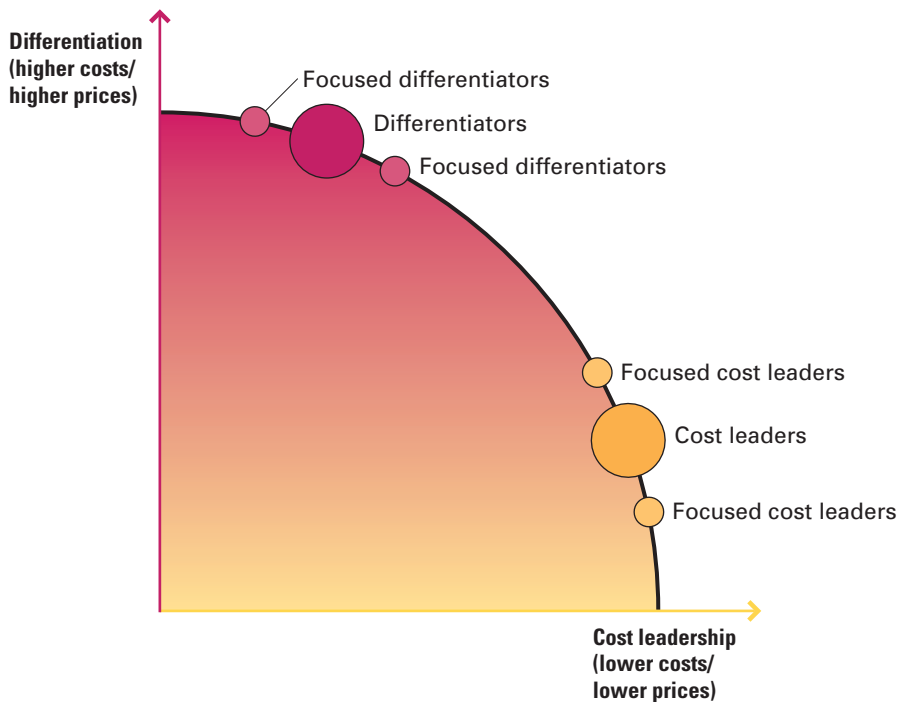
Finally, a danger arises if a strategic manager's single-minded desire to reduce costs to remain the cost leader results in decisions that might lower costs but also drastically reduce demand for the product. This happened to Gateway Computer when, to reduce the costs of customer service to better compete with Dell, customer support people were instructed not to help customers who were experiencing problems with their new Gateway PCs if they had installed their own new software on the machines. New buyers, most of whom install their own software, began to complain vociferously, and Gateway's sales plunged. Within six months, managers had reversed their decision, and once again began offering full customer support.

## Focused Cost Leadership

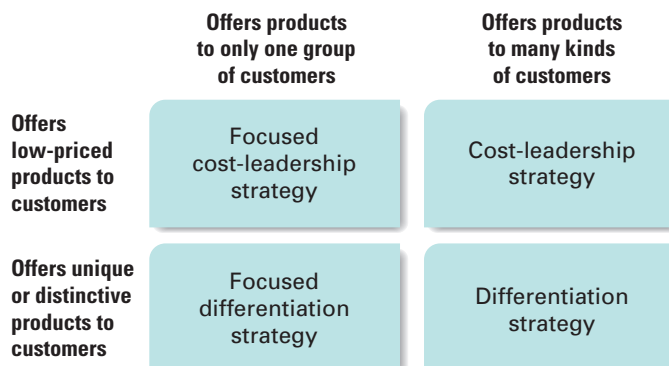
A cost leader is not always a large, national company that targets the average customer. Sometimes a company can pursue a **focused cost leadership** business model based on combining the cost leadership and focused business-level strategies to compete for customers in just one or a few market segments. Focused cost leaders concentrate on a narrow market segment, which may be defined geographically, by type of customer, or by segment of the product line.<sup>16</sup> In Figure 5.6, focused cost leaders are represented by the smaller circles next to the cost leader's circle. For example, because a geographic niche can be defined by region or even by locality, a cement-making company, a carpet-cleaning business, or a pizza chain could pursue a cost-leadership strategy in one or more cities in a region. Figure 5.7 compares a focused cost-leadership business model with a pure cost-leadership model.

If a company uses a focused cost-leadership approach, it competes against the cost leader in the market segments where it can operate at no cost disadvantage. For example, in local lumber, cement, bookkeeping, or pizza delivery markets, the focuser may have lower materials or transportation costs than the national cost leader. The focuser may also have a cost advantage because it is producing complex or custom-built products that do not lend themselves easily to economies of scale in production and therefore offer few cost-saving possibilities. The focused cost leader concentrates on small-volume custom products, for which it has a cost advantage, and leaves the large-volume standardized market to the national cost leader—for example, low-priced Mexican food specials versus Big Macs.

Because it has no cost disadvantage in its market segments, a focused cost leader also operates on the value creation frontier and so earns above-average profits.

**Figure 5.6** Generic Business Models and the Value Creation Frontier

Such a company has great opportunity to enlarge its market segment and compete against companies pursuing cost-leadership or differentiated strategies. Ryanair, for example, began as a focus company because at first it operated flights only between Dublin and London. Because there was no cost leader in the European market, it was able to quickly expand its operations, and today it is the European cost leader. Similarly, Southwest began as a focused cost leader within the Texas market but is

**Figure 5.7** Why Focus Strategies Are Different

now a national airline and competes against new companies that pursue focused cost leadership, such as JetBlue.

Because a focused company makes and sells only a relatively small quantity of a product, its cost structure will often be higher than that of the cost leader. In some industries, such as automotive, this can make it very difficult or impossible to compete with the cost leader. However, sometimes, by targeting some new market segment or by implementing a business model in a superior way—such as by adopting a more advanced technology—focused companies can be a threat to large cost leaders. For example, flexible manufacturing systems have opened up many new opportunities for focused companies because small production runs become possible at a lower cost. The steel mini-mills discussed in Chapter 4 provide another good example of how a focused company, in this case Nucor, by specializing in one market can grow so efficient that it becomes *the* cost leader. Similarly, the growth of the Internet has opened up many new opportunities for focused companies to develop business models based on being the cost leader compared to bricks-and-mortar companies. Amazon.com shows how effectively a company can craft a business model to become the cost leader.

**Implications and Conclusions** To pursue cost leadership, strategic managers need to devote enormous efforts to incorporate all the latest information, materials management, and manufacturing technology into their operations to find new ways to reduce costs. Often, as we saw in Chapter 4, using new technology will also raise quality and increase responsiveness to customers. A low-cost approach requires ongoing strategic thinking to make sure the business model is aligned with changing environmental opportunities and threats.

Strategic managers in companies throughout the industry are watching the cost leader and will move quickly to imitate its innovations because they also want to reduce their costs. Today, a differentiator cannot let a cost leader get too great a cost advantage because the leader might then be able to use its high profits to invest more in product differentiation and beat the differentiator at its own competitive game. For example, Toyota and Honda began as focused cost leaders, manufacturing a reliable low-priced car. Their cars sold well, and they then invested their profits to design and make new models of cars that became increasingly differentiated in features and quality. Today, Toyota and Honda, with cars in every market segment, pursue a differentiation strategy, although Toyota also has the lowest cost structure of any global carmaker.

A cost leader must also imitate the strategic moves of its differentiated competitors, and increase the quality and features of its products when they do, to prosper in the long run. Even low-priced products, such as Timex watches and BIC razors, cannot be too inferior to the more expensive Seiko watches or Gillette razors if the lower costs/lower prices model is to succeed. Companies in an industry watch the strategies their rivals are pursuing, and the changes they make to those strategies. So, if Seiko or Swatch introduces a novel kind of LCD watch dial or Gillette a three- or four-bladed razor, managers at Timex and BIC will respond within months by incorporating these innovations in their low-priced products if required. This situation is also very common in the high-priced women's fashion industry. As soon as famous designers like Gucci and Dior have shown their spring and fall collections, their designs are copied and the plans are transmitted to factories in Malaysia, where workers are ready to manufacture low-priced imitations that within months will reach low-price clothing retail stores around the world.

## Differentiation

A company pursuing a **differentiation** business model pursues business-level strategies that allow it to create a unique product, one that customers perceive as different or distinct in some important way. A differentiator (that is, a differentiated company) gains a competitive advantage because it has the ability to satisfy customers' needs in a way that its competitors cannot, which allows it to charge a premium price for its product. The ability to increase revenues by charging premium prices (rather than by reducing costs, as the cost leader does) allows the differentiator to reach the value frontier, outperform its competitors, and achieve superior profitability, as shown in Figure 5.6. Customers pay a premium price when they believe the product's differentiated qualities are worth the extra money, so differentiated products are priced as high as customers are willing to pay.

Mercedes-Benz cars are more expensive than the cars of its closest rivals because customers believe they offer more features and confer more status on their owners. Similarly, a BMW is not much more expensive to produce than a Honda, but its high price is determined by customers who want its distinctive sporty ride and the prestige of owning a BMW. (In fact, in Japan, BMW prices its entry cars quite modestly to attract young, well-heeled Japanese customers from Honda.) Similarly, Rolex watches do not cost much to produce—their design has not changed very much for years—and their gold content represents only a small fraction of their price. Customers, however, buy a Rolex because of the distinct qualities they perceive in it: its beautiful design and its ability to hold its value as well as to confer status on its wearer.

**Competitive Positioning Decisions** A differentiator invests its resources to gain a competitive advantage from superior innovation, excellent quality, and responsiveness to customer needs—the three principal routes to high product differentiation. For example, Procter & Gamble claims that its product quality is high and that Ivory soap is 99.44% pure. Toyota stresses reliability and the best repair record of any carmaker. IBM promotes the quality service provided by its well-trained sales force. Innovation is commonly the source of differentiation for technologically complex products, and many people pay a premium price for new and innovative products, such as a state-of-the-art gaming PC, gaming console, or car.

When differentiation is based on responsiveness to customers, a company offers comprehensive after-sales service and product repair. This is an especially important consideration for complex products such as cars and domestic appliances, which are likely to break down periodically. Whirlpool, Dell, and BMW all excel in responsiveness to customers. In service organizations, quality-of-service attributes are also very important. Neiman Marcus, Nordstrom, and FedEx can charge premium prices because they offer an exceptionally high level of service. Firms of lawyers, accountants, and consultants stress the service aspects of their operations to clients: their knowledge, professionalism, and reputation.

Finally, a product's appeal to customers' psychological desires is a source of differentiation. The appeal can be prestige or status, as it is with Rolls-Royce cars and Rolex watches; safety of home and family, as with Aetna or Prudential Insurance; or simply providing a superior shopping experience, as with Target and Macy's. Differentiation can also be tailored to age groups and socioeconomic groups. Indeed, the bases of differentiation are endless.



A company pursuing a business model based on differentiation pursues strategies to differentiate itself along as many competitive dimensions as possible. The less it resembles its rivals, the more it is protected from competition and the wider is its market appeal. Thus, BMWs offer more than prestige; they also offer technological sophistication, luxury, reliability, and good, although very expensive, repair service. All these bases of differentiation help increase sales.

Generally, a differentiator chooses to divide its market into many segments and offer different products in each segment, just as Sony, Toyota, and Dell do. Strategic managers recognize how much revenues can be increased when each of a company's products, targeted at different market segments, can attract more customers. A differentiator targets only the market segments in which customers are willing to pay a premium price, however. For example, Sony produces many flat screen TV models, but it targets only the niches from mid-priced to high-priced sets; its lowest-priced model is still a few hundred dollars above that of its low-cost competitors—despite its current problems.

Finally, in choosing how to implement its business model, a differentiated company concentrates on developing distinctive competencies in the functions that provide the source of its competitive advantage. Differentiation on the basis of innovation and technological competency depends on the R&D function, as discussed in Chapter 4. Efforts to improve service to customers depend on the quality of the sales and customer service function.

Pursuing a business model based on differentiation is expensive, so a differentiator has a cost structure that is higher than a cost leader's. Building new competencies in the functions necessary to sustain a company's differentiated appeal does not mean neglecting the cost structure, however. Even differentiators benchmark how cost leaders operate to find ways to imitate their cost-saving innovations while preserving their products' differentiated appeal. A differentiator must control its cost structure to ensure the price of its products does not exceed the price customers are willing to pay for them—something that Sony has failed to do. Also, superior profitability is a function of a company's cost structure, so it is important to keep costs under control but not to reduce them so far that a company loses the source of its differentiated appeal.<sup>17</sup> The owners of the famous Savoy Hotel in London, England, face just this problem. The Savoy's reputation has always been based on the incredibly high level of service it offers its customers. Three hotel employees serve the needs of each guest, and in every room, a guest can summon a waiter, maid, or valet by pressing a button at bedside. The cost of offering this level of service has been so high that the hotel makes less than 1% net profit every year, despite the fact that a room costs at least \$500 a night!<sup>18</sup> Its owners try to find ways to reduce costs to increase profits, but if they reduce the number of hotel staff (the main source of the Savoy's high costs), they will destroy the main source of its differentiated appeal.

**Competitive Advantages and Disadvantages** The reason why the differentiation business model also allows a company to obtain a competitive advantage and reach the value creation frontier can also be explained by the five forces model. Differentiation protects a company from competitors when customers develop brand loyalty for its products, a valuable asset that allows it to charge a premium price. Because the differentiated company's strategy is geared more toward the premium price it can charge than toward costs, powerful suppliers become less of a problem, especially as differentiators can often pass on price increases to loyal customers. Thus, a differentiator can tolerate moderate increases in input prices better than the

cost leader can. Differentiators are unlikely to experience problems with powerful buyers because they offer a distinctive product that commands brand loyalty and only they can supply it. Differentiation and brand loyalty also create a barrier to entry for other companies seeking to enter the industry. A new company must find a way to make its own product distinctive to be able to compete, which involves an expensive investment in building some kind of distinctive competence. Finally, substitute products are a threat only if a competitor can develop a product that satisfies a similar customer need as the differentiator's product, thus causing customers to switch to the new product. This can happen; wired phone companies have suffered as mobile phone companies offer an attractive wireless product, and lower-cost alternative ways of making phone calls through PCs and the Internet are becoming increasingly popular.

The main problems with a differentiation strategy center on how well strategic managers can maintain a product's perceived difference or distinctness to customers and hence maintain premium pricing. In the 2000s, it has become clear that it is easier than ever for agile competitors to imitate and copy successful differentiators. This has happened across many industries, such as retailing, computers, cars, home electronics, telecommunications, and pharmaceuticals. Patents and first-mover advantages (the advantages of being the first to market a product or service) last only so long, and as the overall quality of competing products increases, brand loyalty declines, as do prices. The problems L.L.Bean has had in maintaining its competitive advantage, described in Strategy in Action 5.2, highlight many of the threats that face a differentiator.

**Implications and Conclusions** A business model based on differentiation requires a company to make strategic choices that reinforce each other and together increase the value of a good or service in the eyes of customers. When a product has distinctness, differentiators can charge a premium price. The disadvantages of pursuing differentiation are the ease with which competitors can imitate a differentiator's product and the difficulty of maintaining a premium price. When differentiation stems from the design or physical features of the product, differentiators are at great risk because imitation is easy; over time products such as LCD televisions and cell phones became commodity-like products, and customers became increasingly price sensitive. However, when differentiation stems from functional-level strategies that lead to superior service or reliability, or from any intangible source, such as FedEx's guarantee or the prestige of a Rolex, a company is much more secure. It is difficult to imitate intangible products, and a differentiator can often reap the benefits of premium prices for an indefinite time. Nevertheless, all differentiators must watch out for imitators and be careful that they do not charge a premium price that is higher than customers are willing to pay. These are issues that Sony neglected, contributing to its currently declining sales as it loses its competitive advantage.

## Focused Differentiation

A company that pursues a business model based on **focused differentiation** chooses to combine the differentiation and focused generic business-level strategies and specializes in making distinctive products for one or two market segments. All the means of differentiation that are open to the differentiator are available to the focused differentiator. The point is that the focused company develops a business model that allows it to successfully position itself to compete with the differentiator

## 5.2 STRATEGY IN ACTION

### L.L.Bean's New Business Model

In 1911, Leon Leonwood Bean, a hunter who grew weary of walking miles to hunt game as his feet became wetter and wetter, decided he would create waterproof boots. The ones he invented had leather uppers attached to large rounded rubber bases. Soon he began selling his boots through mail order. As word spread about their reliability, backed by his policy of being responsive to customers who complained (often replacing their boots years after a sale), his company's reputation spread. As the years went by, L.L.Bean expanded its now well-known product line to include products such as canvas tote bags and, of course, flannel dog beds. By 2000, the company's mail order revenues exceeded \$1 billion a year, and L.L.Bean became known for offering one of the highest-quality product lines of sporting clothes and accessories.

To display its product line, the company built a 160,000-square-foot signature store in Freeport, Maine, that stocks hundreds of versions of its backpacks, fleece vests, shirts, moccasins, tents, and other items; more than 3 million visitors a year shop its store. L.L.Bean established this store partly to give customers hands-on access to its products so that they would have a better understanding of the high quality they were being offered. Of course, L.L.Bean expects to command a premium price for offering such a wide variety of high-quality products, and historically it has enjoyed high profit margins. Customers buy its products for their personal use but also as gifts for friends and relatives.

L.L. Bean's business model began to suffer when there was an explosion in the number of companies touting high-quality, high-priced products to customers; consequently, L.L. Bean's catalogue lost its unique appeal. Furthermore, the explosive growth of the Internet gave customers access to many more companies that offered

quality products, often at much lower prices, such as Lands' End, which also began to feature fleece vests, dog baskets, and so on, in its product lineup. The problem facing any differentiator is how to protect the distinctiveness of its products from imitators who are always searching for ways to steal away its customers by offering them similar kinds of products at reduced prices.

Finding ways to protect L.L. Bean's business model has proved to be a major challenge. Its catalogue sales were stagnant for several years as buyers switched loyalty to lower-priced companies. To help the company rebuild its competitive advantage, it began to build a chain of L.L.Bean stores in major urban locations to encourage potential customers to examine the quality of its products and so attract them—either to buy them in the stores or to use its Web site.

This has not proved easy to date because physical retail stores have high cost structures; L.L. Bean has had to search for the right way to implement its strategy. It has also had to lower the price of its sporting clothes and accessories in these stores; the days of premium prices are gone. Another strategy has been to launch an aggressive advertising campaign aimed at younger customers who may not know the L.L. Bean story. Then, with physical stores, the Internet, and its catalogues, it may have a better chance of getting their business.

The jury is out, however. Not only are other differentiated sporting goods chains expanding, such as Dick's Sporting Goods and Gander Mountain, but sites like Amazon.com and Landsend.com, owned by Sears, are offering lower-priced products. Whether L.L.Bean's differentiation business model can be reworked to allow it to reach the value creation frontier remains to be seen, and because cost leadership is not an option, the company faces a rocky road ahead.

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**Sources:** D. McGinn, "Swimming Upstream," *Newsweek*, October 1, 2004; E10–12 <http://www.llbean.com>.

in just one or a few segments. For example, Porsche, a focused differentiator, competes against Toyota and BMW only in the sports car and luxury SUV segments of the car market.

For the focused differentiator, selecting a market segment means the decision to focus on one type of customer, such as serving only the very rich, the very young, or the very adventurous; or to focus on only one kind of product in a particular market, such as organic or vegetarian foods, very fast cars, luxury designer clothes, or

exclusive sunglasses. Focused differentiators reach the value frontier when they have developed a distinctive product that better meets the needs of customers in a particular segment than the differentiator (Figure 5.6). A competitive advantage may result, for example, because a focused differentiator possesses better knowledge (than the differentiator) about the needs of a small customer set (such as sports car buyers) or superior expertise in a particular field (such as corporate law, management consulting, or Web site management for retail customers or restaurants). Similarly, it might develop superior skills in responsiveness to customers because of its ability to serve the particular needs of regional or industry customers in ways that a national differentiator would find very expensive. Finally, concentration on a narrow range of products sometimes allows a focuser to develop innovations more quickly than a large differentiator can.

The focuser does not attempt to serve all market segments because that would bring it into direct competition with the differentiator. Instead, it concentrates on building market share in one or a few market segments; if it is successful, it may begin to serve more and more market segments and chip away at the differentiator's competitive advantage. However, if it is too successful at what it does, or if it does try to compete with the differentiator, it may run into trouble because the differentiator has the resources to imitate the focused company's business model. For example, when Ben & Jerry's innovated luxury ice cream, their huge success led other companies like Häagen-Dazs and Godiva to bring out their competing products. A good example of the way competition is changing, even among focused differentiators that make a similar luxury product, in this case designer clothing, is profiled in Strategy in Action 5.3.

In sum, a focused differentiator can protect its competitive advantage in a market segment to the extent that it can provide a good or service that its rivals cannot, for example, by being close to its customers and responding to their changing needs. However, a focused company cannot easily move to another market segment, so if its market segment disappears because of technological change or changes in customers' tastes this is a major danger. For example, few people today want a VCR even if it is state-of-the-art because of the shift to digital technology, and clothing store chain Brooks Brothers ran into great difficulty when business casual not formal suits, its main product, became the clothing norm at most companies. Similarly, corner diners have become almost a thing of the past because they are unable to compete with the low prices and speed of fast-food chains like McDonald's and the upscale atmosphere of Starbucks.

## THE DYNAMICS OF COMPETITIVE POSITIONING

Companies that successfully pursue one of the business models just discussed are able to outperform their rivals and reach the value creation frontier. They have developed the business-level strategies that result in competitive advantage and above-average profitability and are the most successful and well-known companies in their industry. Although some companies are able to develop the business model and strategies that allow them to reach the value creation frontier, many others cannot and so achieve only average or below-average profitability. For example, the most successful

### Ethical Dilemma

You are a top manager of a small company that has pioneered the development of software that allows Web users to interface online in real time. A major rival recognized the value of your product and offered to buy your company at a price you think is inadequate. When you refused to sell your company, the rival began recruiting your top software engineers to obtain their specialized knowledge. One engineer left while others have banded together, threatening to leave if demands aren't met. Consequently, you stand to lose your competitive advantage. Is it ethical for you to apply for a court order preventing engineers from leaving to join your competitor? Is it ethical for your competitor to recruit your employees to obtain their knowledge? Given your answers to these questions, should you let the differentiator buy your company and take over your market niche?

## 5.3 STRATEGY IN ACTION

### Zara Uses IT to Change the World of Fashion

Well-known fashion houses like Chanel, Dior, Gucci, and Armani charge thousands of dollars for the fashionable suits and dresses that they introduce twice yearly in the fall and spring. Because only the very rich can afford such differentiated and expensive clothing, to expand demand for its products, most luxury designers produce less expensive lines of clothing and accessories that are sold in upscale fashion retailers such as Neiman Marcus, Nordstrom, and Saks Fifth Avenue. In the 2000s, however, these luxury designers, which all pursue focused differentiation, have come under increasing pressure from small, agile fashion designers, such as England's Jaeger and Laura Ashley and Spain's Zara, that have developed capabilities in using IT that allow them to pursue a focused differentiation strategy but at a much lower cost than the luxury fashion houses. This has allowed them to circumvent barriers to entry into the high fashion segment and develop well-received brand names that still command a premium price.

Zara, in particular, has achieved significant success. Its sales have soared because it created innovative information and materials management systems that keep

its cost structure low while reducing time to market. The result is that Zara can produce fashionable clothes at lower prices and turn them over quickly by selling them in its own chain of clothing stores. Major fashion houses like Dior and Gucci can take six or more months to design their collections and then three to six more before their moderately priced lines become available in upscale retailers. Zara's designers closely watch the trends in the high fashion industry and the kinds of innovations that the major houses are introducing. Then, using sophisticated IT that links Zara's designers to its suppliers and clothing manufacturers abroad, the company can create a new collection in only five weeks, and these clothes can then be made in a week and delivered to its stores soon after. This short time to market makes Zara very flexible and allows it to compete effectively in the rapidly changing fashion market, where customer tastes evolve quickly.

Because of the quick manufacturing-to-sales cycle and just-in-time fashion, Zara has been able to offer its collections at comparatively low prices and still make profits that are the envy of the fashion clothing industry.

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Sources: C. Vitzthum, "Just-in-Time-Fashion," *Wall Street Journal*, May 18, 2001, B1, B4; <http://www.zara.com>.

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companies in the retail industry, such as Neiman Marcus, Target, and Walmart, have reached the value frontier; but their competitors, such as Saks, JCPenney, and Sears/Kmart have not.

Moreover, few companies are able to continuously outperform their rivals and remain on the value frontier over time. For example, high-performing companies such as Sony and Dell that were on the frontier a few years ago have lost their competitive advantage to rivals such as Panasonic, Samsung, Apple, and Hewlett-Packard (HP). Companies such as Toyota, Walmart, and Zara that have maintained their position on the frontier are rare. Why is it so hard for companies to sustain their competitive advantage over time and remain on the frontier?

To understand why some companies perform better than others, and why the performance of one company can increase or decrease over time, it is necessary to understand the dynamics involved in positioning a company's business model so that it can compete successfully in an industry. In this section, we first explore another business model that helps explain why some companies are able to sustain and increase their competitive advantage over time. Second, we examine how the business model a company pursues places it in a strategic group composed of other companies that compete in a similar way and how this has a major affect on its profitability over

time. Finally, we examine some competitive dynamics that explain why companies run into major problems that can affect their very survival.

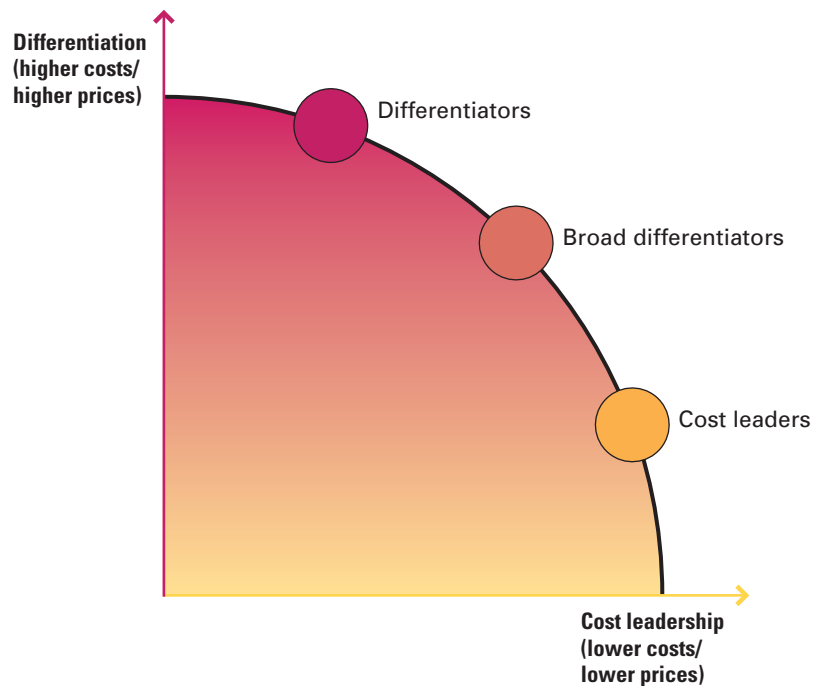
### Competitive Positioning for Superior Performance: Broad Differentiation

Companies that pursue cost leadership pursue a different business model and strategies than companies that choose differentiation, yet each business model is a path to superior performance and profitability. As we emphasize throughout this chapter, no matter what business model a company pursues, it must control its cost structure if it is to maintain and increase its profitability; at the same time, it also must find ways to differentiate its product in some way to attract customers. This is particularly important today because of intense global competition from companies abroad and rapid technological change that allows competitors to develop strategies that provide them with some kind of superior differentiation or cost advantage. In this dynamic situation, a company that can *combine* the strategies necessary to successfully pursue both cost leadership and differentiation will develop the most competitive and profitable business model in its industry.

Today, the most successful companies in an industry are often the ones that have developed strategies to achieve this; these companies are the most profitable because they can offer customers quality products at reasonable prices, that is, they offer customers a superior “value proposition” compared to their rivals. The middle of the value creation frontier is occupied by **broad differentiators**, companies that have developed business-level strategies to better differentiate their products and lower their cost structures *simultaneously*. Broad differentiators operate on the value frontier because they have chosen a level of differentiation that gives them a competitive advantage in the market segments they have targeted, and they have achieved this *in a way that has allowed them to lower their cost structure over time* (see Figure 5.8). Thus, although they may have higher costs than cost leaders, and offer a less differentiated product than differentiators, they have found a competitive position that offers their customers more value than industry rivals. Broad differentiators continually use their distinctive competencies to increase their product range, and they search for new market segments to enter to increase their market share and profits. At the same time, they work continuously to find ways to lower their cost structure and increase their profitability. For example, companies such as Dell, Amazon.com, Best Buy, and eBay have used the Internet as a way to become broad differentiators. These companies have been rapidly expanding the range of products they offer customers and taking advantage of their highly efficient information and/or materials-management systems to drive down costs compared to bricks-and-mortar retailers.

Importantly, broad differentiators that have developed the business-level strategies that enable them to reach this highly profitable position become an increasing threat to both differentiators and cost leaders over time. These companies make differentiated products so that they can charge higher prices than the cost leader, but they can also charge lower (but still premium) prices than differentiators because their cost structures are lower. The result is that many customers perceive the value of the products offered by the broad differentiator versus the cost leader is worth the higher price. At the same time, customers reluctant to pay the high premium prices of a differentiator’s products decide that the lower price of the broad differentiator’s product more than makes up for the loss of the “extra” differentiated features of the luxury premium-priced products. In essence, customers choose TVs from Panasonic



**Figure 5.8** The Broad Differentiation Business Model

(a broad differentiator) over Vizio (a cost leader) or Sony (a differentiator), or a bottle of Pantene shampoo from Procter & Gamble (a broad differentiator) over a bottle from Estée Lauder (a differentiator) or Walmart (a cost leader).

As a result, if strategic managers have the skills to pursue this business model successfully, broad differentiators steadily increase their market share and profitability over time. This provides them with more capital to reinvest in their business, so they can continually improve their business model. For example, their growing profits allow broad differentiators to invest in new technology that both increases their differentiation advantage and lower their cost structure, which weakens the competitive position of their rivals. As they build their competitive advantage and become able to offer customers a better value proposition, they push the value creation frontier to the right and knock their competitors off the frontier, so they become less profitable. Toyota, profiled in Strategy in Action 5.4, provides a good example of a company that uses a broad differentiation business model that has increasingly put its rivals at a competitive disadvantage. The result today is that it has replaced GM as the largest and most profitable global carmaker.

### Competitive Positioning and Strategic Groups

New developments such as (1) technological innovations that permit increased product differentiation, (2) the identification of new customer groups and market segments, and (3) the discovery of superior ways to lower cost structure continually change the competitive forces at work in an industry. In such a dynamic situation, the competitive position of companies can change rapidly. Higher performing

## 5.4 STRATEGY IN ACTION

### Toyota's Goal? A High-Value Vehicle to Match Every Customer Need

The car industry has always been one of the most competitive in the world because of the huge revenues and profits that are at stake. Given the difficult economic conditions in the late 2000s, it is hardly surprising that rivalry has increased as global carmakers fight to develop new car models that better satisfy the needs of particular groups of buyers. One company at the competitive forefront is Toyota.

Toyota produced its first car 40 years ago, an ugly, boxy vehicle that was, however, cheap. As the quality of its car became apparent, sales increased. Toyota, which was then a focused cost leader, plowed back its profits into improving the styling of its vehicles and into efforts to continually reduce production costs. Over time, Toyota has taken advantage of its low cost structure to make an ever-increasing range of reasonably priced vehicles tailored to different segments of the car market. Its ability to go from the initial design stage to the production stage in two to three years allowed it to bring out new models faster than its competitors and capitalize on the development of new market segments. Toyota has been a leader in positioning its whole range of vehicles to take advantage of new, emerging market segments. In the SUV segment, for example, its first offering was the expensive Toyota Land Cruiser, then priced at over \$35,000. Realizing the need for SUVs in lower price ranges, it next introduced the 4Runner,

priced at \$20,000 and designed for the average SUV customer; the RAV4, a small SUV in the low \$20,000 range, followed; then came the Sequoia, a bigger, more powerful version of the 4Runner in the upper \$20,000 range. Finally, taking the technology from its Lexus division, it introduced the luxury Highlander SUV in the low \$30,000 range. Today it offers six SUVs, each offering a particular combination of price, size, performance, styling, and luxury to appeal to a particular customer group within the SUV segment of the car market. In a similar way, Toyota positions its sedans to appeal to the needs of different sets of customers. For example, the Camry is targeted at the middle of the market to customers who can afford to pay about \$23,000 and want a balance of luxury, performance, safety, and reliability.

Toyota's broad differentiation business model is geared toward making a range of vehicles that optimizes the amount of value it can create for different groups of customers. At the same time, the number of models it makes is constrained by the need to maintain a low cost structure and car-pricing options that will generate maximum revenues and profits. Because competition in each car market segment is now intense, all global carmakers need to balance the advantages of having more cars to attract customers against the increasing costs that result when they expand the number of different models of car they make.

**Source:** <http://www.toyota.com>, 2009.

companies are able to gain if they can position themselves competitively to pursue broad differentiation. Poorer performing companies often do not realize how fast their competitive position is deteriorating because of their rivals' strategies and sometimes discover it is too late to rebuild their business models. Strategic group analysis, which we discussed in Chapter 2, is a tool that managers can use to better understand the dynamics of competitive positioning so that they can change their business models to maintain above-average profitability.

A company's business model determines how it will compete for customers in one or more market segments, and typically several companies compete for the same group of customers. This means that, over time, companies competing for the same customer group become rivals locked in a competitive struggle. The goal is to be the company that reaches or pushes out the value frontier by pursuing the business-level strategies that result in sustained competitive advantage and above average profitability.

Within most industries, **strategic groups**, that is, the set of companies that pursue a similar business model, emerge.<sup>19</sup> For example, those companies in an industry that compete to be the cost leader form one strategic group, those that seek some form of differentiation advantage form another, as do those companies that have developed a broad differentiation strategy. Companies pursuing focused differentiation or focused cost leadership form yet other strategic groups.

The concept of strategic groups has several implications for competitive positioning. First, strategic managers must map their competitors according to their choice of specific business model, for example, cost leadership and focused cost leadership. The managers must identify the differences among the specific set of strategies each company uses to pursue the same business model to explain their differences in profitability. For example, how has one company better identified which particular customer needs to satisfy or customer groups to serve, and how have they worked to develop a particular distinctive competence? Strategic managers can then use this knowledge to better position their business model so that they become closer to customers, differentiate themselves from their competitors, or learn how to reduce costs. Careful strategic-group analysis allows managers to uncover the most important ways to compete for customers in one or more market segments and helps reveal what strategies are needed in the future to maintain a competitive advantage.

Second, once a company has mapped its rivals, it can better understand how changes taking place in the industry are affecting its competitive advantage from a differentiation and cost structure perspective, as well as identify opportunities and threats. Often a company's nearest rivals are the competitors in its strategic group that are pursuing a similar business model. Customers tend to view the products of such companies as direct substitutes for each other. Thus, a major threat to a company's profitability can arise from within its own strategic group when its rivals find ways to either improve product differentiation and get closer to customers or lower their cost structure. This is why today companies benchmark their closest competitors on major performance dimensions to determine if they are falling behind in some important respect. For example, UPS and FedEx are constantly examining each other's performance.

In sum, strategic-group analysis involves identifying and charting the business models and business-level strategies that industry rivals are pursuing. Managers can then determine which strategies are successful and unsuccessful and why a certain business model is working or not. Importantly, they can also analyze how the relative competitive position of industry rivals, both those pursuing the same business model and those pursuing different business models, is changing over time. This knowledge allows them to either fine-tune or radically alter their business models and strategies to improve their competitive position and reach or remain on the value frontier.

## Failures in Competitive Positioning

Successful competitive positioning requires that a company achieve a fit between its strategies and its business model. Thus, a cost leader cannot strive for a high level of market segmentation, and provide a wide range of products, as a differentiator does, because this strategy would raise its cost structure too much, causing the company to lose its low-cost advantage. Similarly, a differentiator with a competency in innovation that tries to reduce its R&D costs, or one with a competency in after-sales service that seeks to economize on its sales force to lower costs, is asking for trouble because it is using the wrong strategies to implement its business model.

To pursue a successful business model, managers must be careful to ensure that the set of business-level strategies they have formulated and implemented are working in harmony to support each other and do not result in conflicts that ruin the competitive position a company is aiming for through its choice of business model. Many companies, through neglect, ignorance, or error—perhaps because of the Icarus paradox discussed in Chapter 3—do not work to continuously improve their business model, do not perform strategic-group analysis, and often fail to identify and respond to changing opportunities and threats in the industry environment. As a result, a company's business model starts to fail because its business-level strategies do not work together and its profitability starts to decline, as happened to Sony. Sometimes a company's performance can decline so quickly, it cannot recover and is taken over by its competitors or goes bankrupt. For example, Circuit City could not find a buyer because of its poor competitive situation and declared bankruptcy in 2009.

These companies have lost their position on the value frontier, either because they have lost the source of their competitive advantage or because their rivals have found ways to push out the value creation frontier and leave them behind. Sometimes these companies initially pursued a successful cost-leadership or differentiation business model but then gradually began to pursue business-level strategies that worked against them. Unfortunately, it seems that most companies lose control of their business models over time, often because they become large, complex companies that are difficult to manage or because the environment is changing faster than they can change their business model—such as by adjusting product and market strategies to suit changing industry conditions. This is why it is so important that managers *think strategically*.

There are many factors that can cause a company to make competitive positioning errors. Although some focused companies may succeed spectacularly for a time, a focuser may make a major error if, in its rush to implement its business model, it overexpands and so loses control of its business model. For example, People Express, a United States airline, was the first cost leader to emerge after deregulation of the United States airline industry. It started out as a specialized air carrier serving a narrow market niche: low-priced travel on the eastern seaboard. In pursuing focused cost leadership, it was very successful, but in its rush to expand to other geographic regions, it decided to take over other airlines. These airlines were differentiators that had never pursued cost leadership. This strategy raised People Express' cost structure, and it lost its competitive advantage against other national carriers and was taken over. Herb Kelleher, the founder of Southwest Airlines, watching how People Express had failed, stuck to the cost-leadership business model. He took *20 years* to build his national airline, but he never deviated from the strategies necessary to turn his company from a focused cost leader into the cost leader in the United States airline industry.

Differentiators can also fail in the market and end up stuck in the middle if focused competitors attack their markets with more valuable or low-cost products that blunt their competitive edge. This happened to IBM in the mainframe computer market as PCs became more powerful and able to do the job of the much more expensive mainframes. It also happened to Sony when companies like Apple and Samsung introduced products that better met customer needs. No company is safe in the jungle of competition, and each must be constantly on the lookout to take advantage of new opportunities as they arise. The experience of Holiday Inn described in the closing case describes how a company can lose control of its business model but also how managers can devise strategies that match changing competitive conditions and return to the value frontier.

In sum, strategic managers must employ the tools discussed in this book to continually monitor how well the business-level strategies they use to implement their company's business model are working. There is no more important task than ensuring that their company is optimally positioned against its rivals to compete for customers. And, as we have discussed, the constant changes occurring in the external environment, as well as the actions of competitors who work to develop superior business-level strategies, make competitive positioning a complex, demanding task that requires the highest degree of strategic thinking. That is why companies pay tens of millions of dollars a year to CEOs and other top managers who have demonstrated their ability to create and sustain successful business models.

## SUMMARY OF CHAPTER

1. To create a successful business model, managers must choose business-level strategies that give the company a competitive advantage over its rivals; that is, they must optimize competitive positioning. They must first decide on (a) customer needs, or what is to be satisfied; (b) customer groups, or who is to be satisfied; and (c) distinctive competencies, or how customer needs are to be satisfied. These decisions determine which strategies they formulate and implement to put a company's business model into action.
2. Customer needs are desires, wants, or cravings that can be satisfied through the attributes or characteristics of a product. Customers choose a product based on (a) the way a product is differentiated from other products of its type and (b) the price of the product. Product differentiation is the process of designing products to satisfy customers' needs in ways that competing products cannot. Companies that create something distinct or different can often charge a higher, or premium, price for their products.
3. If managers devise strategies to differentiate a product by innovation, excellent quality, or responsiveness to customers, they are choosing a business model based on offering customers differentiated products. If managers base their business model on finding ways to reduce costs, they are choosing a business model based on offering customers low-priced products.
4. The second main strategy in formulating a successful business model is to decide what kind of product(s) to offer to which customer group(s). Market segmentation is the way a company decides to group customers, based on important differences in their needs or preferences, to gain a competitive advantage.
5. There are three main approaches toward market segmentation. First, a company might choose to ignore differences and make a product targeted at the average or typical customer. Second, a company can choose to recognize the differences between customer groups and make a product targeted toward most or all of the different market segments. Third, a company might choose to target just one or two market segments.
6. To develop a successful business model, strategic managers have to devise a set of strategies that determine (a) how to differentiate and price their product and (b) how much to segment a market and how wide a range of products to develop. Whether these strategies will result in a profitable business model now depends on a strategic manager's ability to provide customers with the most value while keeping the cost structure viable.
7. The value creation frontier represents the maximum amount of value that the products of different companies inside an industry can give customers at any one time by using different business models. Companies on the value frontier are those that have the most successful business models in a particular industry.
8. The value creation frontier can be reached by choosing among four *generic competitive strategies*: cost leadership, focused cost leadership, differentiation, and focused differentiation.
9. A cost-leadership business model is based on lowering the company's cost structure so it can

make and sell goods or services at a lower cost than its rivals. A cost leader is often a large, national company that targets the average customer. Focused cost leadership is developing the right strategies to serve just one or two market segments.

10. A differentiation business model is based on creating a product that customers perceive as different or distinct in some important way. Focused differentiation is providing a differentiated product for just one or two market segments.
11. The middle of the value creation frontier is occupied by broad differentiators, which have pursued their differentiation strategy in a way that has also allowed them to lower their cost structure over time.
12. Strategic-group analysis helps companies in an industry better understand the dynamics of competitive positioning. In strategic-group

analysis, managers identify and chart the business models and business-level strategies their industry rivals are pursuing. Then they can determine which strategies are successful and unsuccessful and why a certain business model is working or not. In turn, this allows them to either fine-tune or radically alter their business models and strategies to improve their competitive position.

13. Many companies, through neglect, ignorance, or error, do not work to continually improve their business model, do not perform strategic-group analysis, and often fail to identify and respond to changing opportunities and threats. As a result, their business-level strategies do not work together, their business model starts to fail, and their profitability starts to decline. There is no more important task than ensuring that one's company is optimally positioned against its rivals to compete for customers.

## DISCUSSION QUESTIONS

1. Why does each generic business model require a different set of business-level strategies? Give examples of pairs of companies in (a) the computer industry, (b) the electronics industry, and (c) the fast-food industry that pursue different types of business models.
2. How do changes in the environment affect the success of a company's business model?
3. What is the value creation frontier? How does each of the four generic business models allow a company to reach this frontier?
4. How can companies pursuing cost leadership and differentiation lose their place on the value frontier? In what ways can they regain their competitive advantage?
5. What strategies does a company need to develop to become a broad differentiator? In what ways does this provide it with a competitive advantage over either cost leaders or differentiators?
6. Why is strategic-group analysis important for superior competitive positioning?
7. What are some of the reasons companies lose control over their business models, and thus their competitive advantage, over time?



## PRACTICING STRATEGIC MANAGEMENT

### Small-Group Exercise: Finding a Strategy for a Restaurant

Break up into groups of three to five people and discuss the following scenario. You are a group of partners contemplating opening a new restaurant in your city. You are trying to decide how to position your restaurant to give it the best competitive advantage.

1. Create a strategic-group map of the restaurants in your city by analyzing their generic business models and strategies. What are the similarities or differences between these groups?
2. Identify which restaurants you think are the most profitable and why.
3. On the basis of this analysis, decide what kind of restaurant you want to open and why.

### Article File 5

Find an example (or several examples) of a company pursuing one of the generic business models. What set of business-level strategies does the company use to formulate and implement its business model? How successful has the company been?

### Strategic Management Project: Module 5

This part of the project focuses on the nature of your company's business model and business-level strategies. If your company operates in more than

one business, concentrate on either its core, or most central or most important, businesses. Using all the information you have collected on your company so far, answer the following questions:

1. How differentiated are the products or services of your company? What is the basis of their differentiated appeal?
2. What is your company's strategy toward market segmentation? If it segments its market, on what basis does it do so?
3. What distinctive competencies does your company have? (Use the information on functional-level strategy in the previous chapter to answer this question.) Is efficiency, quality, innovation, responsiveness to customers, or a combination of these factors the main driving force in your company?
4. What generic business model is your company pursuing? How has it formulated and implemented a set of business-level strategies to pursue this business model?
5. What are the advantages and disadvantages associated with your company's choice of business model and strategies?
6. Is your company a member of a strategic group in an industry? If so, which one?
7. How could you improve your company's business model and strategies to strengthen its competitive advantage?

## CLOSING CASE

### Holiday Inns on Six Continents

The history of the Holiday Inn motel chain is one of the great success stories in United States business. Its founder, Kemmons Wilson, vacationing in the early 1950s, found motels to be small, expensive, and of unpredictable quality. This discovery, along with the prospect of unprecedented highway travel that would

come with the new interstate highway program, triggered a realization: there was an unmet customer need—a gap in the market for quality accommodations.<sup>20</sup> Holiday Inn was founded to meet that need. From the beginning, Holiday Inn set the standard for offering motel features such as air-conditioning

and icemakers while keeping room rates reasonable. These amenities enhanced the motels' popularity, and motel franchising, Wilson's invention, made rapid expansion possible. By 1960, Holiday Inns could be found in virtually every city and on every major highway. Before the 1960s ended, more than 1,000 were in full operation, and occupancy rates averaged 80%. The concept of mass accommodation had arrived.

The service Holiday Inn offered appealed to the average traveler, who wanted a standardized product (a room) at an average price—the middle of the hotel room market. But by the 1970s, travelers were beginning to make different demands on hotels and motels. Some wanted luxury and were willing to pay higher prices for better accommodations and service. Others sought low prices and accepted rock-bottom quality and service in exchange. As the market fragmented into different groups of customers with different needs, Holiday Inn was still offering an undifferentiated, average-cost, average-quality product.

Although Holiday Inn missed the change in the market and thus failed to respond appropriately to it, the competition did not. Companies such as Hyatt siphoned off the top end of the market, where quality and service sold rooms. Chains such as Motel 6 and Days Inn captured the basic-quality, low-price end of the market. In between were many specialty chains that appealed to business travelers, families, or self-caterers (people who want to be able to cook in their hotel rooms). Holiday Inn's position was attacked from all sides. As occupancy rates dropped drastically with increasing competition, profitability declined.

Wounded but not dead, Holiday Inn began a counterattack. The original chain was upgraded to suit quality-oriented travelers. Then, to meet the needs of different kinds of travelers, Holiday Inn created new hotel and motel chains: the luxury Crowne

Plaza; Hampton Inn serving the low-priced end of the market; and the all-suite Embassy Suites. Thus, Holiday Inn attempted to meet the demands of the many niches, or segments, of the hotel market that have emerged as customers' needs have changed over time. These moves were successful in the early 1990s, and Holiday Inn grew to become one of the largest suppliers of hotel rooms in the industry. However, by the late 1990s, falling revenues made it clear that with intense competition in the industry from other chains such as Marriott, Holiday Inn was once again losing its differentiated appeal.<sup>21</sup>

In the fast-changing hotel and lodging market, positioning each hotel brand or chain to maximize customer demand is a continuing endeavor. In 2000, the pressure on all hotel chains to adapt to the challenges of global competition and become globally differentiated brands led to the takeover of Holiday Inn and its incorporation into the international Six Continents Hotels chain. Today, around the globe, more than 3,200 hotels flying the flags of Holiday Inn, Holiday Inn Express, Crowne Plaza, Staybridge Suites by Holiday Inn, and luxury Inter-Continental Hotels and Resorts are positioning themselves to offer the services, amenities, and lodging experiences that will cater to virtually every travel occasion and guest need.<sup>22</sup> In the 2000s, the company has undertaken a massive modernization campaign in the United States to take existing full-service Holiday Inns to their next evolution. Holiday Inn plans to have a room to meet the need of every segment of the lodging market anywhere in the world.

### Case Discussion Questions

1. Why did Holiday Inn's business model and strategies change over time?
2. What are the strategies behind the Six Continents Hotels current business model? In what ways is it trying to improve its competitive advantage?

# 6

## BUSINESS-LEVEL STRATEGY AND THE INDUSTRY ENVIRONMENT

### LEARNING OBJECTIVES

After reading this chapter, you should be able to

- Explain why strategic managers need to tailor their business models to the conditions that exist in different kinds of industry environments
- Identify the strategies managers can develop to increase profitability in fragmented industries
- Discuss the special problems that exist in embryonic and growth industries and how companies can develop successful business models to compete effectively
- Understand competitive dynamics in mature industries and discuss the strategies managers can develop to increase profitability even when competition is intense
- Outline the different strategies companies in declining industries can use to support their business models and profitability

### Competition in the Microchip Business Speeds Up

Intel has always been the leader in the market for central processing units (CPUs) microchips; its Pentium, Atom, and new Nehalem chips provide the processing power for all kinds of PCs, including desktops, laptops, and smartbooks.

Its main competitor is AMD. The market for graphic processing units (GPUs) microchips that provide state-of-the-art animation, high-definition video, and the processing power needed to run high-powered computer games such as Crysis, World of Warcraft, and Grand Theft Auto and that allow for sophisticated 3D rendering of shapes and images has been

dominated by Nvidia. Nvidia's GPU chips are a favorite among sophisticated gamers, animators, and visual designers. Nvidia's main competitor is ATI, which was bought by AMD (Intel's major CPU competitor) in 2006.

AMD's goal in buying ATI was to combine the different processing powers of the CPU and GPU chips to give PC users the best possible

### OPENING CASE



computer processing power and speed while providing stunning graphic capabilities. By combining both kinds of chips, AMD's goal was to obtain a competitive advantage over Intel. Intel's CPUs have only very basic graphic processing power—enough for ordinary PC tasks but not sufficient for powerful gaming applications, video processing, or sophisticated graphic interfaces such as those inside Apple's PCs. GPUs are the heart of all gaming consoles, and Nvidia provided the chip used in the first Xbox. Currently AMD's ATI division supplies the GPU that powers the Nintendo Wii, and Nvidia's GPU is inside the PlayStation3. Nvidia scored a major coup in 2009 when Apple announced that all its new PCs would contain Nvidia's advanced GPUs because of their state-of-the-art performance. Nevertheless, in 2009, ATI also introduced powerful new GPUs that compete with Nvidia's. Today, both Nvidia and ATI compete to provide the GPUs in the PCs offered by makers such as Dell, HP, and Lenovo; in addition, Intel and AMD compete to provide the CPU in these PCs.

The complex, competitive situation between these three companies has led to major changes in their business models, competitive positioning, and strategies in the maturing PC market. For example, fierce competition between AMD and Intel came to a head in 2005 when AMD introduced a new generation 64-bit CPU that performed better than Intel's, and its stock price shot up as Intel struggled to catch up. But Intel, a broad differentiator with massive resources invested heavily, innovated an even more powerful CPU, and by 2007, it had matched and outperformed AMD's. At the same time, Intel had the resources to make its next-generation CPUs smaller, something which is increasingly important today because of the need to cool the smaller-sized laptops. AMD's stock price plunged as Intel's soared because it had lost its lead in CPUs and because in 2007 it still had no viable GPU to compete with Nvidia's.

Then, as noted, in 2008 Nvidia received a major shock when AMD's ATI introduced its

next-generation GPU chip that outperformed Nvidia's and offered these powerful GPUs at lower prices to regain market share. Then, Nvidia's stock price plunged; it was forced to reduce the price of its GPUs to compete. A price war began, and the profits of both companies fell. At the same time, ATI was still battling with Intel in the CPU market, in which Intel's new "dual core" processors had become the market leader. AMD introduced its next-generation chips that matched and even outperformed Intel's; the result again was a price war in which companies reduced the price of their CPUs to fight for market share. The result was that each of the three chipmakers' profits were falling because they locked in an intense competitive battle; at the same time, PC customers obtained more powerful PCs at lower and lower prices.

Then, in 2008, to worsen the competitive situation, Intel announced that it was developing its own state-of-the-art GPU code named Larrabee to compete directly against Nvidia and AMD. Intel had recognized how rapidly the GPU market was growing because of the increasing popularity of online video, animations, HD movies, and, of course, high-powered games played on PCs. With Intel, the giant in CPUs now competing in the GPU segment of the market, the stock price of Nvidia and AMD crumbled. Prices of all kinds of chips continued to plunge just as all three companies have had to spend billions on expensive new R&D to innovate improved chips, even as their profits plunge. The bottom line is that the intense competition in the computer chip market is leading to falling profitability of the three major companies, even though they are providing customers with much more value for their money. Clearly, the most innovative companies need to manage industry competition to ensure that they can provide their customers with superior products and, at the same time, obtain above-average profits so they can fund the innovation necessary to improve products and profitability over time.



## Overview

As competition in the microchip industry suggests, even leading industry companies—those with the most successful business models—face major problems in maintaining their profitability over time. Even if strategic managers do create a successful business model, they still face another challenge: the need to continuously develop and improve their business-level strategies to sustain their competitive advantage over time as the industry environment changes. As the industry environment changes over the life cycle, the kinds of opportunities and threats that face a company change; its business model and strategies have to adapt and change to meet this changing environment.

This chapter first examines how companies in fragmented industries can develop new kinds of business-level strategies to strengthen their business models. It then considers the challenges of developing and sustaining a competitive advantage in embryonic, growth, mature, and declining industries. By the end of this chapter, you will understand how forces in the changing industry environment require managers to pursue new kinds of strategies to strengthen their company's business model and keep it at the value creation frontier where the most profit is earned.

## STRATEGIES IN FRAGMENTED INDUSTRIES

A *fragmented industry* is one composed of a large number of small and medium-sized companies, for example, the dry cleaning, restaurant, health club, and legal services industries. There are several reasons that an industry may consist of many small companies rather than a few large ones.<sup>1</sup>

First, fragmented industries are characterized by low barriers to entry because they lack economies of scale. Many homebuyers, for example, prefer dealing with local real estate agents, whom they perceive as having better local knowledge than national chains. Second, in some industries, there may even be diseconomies of scale. In the restaurant business, for example, customers often prefer the unique food and style of a popular local restaurant rather than the standardized offerings of some national chain. Third, low entry barriers that permit constant entry by new companies also serve to keep an industry fragmented. The restaurant industry exemplifies this situation. The costs of opening a restaurant are moderate and can be borne by a single entrepreneur. High transportation costs, too, can keep an industry fragmented, and local or regional production may be the only efficient way to satisfy customers' needs, as in the dirt, cement, brick, or custom glass industries. Finally, an industry may be fragmented because customer needs are so specialized that only a small amount of a product is required, hence, there is no scope for a large mass-production operation to satisfy the market, for example, custom-made jewelry or catering.

If these conditions exist, in many fragmented industries the focus business model will be the most profitable to pursue. Companies may specialize by customer group, customer need, or geographic region so that many small specialty companies operate in local or regional markets. All kinds of specialized or custom-made products—furniture, clothing, hats, boots, houses, and so on—fall into this category, as do all small service operations that cater to personalized customer needs, such as laundries, restaurants, health clubs, and furniture rental stores.

However, strategic managers are eager to gain the cost advantages of pursuing cost leadership or the sales-revenue-enhancing advantages of differentiation by circumventing the competitive conditions that have allowed focus companies to dominate an industry. Essentially, companies search for a business model and strategies that will allow them to *consolidate* a fragmented industry to obtain the above average profitability possible in a consolidated industry. These companies include large retailers such as Walmart and Target and fast-food chains such as McDonald's and Subway; repair shops such as Midas, Inc.; and even lawyers, consultants, and tax preparers.

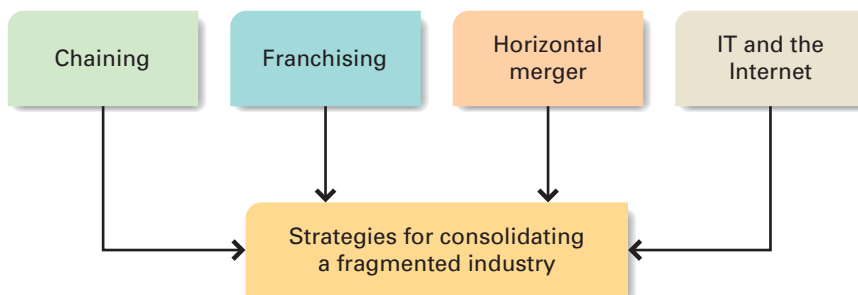
To grow, consolidate their industries, and become industry leaders, these companies have developed strategies—such as chaining, franchising, horizontal merger, and using the Internet and IT—to realize the advantages of a cost-leadership or differentiation business model. By doing so, many focus companies lost their competitive advantage and have disappeared (Figure 6.1).

## Chaining

Companies such as Walmart and Midas pursue a **chaining** strategy to obtain the advantages of cost leadership. They establish networks of linked merchandising outlets that are interconnected by IT and function as one large company. The enormous buying power these companies possess through their chain of nationwide stores allows them to negotiate large price reductions with suppliers that promote their competitive advantage. They overcome the barrier of high transportation costs by establishing regional distribution centers that can economize on inventory costs and maximize responsiveness to the needs of regional stores and customers. They also realize economies of scale by sharing managerial skills across the chain, and they can use nationwide, rather than local, advertising.

Thus, by the use of chaining, companies achieve the cost and differentiation advantages enjoyed by industry leaders; indeed, they often become the new industry leaders. For example, the chaining strategy has been used in a wide range of retail industries, consolidating one after the other. Barnes & Noble and Borders used this strategy in book retailing; Staples applied it to office supplies; Best Buy to electronics retailing; Home Depot to building supplies; and so on. In each case, the companies that used chaining to pursue a business model based on cost leadership or differentiation changed the competitive structure of the industry to its advantage, consolidating the industry and weakening the five forces of competition in the process.

**Figure 6.1** Strategies for Consolidating a Fragmented Industry





## Franchising

Like chaining, franchising is a business-level strategy that allows companies, particularly service companies such as McDonald's or Century 21 Real Estate, to enjoy the competitive advantages that result from cost leadership or differentiation. In franchising, the franchisor (parent) grants to its franchisees the right to use the parent's name, reputation, and business model in a particular location or area in return for a sizable franchise fee and often a percentage of the profits.<sup>2</sup>

One particular advantage of this strategy is that because franchisees essentially own their businesses, they are strongly motivated to make the company-wide business model work effectively and make sure that quality and standards are consistently high so that customers' needs are always satisfied. Such motivation is particularly critical for a differentiator that must continually work to maintain its unique or distinctive appeal. In addition, franchising lessens the financial burden of swift expansion, which permits rapid growth of the company. Finally, a nationwide franchised company can reap the advantages of large-scale advertising, as well as economies in purchasing, management, and distribution, as McDonald's does very efficiently in pursuing its cost-leadership model.

## Horizontal Merger

Companies such as Anheuser-Busch, Dillard's, and Blockbuster chose a strategy of *horizontal merger* to consolidate their respective industries. For example, Dillard's arranged the merger of regional store chains to form a national company. By pursuing horizontal merger, companies are able to obtain economies of scale and secure a national market for their product. As a result, they are able to pursue a cost-leadership or a differentiation business model (although, Dillard's has been struggling to pursue its differentiation model effectively). The many important strategic implications of horizontal merger are discussed in detail in Chapter 9.

## Using Information Technology and the Internet

The development of new IT often gives a company the opportunity to develop new business strategies to consolidate a fragmented industry. eBay and amazon.com, for example, use the Internet and the associated strategies e-commerce makes possible to pursue a cost-leadership model and consolidate the fragmented auction and book-selling industries. Before eBay, the auction business was extremely fragmented, with local auctions in cities being the principal way in which people could dispose of their antiques and collectibles. By harnessing the Internet, eBay can now assure sellers that they are getting wide visibility for their collectibles and are likely to receive higher prices for their products. Similarly, amazon.com's success in the book market has accelerated the consolidation of the book retail industry, and many small bookstores have closed because they cannot compete by price or selection. Clear Channel Communications, profiled in Strategy in Action 6.1, used many of the strategies discussed previously to become the biggest radio broadcaster in the United States.

The challenge in a fragmented industry is to figure out the best set of strategies to overcome a fragmented market so that the competitive advantages associated with pursuing one of the different business models can be realized. It is difficult to think of any major service activities—from consulting and accounting firms to businesses satisfying the smallest customer need, such as beauty parlors and car repair shops—that have not been consolidated by companies seeking to pursue a more profitable business model.

## 6.1 STRATEGY IN ACTION

### Clear Channel Creates a National Chain of Local Radio Stations

Clear Channel Communications started out with only one radio station in San Antonio in 1995. Historically, the radio broadcasting industry was fragmented because federal law did not allow one company to own more than 40 stations nationwide; as a result, most local radio stations were independently owned. Clear Channel took advantage of the repeal of this law in 1996 to purchase radio stations and, most importantly, develop a business model (which today is one of *broad differentiation*) that would allow it to obtain the gains from consolidating this fragmented industry; by the 2000s, it operated more than 1,200 United States radio stations.

Clear Channel's strategic managers recognized from the beginning that the major way to increase the profitability of local radio stations was to obtain economies of scale by operating and marketing them on a national level. The question was how to find ways to raise the quality of its programming to increase the number of listeners and thus increase advertising revenues (advertising rates are based on the number of listeners). At the same time, it needed to find ways to reduce each station's high operating costs, that is, lower its cost structure. How to do both simultaneously was the challenge. Clear Channel's managers took advantage of emerging digital technology that allowed for the easy and rapid manipulation and transfer of large volumes of data to accomplish both these goals.

By the late 1990s, music and programming could easily be recorded, stored in digital format, and edited. Its managers hit on a strategy called "voice tracking." To obtain economies of scale, Clear Channel employed popular regional or national DJs to record its daily programs, and these DJs customized their productions to suit the needs of local markets. For example, one technology

allows DJs to isolate and listen to the end of one track and the beginning of the next; then they can insert whatever talk, news, or information is appropriate between tracks how and when they like. The local stations supply this local information; after they have customized their program, the DJs send it over the Internet, where the local operators handle it. This practice has enormous advantages. On the cost side, the programming costs of a limited number of popular DJs are much lower than the cost of employing an army of local DJs. On the differentiation side, the quality of programming is much higher because Clear Channel can invest more in its programming and because the appeal of some DJs is much higher than others. Over time, higher-quality programming increases the number of listeners, and this attracts more national advertisers, whose digital advertisements can be easily inserted in the programming by local operators.

In addition, Clear Channel developed its own proprietary brand name, KISS, across its radio stations so that when people travel, they will be attracted to its local stations wherever they are. It hoped that the resulting increased customer demand would drive up advertising revenues, thereby lowering its cost structure and increasing its future profitability. Clear Channel received a major shock in the 2000s when the growing popularity of MP3 players like the iPod and online videos began to sharply reduce the size of its listening audience, hurting its advertising revenues. It has been forced to experiment with new ways to tailor radio advertising to listeners, experimenting with short sound bites, and also partnered with Google to find ways to better tailor advertising to the particular needs of the local market. Once again, nothing stays the same for long in any competitive industry environment.

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**Sources:** <http://www.clearchannel.com>, 2009; A. W. Mathews, "From a Distance: A Giant Chain Is Perfecting the Art of Seeming Local," *Wall Street Journal*, February 25, 2002, A1, A4.

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## STRATEGIES IN EMBRYONIC AND GROWTH INDUSTRIES

As Chapter 2 discusses, an embryonic industry is one that is just beginning to develop, and a growth industry is one in which first-time demand is expanding rapidly as many new customers enter the market. In choosing the strategies needed to pursue a business model, embryonic and growth industries pose special challenges

because new groups of customers with different kinds of needs emerge. Strategic managers need to be aware of the way competitive forces in embryonic and growth industries change over time because they commonly have to build and develop new kinds of competencies and refine their business models to compete effectively in the long term.

Most embryonic industries emerge when a technological innovation creates a new product opportunity. For example, a century ago, the introduction of the internal combustion engine led to the development of “moving vehicles” and the rise of new industries making such products as motorcars, motorbuses, and motorbikes. In 1975, the PC industry was born after Intel developed new microprocessor (CPU) technology that allowed companies to build the world’s first PCs; the PC software industry was born when Microsoft developed an operating system for IBM.<sup>3</sup> Customer demand for the products of an embryonic industry is limited at first for a variety of reasons. Reasons for slow growth in market demand include (1) the limited performance and poor quality of the first products; (2) customer unfamiliarity with what the new product can do for them; (3) poorly developed distribution channels to get the product to customers; (4) a lack of complementary products to increase the value of the product for customers; and (5) high production costs because of small volumes of production. Strategic managers who understand how markets develop are in a much better position to pursue a business model and strategies that will lead to a sustained competitive advantage.

Customer demand for the first cars, for example, was limited by their poor performance (they were no faster than a horse, far noisier, and frequently broke down), a lack of important complementary products such as a network of paved roads and gas stations, and high production costs that made them a luxury. Similarly, demand for the first PCs was limited because buyers had to be able to program computers to use them; there were no software programs to purchase that could run on the original PCs. Because of such problems, early demand for the products of embryonic industries came from a small set of technologically savvy customers willing and able to tolerate and even enjoy imperfections in their new purchase. Computer geeks who derive great joy out of tinkering with their (still) imperfect PCs and try to find ways to make them work better are the ones who buy the next-generation PCs—laptops, smartbooks, or smartphones.

An industry moves from the embryonic to the growth stage when a mass market, that is, one in which a large numbers of customers enter the market, starts to develop for its product. Mass markets start to develop when three things happen: (1) ongoing technological progress makes a product easier to use and increases its value for the average customer; (2) complementary products are developed that also increase its value; and (3) companies in the industry work to find ways to reduce the costs of making the new products so they can lower their prices and stimulate high demand.<sup>4</sup> For example, the mass market for cars emerged and the demand for cars surged when (1) technological progress increased the performance of cars; (2) a network of paved roads and gas stations was established; and (3) Henry Ford began to mass produce cars, something that dramatically reduced production costs, which allowed him to reduce car prices. Similarly, the mass market for PCs emerged when technological advances made them easier to use, a supply of complementary software such as spreadsheets and word processing programs was developed that increased the value of owning a PC, and companies in the industry such as Dell began to use mass production to build PCs at low cost.

## The Changing Nature of Market Demand

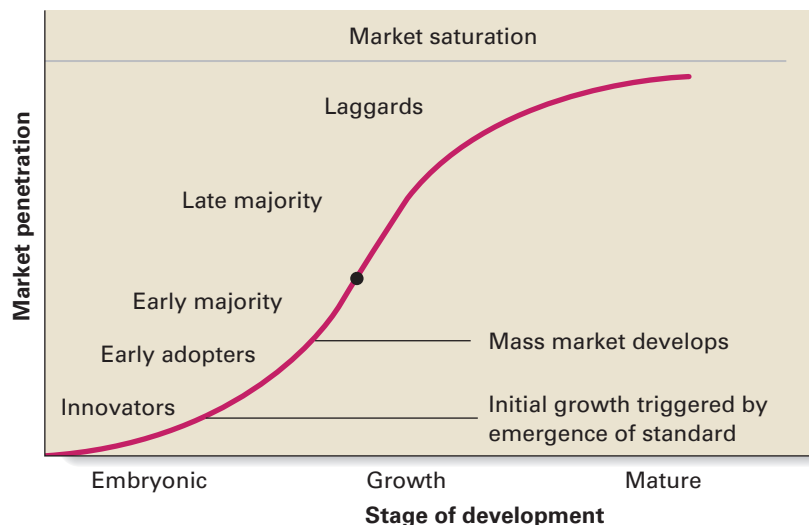
Strategic managers who understand how the demand for a product is affected by the changing needs of customers can focus on developing new strategies that will protect and strengthen their business models, such as building competencies to lower manufacturing costs or speed product development. In most product markets, the changing needs of customers lead to the S-shaped growth curve illustrated in Figure 6.2, which illustrates how different groups of customers with different needs enter the market over time. The curve is S-shaped because as the stage of market development moves from embryonic to mature, customer demand first accelerates then decelerates as the market approaches the saturation point where most customers have already bought the product. This curve has major implications for a company's differentiation, cost, and pricing competitive positioning decisions.

The first group of customers to enter the market are referred to as the *innovators*. Innovators are “technocrats,” people who are delighted by being the first to purchase and experiment with a product based on a new technology—even though it is imperfect and expensive. Frequently, they have an engineering mindset and want to “own” the technology because it is so new. In the PC market, the first customers were software engineers and computer hobbyists who wanted to write computer code at home.<sup>5</sup>

*Early adopters* are the second group of customers to enter the market; they understand that the technology may have important future applications and are willing to experiment with it to see if they can pioneer uses for it. Early adopters are often people who envision how the technology may be used in the future, and they try to be the first to profit from its use. Jeff Bezos, the founder of amazon.com, was an early adopter of Internet technology. He saw in 1994 before anyone else that the Internet could be used in innovative ways to sell books.

Both innovators and early adopters enter the market while the industry is in its embryonic stage. The next group of customers, the *early majority*, forms the leading wave or edge of the mass market, and their entry into the market signifies the beginning of the

**Figure 6.2** Market Development and Customer Groups



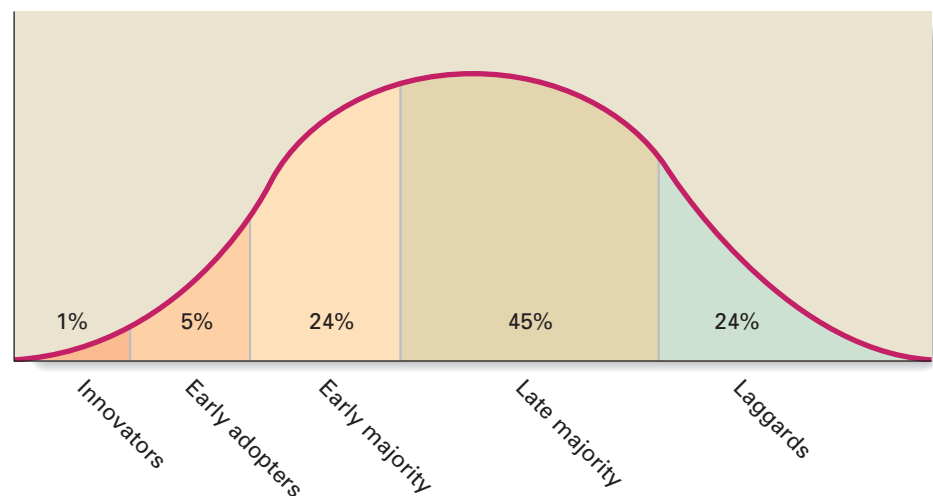
growth stage. Customers in the early majority are practical, understanding the new technology. They weigh the benefits of adopting its new products against their costs and wait to enter the market until they are confident they will benefit. When they decide to enter the market, a large number of new buyers may be expected. This is what happened in the PC market after IBM's introduction of the PC in 1981. For the early majority, IBM's entry into the market legitimized PC technology and signaled that the benefits of adopting it would be worth the cost to purchase and learn how to use a PC. The growth of the PC market was then further strengthened by the development of applications that added value to the PC, such as new spreadsheet and word processing programs. These applications transformed the PC from a hobbyist's toy into a business productivity tool.

When the mass market reaches a critical mass, with about 30% of the potential market penetrated, the next group of customers enters the market. This group is characterized as the *late majority*, the customers who purchase a new technology or product only when it is obvious it has great utility and is here to stay. A typical late majority customer group is the older set of customers, unfamiliar with the new technology that began to enter the PC market in the mid-1990s. However, by observing other people buying PCs to send e-mail and browse the Web, they overcame their hesitancy and started to purchase PCs. By 2002, some 65% of homes in the United States had at least one PC, suggesting that the product was well into the late majority group, and the market was approaching saturation. Indeed, the entry of the late majority signals the end of the growth stage.

*Laggards*, the last group of customers to enter the market, are people who are inherently conservative and distrustful of new technology. Laggards frequently refuse to adopt it even when its benefits are obvious or unless they are forced to do so by circumstances—for work reasons, for example. People who use typewriters rather than computers to write letters and books or insist on using fountain pens rather than “micro” ballpoints would be considered laggards.

In Figure 6.3, the bell-shaped curve represents the total market, and the divisions in the curve show the average percentage of customers who fall into each of these

**Figure 6.3** Market Share of Different Customer Segments



customer groups. Note that early adopters are a very small percentage of the market; hence, the figure illustrates a vital competitive dynamic—the highest market demand and industry profits arise when the early and late majority enters the market. And research has found that although early pioneering companies succeed in attracting innovators and early adopters, many of these companies often *fail* to attract a significant share of early and late majority customers and ultimately go out of business.

### Strategic Implications: Crossing the Chasm

Why are pioneering companies often unable to create a business model that allows them to be successful over time and remain the market leaders? *Innovators and early adopters have very different customer needs from the early majority.* In an influential book, Geoffrey Moore argues that because of the differences in customer needs between these groups, the business-level strategies required for companies to succeed in the emerging mass market are quite different from those required to succeed in the embryonic market.<sup>6</sup> Pioneering companies that do not change the strategies they use to pursue their business model will therefore lose their competitive advantage to those companies that implement new strategies to remain on the value creation frontier. New strategies are often required to strengthen a company's business model as a market develops over time for the following reasons:

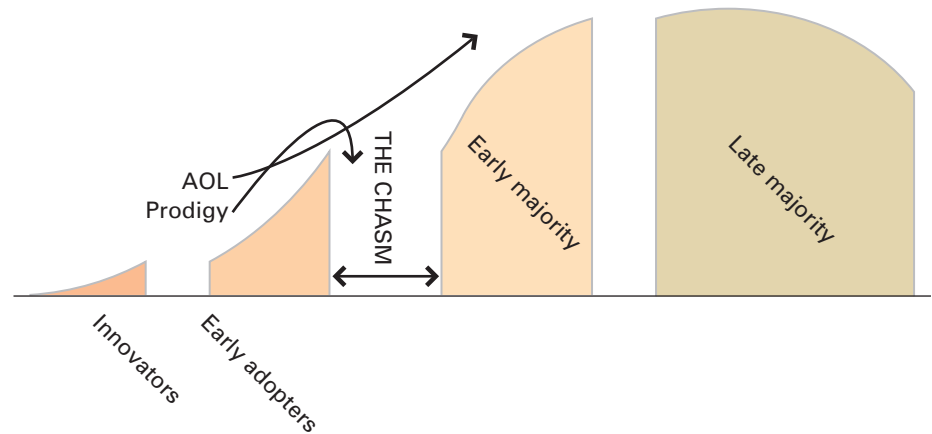
- Innovators and early adopters are technologically sophisticated customers willing to tolerate the limitations of the product; the early majority, however, value ease of use and reliability. Companies competing in an embryonic market typically pay more attention to increasing the performance of a product than to its ease of use and reliability. Those competing in a mass market need to make sure that the product is reliable and easy to use. Thus, the product development strategies required for success are different as a market develops over time.
- Innovators and early adopters are typically reached through specialized distribution channels, and products are often sold by word of mouth. Reaching the early majority requires mass-market distribution channels and mass media advertising campaigns that require a different set of marketing and sales strategies.
- Because innovators and the early majority are relatively few in number and are not particularly price sensitive, companies serving them typically pursue a focus model and produce small quantities of a product. To serve the rapidly growing mass market, a cost-leadership model based on large-scale mass production may be critical to ensure that a high-quality product can be produced reliably at a low price point.

In sum, the business model and strategies required to compete in an embryonic market populated by early adopters and innovators are very different from those required to compete in a high-growth mass market populated by the early majority. As a consequence, the transition between the embryonic market and the mass market is not a smooth, seamless one. Rather, it represents a *competitive chasm* or gulf that companies must cross. According to Moore, many companies do not or cannot develop the right business model; they fall into the chasm and go out of business. Thus, although embryonic markets are typically populated by a large number of small companies, once the mass market begins to develop, the number of companies falls sharply.<sup>7</sup>

Figure 6.4, which compares the strategies of AOL Time Warner and Prodigy Communications, illustrates Moore's thesis by showing that a chasm exists between innovators and the early majority, that is, between the embryonic market and the rapidly growing mass market. Note also that other chasms exist between other sets of



**Figure 6.4** The Chasm: AOL and Prodigy



customers; these also represent important changes in customer demand that require changes in business-level strategy (for example, a different approach to market segmentation). To successfully cross a chasm, Moore implied a company must continually work to develop the right strategies and build new competencies to create a business model that will allow it to cross the chasm, survive, and prosper. Strategy in Action 6.2 describes how one company, AOL, successfully built a business model to cross a chasm, and how another company, Prodigy, failed.

The implication is clear: to cross this chasm successfully, managers must correctly identify the customer needs of the first wave of early majority users—the leading edge of the mass market. Then they must alter their business models by developing new strategies to redesign products and create distribution channels and marketing campaigns to satisfy the needs of the early majority. They must have available a suitable product at a reasonable price that they can sell to the early majority when they begin to enter the market in large numbers. At the same time, the industry pioneers must abandon their old focused business model that was directed solely at the needs of innovators and early adopters because this focus will lead them to ignore the needs of the early majority—and the need to develop the strategies needed to pursue a differentiation or cost-leadership business model and remain a dominant industry competitor.

### Strategic Implications of Market Growth Rates

A final important issue that strategic managers must understand in embryonic and growth industries is that different markets develop at different rates. The speed at which a market develops can be measured by its growth rate, that is, the rate at which the industry's product is bought by customers in that market. A number of factors explain the variation in market growth rates for different products and thus the speed with which a particular industry develops. It is important for strategic managers to understand the source of these differences, for by their choice of business model and strategies, they can accelerate or retard the rate at which a particular market grows.<sup>8</sup> In other words, business-level strategy is a major determinant of industry profitability.

## 6.2 STRATEGY IN ACTION

### AOL, Prodigy, and the Chasm between Innovators and the Early Majority

Before America Online (AOL) became a household name, Prodigy Communications was a market leader. When its online network was launched in 1990, Prodigy's business model was differentiation, and its goal was to build the largest proprietary online shopping network. It quickly attracted a half a million users. Competition was low at this time; the largest competitor, CompuServe, was conservatively managed, and it pursued a focused business model based on servicing the needs of technical and financial users. There was one smaller competitor, AOL, but as one Prodigy executive commented, "It was just a little thing off to the side." Ten years later, the little thing had become the largest online service in the world with 33 million members, and Prodigy had been forced to exit the online business altogether.

Why did Prodigy fail? The company appeared to be focusing on the mass market; its target customers were not computer-oriented early adopters but typical middle-class Americans. And its business model to sell products online seemed correct; surely this ultimately had to become a major Internet application. The problem was that Prodigy's managers did not choose the right set of strategies to formulate its business model to attract the early majority because they did not understand the full range of needs customers were trying to satisfy by using the Internet.

One of the surprise early drivers of customer demand for online services, and a major factor in creating the mass market, was e-mail. To attract the early majority, AOL's strategy was to offer its members unlimited e-mail, but Prodigy charged its members a fee for sending more than 30 e-mails per month—a big difference in business strategy. Another important application of online service that customers were increasingly embracing was chat rooms. AOL saw chat rooms as an important online application to satisfy customer needs; its strategy was to quickly develop the software that soon made chat rooms one of its most popular services. Prodigy's lawyers, however, feared it might be held legally liable for comments made in chat rooms or events that arose from them. They discouraged Prodigy from offering this service. This censorship, lack of chat rooms, and charges for e-mail rankled its members, and they began to switch to AOL.

By 1996, the battle was effectively over: AOL was growing by leaps and bounds, and Prodigy was losing customers at a rapid pace because it had not developed the right set of strategies to pursue a differentiation business model that allowed it remain on the value frontier. AOL, by correctly sensing the way customer needs were changing and then providing a differentiated product that met those needs, crossed the chasm with ease.

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**Sources:** <http://www.aol.com> (2009); Kara Swisher, AOL.com (New York: Random House, 1998).

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The first factor that accelerates customer demand is a new product's *relative advantage*, that is, the degree to which a new product is perceived as better at satisfying customer needs than the product it supersedes. For example, the early growth in demand for cell phones was partly driven by their economic benefits. Studies showed that because business customers could always be reached by cell phone, they made better use of their time—for example, by not showing up at a meeting that had been cancelled at the last minute—and saved two hours per week in time that would otherwise have been wasted. For busy executives, the early adopters, the productivity benefits of owning a cell phone outweighed the costs. Cell phones also diffused rapidly for social reasons, in particular, because they conferred glamour or prestige on their users (something that also drives demand for advanced kinds of handheld computers and smartphones).

Another factor driving growth in demand is *compatibility*, the degree to which a new product is perceived as being consistent with the current needs or existing values of potential adopters. Demand for cell phones grew rapidly because their operation

was compatible with the prior experience of potential adopters who used traditional landline phones. *Complexity*, the degree to which a new product is perceived as difficult to understand and use, is a third factor. Early PCs with their clunky operating system interfaces were complex to use, and, hence, slow to be adopted. The first cell phones were simple to use and were adopted quickly. A fourth factor is *trialability*, the degree to which potential customers can experiment with a new product on a hands-on trial basis. Many people first used cell phones by borrowing them from colleagues to make calls, and the positive experiences helped accelerate growth rates. In contrast, early PCs were more difficult to experiment with because they were rare and expensive, and because some training was needed in how to use them. These complications led to slower growth rates. A final factor is *observability*, the degree to which the results of using and enjoying a new product can be seen and appreciated by other people. The Palm Pilot and later the Blackberry diffused rapidly because it was easy to see how quickly their users could schedule meetings, enter addresses, record expenses, and so on. When the convenience of the devices is clear, they are rapidly adopted.

Thus, strategic managers must be sure to devise strategies that help to educate customers about the value of their products if they are to grow their company's market share over time.

A related strategic issue when a market is growing rapidly is that the popularity of a new product often increases or spreads in a way that is analogous to a *viral model of infection*. Lead adopters (the first customers who buy a product) in a market become "infected" or enthused with the product, such as Blackberry or iPhone users. Subsequently, they infect other people by telling them about their advantages. After having observed the benefits of the product, these people also adopt it. Companies promoting new products can take advantage of viral diffusion by identifying and aggressively courting opinion leaders in a particular market—the customers whose views command respect. For example, when the manufacturers of new high-tech medical equipment, such as an MRI scanner, start to sell a new product, they first try to get well-known doctors at major research and teaching hospitals to use the product. They may give these opinion leaders free machines for their research purposes and work closely with them in developing the technology. Once these opinion leaders commit to the product and give it their stamp of approval, doctors at many other hospitals often follow.

In sum, understanding competitive dynamics in embryonic and growth industries is an important strategic issue. The ways in which different kinds of customer groups emerge and customer needs change are important determinants of the strategies that need to be pursued to make a business model successful over time. Similarly, understanding the factors that affect a market's growth rate allows managers to tailor their business model to a changing industry environment. (More is said about competition in high-tech industries in the next chapter.)

## NAVIGATING THROUGH THE LIFE CYCLE TO MATURITY

Another crucial business decision that faces strategic managers at each stage of the industry life cycle is which investment strategy to pursue. An investment strategy determines the amount and type of resources and capital—human, functional, and financial—that must be spent to configure a company's value chain so that it can

pursue a business model successfully over time.<sup>9</sup> In deciding on an investment strategy, managers must evaluate the potential return (on invested capital) from investing in a particular business model against the cost. In this way, they can determine whether pursuing a certain business model is likely to be profitable and how the profitability of a particular business model will change as competition within the industry changes.

Two factors are crucial in choosing an investment strategy: (1) the competitive advantage a company's business model gives it in an industry relative to its competitors and (2) the stage of the industry's life cycle in which the company is competing.<sup>10</sup> In determining the strength of a company's relative competitive position, market share and distinctive competencies become important. A large market share signals greater potential returns from future investment because it suggests a company has brand loyalty and is in a strong position to grow its profits in the future. Similarly, the more difficult it is to imitate a company's distinctive competencies, such as those in R&D or manufacturing and marketing, the more sustainable is the competitive advantage supplied by its business model and the greater the likelihood that investment in it will lead to higher profitability. These two attributes also reinforce one another; for example, a large market share may help a company create and develop distinctive competencies that strengthen its business model over time because high demand allows it to ride down the experience curve and lower its cost structure. Also, a large market share may create a large cash flow that allows a company to invest more to develop competencies in R&D or elsewhere. In general, companies with the largest market share and the strongest distinctive competencies are in the best position to build and sustain their competitive advantage. Companies with small market shares and little ability to develop distinctive competencies are in a much weaker competitive position.<sup>15</sup>

Because different kinds of opportunities and threats are found in each life cycle stage, the stage of the industry life cycle also influences a company's choice of how much to invest in its business model. Each stage, therefore, has different implications for the investment of resources needed to obtain a competitive advantage. Competition is strongest in the shakeout stage of the life cycle and least important in the embryonic stage, for example. The *risks* associated with pursuing a certain business model change over time. The difference in risk explains why the potential returns from investing in a particular business model depend on the life cycle stage.

## Embryonic Strategies

In the embryonic stage, all companies, weak and strong, emphasize the development of a distinctive competency to build a successful business model. During this stage, investment needs are great because a company has to establish a competitive advantage. Many fledgling companies in the industry are seeking resources to develop a distinctive competency. Thus, the appropriate business-level investment strategy is a **share-building strategy**. The aim is to build market share by developing a stable and distinct competitive advantage to attract customers who have no knowledge of the company's products.

Companies require large amounts of capital to develop R&D or sales and service competencies. They cannot generate much of this capital internally. Thus, a company's success depends on its ability to demonstrate a distinctive competency to attract outside investors, or venture capitalists. If a company gains the resources to develop a distinctive competency, it will be in a relatively stronger competitive

position. If it fails, its only option may be to exit the industry. In fact, companies in weak competitive positions at all stages in the life cycle may choose to exit the industry to cut their losses.

## Growth Strategies

At the growth stage, the task facing a company is to strengthen its business model to provide the competitive foundation it needs to survive the coming shakeout. Thus, the appropriate investment strategy is the **growth strategy**. The goal is to maintain its relative competitive position in a rapidly expanding market and, if possible, to increase it—in other words, to grow with the expanding market. However, other companies are entering the market and catching up with the industry's innovators. As a result, the companies first into the market with a particular kind of product often require successive waves of capital infusion to maintain the momentum generated by their success in the embryonic stage. For example, differentiators need to engage in extensive R&D to maintain their technological lead, and cost leaders need to invest in state-of-the-art machinery and computers to obtain new experience-curve economies. All this investment to strengthen their business model is very expensive. And, as we discussed previously, many companies fail to recognize the changing needs of customers in the market and invest their capital in ways that do not lead to the distinctive competencies required for long-term success.

The growth stage is also the time when companies attempt to secure their grip over customers in existing market segments and enter new segments so that they can increase their market share. Increasing the level of market segmentation to become a broad differentiator is expensive as well. A company has to invest resources to develop a new sales and marketing competency, for example. Consequently, at the growth stage, companies must make investment decisions about the relative advantages of differentiation, cost-leadership, or focus business models given their financial needs and relative competitive position. If one or a few companies have emerged as the clear cost leaders, for example, other companies might realize that it is futile to compete head-to-head with these companies and instead decide to pursue a growth strategy using a differentiation or focus approach and invest resources in developing other competencies. As a result, strategic groups start to develop in an industry as each company seeks the best way to invest its scarce resources to maximize its competitive advantage.

Companies must spend a lot of money just to keep up with growth in the market, and finding additional resources to develop new competencies is a difficult task for strategic managers. Consequently, companies in a weak competitive position at this stage engage in a **market concentration** strategy to find a viable competitive position. They seek to specialize in some way and adopt a focus business model to reduce their investment needs. If they are very weak, they may also choose to exit the industry and sell out to a stronger competitor.

## Shakeout Strategies

By the shakeout stage, customer demand is increasing, and competition by price or product characteristics becomes intense. Companies in strong competitive positions need resources to invest in a **share-increasing strategy** to attract customers from weak companies exiting the market. In other words, companies attempt to maintain and increase market share despite fierce competition. The way companies invest their resources depends on their business model.

For cost leaders, because of the price wars that can occur, investment in cost control is crucial if they are to survive the shakeout stage; they must do all they can to reduce their cost structure. Differentiators in a strong competitive position choose to forge ahead and increase their market share by investing in marketing, and they are likely to develop a sophisticated after-sales service network. Differentiators in a weak position reduce their investment burden by withdrawing to a focused model, the market concentration strategy, to specialize in serving the needs of customers in a particular market segment. A market concentration strategy indicates that a company is trying to turn around its business so that it can survive in the long run.

Weak companies exiting the industry engage in a harvest strategy. A company using a **harvest strategy** must limit or decrease its investment in a business and extract or milk its investment as much as it can. For example, a company reduces to a minimum the assets it employs in the business and forgoes investment to reduce its cost structure.<sup>11</sup> Then the company “harvests” all the sales revenues it can profitably obtain before it liquidates its assets and exits the industry. Companies that have lost their cost-leadership position to more efficient companies are more likely to pursue a harvest strategy because a smaller market share means higher costs and they are unable to move to a focus strategy. Differentiators, in contrast, have a competitive advantage in this stage if they can move to a focus model.

## Maturity Strategies

By the maturity stage, companies want to reap the rewards of their previous investments in developing the business models that have made them dominant industry competitors. Until now, profits have been reinvested in the business, and dividends have been small. Investors in leading companies have obtained their rewards through the appreciation of the value of their stock, because the company has reinvested most of its capital to maintain and increase market share. As market growth slows in the maturity stage, a company’s investment strategy depends on the level of competition in the industry and the source of the company’s competitive advantage.

In industries in which competition is high because of technological change or low barriers to entry, companies need to defend their competitive position. Strategic managers need to continue to invest heavily in building the company’s business model to maintain its competitive advantage. Both cost leaders and differentiators adopt a **hold-and-maintain strategy** to defend their business models and ward off threats from focused companies that might be attempting to grow and compete with the industry leaders. They expend resources to develop their distinctive competency so as to remain the market leaders. For example, differentiated companies may invest in improved after-sales service, and low-cost companies may invest in the latest production technologies.

It is at this point that many companies realize the benefits that can be obtained by investing resources to become broad differentiators to protect themselves from aggressive competitors (both at home and abroad) that are watching for any opportunity or perceived weakness to take the lead in the industry. Differentiators enter new market segments to increase their market share; they also take advantage of their growing profits to develop flexible manufacturing systems to reduce their production costs. Cost leaders also begin to enter more market segments and increase product differentiation to expand their market share. For example, Gallo moved from the bulk wine segment and began marketing premium wines and wine coolers to take advantage of its low production costs. Soon Gallo’s new premium brands,



### Ethical Dilemma

A team of marketing managers for a major differentiated consumer products company has been instructed by top managers to develop new strategies to increase the profitability of the company's products. One idea on the table is to lower the cost of ingredients, which will reduce product quality; another is to reduce the content of the products while maintaining the size of the packaging; a third is to slightly change an existing product and then to offer it as a "new" premium brand that can be sold at a higher price. Do you think it is ethical to pursue these strategies and present them to management? In what ways could these strategies backfire and end up causing the company harm?

such as Falling Leaf chardonnay, became best-selling wines in the United States. As time goes on, the competitive positions of the leading differentiators and cost leaders become closer, and the pattern of industry competition changes yet again, as we discuss in the next section.

## STRATEGY IN MATURE INDUSTRIES

As a result of fierce competition in the shakeout stage, an industry becomes consolidated; hence, a mature industry is commonly dominated by a small number of large companies. Although they may also contain many medium-sized companies and a host of small, specialized ones, the large companies determine the nature of competition in the industry because they can influence the five competitive forces. Indeed, these large companies hold their leading positions because they have developed the most successful business models and strategies in the industry.

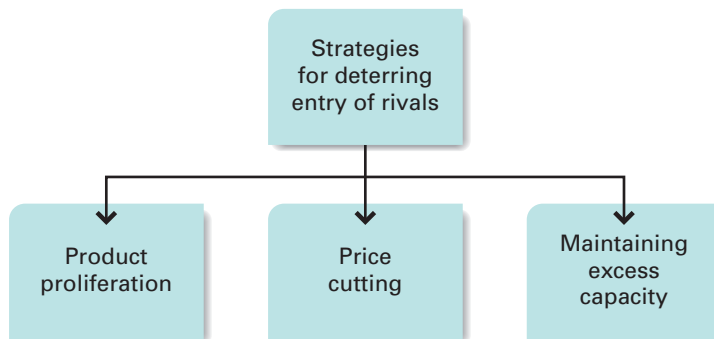
By the end of the shakeout stage, companies have learned how important it is to analyze each other's business model and strategies. They also know that if they change their strategies, their actions are likely to stimulate a competitive response from industry rivals. For example, a differentiator that starts to lower its prices because it has adopted a more cost-efficient technology not only threatens other differentiators but may also threaten cost leaders that see their competitive advantage being eroded. Hence, by the mature stage of the life cycle, companies have learned the meaning of competitive independence.

As a result, in mature industries, business-level strategy revolves around understanding how established companies *collectively* try to reduce the strength of industry competition to preserve both company and industry profitability. Interdependent companies can help protect their competitive advantage and profitability by adopting strategies and tactics, first, to deter entry into an industry, and second, to reduce the level of rivalry within an industry.

### Strategies to Deter Entry: Product Proliferation, Price Cutting, and Maintaining Excess Capacity

Companies can use three main methods to deter entry by potential rivals and hence maintain and increase industry profitability: product proliferation, price cutting, and maintaining excess capacity (see Figure 6.5). Of course, *potential entrants* will try to circumvent such entry-detering strategies by incumbent companies. Competition is rarely a one-way street.

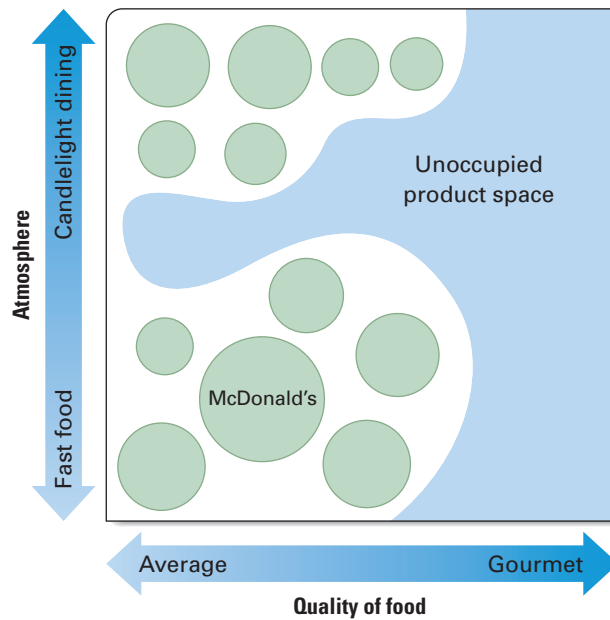
**Product Proliferation** As we noted earlier, in the maturity stage, most companies move to increase their market share by producing a wide range of products targeted at different market segments. Sometimes, however, to reduce the threat of entry, existing companies ensure that they are offering a product targeted at every segment in the market. This creates a barrier to entry because potential competitors find it hard to break into an industry and establish a "beachhead" when there is no obvious group of customers whose needs are not being met by existing companies.<sup>12</sup> This strategy of "filling the niches," or catering to the needs of customers in all market segments to deter entry, is known as **product proliferation**.

**Figure 6.5** Strategies for Deterring Entry of Rivals

Because the large United States carmakers were so slow to fill the small-car niches (they did *not* pursue a product proliferation strategy), they were vulnerable to the entry of the Japanese into these market segments in the United States in the 1980s. Ford and GM had no excuse for this situation, for in their European operations, they had a long history of small-car manufacturing. Managers should have seen the opening and filled it 10 years earlier, but the (mistaken) view was that “small cars mean small profits.” Better small profits than no profits! In the soap and detergent industry, on the other hand, competition is based on the production of new kinds of soaps and detergents to satisfy or create new desires by customers. Thus, the number of soaps and detergents, and especially the way they are packaged (powder, liquid, or tablets), proliferates, making it very difficult for prospective entrants to attack a new market segment. Figure 6.6 indicates how product proliferation can deter entry. It depicts product space in the restaurant industry along two dimensions: atmosphere, which ranges from fast food to candlelight dining, and quality of food, which ranges from average to gourmet. The circles represent product spaces filled by restaurants located along the two dimensions. Thus, McDonald’s is situated in the average quality/fast food area. A gap in the product space gives a potential entrant or an existing rival an opportunity to enter the market and make inroads. The shaded unoccupied product space represents areas where new restaurants can enter the market. When all the product spaces are filled, this barrier to entry makes it much more difficult for a new company to gain a foothold in the market and differentiate itself.

**Price Cutting** In some situations, pricing strategies can be used to deter entry by other companies, thus protecting the profit margins of companies already in an industry. One entry-deterring strategy is to cut prices every time a new company enters the industry or, even better, every time a potential entrant is *contemplating* entry, and then raise prices once the new or potential entrant has withdrawn. The goal is to send a signal to potential entrants that new entry will be met with price cuts. If incumbent companies in an industry consistently pursue such a strategy, potential entrants will come to understand that their entry will spark off a price war, the threat of new entry will be reduced, average prices will be higher, and industry profitability will increase. However, a price-cutting strategy will not keep out an entrant that plans to adopt a new technology that will give it a cost advantage over

**Figure 6.6** Product Proliferation in the Restaurant Industry



established companies or has pioneered a new business model that its managers expect will also give it a competitive advantage. In fact, many of the most successful entrants into mature industries are companies that have done just this. For example, the Japanese car companies were able to enter the United States market because they had pioneered new lean manufacturing technologies that gave them a cost and quality advantage over established United States companies.

A second price-cutting strategy is to charge a high price initially for a product and seize short-term profits but then to cut prices aggressively to build market share *and* deter potential entrants simultaneously.<sup>13</sup> The incumbent companies thus signal to potential entrants that if they enter the industry, the incumbents will use their competitive advantage to drive down prices to a level at which new companies will be unable to cover their costs. This pricing strategy also allows a company to ride down the experience curve and obtain substantial economies of scale. Because costs fall with prices, profit margins could still be maintained. However, this strategy is unlikely to deter a strong potential competitor—an established company that is trying to find profitable investment opportunities in other industries. It is difficult, for example, to imagine 3M being afraid to enter an industry because companies threaten to drive down prices. A company such as 3M has the resources to withstand any short-term losses. Hence, when faced with such a scenario, it may be in the interests of incumbent companies to accept new entry gracefully, giving up market share gradually to the new entrants to prevent price wars from developing and thus saving their profits, if this is feasible.

**Maintaining Excess Capacity** A third competitive technique that allows companies to deter entry involves maintaining excess capacity, that is, maintaining the physical capability to produce more product than customers currently demand.

Existing industry companies may deliberately develop some limited amount of excess capacity to warn potential entrants that if they enter the industry, existing firms can retaliate by increasing output and forcing down prices until entry would become unprofitable. However, the threat to increase output has to be *credible*; that is, companies in an industry must collectively be able to raise the level of production quickly if entry appears likely.

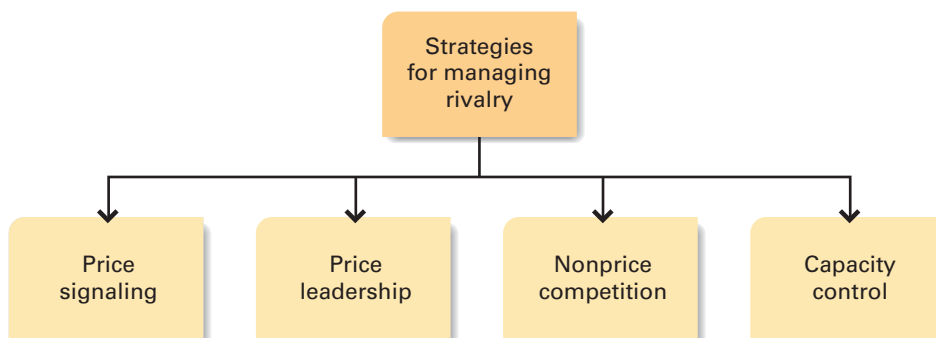
## Strategies to Manage Rivalry

Beyond seeking to deter entry, companies also wish to develop strategies to manage their competitive interdependence and decrease price rivalry. Unrestricted competition over prices reduces both company and industry profitability. Several strategies are available to companies to manage industry rivalry. The most important are price signaling, price leadership, non-price competition, and capacity control (Figure 6.7).

**Price Signaling** A company's ability to choose the price option that leads to superior performance is a function of several factors, including the strength of demand for a product and the intensity of competition between rivals. Price signaling is a first means by which companies attempt to control rivalry among competitors so as to allow the *industry* to choose the most favorable pricing option.<sup>14</sup> **Price signaling** is the process by which companies increase or decrease product prices to convey their intentions to other companies and so influence the way they price their products.<sup>15</sup> Companies use price signaling to improve industry profitability.

Companies may use price signaling to announce that they will respond vigorously to hostile competitive moves that threaten them. For example, they may signal that if one company starts to cut prices aggressively, they will respond in kind. A **tit-for-tat strategy** is a well-known price signaling strategy in which a company does exactly what its rivals do: if its rivals cut prices, the company follows; if its rivals raise prices, the company follows. By pursuing this strategy consistently over time, a company sends a clear signal to its rivals that it will match any pricing moves they make, the idea being that, sooner or later, rivals will learn that the company will always pursue a tit-for-tat strategy. Because rivals now know that the company will match any price reductions and cutting prices will only reduce profits, price cutting

**Figure 6.7** Strategies for Managing Industry Rivalry

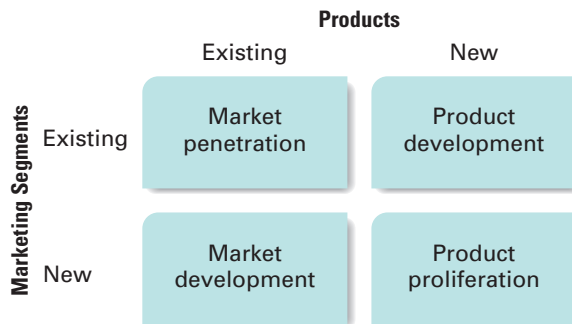


becomes less common in the industry. Moreover, a tit-for-tat strategy also signals to rivals that price increases will be imitated, increasing the probability that rivals will initiate price increases to raise profits. Thus, a tit-for-tat strategy can be a useful way of shaping pricing behavior in an industry.<sup>16</sup>

The airline industry is a good example of the power of price signaling when prices typically rise and fall depending on the current state of customer demand. If one carrier signals the intention to lower prices, a price war frequently ensues as other carriers copy each other's signals. If one carrier feels demand is strong, it tests the waters by signaling an intention to increase prices, and price signaling becomes a strategy to obtain uniform price increases. Nonrefundable tickets, another strategy adopted to obtain a more favorable pricing option, originated as a market signal by one company that was quickly copied by all other companies in the industry. Carriers recognized that they could stabilize their revenues and earn interest on customers' money if they collectively acted to force customers to assume the risk of buying airline tickets in advance. In essence, price signaling allows companies to give one another information that enables them to understand each other's competitive product or market strategy and make coordinated, price-competitive moves.

**Price Leadership** Price leadership—in which one company assumes the responsibility for setting the pricing option that maximizes industry profitability—is a second tactic used to reduce price rivalry between companies in a mature industry.<sup>17</sup> Formal price leadership, or price setting by companies jointly, is illegal under anti-trust laws, so the process of price leadership is often very subtle. In the car industry, for example, prices are set by imitation. The price set by the weakest company—that is, the one with the highest cost structure—is often used as the basis for competitors' pricing. Thus, United States carmakers set their prices, and Japanese carmakers then set theirs with reference to the United States prices. The Japanese are happy to do this because they have lower costs than United States companies. They make higher profits than United States carmakers without competing with them on price. Pricing is done by market segment. The prices of different auto models in the model range indicate the customer segments that the companies are aiming for and the price range they believe the market segment can tolerate. Each manufacturer prices a model in the segment with reference to the prices charged by its competitors, not by reference to competitors' costs. Price leadership also allows differentiators to charge a premium price.

Although price leadership can stabilize industry relationships by preventing head-to-head competition and thus raise the level of profitability within an industry, it has its dangers. It helps companies with high cost structures, allowing them to survive without having to implement strategies to become more productive and efficient. In the long term, such behavior makes them vulnerable to new entrants that have lower costs because they have developed new low-cost production techniques. That is what happened in the United States car industry after the Japanese entered the market. After years of tacit price fixing, with GM as the price leader, the carmakers were subjected to growing low-cost Japanese competition, to which they were unable to respond. Indeed, most United States carmakers survived only because the Japanese carmakers were foreign firms. Had the foreign firms been new United States entrants, the government would probably not have taken steps to protect Chrysler, Ford, or GM, including bailing them out with billions of dollars in loans in 2009 to prevent them from going bankrupt.

**Figure 6.8** Four Nonprice Competitive Strategies

**Nonprice Competition** A third very important aspect of product and market strategy in mature industries is the use of **nonprice competition** to manage rivalry within an industry. The use of strategies to try to prevent costly price cutting and price wars does not preclude competition by product differentiation. Indeed, in many industries, product-differentiation strategies are the principal tools companies use to deter potential entrants and manage rivalry within their industry.

Product differentiation allows industry rivals to compete for market share by offering products with different or superior features, such as more powerful, smaller, or sophisticated CPUs and GPUs as AMD, Intel, and Nvidia compete to do, or by applying different marketing techniques. In Figure 6.8, product and market segment dimensions are used to identify four nonprice competitive strategies based on product differentiation: market penetration, product development, market development, and product proliferation. (Notice that this model applies to new market segments, not new markets.)<sup>18</sup>

**Market Penetration** When a company concentrates on expanding market share in its existing product markets, it is engaging in a strategy of **market penetration**.<sup>19</sup> Market penetration involves heavy advertising to promote and build product differentiation. For example, Intel has actively pursued penetration with its aggressive marketing campaign of “Intel Inside.” In a mature industry, advertising aims to influence customers’ brand choice and create a brand-name reputation for the company and its products. In this way, a company can increase its market share by attracting the customers of its rivals. Because brand-name products often command premium prices, building market share in this situation is very profitable.

In some mature industries—for example, soap and detergent, disposable diapers, and brewing—a market-penetration strategy becomes a way of life.<sup>20</sup> In these industries, all companies engage in intensive advertising and battle for market share. Each company fears that if it does not advertise, it will lose market share to rivals who do. Consequently, in the soap and detergent industry, Proctor & Gamble spends more than 20% of sales revenues on advertising, with the aim of maintaining and perhaps building market share. These huge advertising outlays constitute a barrier to entry for prospective entrants.



**Product Development** Product development is the creation of new or improved products to replace existing ones.<sup>21</sup> The wet-shaving industry depends on product replacement to create successive waves of customer demand, which then create new sources of revenue for companies in the industry. Gillette, for example, periodically comes out with a new and improved razor, such as its vibrating razor that competes with Schick's four-bladed razor, to try to boost its market share. Similarly, in the car industry, each major car company replaces its models every three to five years to encourage customers to trade in their old models and buy the new one.

Product development is crucial for maintaining product differentiation and building market share. For instance, the laundry detergent Tide has gone through more than 50 changes in formulation during the past 40 years to improve its performance. The product is always advertised as Tide, but it is a different product each year. Refining and improving products is a crucial strategy companies use to fine-tune and improve their business models in a mature industry, but this kind of competition can be as vicious as a price war because it is very expensive and can dramatically increase a company's cost structure. This happened in the chip industry where intense competition to make the fastest or most powerful CPU or GPU and become the market leader has dramatically increased the cost structure of Intel, AMD, and Nvidia and sharply reduced their profitability.

**Market Development** Market development finds new market segments for a company's products. A company pursuing this strategy wants to capitalize on the brand name it has developed in one market segment by locating new market segments in which to compete—just as Mattel and Nike do by entering many different segments of the toy and shoe market, respectively. In this way, companies can leverage the product differentiation advantages of their brand name. The Japanese auto manufacturers provide an interesting example of the use of market development. When they entered the market, each Japanese manufacturer offered a car model aimed at the economy segment of the auto market, such as the Toyota Corolla and the Honda Accord. Then they upgraded each model over time, and now each is directed at a more expensive market segment. The Accord is a leading contender in the mid-sized car segment, and the Corolla fills the small-car segment. By redefining their product offerings, Japanese manufacturers have profitably developed their market segments and successfully attacked their United States rivals, wresting market share from these companies. Although the Japanese used to compete primarily as cost leaders, market development has allowed them to become differentiators as well. In fact, as we noted in the previous chapter, Toyota has used market development to be come a broad differentiator. Figure 6.9 illustrates how, over time, Toyota has used market development to develop a vehicle for almost every main segment of the car market.<sup>22</sup>

**Product Proliferation** Product proliferation can be used to manage rivalry within an industry and to deter entry. The strategy of product proliferation generally means that large companies in an industry all have a product in each market segment or niche and compete head-to-head for customers. If a new niche develops, such as SUVs, designer sunglasses, or Internet Web sites, then the leader gets a first-mover advantage, but soon all the other companies catch up. Once again, competition is stabilized, and rivalry within the industry is reduced. Product proliferation thus allows the development of stable industry competition based on product differentiation, not price—that is, nonprice competition based on the development of new products. The competitive battle is over a product's perceived uniqueness, quality, features, and performance, not over its price. The way in which Nike has used these

**Figure 6.9** Toyota's Product Lineup

Price	Utility Vehicles (SUVs)	Passenger/ Sports Sedans	Passenger Vans	Personal Luxury Vehicles	Sporty Cars	Pickup Trucks
\$11–\$20K	Scion xB	Camry, Matrix, Corolla, Prism, Scion xA			Celica GT	Tacoma
\$21–\$30K	RAV4- 4Runner, Highlander	Venza, Avalon	Sienna	Avalon	MR2, Spyder	Tundra
\$31–\$45K	Sequoia, RX330	GS 300, IS 300		ES 330	Camry, Solara	Tundra Double Cab
\$46–\$75K	Land Cruiser GX, LX	GS 430		LS 430	SC 430	

Source: www.toyota.com, accessed August 2009.

nonprice competitive strategies to strengthen its differentiation business model is profiled in Strategy in Action 6.3.

**Capacity Control** Although nonprice competition helps mature industries avoid the cutthroat price cutting that reduces company and industry levels of profitability, price competition does periodically break out when excess capacity exists in an industry. Excess capacity arises when companies collectively produce too much output; to dispose of it, they cut prices. When one company cuts prices, the others quickly follow because they fear that the price cutter will be able to sell its entire inventory while they will be left with unwanted goods. The result is that a price war develops.

Excess capacity may be caused by a shortfall in demand, as when a recession lowers the demand for cars and causes car companies to give customers price incentives to purchase new cars. In this situation, companies can do nothing except wait for better times. By and large, however, excess capacity results from companies within an industry simultaneously responding to favorable conditions; they all invest in new plants to be able to take advantage of the predicted upsurge in demand. Paradoxically, each individual company's effort to outperform the others means that, collectively, the companies create industry overcapacity, which hurts them all. Although demand is rising, the consequence of each company's decision to increase capacity is a surge in industry capacity, which drives down prices. To prevent the accumulation of costly excess capacity, companies must devise strategies that let them control—or at least benefit from—capacity expansion programs. Before we examine these strategies, however, we need to consider in greater detail the factors that cause excess capacity.<sup>23</sup>

**Factors Causing Excess Capacity** The problem of excess capacity often derives from technological developments. Sometimes new low-cost technology is the culprit because all companies invest in it simultaneously to prevent being left behind. Excess capacity occurs because the new technology can produce more than the old. In addition, new technology is often introduced in large increments, which generate overcapacity. For instance, an airline that needs more seats on a route must add

## 6.3 STRATEGY IN ACTION

### Nonprice Competitive Strategies at Nike

Nike, headquartered in Beaverton, Oregon, was founded by Bill Bowerman, a former University of Oregon track coach, and Phil Knight, an entrepreneur in search of a profitable business opportunity. Bowerman's goal was to dream up a new kind of sneaker tread that would enhance a runner's traction and speed, and he came up with the idea for Nike's "waffle tread" after studying the waffle iron in his home. Bowerman and Knight made their shoe and began by selling it out of the trunk of a car at track meets. From this small beginning, Nike has grown into a company that sold more than \$18 billion worth of shoes in the \$40 billion athletic footwear and apparel industries in 2008 and made more than \$1.8 billion in profit.

Nike's amazing growth came from its business model, which from the beginning was based on differentiation; its strategy was to innovate state-of-the-art athletic shoes and then to publicize the qualities of its shoes through dramatic "guerrilla" marketing. Nike's marketing is designed to persuade customers that its shoes are not only superior but also a high fashion statement and a necessary part of a lifestyle based on sporting or athletic interests. Nike's strategy to emphasize the uniqueness of its product obviously paid off as its market share soared. However, the company received a shock in 1998, when its sales suddenly began to fall; it was becoming more and more difficult to design new shoes that its existing customers perceived to be significantly better and worth their premium price—in other words, its strategy of market penetration and product development was no longer paying off. Phil Knight recruited a team of talented top managers from leading consumer products companies to help him change Nike's business model in some fundamental ways.

In the past, Nike shunned sports like golf, soccer, rollerblading, and so on, and focused most of its efforts

on making shoes for the track and basketball market segments. However, when its sales started to fall, it realized that using marketing to increase sales in a particular market segment (market penetration) can only grow sales and profits so far. So Nike took its existing design and marketing competencies and began to craft new lines of shoes for new market segments. In other words, it began to pursue market development and product proliferation as well as the other nonprice strategies. For example, it revamped its aerobics shoes and launched a line of soccer shoes and perfected their design over time; by the mid-2000s, it took over as the market leader from its archrival Adidas. In addition, it launched its Total 90 III shoes, which are aimed at the millions of casual soccer players throughout the world who want a shoe they can just "play" in.

To take advantage of its competencies in design and marketing, Nike decided to enter new market segments by purchasing other footwear companies that offered shoes that extended or complemented its product lines. Continuing its pursuit of product proliferation, it bought Converse, the maker of retro-style sneakers, and Official Starter, a licensor of athletic shoes and apparel whose brands include the low-priced Shaq brand. Allowing Converse to take advantage of Nike's in-house competencies has resulted in dramatic increases in the sales of its sneakers. Nike also entered another market segment when it bought Cole Haan, the dress shoemaker. Nike also entered the athletic apparel market to use its skills there, and by 2004, apparel sales were more than \$1 billion. Nike's new strategies significantly strengthened its differentiation business model, which is why its market share and profitability have continued to increase and are the envy of its competitors.

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**Sources:** <http://www.nike.com>, press release, 2004; "The New Nike," <http://www.yahoo.com> (2004), September 12; A. Wong, "Nike: Just Don't Do It," *Newsweek*, November 1, 2004, 84; <http://www.nike>, 2009.

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another plane, thereby adding hundreds of seats even if only 50 are needed. To take another example, a new chemical process may operate efficiently at the rate of only 1,000 gallons a day, whereas the previous process was efficient at 500 gallons a day. If all companies within an industry change technologies, industry capacity may double, and enormous problems can result.

Overcapacity may also be caused by competitive factors within an industry. Entry into an industry is one such a factor. The entry of steel producers from the former Soviet Union countries into the global steel market produced excess capacity and plunging prices in the world steel market in the early 2000s. The recession of 2009 has once again caused global overcapacity, and the price of steel has plunged. Sometimes the age of a company's physical assets is the source of the problem. For example, in the hotel industry, given the rapidity with which the quality of hotel furnishings declines, customers are always attracted to new hotels. When new hotel chains are built alongside the old chains, excess capacity can result. Often, companies are simply making simultaneous competitive moves based on industry trends, but those moves eventually lead to head-to-head competition. Most fast-food chains, for instance, establish new outlets whenever demographic data show population increases. However, the companies seem to forget that all other chains use the same data (they are not anticipating their rivals' actions). Thus, a locality that has no fast-food outlets may suddenly see several being built at the same time. Whether they can all survive depends on the growth rate of demand relative to the growth rate of the chains.

**Choosing a Capacity-Control Strategy** Given the various ways in which capacity can expand, companies clearly need to find some means of controlling it. If they are always plagued by price cutting and price wars, they will be unable to recoup the investments in their generic strategies. Low profitability within an industry caused by overcapacity forces not just the weakest companies but also sometimes the major players to exit the industry. In general, companies have two strategic choices: (1) each company individually must try to preempt its rivals and seize the initiative, or (2) the companies collectively must find indirect means of coordinating with each other so that they are all aware of the mutual effects of their actions.

To *preempt* rivals, a company must forecast a large increase in demand in the product market and then move rapidly to establish large-scale operations that will be able to satisfy the predicted demand. By achieving a first-mover advantage, the company may deter other firms from entering the market because the preemptor will usually be able to move down the experience curve, reduce its costs and therefore its prices as well, and threaten a price war if necessary.

This strategy, however, is extremely risky, for it involves investing resources before the extent and profitability of the future market are clear. Walmart, with its strategy of locating in small rural towns to tap an underexploited market for discount goods, preempted Sears and Kmart. Walmart has been able to engage in market penetration and market expansion because of the secure base it established in its rural strongholds. A preemptive strategy is also risky if it does not deter competitors and they decide to enter the market. If the competitors have a stronger generic strategy or more resources, such as Microsoft or Intel, they can make the preemptor suffer. Thus, for the strategy to succeed, the preemptor must generally be a credible company with enough resources to withstand a possible price war.

To *coordinate* with rivals as a capacity-control strategy, caution must be exercised because collusion on the timing of new investments is illegal under antitrust law. However, tacit coordination is practiced in many industries as companies attempt to understand and forecast one another's competitive moves. Generally, companies use market signaling to secure coordination. They make announcements about their future investment decisions in trade journals and newspapers. In addition, they share information about their production levels and their forecasts of demand within an industry to bring supply and demand into equilibrium. Thus, a coordination strategy

reduces the risks associated with investment in the industry. This is very common in the chemical refining and oil businesses, where new capacity investments frequently cost hundreds of millions of dollars.

## STRATEGIES IN DECLINING INDUSTRIES

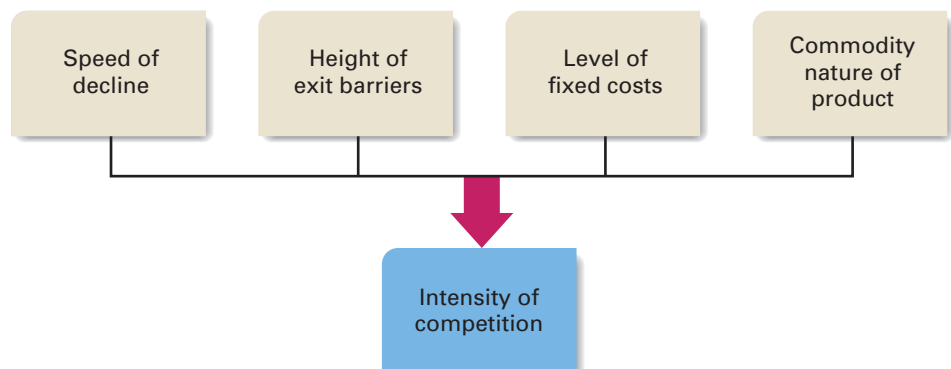
Sooner or later, many industries enter into a decline stage, in which the size of the total market starts to shrink. Examples are the railroad industry, the tobacco industry, and the steel industry. Industries start declining for a number of reasons, including technological change, social trends, and demographic shifts. The railroad and steel industries began to decline when technological changes brought viable substitutes for their products. The advent of the internal combustion engine drove the railroad industry into decline, and the steel industry fell into decline with the rise of plastics and composite materials. As for the tobacco industry, changing social attitudes toward smoking, which are themselves a product of growing concerns about the health effects of smoking, have caused the decline.

### The Severity of Decline

When the size of the total market is shrinking, competition tends to intensify in a declining industry, and profit rates tend to fall. The intensity of competition in a declining industry depends on four critical factors, which are indicated in Figure 6.10. First, the intensity of competition is greater in industries in which decline is rapid as opposed to industries such as tobacco in which decline is slow and gradual.

Second, the intensity of competition is greater in declining industries in which exit barriers are high. As you recall from Chapter 2, high exit barriers keep companies locked into an industry, even when demand is falling. The result is the emergence of excess productive capacity and, hence, an increased probability of fierce price competition.

**Figure 6.10** Factors that Determine the Intensity of Competition in Declining Industries



Third, and related to the previous point, the intensity of competition is greater in declining industries in which fixed costs are high (as in the steel industry). The reason is that the need to cover fixed costs, such as the costs of maintaining productive capacity, can make companies try to use any excess capacity they have by slashing prices, which can trigger a price war.

Finally, the intensity of competition is greater in declining industries in which the product is perceived as a commodity (as it is in the steel industry) in contrast to industries in which differentiation gives rise to significant brand loyalty, as was true until very recently of the declining tobacco industry.

Not all segments of an industry typically decline at the same rate. In some segments, demand may remain reasonably strong despite decline elsewhere. The steel industry illustrates this situation. Although bulk steel products, such as sheet steel, have suffered a general decline, demand has actually risen for specialty steels, such as those used in high-speed machine tools. Vacuum tubes provide another example. Although demand for them collapsed when transistors replaced them as a key component in many electronics products, vacuum tubes still had some limited applications in radar equipment for years afterward. Consequently, demand in this vacuum tube segment remained strong despite the general decline in the demand for vacuum tubes. The point, then, is that there may be pockets of demand in an industry in which demand is declining more slowly than in the industry as a whole or not declining at all. Price competition thus may be far less intense among the companies serving such pockets of demand than within the industry as a whole.

## Choosing a Strategy

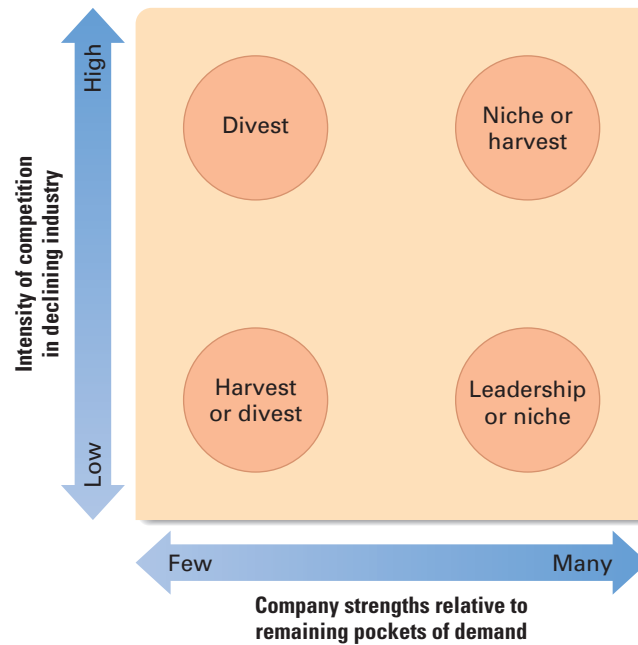
There are four main strategies that companies can adopt to deal with decline: (1) a **leadership strategy**, by which a company seeks to become the dominant player in a declining industry; (2) a **niche strategy**, which focuses on pockets of demand that are declining more slowly than the industry as a whole; (3) a **harvest strategy**, which optimizes cash flow; and (4) a **divestment strategy**, by which a company sells off the business to others. Figure 6.11 provides a simple framework for guiding strategic choice. Note that the intensity of competition in the declining industry is measured on the vertical axis and a company's strengths relative to remaining pockets of demand are measured on the horizontal axis.

**Leadership Strategy** A leadership strategy aims at growing in a declining industry by picking up the market share of companies that are leaving the industry. A leadership strategy makes most sense when (1) the company has distinctive strengths that allow it to capture market share in a declining industry and (2) the speed of decline and the intensity of competition in the declining industry are moderate. Philip Morris has pursued such a strategy in the tobacco industry. Through aggressive marketing, Philip Morris has increased its market share in a declining industry and earned enormous profits in the process.

The tactical steps companies might use to achieve a leadership position include using aggressive pricing and marketing to build market share, acquiring established competitors to consolidate the industry, and raising the stakes for other competitors, for example, by making new investments in productive capacity. Such competitive tactics signal to other competitors that the company is willing and able to stay and compete in the declining industry. These signals may persuade other companies to exit the industry, which would further enhance the competitive position of the



**Figure 6.11** Strategy Selection in a Declining Industry



industry leader. Strategy in Action 6.4 offers an example of a company, Richardson Electronics, that has prospered by taking a leadership position in a declining industry. It is one of the last companies in the vacuum tube business.

**Niche Strategy** A niche strategy focuses on pockets of demand in the industry in which demand is stable or declining less rapidly than the industry as a whole. The strategy makes sense when the company has some unique strengths relative to those niches in which demand remains relatively strong. As an example, consider Naval, a company that manufactures whaling harpoons and small guns to fire them and makes money doing so. This might be considered rather odd because the world community has outlawed whaling. However, Naval survived the terminal decline of the harpoon industry by focusing on the one group of people who are still allowed to hunt whales, although only in very limited numbers: North American Eskimos. Eskimos are permitted to hunt bowhead whales, provided that they do so only for food and not for commercial purposes. Naval is the sole supplier of small harpoon whaling guns to Eskimo communities, and its monopoly position allows it to earn a healthy return in this small market.

**Harvest Strategy** As we noted earlier, a harvest strategy is the best choice when a company wishes to get out of a declining industry and optimize cash flow in the process. This strategy makes the most sense when the company foresees a steep decline and intense future competition or lacks strengths relative to remaining pockets of demand in the industry. A harvest strategy requires the company to cut all new investments in capital equipment, advertising, R&D, and the like. The inevitable result is

## 6.4 STRATEGY IN ACTION

### How to Make Money in the Vacuum Tube Business

At its peak in the early 1950s, the vacuum tube business was a major industry in which companies such as Westinghouse, GE, RCA, and Western Electric had a large stake. Then along came the transistor, making most vacuum tubes obsolete, and one by one all the big companies exited the industry. One company, however, Richardson Electronics, not only stayed in the business but also demonstrated that high returns are possible in a declining industry. Primarily a distributor (although it does have some manufacturing capabilities), Richardson bought the remains of a dozen companies in the United States and Europe as they exited the vacuum tube industry. It now has a warehouse that stocks more than 10,000 different types of vacuum tubes. The company is the world's only supplier of many of them, which helps explain why its gross margin is in the 35% to 40% range.

Richardson survives and prospers because vacuum tubes are vital parts of some older electronic equipment that would be costly to replace with solid-state equipment. In addition, vacuum tubes still outperform

semiconductors in some limited applications, including radar and welding machines. The United States government and GM are big customers of Richardson.

Speed is the essence of Richardson's business. The company's Illinois warehouse offers overnight delivery to some 40,000 customers, and it processes 650 orders a day at an average price of \$550. Customers such as GM do not really care whether a vacuum tube costs \$250 or \$350; what they care about is the \$40,000 to \$50,000 downtime loss that they face when a key piece of welding equipment is not working. By responding quickly to the demands of such customers and being the only major supplier of many types of vacuum tubes, Richardson has placed itself in a position that many companies in growing industries would envy: a monopoly position. However, a new company, Westrex Corp., was formed to take advantage of the growing popularity of vacuum tubes in high-end stereo systems, and today it is competing head-to-head with Richardson in some market segments. Clearly, good profits can be made even in a declining industry.

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**Sources:** P. Haynes, "Western Electric Redux," *Forbes*, January 26, 1998, 46–47; <http://www.westrexcorp.com>, 2009.

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that it will lose market share, but because it is no longer investing in this business, initially its positive cash flow will increase. Essentially, the company is taking cash flow in exchange for market share. Ultimately, cash flow will start to decline, and at this stage it makes sense for the company to liquidate the business. Although this strategy is very appealing in theory, it can be somewhat difficult to put into practice. Employee morale in a business that is being run down may suffer. Furthermore, if customers catch on to what the company is doing, they may defect rapidly. Then market share may decline much faster than the company expected.

**Divestment Strategy** A divestment strategy rests on the idea that a company can recover most of its investment in an underperforming business by selling it early, before the industry has entered into a steep decline. This strategy is appropriate when the company has few strengths relative to whatever pockets of demand are likely to remain in the industry and when the competition in the declining industry is likely to be intense. The best option may be to sell out to a company that is pursuing a leadership strategy in the industry. The drawback of the divestment strategy is that it depends for its success on the ability of the company to spot its industry's decline before it becomes serious and to sell out while the company's assets are still valued by others.

## SUMMARY OF CHAPTER

1. In fragmented industries composed of a large number of small and medium-sized companies, the principal forms of competitive strategy are chaining, franchising, and horizontal merger, as well as using the Internet.
2. In embryonic and growth industries, strategy is determined partly by market demand. The innovators and early adopters have different needs from the early and the late majority, and a company must have the right strategies in place to cross the chasms and survive. Similarly, managers must understand the factors that affect a market's growth rate so that they can tailor their business model to a changing industry environment.
3. Companies need to navigate the difficult road from growth to maturity by choosing an investment strategy that supports their business models. In choosing this strategy, managers must consider the company's competitive position in the industry and the stage of the industry's life cycle. Some main types of investment strategy are share building, growth, market concentration, share increasing, harvest, and hold-and-maintain.
4. Mature industries are composed of a few large companies whose actions are so highly interdependent that the success of one company's strategy depends on the responses of its rivals.
5. The principal strategies used by companies in mature industries to deter entry are product proliferation, price cutting, and maintaining excess capacity.
6. The principal strategies used by companies in mature industries to manage rivalry are price signaling, price leadership, nonprice competition, and capacity control.
7. In declining industries, in which market demand has leveled off or is falling, companies must tailor their price and nonprice strategies to the new competitive environment. They also need to manage industry capacity to prevent the emergence of capacity expansion problems.
8. There are four main strategies a company can pursue when demand is falling: leadership, niche, harvest, and divestment. The choice is determined by the severity of industry decline and the company's strengths relative to the remaining pockets of demand.

## DISCUSSION QUESTIONS

1. Why are industries fragmented? What are the main ways in which companies can turn a fragmented industry into a consolidated one?
2. What are the key problems in maintaining a competitive advantage in embryonic and growth industry environments? What are the dangers associated with being the leader?
3. In managing their growth through the life cycle, what investment strategies should be made by (a) differentiators in a strong competitive position and (b) differentiators in a weak competitive position?
4. Discuss how companies can use (a) product differentiation and (b) capacity control to manage rivalry and increase an industry's profitability.
5. What kinds of strategies might a (a) small pizza place operating in a crowded college market and (b) detergent manufacturer seeking to bring out new products in an established market use to strengthen their business models?

## PRACTICING STRATEGIC MANAGEMENT

### Small-Group Exercise: How to Keep the Salsa Hot

Break up into groups of three to five people and discuss the following scenario. Appoint one group member as a spokesperson who will communicate your findings to the class. You are the managers of a company that has pioneered a new kind of salsa for chicken that has taken the market by storm. The salsa's differentiated appeal has been based on a unique combination of spices and packaging that has allowed you to charge a premium price. Over the past three years, your salsa has achieved a national reputation, and now major food companies such as Kraft and Nabisco, seeing the potential of this market segment, are beginning to introduce new salsas of their own, imitating your product.

1. Describe your business model and the strategies you are pursuing.
2. Describe the industry's environment in which you are competing.
3. What kinds of competitive strategies could you adopt to strengthen your business model in this kind of environment?

### Article File 6

Choose a company or group of companies in a particular industry environment and explain how it has adopted a competitive strategy to protect or enhance its business-level strategy.

### Strategic Management Project: Module 6

This part of the project considers how conditions in the industry environment affect the success of your company's business model and strategies. With the information you have at your disposal, perform the tasks and answer the questions listed:

1. In what kind of industry environment (for example, embryonic, mature) does your company operate? Use the information from Strategic Management Project: Module 2 to answer this question.
2. Discuss how your company has attempted to develop strategies to protect and strengthen its business model. For example, if your company is operating in an embryonic industry, how has it attempted to increase its competitive advantage over time? If it operates in a mature industry, discuss how it has tried to manage industry competition.
3. What new strategies would you advise your company to pursue to increase its competitive advantage? For example, how should it attempt to differentiate its products in the future or lower its cost structure?
4. On the basis of this analysis, do you think your company will be able to maintain its competitive advantage in the future? Why or why not?

## CLOSING CASE

### Warfare in Toyland

The rapid pace at which the world is changing is forcing strategic managers at all kinds of companies to speed up their decision making; otherwise they get left behind by agile competitors who respond faster

to changing customer fads and fashions. Nowhere is this truer than in the global toy industry, in which the doll business, worth more than \$10 billion a year in sales, vicious combat is raging. The largest global

toy company, Mattel, has earned tens of billions of dollars from the world's best-selling doll, Barbie, since it introduced her almost 50 years ago.<sup>24</sup> Mothers who played with the original dolls bought them for their daughters and granddaughters and Barbie became an American icon. However, Barbie's advantage as best-selling global doll led Mattel's managers to make major strategic errors in the 2000s.

Barbie and all Barbie accessories accounted for almost 50% of Mattel's toy sales in the 1990s, so protecting its star product was crucial. The Barbie doll was created in the 1960s when most women were homemakers; her voluptuous shape was a response to a dated view of what the "ideal" woman should look like. Barbie's continuing success, however, led Bob Eckert, Mattel's CEO, and his top managers to underestimate how much the world had altered. Changing cultural views about the role of girls, women, sex, marriage, and women working in the last decades shifted the tastes of doll buyers. But Mattel's managers continued to bet on Barbie's eternal appeal and collectively bought into an "If it's not broken, don't fix it" approach. In fact, given that Barbie was the best-selling doll, they thought it might be very dangerous to make major changes to her appearance; customers might not like the product development changes and stop buying her. Mattel's top managers decided not to rock the boat; they left the brand and business model unchanged and focused their efforts on developing new digital kinds of toys.

As a result, Mattel was unprepared when a challenge came along in the form of a new kind of doll, the Bratz doll, introduced by MGA Entertainment. Many competitors to Barbie had emerged over the years, and the doll business is highly profitable, but no other doll had matched Barbie's appeal to young girls (or their mothers). The marketers and designers behind the Bratz line of dolls had spent a lot of time to discover what the new generation of girls, especially those aged 7–11, wanted from a doll, however. It turned out that the Bratz dolls they designed met the desires of these girls. Bratz dolls have larger heads, oversized eyes, wear lots of makeup, short dresses, and are multicultural to give each doll "personality and attitude."<sup>25</sup> The dolls were designed to appeal to a new generation of girls brought up in a fast-changing fashion, music, and television market/age. The Bratz dolls met the untapped needs of "tween" girls, and the new line took off. MGA quickly licensed the rights to make and sell the doll to toy companies overseas, and Bratz quickly became a serious competitor to Barbie.

Mattel was in trouble. Its strategic managers had to change its business model and strategies and bring Barbie up to date; Mattel's designers must have been wishing they had been adventurous and made more radical changes earlier when they did not need to change. However, they decided to change Barbie's "extreme" vital statistics; they killed off her old-time boyfriend Ken and replaced him with Blaine, an Aussie surfer.<sup>26</sup> They also recognized they had waited much too long to introduce new lines of dolls to meet the changed needs of tweens and older girls in the 2000s. They rushed out the "My Scene" line of dolls in 2002, which were obvious imitations of Bratz dolls. This new line has not matched the popularity of Bratz dolls. Mattel also introduced a new line called Flava in 2003 to appeal to even younger girls, but this line flopped completely. At the same time, the decisions that they made to change Barbie and her figure, looks, clothing, and boyfriends came too late, and sales of Barbie dolls continued to fall.

By 2006, sales of the Barbie collection had dropped by 30%. This was serious because Mattel's profits and stock price hinged on Barbie's success and they both plunged. Analysts argue that Mattel had not paid enough attention to its customers' changing needs or moved quickly to introduce the new and improved products necessary to keep a company on top of its market. Mattel brought Ken back in 2006, but in recognition of its mounting problems in November 2006, Mattel's lawyers filed suit against MGA Entertainment. They argued that the Bratz dolls' copyright rightfully belonged to them. Mattel complained that the head designer of Bratz was a Mattel employee when he made the initial drawings for the dolls and that they had applied for copyright protection on a number of early Bratz drawings. In addition, they claim that MGA hired key Mattel employees away from the firm, and these employees "stole" sensitive sales information and transferred it to MGA. In 2008, a judge ruled in Mattel's favor and ordered MGA to stop using the Bratz name; the case was still under appeal in 2009.

### Case Discussion Questions

1. What business model and strategies made Mattel the industry leader?
2. What strategies have its rival, MGA, pursued that have threatened its competitive position?
3. What new strategies does Mattel need to pursue to regain its competitive advantage?





## STRATEGY AND TECHNOLOGY

### LEARNING OBJECTIVES

After reading this chapter, you should be able to

- Understand the tendency toward standardization in many high technology markets
- Describe the strategies that firms can use to establish their technology as the standard in a market
- Explain what the cost structure of many high technology firms looks like and articulate the strategic implications of this
- Explain the nature of technological paradigm shifts and their implications for enterprise strategy

### The Format War in Smartphones

There is a format war unfolding in the smartphone business as a number of companies battle for dominance in what is fast evolving into the next large high-technology market.

Smartphones are wireless handsets with extended data capabilities that allow users to browse the Internet, send e-mails, and run a growing number of applications from spreadsheets and restaurant locators to games and music players. The development of smartphones is rapidly transforming wireless handsets into powerful general-purpose computing devices that can perform many of the functions we typically associate with desktop and laptop computers. A key feature of smartphones is the operating system that resides on the device and runs all of the onboard functions and applications.

The main competitors in this market include Research in Motion, with its BlackBerry phones; Apple, with its iPhone; Nokia, which owns the Symbian operating system for smartphones; Microsoft, with its Windows mobile offering; and Google, with the Google phone. In 2008, some \$45 billion worth of smartphones were sold worldwide. Despite a global economic slowdown, forecasts call for sales of close to \$100 billion by 2013, when one-third of all phones sold will be smartphones. While Research in Motion, Apple, and Nokia make both the phone and the operating system and sell the integrated







bundle to end users, Microsoft and Google make just the operating system and partner with various hardware manufacturers to sell the phone to end users. All companies sell their phones in conjunction with wireless service providers.

One of the key developments in the market was the introduction of the Apple iPhone. This revolutionary device, with its elegant touch screen interface, Apple operating system, and multimedia capabilities, helped to redefine the smartphone business and rapidly started to create a mass market for these devices. Prior to the iPhone, most adopters had been business users. Now, increasingly, they are consumers. By the end of 2008, Nokia's Symbian operating system had a 46% share of the market, followed by Apple with a 17% share, RIM with a 15% share, and Microsoft with a 13.6% share. Apple, however, is growing most rapidly and gaining ground on its rivals.

Observers wonder whether the same trends toward operating system standardization seen in the PC industry will also play out

in the smartphone business, with the market ultimately settling on one or two dominant systems. Certainly, Apple's strategy with its iPhone is consistent with the attainment of such a goal. Apple has realized that applications add value to the iPhone. Toward this end, Apple has provided tools to developers to help them develop applications and a novel way of distributing those applications—Apple's online App store. Apple's hope is that more applications will drive adoption of more iPhones, and that adoption of more iPhones, because it increases the size of the addressable market, will result in more applications being written to run on the iPhone than competing devices. The result could be a positive feedback loop, similar to the one that led to the dominance of Microsoft in the PC operating system business. Apple is not having it all its own way, however. Other companies are pursuing a similar strategy. Google, for example, has opened its own online store for applications, and Microsoft has a large base of developers who are writing applications to run on Windows Mobile devices.<sup>1</sup>

## Overview

The format war now unfolding in the smartphone business is typical of the nature of competition in high-technology industries (see the Opening Case). In this chapter, we will take a close look at the nature of competition and strategy in high-technology industries. **Technology** refers to the body of scientific knowledge used in the production of goods or services. **High-technology (high-tech) industries** are those in which the underlying scientific knowledge that companies in the industry use is advancing rapidly, and, by implication, so are the attributes of the products and services that result from its application. The computer industry is often thought of as the quintessential example of a high-tech industry. Other industries often considered high tech are telecommunications, in which new technologies based on wireless and the Internet have proliferated in recent years; consumer electronics, where the digital technology underlying products from high-definition DVD players to gaming terminals and digital cameras is advancing rapidly; pharmaceuticals, where new technologies based on cell biology, recombinant DNA, and genomics are revolutionizing the process of drug discovery; power

generation, where new technologies based on fuel cells and cogeneration may change the economics of the industry; and aerospace, where the combination of new composite materials, electronics, and more efficient jet engines are giving birth to a new era of super efficient commercial jet aircraft, such as Boeing's 787.

This chapter focuses on high-technology industries for a number of reasons. First, technology is accounting for an ever-larger share of economic activity. Estimates suggest that 12% to 15% of total economic activity in the United States is in information technology industries.<sup>2</sup> This figure actually underestimates the true impact of technology on the economy because it ignores the other high-tech areas we just mentioned. Moreover, as technology advances, many low-technology industries are becoming more high tech. For example, the development of biotechnology and genetic engineering transformed the production of seed corn, long considered a low-technology business, into a high-tech business. Retailing used to be considered a low-technology business, but the shift to online retailing, led by companies such as Amazon, has changed this. Moreover, high-tech products are making their way into a wide range of businesses; today most automobiles contain more computing power than the multimillion-dollar mainframe computers used in the Apollo space program, and the competitive advantage of physical stores, such as Walmart, is based on their use of information technology. The circle of high-tech industries is both large and expanding, and even in industries not thought of as high tech, technology is revolutionizing aspects of the product or production system.

Although high-tech industries may produce very different products, when it comes to developing a business model and strategies that will lead to a competitive advantage, superior profitability, and profit growth, they often face a similar situation. For example, “winner-take-all” format wars are common in many high-tech industries, such as the consumer electronics and computer industries (see the Opening Case for an example of an ongoing format war). This chapter examines the competitive features found in many high-tech industries and the kinds of strategies that companies must adopt to build business models that will allow them to achieve superior profitability and profit growth.

After you have completed this chapter, you will have an understanding of the nature of competition in high-tech industries and the strategies that companies can pursue to succeed in those industries.

## TECHNICAL STANDARDS AND FORMAT WARS

Especially in high-tech industries, the ownership of **technical standards**—a set of technical specifications that producers adhere to when making a product or a component of it—can be an important source of competitive advantage.<sup>3</sup> Indeed, in many cases the source of product differentiation is based on the technical standard. As in the high-definition DVD market, often only one standard will become the dominant standard, so many battles in high-tech industries revolve around companies competing to be the one that sets the standard.

Battles to set and control technical standards in a market are referred to as **format wars**; they are essentially battles to control the source of differentiation

and thus the value that such differentiation can create for the customer. Because differentiated products often command premium prices and are often expensive to develop, the competitive stakes are enormous. The profitability and very survival of a company may depend on the outcome of the battle. For example, the outcome of the battle now being waged over the establishment and ownership of the standard for smartphone operating systems will help determine which companies will be leaders for the next decade in that marketplace (see the Opening Case).

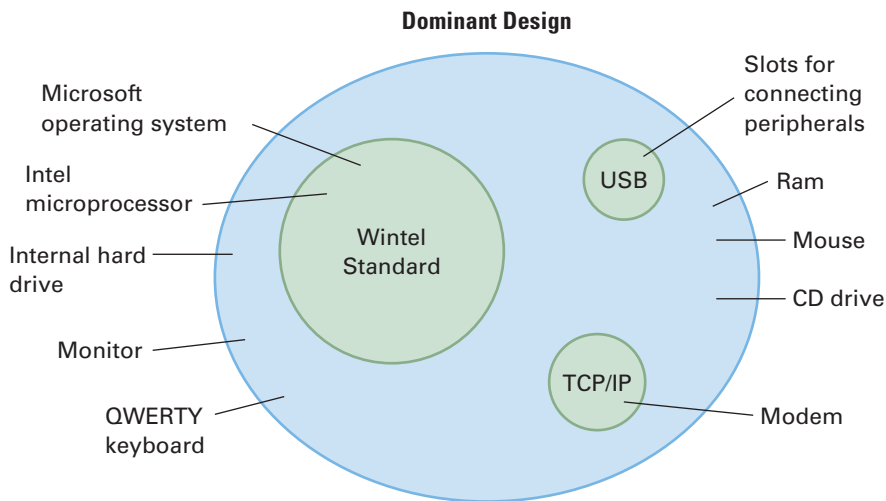
## Examples of Standards

A familiar example of a standard is the layout of a computer keyboard. No matter what keyboard you buy, the letters are all in the same pattern.<sup>4</sup> The reason is quite obvious. Imagine if each computer maker changed the ways the keys were laid out—if some started with QWERTY on the top row of letters (which is indeed the format used and is known as the QWERTY format), some with YUHGF, and some with ACFRDS. If you learned to type on one layout, it would be irritating and time-consuming to have to relearn another layout. The standard format (QWERTY) makes it easy for people to move from computer to computer because the input medium, the keyboard, is set out in a standard way.

Another example of a technical standard concerns the dimensions of containers used to ship goods on trucks, railcars, and ships. All have the same basic dimensions—the same height, length, and width—and all make use of the same locking mechanisms to hold them onto a surface or to bolt against each other. Having a standard ensures that containers can easily be moved from one mode of transportation to another—from trucks, to railcars, to ships, and back to railcars. If containers lacked standard dimensions and locking mechanisms, it would suddenly become much more difficult to ship containers around the world. Shippers would have to make sure that they had the right kind of container to go on the ships and trucks and railcars scheduled to carry a particular container around the world—very complicated indeed.

Consider, finally, the PC. Most share a common set of features: an Intel or Intel-compatible microprocessor, random access memory (RAM), a Microsoft operating system, an internal hard drive, a CD or DVD drive, a keyboard, a monitor, a mouse, a modem, and so on. We call this set of features the dominant design for personal computers (a **dominant design** refers to a common set of features or design characteristics). Embedded in this design are several technical standards (see Figure 7.1). For example, there is the Wintel technical standard based on an Intel microprocessor and a Microsoft operating system. Microsoft and Intel “own” that standard, which is central to the PC. Developers of software applications, component parts, and peripherals such as printers adhere to this standard when developing their own products because this guarantees that their products will work well with a PC based on the Wintel standard. Another technical standard for connecting peripherals to the PC is the Universal Serial Bus (or USB), established by an industry standards-setting board. No one owns it; the standard is in the public domain. A third technical standard is for communication between a PC and the Internet via a modem. Known as TCP/IP, this standard was also set by an industry association and is in the public domain. Thus, as with many other products, the PC is actually based on several technical standards. It is also important to note that when a company owns a standard,

**Figure 7.1** Technical Standards for Personal Computers



as Microsoft and Intel do with the Wintel standard, it may be a source of competitive advantage and high profitability.

## Benefits of Standards

Standards emerge because there are economic benefits associated with them. First, having a technical standard helps to guarantee compatibility between products and their complements—other products used with them. For example, containers are used with railcars, trucks, and ships; PCs are used with software applications. Compatibility has the tangible economic benefit of reducing the costs associated with making sure that products work well with each other.

Second, having a standard can help to reduce confusion in the minds of consumers. Years ago, several consumer electronics companies were vying with each other to produce and market the first generation of DVD players and championing different variants of the basic DVD technology—different standards—that were incompatible with each other; a DVD disk designed to run on a DVD player made by Toshiba would not run on a player made by Sony, and vice versa. The companies feared that selling these incompatible versions of the same technology would produce confusion in the minds of consumers, who would not know which version to purchase and might decide to wait and see which technology ultimately dominated the marketplace. With lack of demand, the technology might fail to gain traction in the marketplace and would not be successful. To avoid this possibility, the developers of DVD equipment established a standard-setting body for the industry, the DVD Forum, which established a common technical standard for DVD players and disks that all companies adhered to. The result was that when DVDs were introduced, there was a common standard and no confusion in consumers' minds. This helped to boost demand for DVD players, making this one of the fastest-selling technologies of the late 1990s and early 2000s.

Third, the emergence of a standard can help to reduce production costs. Once a standard emerges, products based on that standard design can be mass-produced, enabling manufacturers to realize substantial economies of scale and lower their cost structures. The fact that there is a central standard for PCs (the Wintel standard) means that the component parts for a PC can be mass-produced. A manufacturer of internal hard drives, for example, can mass-produce drives for Wintel PCs, and, thus, can realize substantial scale economies. If there were several competing and incompatible standards, each of which required a unique type of hard drive, production runs for hard drives would be shorter, unit costs would be higher, and the cost of PCs would go up.

Fourth, the emergence of standards can help to reduce the risks associated with supplying complementary products and thus increase the supply for those complements. Consider the risks associated with writing software applications to run on personal computers. This is a risky proposition, requiring the investment of considerable sums of money for developing the software before a single unit is sold. Imagine what would occur if there were 10 different operating systems in use for PCs, each with only 10% of the market, rather than the current situation, in which 95% of the world's PCs adhere to the Wintel standard. Software developers would be faced with the need to write 10 different versions of the same software application, each for a much smaller market segment. This would change the economics of software development, increase its risks, and reduce potential profitability. Moreover, because of their higher cost structure and fewer economies of scale, the price of software programs would increase.

Thus, although many people complain about the consequences of Microsoft's near monopoly of PC operating systems, that monopoly does have at least one good effect: it substantially reduces the risks facing the makers of complementary products and the costs of those products. In fact, standards lead to both low-cost and differentiation advantages for individual companies and can help raise the level of industry profitability.

## Establishment of Standards

Standards emerge in an industry in three main ways. First, recognizing the benefits of establishing a standard, companies in an industry might lobby the government to mandate an industry standard. In the United States, for example, the Federal Communications Commission (FCC), after detailed discussions with broadcasters and consumer electronics companies, has mandated a single technical standard for digital television (DTV) broadcasts and required broadcasters to have capabilities in place for broadcasting digital signals based on this standard by 2006. The FCC took this step because it believed that without government action to set the standard, the rollout of DTV would be very slow. With a standard set by the government, consumer electronics companies can have greater confidence that a market will emerge, and this should encourage them to develop DTV products.

Second, technical standards are often set by cooperation among businesses, without government help, often through the medium of an industry forum, such as the DVD Forum. Companies cooperate in this way when they decide that competition among them to create a standard might be harmful because of the uncertainty that it would create in the minds of consumers.

When standards are set by the government or an industry association, they fall into the **public domain**, meaning that any company can freely incorporate the

knowledge and technology on which the standard is based into its products. For example, no one owns the QWERTY format, therefore, no one company can profit from it directly. Similarly, the language that underlies the presentation of text and graphics on the Web, hypertext markup language (HTML), is in the public domain; it is free for all to use. The same is true for TCP/IP, the communications standard used for transmitting data on the Internet.

Often, however, the industry standard is selected competitively by the purchasing patterns of customers in the marketplace—that is, by market demand. In this case, the strategy and business model a company has developed for promoting its technological standard are of critical importance because ownership of an industry standard that is protected from imitation by patents and copyrights is a valuable asset—a source of sustained competitive advantage and superior profitability. Microsoft and Intel, for example, both owe their competitive advantage to their ownership of format wars, which exist between two or more companies competing against each other to get their designs adopted as the industry standard. Format wars are common in high-tech industries because of the high stakes. The Wintel standard became the dominant standard for PCs only after Microsoft and Intel won format wars against Apple Computer's proprietary system and later against IBM's OS/2 operating system. Microsoft and Real Networks are currently competing head-to-head in a format war to establish rival technologies—Windows Media Player and RealPlayer—as the standard for streaming video and audio technology on the Web. The Opening Case tells how a number of firms are engaged in a format war in the smartphone business.

### Network Effects, Positive Feedback, and Lockout

There has been a growing realization that when standards are set by competition between companies promoting different formats, network effects are a primary determinant of how standards are established.<sup>5</sup> **Network effects** arise in industries where the size of the “network” of complementary products is a primary determinant of demand for an industry's product. For example, the demand for automobiles early in the 20th century was an increasing function of the network of paved roads and gas stations. Similarly, the demand for telephones is an increasing function of the quantity of other numbers that can be called with that phone; that is, of the size of the telephone network (the telephone network is the complementary product). When the first telephone service was introduced in New York City, only 100 numbers could be called. The network was very small because of the limited number of wires and telephone switches, which made the telephone a relatively useless piece of equipment. As more and more people purchased telephones and as the network of wires and switches expanded, the value of a telephone connection increased. This led to an increase in the demand for telephone lines, which further increased the value of owning a telephone, setting up a positive feedback loop.

To understand why network effects are important in the establishment of standards, consider the classic example of a format war: the battle between Sony and Matsushita to establish their respective technology for videocassette recorders (VCRs) as the standard in the marketplace. Sony was first to market with its Betamax technology, followed by Matsushita with its VHS technology. Both companies sold VCR recorder-players, and movie studios issued films prerecorded on VCR tapes for rental to consumers. Initially, all tapes were issued in Betamax format to play on Sony's machine. Sony did not license its Betamax technology, preferring to

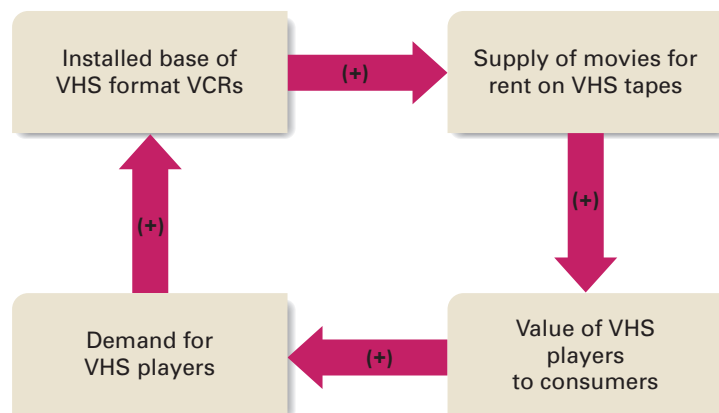


make all of the player-recorders itself. When Matsushita entered the market, it realized that to make its VHS format players valuable to consumers, it would have to encourage movie studios to issue movies for rental on VHS tapes. The only way to do that, Matsushita's managers reasoned, was to increase the installed base of VHS players as rapidly as possible. They believed that the greater the installed base of VHS players, the greater the incentive would be for movie studios to issue movies for rental on VHS format tapes. The more prerecorded VHS tapes were available for rental, the greater the value of a VHS player became to consumers, and therefore, the greater the demand would be for VHS players (see Figure 7.2). Matsushita wanted to exploit a positive feedback loop.

To do this, Matsushita chose a licensing strategy under which any consumer electronics company was allowed to manufacture VHS format players under license. The strategy worked. A large number of companies signed on to manufacture VHS players. Soon, far more VHS players were available for purchase in stores than Betamax players. As sales of VHS players started to grow, movie studios issued more films for rental in VHS format, and this stoked demand. Before long, it was clear to anyone who walked into a video rental store that there were more and more VHS tapes available for rent and fewer and fewer Betamax tapes. This served to reinforce the positive feedback loop, and, ultimately, Sony's Betamax technology was shut out of the market. The pivotal difference between the two companies was strategy: Matsushita chose a licensing strategy, and Sony did not. As a result, Matsushita's VHS technology became the de facto standard for VCRs, while Sony's Betamax technology was locked out.

The general principle that emerges from this example is that when two or more companies are competing with each other to get their technology adopted as a standard in an industry, and when network effects and positive feedback loops are important, the company that wins the format war will be the one whose strategy best exploits positive feedback loops. It turns out that this is a very important strategic principle in many high-tech industries, particularly computer hardware, software, telecommunications, and consumer electronics. Microsoft is where it is today because it exploited a positive feedback loop. So did Dolby (see Strategy in Action 7.1).

**Figure 7.2** Positive Feedback in the Market for VCRs



## 7.1 STRATEGY IN ACTION

### How Dolby Became the Standard in Sound Technology

Inventor Ray Dolby's name has become synonymous with superior sound in homes, movie theaters, and recording studios. The technology produced by his company, Dolby Laboratories, is part of nearly every music cassette and cassette recorder, prerecorded videotape, and, most recently, DVD movie disc and player. Since 1976, close to 1.5 billion audio products that use Dolby's technology have been sold worldwide. More than 44,000 movie theaters now show films in Dolby Digital Surround Sound, and some 50 million Dolby Digital home theater receivers have been sold since 1999. Dolby technology has become the de facto industry standard for high-quality sound in the music and film industry. How did Dolby build this technology franchise?

The story goes back to 1965 when Dolby Laboratories was founded in London by Ray Dolby (the company's headquarters moved to San Francisco in 1976). Dolby, who had a PhD in physics from Cambridge University in England, had invented a technology for reducing the background hiss in professional tape recording without compromising the quality of the material being recorded. In 1968, Dolby reached an agreement to license his noise-reduction technology to KLH, a highly regarded American producer of audio equipment (record players and tape decks) for the consumer market. Soon other manufacturers of consumer equipment started to approach Dolby to license the technology. Dolby briefly considered manufacturing record players and tape decks for the consumer market, but as he later commented, "I knew that if we entered that market and tried to make something like a cassette deck, we would be in competition with any licensee that we took on. . . . So we had to stay out of manufacturing in that area in order to license in that area."

Dolby adopted a licensing business model and then had to determine what licensing fee to charge. He knew his technology was valuable, but he also understood that charging a high licensing fee would encourage manufacturers to invest in developing their own noise-reduction technology. He decided to charge a modest fee to reduce the incentive that manufacturers would have to develop their own technology. Then there was the question of which companies to license to. Dolby wanted the Dolby name associated

with superior sound, so he needed to make sure that licensees adhered to quality standards. Therefore, the company set up a formal quality-control program for its licensees' products. Licensees have to agree to have their products tested by Dolby, and the licensing agreement states that they cannot sell products that do not pass Dolby's quality tests. By preventing products with substandard performance from reaching the market, Dolby has maintained the quality image of products featuring Dolby technology and trademarks. Today, Dolby Laboratories tests samples of hundreds of licensed products every year under this program. By making sure that the Dolby name is associated with superior sound quality, Dolby's quality assurance strategy has increased the power of the Dolby brand, making it very valuable to license.

Another key aspect of Dolby's strategy was born in 1970 when Dolby began to promote the idea of releasing prerecorded cassettes encoded with Dolby noise-reduction technology so that they would have low noise when played on players equipped with Dolby noise-reduction technology. Dolby decided to license the technology on prerecorded tapes for free, opting to collect licensing fees just from the sales of tape players that used Dolby technology. This strategy was hugely successful and set up a positive feedback loop that helped to make Dolby technology ubiquitous. Growing sales of prerecorded tapes encoded with Dolby technology created a demand for players that contained Dolby technology. As the installed base of players with Dolby technology grew, the proportion of prerecorded tapes that were encoded with Dolby technology surged, further boosting demand for players incorporating Dolby technology. By the mid-1970s, virtually all prerecorded tapes were encoded with Dolby noise-reduction technology. This strategy remains in effect today for all media recorded with Dolby technology and encompasses not only videocassettes but also video games and DVD releases encoded with Dolby Surround or Dolby Digital.

As a result of its licensing and quality assurance strategies, Dolby has become the standard for high-quality sound in the music and film industries. Although the company is not large—its revenues were \$537 million in 2008—its influence is large. It continues to push the boundaries of sound-reduction technology (it has been

*(continued)*

a leader in digital sound since the mid-1980s) and has successfully extended its noise-reduction franchise, first into films, then into DVD and gaming technology, and finally onto the Web, where it has licensed its digital technology to a wide range of media companies for

digital music delivery and digital audio players, such as those built into personal computers and handheld music players. Dolby has also licensed its technology for use in the newest generation of products: high-definition DVDs.

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**Sources:** M. Snider, "Ray Dolby, Audio Inventor," *USA Today*, December 28, 2000, D3; D. Dritas, "Dealerscope Hall of Fame: Ray Dolby," *Dealerscope*, January 2002: 74–76; J. Pinkerton, "At Dolby Laboratories: A Clean Audio Pipe," *Dealerscope*, December 2000: 33–34; Company history archived at [www.dolby.com](http://www.dolby.com); L. Himelstein, "Dolby Gets Ready to Make a Big Noise," *BusinessWeek*, February 9, 2004, 78; D. Pomerantz, "Seeing in Dolby," *Forbes*, January 30, 2006, 56.

An important implication of the positive feedback process is that as the market settles on a standard, companies promoting alternative standards can become locked out of the market when consumers are unwilling to bear the switching costs required for them to abandon the established standard and adopt the new standard. In this context, *switching costs* are the costs that consumers must bear to switch from a product based on one technological standard to a product based on another.

For illustration, imagine that a company developed an operating system for PCs that was both faster and more stable than the current standard in the marketplace, Microsoft Windows. Would this company be able to gain significant market share from Microsoft? They could do so only with great difficulty. Consumers buy PCs not for their operating systems but for the applications that run on that system. A new operating system would initially have a very small installed base, so few developers would be willing to take the risks in writing word processing programs, spreadsheets, games, and other applications for that operating system. Because there would be very few applications available, consumers who did make the switch would have to bear the switching costs associated with giving up some of their applications—something that they might be unwilling to do. Moreover, even if applications were available for the new operating system, consumers would have to bear the costs of purchasing those applications, another source of switching costs. In addition, they would have to bear the costs associated with learning to use the new operating system, yet another source of switching costs. Thus, many consumers would be unwilling to switch even if the new operating system performed better than Windows, and the company promoting the new operating system would be locked out of the market.

However, consumers will bear switching costs if the benefits of adopting the new technology outweigh the costs of switching. For example, in the late 1980s and early 1990s, millions of people switched from analog record players to digital CD players, even though the switching costs were significant: they had to purchase the new player technology, and many people purchased duplicate copies of their favorite music recordings. They nevertheless made the switch because for many people, the perceived benefit—the incredibly better sound quality associated with CDs—outweighed the costs of switching.

As this process started to get under way, a positive feedback started to develop, with the growing installed base of CD players leading to an increase in the number of music recordings issued on CDs, as opposed to or in addition to vinyl records. Past some point, the installed base of CD players got so big that music companies started to issue recordings on CDs only. Once this happened, even those who did

not want to switch to the new technology were required to do so if they wished to purchase new music recordings. The industry standard had shifted: the new technology had locked in as the standard, and the old technology was locked out. It follows that despite its dominance, the Wintel standard for PCs could one day be superseded if a competitor finds a way of providing sufficient benefits that enough consumers are willing to bear the switching costs associated with moving to a new operating system. Indeed, there are signs that Apple is starting to chip away at the dominance of the Wintel standard, primarily by using elegant design and ease of use as tools to get people to bear the costs of switching from Wintel computers to Apple machines.

## STRATEGIES FOR WINNING A FORMAT WAR

From the perspective of a company pioneering a new technological standard in a marketplace where network effects and positive feedback loops operate, the key question becomes, “What strategy should we pursue to establish our format as the dominant one?”

The various strategies that companies should adopt to win format wars revolve around *finding ways to make network effects work in their favor and against their competitors*. Winning a format war requires a company to build the installed base for its standard as rapidly as possible, thereby leveraging the positive feedback loop, inducing consumers to bear switching costs and ultimately locking the market into its technology. It requires the company to jump-start and then accelerate demand for its technological standard or format such that it becomes established as quickly as possible as the industry standard, thereby locking out competing formats. There are a number of key strategies and tactics that can be adopted to achieve this.<sup>6</sup>

### Ensure a Supply of Complements

It is important for the company to make sure that, in addition to the product itself, there is an adequate supply of complements. For example, no one will buy the Sony PlayStation 3 unless there is an adequate supply of games to run on that machine. Companies normally take two steps to ensure an adequate supply of complements.

First, they may diversify into the production of complements and seed the market with sufficient supply to help jump-start demand for their format. Before Sony produced the original PlayStation in the early 1990s, it established its own in-house unit to produce video games for the PlayStation. When it launched the PlayStation, Sony also simultaneously issued 16 games to run on the machine, giving consumers a reason to purchase the format. Second, companies may create incentives or make it easy for independent companies to produce complements. Sony also licensed the right to produce games to a number of independent game developers, charged the developers a lower royalty rate than they had to pay to competitors such as Nintendo and Sega, and provided them with software tools that made it easier for them to develop the games (note that Apple is now doing the same thing with its smartphones—see the Opening Case). Thus, the launch of the Sony PlayStation was accompanied by the simultaneous launch of compatible games, which quickly helped to stimulate demand for the machine.

## Leverage Killer Applications

**Killer applications** are applications or uses of a new technology or product that are so compelling that they persuade customers to adopt the new format or technology in droves, thereby “killing” demand for competing formats. Killer applications often help to jump-start demand for the new standard. For example, the killer applications that induced consumers to sign up to online services such as AOL in the 1990s were e-mail, chat rooms, and the ability to browse the Web.

Ideally, the company promoting a technological standard will want to develop the killer applications itself—that is, develop the appropriate complementary products. However, it may also be able to leverage the applications that others develop. For example, the early sales of the IBM PC following its 1981 introduction were driven primarily by IBM’s decision to license two important software programs for the PC, VisiCalc (a spreadsheet program) and Easy Writer (a word processing program), both developed by independent companies. IBM saw that they were driving rapid adoption of rival PCs, such as the Apple II, so it quickly licensed them, produced versions that would run on the IBM PC, and sold them as complements to the IBM PC, a strategy that was to prove very successful.

## Aggressively Pricing and Marketing

A common tactic to jump-start demand is to adopt a **razor and blade strategy**: pricing the product (razor) low to stimulate demand and increase the installed base and then trying to make high profits on the sale of complements (razor blades), which are priced relatively high. This strategy owes its name to the fact that it was pioneered by Gillette to sell its razors and razor blades. Many other companies have followed this strategy. For example, HP typically sells its printers at cost but makes significant profits on the subsequent sale of its replacement cartridges. In this case, the printer is the “razor,” and it is priced low to stimulate demand and induce consumers to switch from their existing printer, while the cartridges are the “blades,” which are priced high to make profits. The inkjet printer represents a proprietary technological format because only HP cartridges can be used with printers, not cartridges designed for competing inkjet printers, such as those sold by Canon. A similar strategy is used in the gaming industry: manufacturers price gaming consoles at cost to induce consumers to adopt their technology, while making profits on the royalties they receive from the sales of games that run on their system.

Aggressive marketing is also a key factor in jump-starting demand to get an early lead in an installed base. Substantial upfront marketing and point-of-sales promotion techniques are often used to get potential early adopters to bear the switching costs associated with adopting the format. If these efforts are successful, they can be the start of a positive feedback loop. Again, the Sony PlayStation provides a good example. Sony linked the introduction of the PlayStation with nationwide television advertising aimed at its primary demographic (18- to 34-year-olds) and in-store displays that allowed potential buyers to play games on the machine before making a purchase.

## Cooperate with Competitors

Companies have been close to simultaneously introducing competing and incompatible technological standards a number of times. A good example is the compact disc. Initially four companies—Sony, Philips, JVC, and Telefunken—were developing CD

players using different variations of the underlying laser technology. If this situation had persisted, they might have ultimately introduced incompatible technologies into the marketplace, so a CD made for a Philips CD player would not play on a Sony CD player. Understanding that the nearly simultaneous introduction of such incompatible technologies can create significant confusion among consumers and often leads them to delay their purchases, Sony and Philips decided to join forces with each other and cooperate on developing the technology. Sony contributed its error correction technology, and Philips contributed its laser technology. The result of this cooperation was that momentum among other players in the industry shifted toward the Sony-Philips alliances; JVC and Telefunken were left with little support. Most important, recording labels announced that they would support the Sony-Philips format but not the Telefunken or JVC format. Telefunken and JVC subsequently decided to abandon their efforts to develop CD technology. The cooperation between Sony and Philips was important because it reduced confusion in the industry and allowed a single format to rise to the fore, which speeded up adoption of the technology. The cooperation was a win-win situation for both Philips and Sony. It eliminated the competitors and enabled the companies to share in the success of the format.

## License the Format

Another strategy often adopted is to license the format to other enterprises so that they can produce products based on it. The company that pioneered the format gains from the licensing fees that flow back to it and from the enlarged supply of the product, which can stimulate demand and help accelerate market adoption. This was the strategy that Matsushita adopted with its VHS format for the VCR. In addition to producing VCRs at its own factory in Osaka, Matsushita allowed a number of other companies to produce VHS format players under license (Sony decided not to license its competing Betamax format and produced all Betamax format players itself); hence, VHS players were more widely available. More people purchased VHS players, which created an incentive for film companies to issue more films on VHS tapes (as opposed to Betamax tapes), which further increased demand for VHS players and helped Matsushita to lock in VHS as the dominant format in the marketplace. Sony, ironically the first to market, saw its position marginalized by the reduced supply of the critical complement, prerecorded films, and ultimately withdrew Betamax players from the consumer marketplace.

Dolby, as we saw in Strategy in Action 7.1, adopted a similar licensing strategy to get its noise-reduction technology adopted as the technological standard in the music and film industries. By charging a modest licensing fee for use of the technology in recording equipment and forgoing licensing fees on media recorded using Dolby technology, Dolby deliberately sought to reduce the financial incentive that potential competitors might have to develop their own, possibly superior, technology. Dolby calculated that its long-run profitability would be maximized by adopting a licensing strategy that limited the incentive of competitors to enter the market.

The correct strategy to pursue in a particular scenario requires that a company consider all of these different strategies and tactics and pursue those that seem most appropriate given the competitive circumstances prevailing in the industry and the likely strategy of rivals. Although there is no one best mix of strategies and tactics, a company must keep the goal of rapidly increasing the installed base of products based on its standard at the front of its mind. By helping to jump-start demand for



its format, a company can induce consumers to bear the switching costs associated with adopting its technology and leverage any positive feedback process that might exist. Also important is not pursuing strategies that have the opposite effect. For example, pricing high to capture profits from early adopters, who tend not to be as price sensitive as later adopters, can have the unfortunate effect of slowing demand growth and letting a more aggressive competitor pick up share and establish its format as the industry standard.

## COSTS IN HIGH-TECHNOLOGY INDUSTRIES

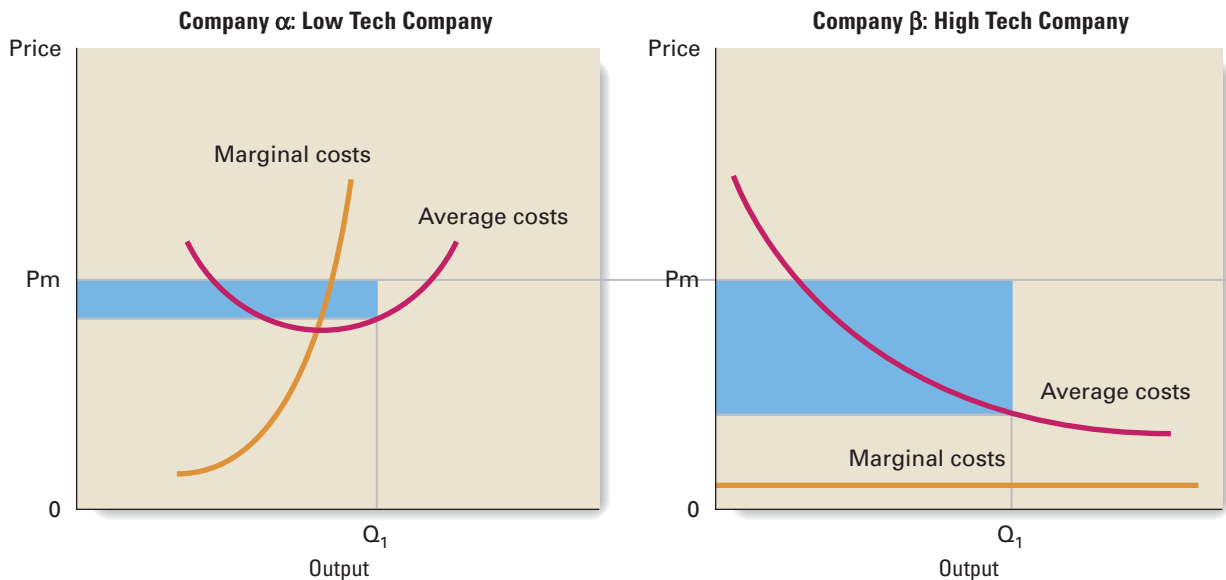
In many high-tech industries, the fixed costs of developing the product are very high, but the costs of producing one extra unit of the product are very low. This is most obvious in the case of software. For example, it reportedly cost Microsoft \$5 billion to develop Windows Vista, the latest version of its Windows operating system, but the cost of producing one more copy of Windows Vista is virtually zero. Once Windows Vista was completed, Microsoft produced master disks that it sent out to PC manufacturers, such as Dell Computer, who then loaded a copy of Windows Vista onto every PC it sold. The cost to Microsoft was effectively zero, yet it receives a significant licensing fee for each copy of Windows Vista installed on a PC.<sup>7</sup> For Microsoft, the marginal cost of making one more copy of Windows Vista is close to zero, although the fixed costs of developing the product are \$5 billion.

Many other high-tech products have similar cost economics: very high fixed costs and very low marginal costs. Most software products share these features, although if the software is sold through stores, the costs of packaging and distribution will raise the marginal costs, and if it is sold by a sales force direct to end-users, this will also raise the marginal costs. Many consumer electronics products have the same basic economics. The fixed costs of developing a DVD player or a gaming console can be very expensive, but the costs of producing an incremental unit are very low. The costs of developing a new drug, such as Viagra, can run to more than \$800 million, but the marginal cost of producing each additional pill is at most a few cents.

### Comparative Cost Economics

To grasp why this cost structure is strategically important, a company must understand that, in many industries, marginal costs rise as a company tries to expand output (economists call this the *law of diminishing returns*). To produce more of a good, a company has to hire more labor and invest in more plant and machinery. At the margin, the additional resources used are not as productive, so this leads to increasing marginal costs. However, the law of diminishing returns often does not apply in many high-tech settings, such as the production of software or sending one more bit of data down a digital telecommunications network.

Consider two companies,  $\alpha$  and  $\beta$  (see Figure 7.3). Company  $\alpha$  is a conventional producer and faces diminishing returns, so as it tries to expand output, its marginal costs rise. Company  $\beta$  is a high-tech producer, and its marginal costs do not rise as output is increased. Note that in Figure 7.3, company  $\beta$ 's marginal cost curve is drawn as a straight line near the horizontal axis, implying that marginal costs are close to zero and do not vary with output, whereas company  $\alpha$ 's marginal costs rise

**Figure 7.3** Cost Structures in High-Technology Industries

as output is expanded, illustrating diminishing returns. Company β's flat and low marginal cost curve means that its average cost curve will fall continuously over all ranges of output as it spreads its fixed costs out over greater volume. In contrast, the rising marginal costs encountered by company α mean that its average cost curve is the U-shaped curve familiar from basic economics texts. For simplicity, assume that both companies sell their product at the same price,  $P_m$ , and both sell exactly the same quantity of output,  $0 - Q_1$ . You will see from Figure 7.3 that at an output of  $Q_1$ , company β has much lower average costs than company α and, as a consequence, is making far more profit (profit is the shaded area in Figure 7.3).

### Strategic Significance

If a company can shift from a cost structure where it encounters increasing marginal costs to one where fixed costs may be high but marginal costs are much lower, its profitability may increase. In the consumer electronics industry, such a shift has been playing out for two decades. Music recordings previously were based on analog technology, where marginal costs rose as output expanded due to diminishing returns (as in the case of company α in Figure 7.3). Since the 1980s, digital systems such as CD players have replaced analog systems. Digital systems are software based, and this implies much lower marginal costs of producing one more copy of a recording. As a result, the music labels have been able to lower prices, expand demand, and see their profitability increase (their production system has more in common with company β in Figure 7.3).

This process is still unfolding. The latest technology for making copies of music recordings is based on distribution over the Internet (for example, by downloading onto an iPod). In this case, the marginal costs of making one more copy of a recording are lower still. In fact, they are close to zero and do not increase with output. The

only problem is that the low costs of copying and distributing music recordings have created a major copyright problem that the major music labels have yet to solve. (We will discuss this in more detail shortly when we consider intellectual property rights.) The same shift is now beginning to affect other industries. Some companies are building their strategies around trying to exploit and profit from this shift. For an example, Strategy in Action 7.2 looks at SonoSite.

Another implication of its cost structure is that when a high-tech company faces high fixed costs and low marginal costs, its strategy should emphasize the low-cost option: deliberately drive prices down to drive volume up. Look again at Figure 7.3 and you will see that the high-tech company's average costs fall rapidly as output expands. This implies that prices can be reduced to stimulate demand, and so long

## 7.2 STRATEGY IN ACTION

### Lowering the Cost of Ultrasound Equipment Through Digitalization

The ultrasound unit has been an important piece of diagnostic equipment in hospitals for some time. Ultrasound units use the physics of sound to produce images of soft tissues in the human body. They can produce detailed, three-dimensional color images of organs and, by using contrast agents, track the flow of fluids through an organ. A cardiologist, for example, can use an ultrasound in combination with contrast agents injected into the bloodstream to track the flow of blood through a beating heart. In addition to the visual diagnosis, ultrasound also produces an array of quantitative diagnostic information of great value to physicians.

Modern ultrasound units are sophisticated instruments that cost \$250,000 to \$300,000 each for a top-line model. They are fairly bulky instruments, weighing some 300 pounds, and are wheeled around hospitals on carts.

A few years back, a group of researchers at ATL, one of the leading ultrasound companies, came up with an idea for reducing the size and cost of a basic unit. They theorized that it might be possible to replace up to 80% of the solid circuits in an ultrasound unit with software, in the process significantly shrinking the size and reducing the weight of machines and thereby producing portable ultrasound units. Moreover, by digitalizing much of the ultrasound unit, replacing hardware with software, they could considerably drive down the marginal costs of making additional units and would thus be able to make a good profit at much lower price points.

The researchers reasoned that a portable and inexpensive ultrasound unit would find market opportunities in totally new niches. For example, a small, inexpensive ultrasound unit could be placed in an ambulance, carried into battle by an army medic, or purchased by family physicians for use in their offices. Although they realized that it would be some time, perhaps decades, before such small, inexpensive machines could attain the image quality and diagnostic sophistication of top-of-the-line machines, they saw the opportunity in terms of creating market niches that previously could not be served by ultrasound companies because of the high costs and bulk of the product.

The researchers ultimately became a project team within ATL and were then spun out of ATL as an entirely new company, SonoSite. In late 1999, they introduced their first portable product, weighing just six pounds and costing about \$25,000. SonoSite targeted niches that full-sized ultrasound products could not reach: ambulatory care and foreign markets that could not afford the more expensive equipment. In 2008, the company sold more than \$200 million worth of its product. In the long run, SonoSite plans to build more features and greater image quality into the small handheld machines, primarily by improving the software. This could allow the units to penetrate United States hospital markets that currently purchase the established technology, much as client-server systems based on PC technology came to replace mainframes for some functions in business corporations.

**Source:** Interviews by Charles W. L. Hill.

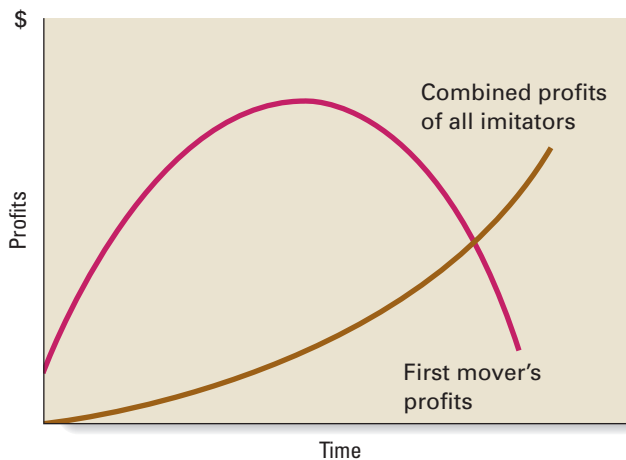
as prices fall less rapidly than average costs, per unit profit margins will expand as prices fall. This is a consequence of the fact that the firm's marginal costs are low and do not rise with output. This strategy of pricing low to drive volume and reap wider profit margins is central to the business model of some very successful high-tech companies, including Microsoft.

## CAPTURING FIRST-MOVER ADVANTAGES

In high-tech industries, companies often compete by striving to be the first to develop revolutionary new products, that is, to be a **first mover**. By definition, the first mover with regard to a revolutionary product is in a monopoly position. If the new product satisfies unmet consumer needs and demand is high, the first mover can capture significant revenues and profits. Such revenues and profits signal to potential rivals that there is money to be made by imitating the first mover. As illustrated in Figure 7.4, in the absence of strong barriers to imitation, this implies that imitators will rush into the market created by the first mover, competing away the first mover's monopoly profits and leaving all participants in the market with a much lower level of returns.

Despite imitation, some first movers have the ability to capitalize on and reap substantial first-mover advantages—the advantages of pioneering new technologies and products that lead to an enduring competitive advantage. Intel introduced the world's first microprocessor in 1971 and today still dominates the microprocessor segment of the semiconductor industry. Xerox introduced the world's first photocopier and for a long time enjoyed a leading position in the industry. Cisco introduced the first Internet protocol network router in 1986 and still dominates the market for that equipment today. Some first movers can reap substantial advantages from their pioneering activities that lead to an enduring competitive advantage. They can, in other words, limit or slow the rate of imitation.

**Figure 7.4** The Impact of Imitation on Profits of a First Mover



But there are plenty of counterexamples suggesting that first-mover advantages might not be easy to capture. In fact, that there might be **first-mover disadvantages**—the competitive disadvantages associated with being first. For example, Apple Computer was the first company to introduce a handheld computer, the Apple Newton, but the product failed; a second mover, Palm, succeeded where Apple had failed. In the market for commercial jet aircraft, DeHavilland was the first to market with the Comet, but it was the second mover, Boeing, with its 707 jetliner, that went on to dominate the market.

Clearly being a first mover does not by itself guarantee success. As we shall see, the difference between innovating companies that capture first-mover advantages and those that fall victim to first-mover disadvantages in part turns on the strategy that the first mover pursues. Before considering the strategy issue, however, we need to take a closer look at the nature of first-mover advantages and disadvantages.<sup>8</sup>

## First-Mover Advantages

There are five main sources of first-mover advantages.<sup>9</sup> First, the first mover has an opportunity to exploit network effects and positive feedback loops, locking consumers into its technology. In the VCR industry, Sony could have exploited network effects by licensing its technology, but instead the company ceded its first-mover advantage to the second mover, Matsushita.

Second, the first mover may be able to establish significant brand loyalty, which is expensive for later entrants to break down. Indeed, if the company is successful in this endeavor, its name may become closely associated with the entire class of products, including those produced by rivals. People still talk of “Xeroxing” when they are going to make a photocopy or “FedExing” when they are going to send a package by overnight mail, and when we want to find something on the Web, we “Google” it.

Third, the first mover may be able to ramp up sales volume ahead of rivals and thus reap cost advantages associated with the realization of scale economies and learning effects (see Chapter 4). Once the first mover has these cost advantages, it can respond to new entrants by cutting prices to hold onto its market share and still earn significant profits.

Fourth, the first mover may be able to create switching costs for its customers that subsequently make it difficult for rivals to enter the market and take customers away from the first mover. Wireless service providers, for example, will give new customers a “free” wireless phone, but customers must sign a contract agreeing to pay for the phone if they terminate the service contract within a specified time period, such as a year. Because the real cost of a wireless phone may run from \$100 to \$200, this represents a significant switching cost that later entrants have to overcome.

Finally, the first mover may be able to accumulate valuable knowledge related to customer needs, distribution channels, product technology, process technology, and so on. This accumulated knowledge gives it a knowledge advantage that later entrants might find difficult or expensive to match. Sharp, for example, was the first mover in the commercial manufacture of active matrix liquid crystal displays (LCDs) used in laptop computers. The process for manufacturing these displays is very difficult, with a high reject rate for flawed displays. Sharp has accumulated such an advantage with regard to production processes that it has been very difficult for later entrants to match it on product quality, and thus costs.

## First-Mover Disadvantages

Balanced against these first-mover advantages are a number of disadvantages.<sup>10</sup> First, the first mover has to bear significant pioneering costs that later entrants do not. The first mover has to pioneer the technology, develop distribution channels, and educate customers about the nature of the product. All of this can be expensive and time-consuming. Later entrants, by way of contrast, might be able to free-ride on the first mover's investments in pioneering the market and customer education.

Related to this, first movers are more prone to make mistakes because there are so many uncertainties in a new market. Later entrants may be able to learn from the mistakes made by first movers, improve on the product or the way in which it is sold, and come to market with a superior offering that captures significant market share from the first mover. For example, one of the reasons that the Apple Newton failed was that the handwriting software in the handheld computer failed to recognize human handwriting. The second mover in this market, Palm, learned from Apple's error. When it introduced the PalmPilot, it used software that recognized letters written in a particular way, Graffiti, and then persuaded customers to learn this method of inputting data into the handheld computer.

Third, first movers run the risk of building the wrong resources and capabilities because they are focusing on a customer set that is not going to be characteristic of the mass market. This is the *crossing the chasm* problem that we discussed in the previous chapter. You will recall that the customers in the early market—those we categorized as innovators and early adopters—have different characteristics from the first wave of the mass market, the early majority. The first mover runs the risk of gearing its resources and capabilities to the needs of innovators and early adopters and not being able to switch when the early majority enters the market. As a result, first movers run a greater risk of plunging into the chasm that separates the early market from the mass market.

Finally, the first mover may invest in inferior or obsolete technology. This can happen when its product innovation is based on underlying technology that is advancing rapidly. By basing its product on an early version of the technology, it may lock itself into something that rapidly becomes obsolete. In contrast, later entrants may be able to leapfrog the first mover and introduce products that are based on later versions of the underlying technology. This happened in France during the 1980s when, at the urging of the government, France Telecom introduced the world's first consumer online service, Minitel. France Telecom distributed crude terminals to consumers for free, which they could hook up to their phone line and use to browse phone directories. Other simple services were soon added, and before long the French could carry out online shopping, banking, travel, weather, and news—all years before the Web was invented. The problem was that by the standards of the Web, Minitel was very crude and inflexible, and France Telecom, as the first mover, suffered. The French were very slow to adopt PCs and the Internet, primarily because Minitel had such a presence. As late as 1998, only one-fifth of French households had computers, compared with two-fifths in the United States, and only 2% of households were connected to the Internet, compared to more than 30% in the United States. As the result of a government decision, France Telecom, and indeed an entire nation, was slow to adopt a revolutionary new online medium, the Web, because they were the first to invest in a more primitive version of the technology.<sup>11</sup>



## Strategies for Exploiting First-Mover Advantages

The task facing a first mover is how to exploit its lead to capitalize on first-mover advantages and build a sustainable long-term competitive advantage while simultaneously reducing the risks associated with first-mover disadvantages. There are three basic strategies available: (1) develop and market the innovation itself, (2) develop and market the innovation jointly with other companies through a strategic alliance or joint venture, and (3) license the innovation to others and let them develop the market.

The optimal choice of strategy depends on the answers to three questions:

1. Does the innovating company have the complementary assets to exploit its innovation and capture first-mover advantages?
2. How difficult is it for imitators to copy the company's innovation? In other words, what is the height of barriers to imitation?
3. Are there capable competitors that could rapidly imitate the innovation?

**Complementary Assets** Complementary assets are the assets required to exploit a new innovation and gain a competitive advantage.<sup>12</sup> Among the most important complementary assets are competitive manufacturing facilities capable of handling rapid growth in customer demand while maintaining high product quality. State-of-the-art manufacturing facilities enable the first mover to move quickly down the experience curve without encountering production bottlenecks or problems with the quality of the product. The inability to satisfy demand because of these problems, however, creates the opportunity for imitators to enter the marketplace. For example, in 1998, Immunex was the first company to introduce a revolutionary new biological treatment for rheumatoid arthritis. Sales for this product, Enbrel, ramped up very rapidly, hitting \$750 million in 2001. However, Immunex had not invested in sufficient manufacturing capacity. In mid-2000, it announced that it lacked the capacity to satisfy demand and that bringing additional capacity online would take at least two years. This manufacturing bottleneck gave the second mover in the market, Johnson & Johnson, the opportunity to expand demand for its product rapidly, which by early 2002 was outselling Enbrel. Immunex's first-mover advantage had been partly eroded because it lacked an important complementary asset, the manufacturing capability required to satisfy demand.

Complementary assets also include marketing know-how, an adequate sales force, access to distribution systems, and an after-sales service and support network. All of these assets can help an innovator build brand loyalty and achieve market penetration more rapidly.<sup>13</sup> In turn, the resulting increases in volume facilitate more rapid movement down the experience curve and the attainment of a sustainable cost-based advantage due to scale economies and learning effects. One of the reasons that EMI, the first mover in the market for CT scanners, ultimately lost out to established medical equipment companies, such as GE Medical Systems, was that it lacked the marketing know-how, sales force, and distribution systems required to compete effectively in the world's largest market for medical equipment, the United States.

Developing complementary assets can be very expensive, and companies often need large infusions of capital for this purpose. That is why first movers often lose out to late movers that are large, successful companies in other industries with the resources to quickly develop a presence in the new industry. Microsoft and 3M exemplify companies that can move quickly to capitalize on the opportunities when other

companies open up new product markets, such as CDs or floppy disks. For example, although Netscape pioneered the market for Internet browsers with the Netscape Navigator, Microsoft's Internet Explorer ultimately dominated the market for Internet browsers.

**Height of Barriers to Imitation** Recall from Chapter 3 that barriers to imitation are factors that prevent rivals from imitating a company's distinctive competencies and innovations. Although ultimately any innovation can be copied, the higher the barriers are, the longer it takes for rivals to imitate, and the more time the first mover has to build an enduring competitive advantage.

Barriers to imitation give an innovator time to establish a competitive advantage and build more enduring barriers to entry in the newly created market. Patents, for example, are among the most widely used barriers to imitation. By protecting its photocopier technology with a thicket of patents, Xerox was able to delay any significant imitation of its product for 17 years. However, patents are often easy to "invent around." For example, one study found that this happened to 60% of patented innovations within four years.<sup>14</sup> If patent protection is weak, a company might try to slow imitation by developing new products and processes in secret. The most famous example of this approach is Coca-Cola, which has kept the formula for Coke a secret for generations. But Coca-Cola's success in this regard is an exception. A study of 100 companies has estimated that proprietary information about a company's decision to develop a major new product or process is known to its rivals within about 12 to 18 months of the original development decision.<sup>15</sup>

**Capable Competitors** Capable competitors are companies that can move quickly to imitate the pioneering company. A competitor's capability to imitate a pioneer's innovation depends primarily on two factors: (1) R&D skills and (2) access to complementary assets. In general, the greater the number of capable competitors with access to the R&D skills and complementary assets needed to imitate an innovation, the more rapid imitation is likely to be.

In this context, R&D skills refer to the ability of rivals to reverse-engineer an innovation to find out how it works and quickly develop a comparable product. As an example, consider the CT scanner. GE bought one of the first CT scanners produced by EMI, and its technical experts reverse-engineered it. Despite the product's technological complexity, GE developed its own version, which allowed it to imitate EMI quickly and ultimately replace EMI as the major supplier of CT scanners.

With regard to complementary assets, the access that rivals have to marketing, sales know-how, or manufacturing capabilities is one of the key determinants of the rate of imitation. If would-be imitators lack critical complementary assets, not only do they have to imitate the innovation, but they may also have to imitate the innovator's complementary assets. This is expensive, as AT&T discovered when it tried to enter the PC business in 1984. AT&T lacked the marketing assets (sales force and distribution systems) necessary to support PC products. The lack of these assets and the time it takes to build them partly explain why, four years after it entered the market, AT&T had lost \$2.5 billion and still had not emerged as a viable contender. It subsequently pulled out of this business.

**Three Innovation Strategies** The way in which these three factors—complementary assets, height of barriers to imitation, and the capability of competitors—influence the choice of innovation strategy is summarized in Table 7.1. The competitive

**Table 7.1** Strategies for Profiting from Innovation

Strategy	Does the Innovator Have the Required Complementary Assets?	Likely Height of Barriers to Imitation	Number of Capable Competitors
Going it alone	Yes	High	Very few
Entering into an alliance	No	High	Moderate number
Licensing the innovation	No	Low	Many

### Ethics Exercise

Your company is in a race with two other enterprises to develop a standard for streaming high-definition video over the Internet. You know that your technology is significantly inferior to your rivals, but you will likely be first to market. Moreover, you know that bundling your product with a very popular system that your company already sells should ensure widespread early adoption. Because your company makes enough money from its other products, you consider initially pricing the new product at zero to ensure rapid take-up to shut out your rivals' superior technology. Once the market has locked into your offering, you can raise the price. One of your colleagues suggests it is unethical to use financial muscle and bundling strategies to lock out a superior technology. Do you agree with him? Why? Can you think of a real-world situation that is similar to this case?

strategy of developing and marketing the innovation alone makes most sense when (1) the innovator has the complementary assets necessary to develop the innovation, (2) the barriers to imitating a new innovation are high, and (3) the number of capable competitors is limited. Complementary assets allow rapid development and promotion of the innovation. High barriers to imitation buy the innovator time to establish a competitive advantage and build enduring barriers to entry through brand loyalty or experience-based cost advantages. The fewer the capable competitors there are, the less likely it is that any one of them will succeed in circumventing barriers to imitation and quickly imitating the innovation.

The competitive strategy of developing and marketing the innovation jointly with other companies through a strategic alliance or joint venture makes most sense when (1) the innovator lacks complementary assets, (2) barriers to imitation are high, and (3) there are several capable competitors. In such circumstances, it makes sense to enter into an alliance with a company that already has the complementary assets—in other words, with a capable competitor. Theoretically, such an alliance should prove to be mutually beneficial, and each partner can share in high profits that neither could earn on its own. Moreover, such a strategy has the benefit of co-opting a potential rival. For example, had EMI teamed up with a capable competitor to develop the market for CT scanners, such as GE Medical Systems, instead of going it alone, the company might not only have been able to build a more enduring competitive advantage, but it would also have co-opted a potentially powerful rival into its camp.

The third strategy, licensing, makes most sense when (1) the innovating company lacks the complementary assets, (2) barriers to imitation are low, and (3) there are many capable competitors. The combination of low barriers to imitation and many capable competitors makes rapid imitation almost certain. The innovator's lack of complementary assets further suggests that an imitator will soon capture the innovator's competitive advantage. Given these factors, because rapid diffusion of the innovator's technology through imitation is inevitable, the innovator can at least share in some of the benefits of this diffusion by licensing out its technology.<sup>16</sup> Moreover, by setting a relatively modest licensing fee, the innovator may be able to reduce the incentive that potential rivals have to develop their own competing, and possibly superior, technology. This seems to have been the strategy Dolby adopted to get its technology established as the standard for noise reduction in the music and film businesses (see Strategy in Action 7.1).

## TECHNOLOGICAL PARADIGM SHIFTS

**Technological paradigm shifts** occur when new technologies come along that revolutionize the structure of the industry, dramatically alter the nature of competition, and require companies to adopt new strategies to survive. A good example of a paradigm shift that is currently unfolding is the shift from chemical to digital photography (another example of digitalization). For more than half a century, the large incumbent enterprises in the photographic industry, such as Kodak and Fujifilm, have generated most of their revenues from selling and processing film using traditional silver halide technology. The rise of digital photography has been a huge disruptive threat to their business models. Digital cameras do not use film, the mainstay of Kodak's and Fuji's business. Moreover, these cameras are more like specialized computers than conventional cameras and are thus based on scientific knowledge that Kodak and Fuji have little expertise in. Although both Kodak and Fuji have invested heavily in the development of digital cameras, they are facing intense competition from companies such as Sony, Canon, and HP, which have developed their own digital cameras; from software developers such as Adobe and Microsoft, which make the software for manipulating digital images; and from printer companies such as HP and Canon, which are making the printers that consumers can use to print out their own high-quality pictures at home. As digital substitution gathers speed in the photography industry, it is not clear that the traditional incumbents will be able to survive this shift; the new competitors might well rise to dominance in the new market.

Kodak and Fuji are hardly the first large incumbents to be felled by a technological paradigm shift in their industry. In the early 1980s, the computer industry was revolutionized by the arrival of PC technology, which gave rise to client-server networks that replaced traditional mainframe and minicomputers for many business uses. Many incumbent companies in the mainframe era, such as Wang, Control Data, and DEC, ultimately did not survive, and even IBM went through a decade of wrenching changes and large losses before it reinvented itself as a provider of e-business solutions. In their place, new entrants such as Microsoft, Intel, Dell, and Compaq rose to dominance in this new computer industry.

Examples such as these raise four questions:

1. When do paradigm shifts occur, and how do they unfold?
2. Why do so many incumbents go into decline following a paradigm shift?
3. What strategies can incumbents adopt to increase the probability that they will survive a paradigm shift and emerge on the other side of the market abyss created by the arrival of new technology as a profitable enterprise?
4. What strategies can new entrants into a market adopt to profit from a paradigm shift?

We answer each of these questions in the remainder of this chapter.

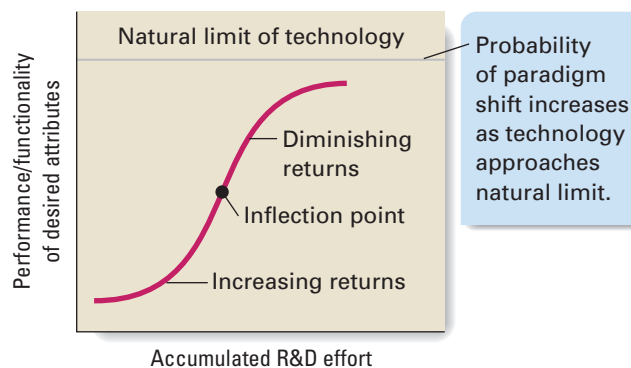
### Paradigm Shifts and the Decline of Established Companies

Paradigm shifts appear to be more likely to occur in an industry when one, or both, of the following conditions are in place.<sup>17</sup> First, the established technology in the industry is mature and approaching or at its “natural limit,” and second, a new “disruptive technology” has entered the marketplace and is taking root in niches that are poorly served by incumbent companies using the established technology.

**The Natural Limits to Technology** Richard Foster has formalized the relationship between the performance of a technology and time in terms of what he calls the technology S-curve (see Figure 7.5).<sup>18</sup> This curve shows the relationship over time of cumulative investments in R&D and the performance (or functionality) of a given technology. Early in its evolution, R&D investments in a new technology tend to yield rapid improvements in performance as basic engineering problems are solved. After a time, diminishing returns to cumulative R&D begin to set in, the rate of improvement in performance slows, and the technology starts to approach its natural limit, where further advances are not possible. For example, one can argue that there was more improvement in the first 50 years of the commercial aerospace business following the pioneering flight by the Wright Brothers than there has been in the second 50 years. Indeed, the venerable Boeing 747 is based on a 1960s design. In commercial aerospace, therefore, we are now in the region of diminishing returns and may be approaching the natural limit to improvements in the technology of commercial aerospace.

Similarly, it can be argued that we are approaching the natural limit to technology in the performance of silicon-based semiconductor chips. Over the past two decades, the performance of semiconductor chips has been increased dramatically by packing ever more transistors onto a single small silicon chip. This process has helped to increase the power of computers, lower their cost, and shrink their size. But we are starting to approach limits to the ability to shrink the width of lines on a chip and therefore pack ever more transistors onto a single chip. The limit is imposed by the natural laws of physics. Light waves are used to help etch lines onto a chip, and one cannot etch a line that is smaller than the wavelength of light being used. Semiconductor companies are already using light with very small wavelengths, such as extreme ultraviolet, to etch lines onto a chip, but there are limits to how far this technology can be pushed, and many believe that we will reach those limits within the decade. Does this mean that our ability to make smaller, faster, cheaper computers is coming to an end? Probably not. It is more likely that we will find another technology to replace silicon-based computing and enable us to continue building smaller, faster, cheaper computers. In fact, several exotic competing technologies are already being developed that may replace silicon-based computing. These include self-organizing molecular computers, three-dimensional microprocessor technology, quantum computing technology, and using DNA to perform computations.<sup>19</sup>

**Figure 7.5** The Technology S-Curve

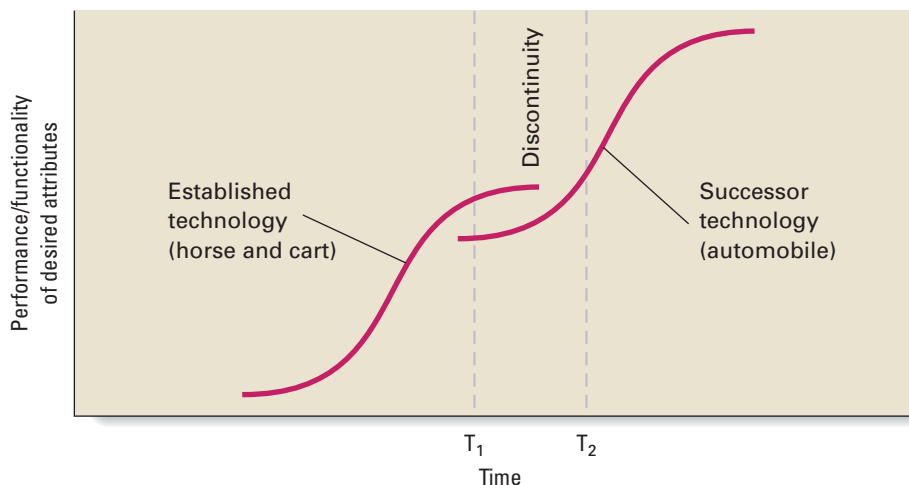


What does all of this have to do with paradigm shifts? According to Foster, when a technology approaches its natural limit, research attention turns to possible alternative technologies, and sooner or later one of those alternatives might be commercialized and replace the established technology. That is, the probability that a paradigm shift will occur increases. Thus, sometime in the next decade or two, another paradigm shift might shake the very foundations of the computer industry as exotic computing technology replaces silicon-based computing. If history is any guide, if and when this happens, many of the incumbents in today's computer industry will go into decline, and new enterprises will rise to dominance.

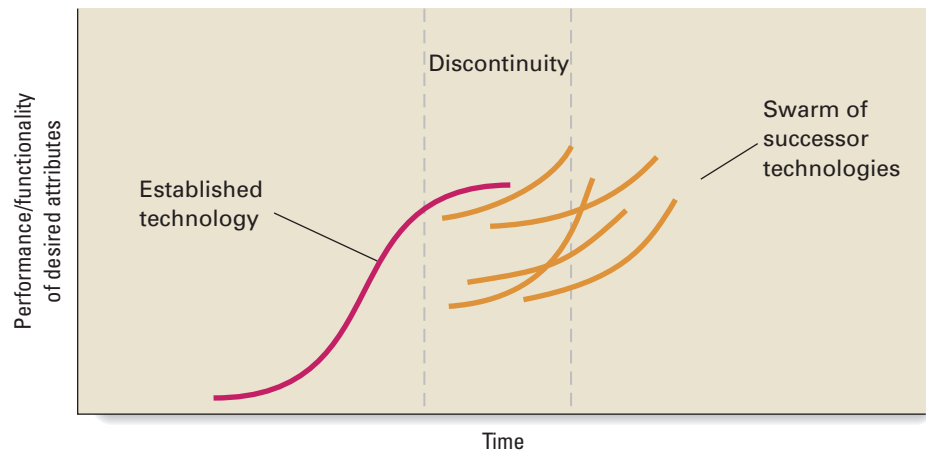
Foster pushes this point a little further, noting that, initially, the contenders for the replacement technology are not as effective as the established technology in producing the attributes and features that consumers demand in a product. For example, in the early years of the 20th century, automobiles were just starting to be produced. They were valued for their ability to move people from place to place, but so was the horse and cart (the established technology). When automobiles originally appeared, the horse and cart was still quite a bit better than the automobile at doing this (see Figure 7.6). After all, the first cars were slow, noisy, and prone to breakdown. Moreover, they needed a network of paved roads and gas stations to be really useful, and that network did not exist, so for most applications, the horse and cart was still the preferred mode of transportation—to say nothing of the fact that it was cheaper.

However, this comparison ignored the fact that in the early 20th century, automobile technology was at the very start of its S-curve and was about to experience dramatic improvements in performance as major engineering problems were solved (and those paved roads and gas stations were built). In contrast, after 3,000 years of continuous improvement and refinement, the horse and cart was almost definitely at the end of its technological S-curve. The result was that the rapidly improving automobile soon replaced the horse and cart as the preferred mode of transportation. At time  $T_1$  in Figure 7.6, the horse and cart was still superior to the automobile. By time  $T_2$ , the automobile had surpassed the horse and cart.

**Figure 7.6** Established and Successor Technologies





**Figure 7.7** Swarm of Successor Technologies

Foster notes that because the successor technology is initially less efficient than the established technology, established companies and their customers often make the mistake of dismissing it, only to be taken off-guard by its rapid performance improvement. A final point here is that often there is not one potential successor technology but a swarm of potential successor technologies, only one of which might ultimately rise to the fore (see Figure 7.7). When this is the case, established companies are put at a disadvantage. Even if they recognize that a paradigm shift is imminent, they may not have the resources to invest in all the potential replacement technologies. If they invest in the wrong one, something that is easy to do given the uncertainty that surrounds the entire process, they may be locked out of subsequent development.

**Disruptive Technology** Clayton Christensen built on Foster's insights and his own research to develop a theory of disruptive technology that has become very influential in high-technology circles.<sup>20</sup> Christensen uses the term *disruptive technology* to refer to a new technology that gets its start away from the mainstream of a market and then, as its functionality improves over time, invades the main market. Such technologies are disruptive because they revolutionize industry structure and competition, often causing the decline of established companies. They cause a technological paradigm shift.

Christensen's greatest insight is that established companies are often aware of the new technology but do not invest in it because they listen to their customers, and their customers do not want it. Of course, this arises because the new technology is early in its development—only at the beginning of the S-curve for that technology. Once the performance of the new technology improves, customers do want it, but by this time it is new entrants, as opposed to established companies, that have accumulated the knowledge required to bring the new technology into the mass market. Christensen supports his view by several detailed historical case studies, one of which is summarized in Strategy in Action 7.3.

In addition to listening too closely to their customers, Christensen also identified a number of other factors that make it very difficult for established companies to adopt a new disruptive technology. He noted that many established companies

## 7.3 STRATEGY IN ACTION

### Disruptive Technology in Mechanical Excavators

Excavators are used to dig out foundations for large buildings, trenches to lay large pipes for sewers and the like, and foundations and trenches for residential construction and farm work. Prior to the 1940s, the dominant technology used to manipulate the bucket on a mechanical excavator was based on a system of cables and pulleys. Although these mechanical systems could lift large buckets of earth, the excavators themselves were quite large, cumbersome, and expensive. Thus, they were rarely used to dig small trenches for house foundations, irrigation ditches for farmers, and the like. In most cases, these small trenches were dug by hand.

In the 1940s, a new technology made its appearance: hydraulics. In theory, hydraulic systems had certain advantages over the established cable and pulley systems. Most important, their energy efficiency was higher. For a given bucket size, a smaller engine would be required using a hydraulic system. However, the initial hydraulic systems also had drawbacks. The seals on hydraulic cylinders were prone to leak under high pressure, effectively limiting the size of bucket that could be lifted using hydraulics. Notwithstanding this drawback, when hydraulics first appeared, many of the incumbent firms in the mechanical excavation industry took the technology seriously enough to ask their primary customers whether they would be interested in products based on hydraulics. Because the primary customers of incum-

bents needed excavators with large buckets to dig out the foundations for buildings and large trenches, their reply was negative. For this customer set, the hydraulic systems of the 1940s were not reliable or powerful enough. Consequently, after consulting with their customers, these established companies in the industry made the strategic decision not to invest in hydraulics. Instead, they continued to produce excavation equipment based on the dominant cable and pulley technology.

It was left to a number of new entrants, which included J. I. Case, John Deere, J. C. Bamford, and Caterpillar, to pioneer hydraulic excavation equipment. Because of the limits on bucket size imposed by the seal problem, these companies initially focused on a poorly served niche in the market that could make use of small buckets: residential contractors and farmers. Over time, these new entrants were able to solve the engineering problems associated with weak hydraulic seals, and as they did so, they manufactured excavators with larger buckets. Ultimately, they invaded the market niches served by the old-line companies: general contractors that dug the foundations for large buildings, sewers, and so on. At this point, Case, Deere, Caterpillar, and their kin rose to dominance in the industry, while the majority of established companies from the prior era lost share. Of the 30 or so manufacturers of cable-actuated equipment in the United States in the late 1930s, only four survived to the 1950s.

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**Source:** Christensen, *The Innovator's Dilemma*.

declined to invest in new disruptive technologies because initially they served such small market niches that it seemed unlikely that they would have an impact on the company's revenues and profits. As the new technology started to improve in functionality and invade the main market, their investment was often hindered by the fact that exploiting the new technology required a new business model totally different from the company's established model, and thus very difficult to implement.

Both of these points can be illustrated by reference to one more example: the rise of online discount stockbrokers during the 1990s such as Ameritrade and E\*TRADE, which made use of a new technology, the Internet, to allow individual investors to trade stocks for a very low commission fee, whereas full-service stockbrokers such as Merrill Lynch, where orders had to be placed through a stockbroker who earned a commission for performing the transaction, did not.

Christensen also noted that a new network of suppliers and distributors typically grows up around the new entrants. Not only do established companies initially ignore disruptive technology but also their suppliers and distributors. This creates an opportunity for new suppliers and distributors to enter the market to serve the new entrants. As the new entrants grow, so does the associated network. Ultimately, Christensen suggests, the new entrants and their network may replace not only established enterprises but also the entire network of suppliers and distributors associated with established companies. Taken to its logical extreme, this view suggests that disruptive technologies may result in the demise of the entire network of enterprises associated with established companies in an industry.

The established companies in an industry that is being rocked by a technological paradigm shift often have to cope with internal inertia forces that limit their ability to adapt, but the new entrants do not and thereby have an advantage. They do not have to deal with an established and conservative customer set and an obsolete business model. Instead, they can focus on optimizing the new technology, improving its performance, and riding the wave of disruptive technology into new market segments until they invade the main market and challenge the established companies, by which time they may be well equipped to beat them.

### Strategic Implications for Established Companies

Although Christensen uncovered an important tendency, it is by no means written in stone that all established companies are doomed to fail when faced with disruptive technologies, as we have seen with IBM and Merrill Lynch. Established companies must meet the challenges created by the emergence of disruptive technologies.<sup>21</sup>

First, having access to knowledge about how disruptive technologies can revolutionize markets is itself a valuable strategic asset. Many of the established companies that Christensen examined failed because they took a myopic view of the new technology and asked their customers the wrong question. Instead of asking, “Are you interested in this new technology?” they should have recognized that the new technology was likely to improve rapidly over time. Instead they should have asked, “Would you be interested in this new technology if it improves its functionality over time?” If they had done this, they may have made very different strategic decisions.

Second, it is clearly important for established enterprises to invest in newly emerging technologies that may ultimately become disruptive technologies. Companies have to hedge their bets about new technology. As we have noted, at any time, there may be a swarm of emerging technologies, any one of which might ultimately become a disruptive technology. Large, established companies that are generating significant cash flows can and often should establish and fund central R&D operations to invest in and develop such technologies. In addition, they may wish to acquire newly emerging companies that are pioneering potentially disruptive technologies or enter into alliances with them to develop the technology jointly. The strategy of acquiring companies that are developing potentially disruptive technology is one that Cisco Systems, a dominant provider of Internet network equipment, is famous for pursuing. At the heart of this strategy must be recognition on the part of the incumbent enterprise that it is better for the company to develop disruptive technology and then cannibalize its established sales base than to have that sales base taken away by new entrants.

However, Christensen makes the important point that even when established companies undertake R&D investments in potentially disruptive technologies, they often fail to commercialize those technologies because of internal forces that suppress change. For example, managers in the parts of the business that are currently generating the most cash may claim that they need the greatest R&D investment to maintain their market position and may lobby top management to delay investment in a new technology. Early on in the S-curve, when it is very unclear what the long-term prospects of a new technology may be, this can be a powerful argument. The consequence, however, may be that the company fails to build a competence in the new technology and will suffer accordingly.

In addition, Christensen argued that the commercialization of new disruptive technology often requires a radically different value chain with a completely different cost structure—a new business model. For example, it may require a different manufacturing system, a different distribution system, and different pricing options and involve very different gross margins and operating margins. Christensen argued that it is almost impossible for two distinct business models to coexist within the same organization. When companies try to do that, almost inevitably the established business model will suffocate the business model associated with the disruptive technology.

The solution to this problem is to separate out the disruptive technology and place it in its own autonomous operating division. For example, during the early 1980s HP built a very successful laser jet printer business. Then along came inkjet technology. Some in the company believed that ink jet printers would cannibalize sales of laser jets and consequently argued that HP should not produce inkjets. Fortunately for HP, senior management at the time saw inkjet technology for what it was: a potential disruptive technology. Far from not investing in it, they allocated significant R&D funds toward its commercialization. Furthermore, when the technology was ready for market introduction, they established an autonomous inkjet division at a different geographic location with its own manufacturing, marketing, and distribution activities. They accepted that the inkjet division might take sales away from the laser jet division and decided that it was better to have an HP division cannibalize the sales of another HP division than have those sales cannibalized by another company. Happily for HP, it turns out that inkjets cannibalize sales of laser jets only on the margin and that both have profitable market niches. This felicitous outcome, however, does not detract from the message of the story: if your company is developing a potentially disruptive technology, the chances of success will be enhanced if it is placed in a stand-alone product division and given its own mandate.

## Strategic Implications for New Entrants

The work just discussed also holds implications for new entrants. The new entrants, or attackers, have several advantages over established enterprises. Pressures to continue the existing out-of-date business model do not hamstring new entrants, which do not have to worry about product cannibalization issues. They do not have to worry about their established customer base or relationships with established suppliers and distributors. Instead, they can focus all their energies on the opportunities offered by the new disruptive technology, ride the S-curve of technology improvement, and grow rapidly with the market for that technology. This does not mean that the new entrants have no problems to solve. They may be constrained by a lack of capital or have to manage the organizational problems associated with rapid

growth; most important, they may need to find a way to take their technology from a small out-of-the-way niche into the mass market.

Perhaps one of the most important issues facing new entrants is the choice of whether to partner with an established company or go it alone in their attempt to develop and profit from a new disruptive technology. Although a new entrant may enjoy all of the advantages of the attacker, it may lack the resources required to exploit them fully. In such a case, it might want to consider forming a strategic alliance with a larger, established company to gain access to those resources. The main issues here are the same as those that we discussed earlier when examining the three strategies that companies can pursue to capture first-mover advantages: go it alone, enter into a strategic alliance, or license its technology.

## SUMMARY OF CHAPTER

1. Technical standards are important in many high-tech industries: they guarantee compatibility, reduce confusion in the minds of customers, allow for mass production and lower costs, and reduce the risks associated with supplying complementary products.
2. Network effects and positive feedback loops often determine which standard comes to dominate a market.
3. Owning a standard can be a source of sustained competitive advantage.
4. Establishing a proprietary standard as the industry standard may require the company to win a format war against a competing and incompatible standard. Strategies for doing this include producing complementary products, leveraging killer applications, using aggressive pricing and marketing, licensing the technology, and cooperating with competitors.
5. Many high-tech products are characterized by high fixed costs of development but very low or zero marginal costs of producing one extra unit of output. These cost economics create a presumption in favor of strategies that emphasize aggressive pricing to increase volume and drive down average total costs.
6. It is very important for a first mover to develop a strategy to capitalize on first-mover advantages. A company can choose from three strategies: develop and market the technology itself, do so jointly with another company, or license the technology to existing companies. The choice depends on the complementary assets required to capture a first-mover advantage, the height of barriers to imitation, and the capability of competitors.
7. Technological paradigm shifts occur when new technologies come along that revolutionize the structure of the industry, dramatically alter the nature of competition, and require companies to adopt new strategies to survive.
8. Technological paradigm shifts are more likely to occur when progress in improving the established technology is slowing because it is giving diminishing returns and a new disruptive technology is taking root in a market niche.
9. Established companies can deal with paradigm shifts by hedging their bets with regard to technology or setting up a stand-alone division to exploit the technology.

## DISCUSSION QUESTIONS

1. What is different about high-tech industries? Were all industries once high tech?
2. Why are standards so important in many high-tech industries? What are the competitive implications of this?
3. You work for a small company that has the leading position in an embryonic market. Your boss believes that the company's future is ensured because it has a 60% share of the market, the lowest cost structure in the industry, and the

- most reliable and highest-valued product. Write a memo to him outlining why his assumptions might be incorrect.
4. You are working for a small company that has developed an operating system for PCs that is faster and more stable than Microsoft's Windows operating system. What strategies might the company pursue to unseat Windows and establish its new operating system as the dominant technical standard in the industry?
  5. You are a manager for a major music record label. Last year, music sales declined by 10%, primarily because of very high piracy rates for CDs. Your boss has asked you to develop a strategy for reducing piracy rates. What would you suggest that the company do?
  6. Read the Closing Case on the emerging format war for high-definition DVD players. On the basis of the information contained in this case, who do you think is most likely to win this format war, Sony or Toshiba? Why?

## PRACTICING STRATEGIC MANAGEMENT

### Small-Group Exercise: Digital Books

Break up into groups of three to five people and discuss the following scenario. Appoint one group member as a spokesperson who will communicate your findings to the class.

You are a group of managers and software engineers at a small start-up that has developed software that enables customers to easily download and view digital books on a variety of digital devices, from PCs to iPods and e-book readers. The same software also allows customers to share digital books using peer-to-peer technology (the same technology that allows people to share music files on the web) and to “burn” digital books onto DVDs.

1. How do you think the market for this software is likely to develop? What factors might inhibit adoption of this software?
2. Can you think of a strategy that your company might pursue in combination with book publishers that will enable your company to increase revenues and the film companies to reduce piracy rates?

### Article File 7

Find an example of an industry that has undergone a technological paradigm shift in recent years. What happened to the established companies as that paradigm shift unfolded?

### Strategic Management Project: Module 7

This module requires you to analyze the industry environment in which your company is based and determine if it is vulnerable to a technological paradigm shift. With the information you have at your disposal, answer the following questions:

1. What is the dominant product technology used in the industry in which your company is based?
2. Are technical standards important in your industry? If so, what are they?
3. What are the attributes of the majority of customers purchasing the product of your company (e.g., early adopters, early majority, late majority)? What does this tell you about the strategic issues that the company is likely to face in the future?
4. Did the dominant technology in your industry diffuse rapidly or slowly? What drove the speed of diffusion?
5. Where is the dominant technology in your industry on its S-curve? Are alternative competing technologies being developed that might give rise to a paradigm shift in your industry?
6. Are intellectual property rights important to your company? If so, what strategies is it adopting to protect those rights? Is it doing enough?



## CLOSING CASE

## Blu-Ray versus HD DVD

Between 2004 and 2008, there was a format war in the consumer electronics industry between two different versions of next generation high-definition DVD players and discs. In one camp, there was Sony with its Blu-ray format; in the other was Toshiba, who was championing the rival HD DVD format. Both high-definition formats offer a dramatic improvement in picture and sound quality over established DVD technology and are designed to work with high-definition television sets. However, although each new format plays old DVDs, the two standards are incompatible with each other. Blu-ray players will not accept DVDs formatted for HD DVD, and vice versa.

Format wars like this have occurred many times in the past. VHS versus Betamax in the videocassette market and Windows versus Macintosh in PC operating systems are classic examples. If history is any guide, format wars tend to be “winner-take-all contests,” with the loser being vanquished to a niche (as in the case of Apple’s Macintosh operating system) or exiting the market altogether (as in the case of Sony’s Betamax format). Format wars are high-stakes games.

Aware of this, both Sony and Toshiba worked hard to ensure that their format gained an early lead in sales. A key strategy of both companies was to line up film studios and get them to commit to issuing discs based on their format.

Initially, it looked as if Sony had the early advantage. Prior to the technology being launched in the market, Columbia Pictures and MGM (both owned by Sony), along with Disney and Fox Studios, all committed exclusively to Blu-ray. By late 2005, several other studios that had initially committed exclusively to HD DVD, including Warner Brothers and Paramount, also indicated that they would support Blu-ray as well. Warner and Paramount cited Blu-ray’s momentum among other studios and its strong copyright protection mechanisms. This left just Universal Studios committed exclusively to HD DVD.

To further strengthen its hand, Sony announced that it would incorporate Blu-ray technology in its

next generation PS3 gaming console and its Vaio line of PCs. HP and Dell also indicated that they would support the Blu-ray format. Sony even licensed the Blu-ray format to several other consumer electronics firms, including Samsung, in a bid to increase the supply of Blu-ray players in stores.

Then things began to go wrong for Sony. The company had to delay delivery of its P3 gaming console by a year due to engineering problems, which sapped some of the momentum from Blu-ray. Microsoft took advantage of this misstep, announcing that it would market an HD DVD player that would work with its own gaming console, Xbox 360. In mid-2006, the first Blu-ray and HD DVD players hit the market: the Blu-ray players were more expensive, as much as twice the price of entry level HD DVD players. According to Toshiba, HD DVD players and discs are cheaper to manufacture, although Sony disputes this. To complicate matters, one of the first Blu-ray players, made by Sony licensee Samsung, was shipped with a bad chip that marred its image quality.

By late 2006, some firms were beginning to hedge their bets. HP reversed its earlier position and said that it would support both standards. Then in mid-2007, Toshiba persuaded Paramount to switch from Blu-ray and exclusively back the HD DVD format, paying it \$150 million to do so. Paradoxically, Sony claimed that the Paramount defection was a sign that it was winning. The fact that Toshiba had to pay Paramount \$150 million showed how desperate they were, claimed Sony.

As it turned out, Sony was right. By late 2007, sales of Blu-ray DVDs were outselling HD DVDs by a margin of two to one, primarily thanks to the P3, which after arriving late to the market, was selling reasonably well. To further accelerate its lead, Sony cut prices on stand-alone Blu-ray players. Then in early 2008, Warner announced that henceforth it would back Blu-ray exclusively, citing Blu-ray’s market momentum. This proved to be the coup de grâce for HD DVD. Very quickly, the remaining fence sitters backed Blu-ray, and HD DVD was effectively dead. Some wonder, however, whether Sony’s

triumph might be something of a pyrrhic victory, for another technology was emerging that promised to make HD DVD players obsolete: video on demand and video downloads onto computer hard drives over the Internet.<sup>22</sup>

### Case Discussion Questions

1. Why did both Sony and Toshiba perceive it to be so important to get an early lead in sales?
2. What strategies and assets enabled Sony to win this format war?
3. What might Toshiba have done that might have led to a different outcome?
4. The companies that developed first generation DVD technology decided not to compete on technology, instead harmonizing their technology under the auspices of the DVD Forum. Why do you think they chose a different approach this time around?
5. What are the risks associated with fighting a format war like this?

# STRATEGY IN THE GLOBAL ENVIRONMENT

## LEARNING OBJECTIVES

After reading this chapter, you should be able to

- Understand the process of globalization and how it impacts a company's strategy
- Discuss the motives for expanding internationally
- Review the different strategies that companies use to compete in the global marketplace
- Explain the pros and cons of different modes for entering foreign markets

## The Evolving Strategy of Coca-Cola

Coca-Cola, the iconic American soda maker, has long been among the most international of enterprises.

The company made its first move outside the United States in 1902, when it entered Cuba. By 1929, Coca-Cola was marketed in 76 countries. In World War II, Coca-Cola struck a deal to supply the United States military, wherever they might be, with its signature soda, Coca-Cola. During this era, the company built 63 bottling plants around the world. Its global push continued after the war, fueled in part by the belief that the United States market would eventually reach maturity and by the perception that huge growth opportunities lay overseas. By 2008, more than 59,000 of the company's 71,000 employees were located in 200 countries outside the United States, and 73% of

Coca-Cola's case volume was in international markets.

Until the 1980s, its strategy could best be characterized as one of considerable localization. Local operations were granted a high degree of independence to manage their own operations as they saw fit. This all changed in the 1980s and 1990s under the leadership of Roberto Goizueta, a talented Cuba immigrant who became the CEO of Coca-Cola in 1981. Goizueta placed renewed emphasis on Coca-Cola's flagship brands, which were extended with the introduction of Diet Coke, Cherry Coke, and the like. His prime belief was that the main difference between the United States



and international markets was the lower level of penetration in the latter, where consumption per capita of colas was only 10–15% of the United States figure. Goizueta pushed Coca-Cola to become a global company, centralizing a great deal of management and marketing activities at the corporate headquarters in Atlanta, focusing on core brands, and taking equity stakes in foreign bottlers so that the company could exert more strategic control over them. This one-size-fits-all strategy was built around standardization and the realization of economies of scale by, for example, using the same advertising message worldwide.

Goizueta's global strategy was adopted by his successor, Douglas Ivester, but by the late 1990s, the drive toward a one-size-fits-all strategy was running out of steam, as smaller, more nimble local competitors marketing local beverages began to halt the Coke growth engine. With Coca-Cola failing to hit its financial targets for the first time in a generation, Ivester resigned in 2000 and was replaced by Douglas Daft. Daft instituted a 180-degree shift in strategy. Daft's belief was that Coca-Cola needed to put more power back in the hands of local country managers. He thought that strategy, product development, and marketing should be tailored to local needs. He laid off 6,000 employees, many of them in Atlanta, and granted country managers much greater autonomy. Moreover, in a striking move for a marketing company, he announced that the company would stop making global advertisements, and he placed advertising budgets and control over creative content back in the hands of country managers.

Ivester's move was in part influenced by the experience of Coca-Cola in Japan, the company's second-most profitable market, where the best selling Coke product is not a carbonated

beverage but a canned cold coffee drink—Georgia Coffee—sold in vending machines. The Japanese experience seemed to signal that products should be customized to local tastes and preferences, and Coca-Cola would do well to decentralize more decision-making authority to local managers.

However, the shift toward localization did not produce the growth that had been expected; by 2002 the pendulum was swinging back toward more central coordination, with Atlanta exercising *oversight* over marketing and product development in different nations. But this time, it was not the one-size-fits-all ethos of the Goizueta era. Under the leadership of Neville Isdell, who became CEO in March 2004, Coca-Cola began reviewing and guiding local marketing and product development but adopted the belief that strategy, including pricing, product offerings, and marketing message, should be varied from market to market to match local conditions. Isdell's position, in other words, represents a midpoint between the strategy of Goizueta and Daft. Moreover, Isdell stressed the importance of leveraging good ideas across nations. A case in point is Georgia Coffee. Having seen the success of this beverage in Japan, in October 2007, Coca-Cola entered into a strategic alliance with Illycaffè, one of Italy's premier coffee makers, to build a global franchise for canned or bottled cold coffee beverages. Similarly, in 2003, the Coke subsidiary in China developed a low-cost, noncarbonated orange-based drink that has rapidly become one of the best-selling drinks in that nation. Seeing the potential of the drink, Coca-Cola is now rolling it out in other Asian countries. It has been a huge hit in Thailand, where it was launched in 2005, and seems to be gaining traction in India, where it was launched in 2007.<sup>1</sup>

## Overview

This chapter begins with a discussion of ongoing changes in the global competitive environment and discusses models managers can use for analyzing competition in different national markets. Then the chapter discusses the various ways in which



international expansion can increase a company's profitability and profit growth. It also looks at the advantages and disadvantages of different strategies companies can pursue to gain competitive advantages in the global marketplace. This is followed by a discussion of two related strategic issues: (1) how managers decide which foreign markets to enter, when to enter them, and on what scale; and (2) what kind of vehicle or means a company should use to expand globally and enter a foreign country. Once a company has entered a foreign market, it becomes a **multinational company**, that is, a company that does business in two or more national markets. The vehicles that companies can employ to enter foreign markets and become multinationals include exporting, licensing, setting up a joint venture with a foreign company, and setting up a wholly owned subsidiary. The chapter closes with a discussion of the benefits and costs of entering into strategic alliances with other global companies.

By the time you have completed this chapter, you will have a good understanding of the various strategic issues that companies face when they decide to expand their operations abroad to achieve competitive advantage and superior profitability.

Coca-Cola, profiled in the opening case, gives us a preview of some issues that we will explore in this chapter. Like many other companies, Coca-Cola moved into other countries because it saw huge growth opportunities there. It thought it could create value by transferring its iconic brand to local subsidiaries and letting them develop the market in conjunction with local bottlers. This worked for a long time, but by the 1980s, Coca-Cola felt the need for greater control over local strategy. It centralized power in Atlanta, while acquiring an equity stake in many local bottlers. For many companies, such a globally coordinated strategy seems to work, and for a time it did for Coca-Cola too. It rolled out centrally produced marketing messages and products worldwide. It realized economies of scale from standardization, and sales grew at a robust rate. But by the end of the 1990s, the strategy was running out of steam. New beverages were springing up in many countries, often marketed by local enterprises, and the growth of Coca-Cola's flagship brands was stalling. The company's response, as it has evolved in the 2000s, has been to allow country managers more strategic autonomy, while maintaining oversight and guidance from Atlanta. At the same time, Coca-Cola has placed more emphasis on trying to reignite growth by transferring good ideas across nations. As we shall see in this chapter, many other enterprises have followed a similar path, focusing first on localization then on global standardization. Like Coca-Cola, many of these companies have come to the conclusion that the best strategy is neither localization nor global standardization; the ideal strategy is one that combines elements of both and that leverages good ideas across nations. We call this orientation a *transnational strategy*, and we discuss it in depth later in the chapter. To begin with, however, we need to define exactly what we mean by strategy.

## THE GLOBAL AND NATIONAL ENVIRONMENTS

In the 1950s, most national markets were isolated from each other by significant barriers to international trade and investment. In those days, managers could focus on analyzing just those national markets in which their company competed. They did not need to pay much attention to entry by global competitors, for there were few and entry was difficult. Nor did they need to pay much attention to entering foreign markets because that was often prohibitively expensive. All of this has now changed. Barriers to international trade and investment have tumbled, huge global

markets for goods and services have been created, and companies from different nations are entering each other's home markets on a hitherto unprecedented scale, increasing the intensity of competition. Rivalry can no longer be understood merely in terms of what happens within the boundaries of a nation; managers now need to consider how globalization is impacting the environment in which their company competes and what strategies their company should adopt to exploit the unfolding opportunities and counter competitive threats. In this section, we look at the changes ushered in by falling barriers to international trade and investment, and we discuss a model for analyzing the competitive situation in different nations.

## The Globalization of Production and Markets

The past half-century has seen a dramatic lowering of barriers to international trade and investment. For example, the average tariff rate on manufactured goods traded between advanced nations has fallen from around 40% to under 4%. Similarly, in nation after nation, regulations prohibiting foreign companies from entering domestic markets and establishing production facilities, or acquiring domestic companies, have been removed. As a result of these two developments, there has been a surge in both the volume of international trade and the value of foreign direct investment. The volume of world merchandise trade has grown faster than the world economy since 1950.<sup>2</sup> From 1970 to 2007, the volume of world merchandise trade expanded 28-fold, outstripping the expansion of world production, which grew about eight times in real terms. Moreover, between 1992 and 2007, the total flow of foreign direct investment from all countries increased by more than 500%, while world trade by value grew by some 145% and world output by about 40%.<sup>3</sup> These two trends have led to the globalization of production and the globalization of markets.<sup>4</sup>

The globalization of production has been increasing as companies take advantage of lower barriers to international trade and investment to disperse important parts of their production processes around the globe. Doing so enables them to take advantage of national differences in the cost and quality of factors of production such as labor, energy, land, and capital, which allow them to lower their cost structures and boost profits. For example, some 30% of the Boeing Company's commercial jet aircraft, the 777, is built by foreign companies. For its next jet airliner, the 787, Boeing is pushing this trend even further, with some 65% of the total value of the aircraft scheduled to be outsourced to foreign companies, 35% of which will go to three major Japanese companies, and another 20% going to companies located in Italy, Singapore, and the United Kingdom.<sup>5</sup> Part of Boeing's rationale for outsourcing so much production to foreign suppliers is that these suppliers are the best in the world at performing their particular activity. Therefore, the result of having foreign suppliers build specific parts is a better final product and higher profitability for Boeing.

As for the globalization of markets, it has been argued that the world's economic system is moving from one in which national markets are distinct entities, isolated from each other by trade barriers and barriers of distance, time, and culture, toward a system in which national markets are merging into one huge global marketplace. Increasingly, customers around the world demand and use the same basic product offerings. Consequently, in many industries, it is no longer meaningful to talk about the German market, the United States market, or the Japanese market; there is only the global market. The global acceptance of Coca-Cola, Citigroup credit cards, blue jeans, Starbucks, McDonald's hamburgers, the Nokia wireless phone, and Microsoft's Windows operating system are examples of this trend.<sup>6</sup>



The trend toward the globalization of production and markets has several important implications for competition within an industry. First, industry boundaries do not stop at national borders. Because many industries are becoming global in scope, actual and potential competitors exist not only in a company's home market but also in other national markets. Managers who analyze only their home market can be caught unprepared by the entry of efficient foreign competitors. The globalization of markets and production implies that companies around the globe are finding their home markets under attack from foreign competitors. For example, in Japan, American financial institutions such as JP Morgan have been making inroads against Japanese financial service institutions. In the United States, Finland's Nokia has taken market share from Motorola in the market for wireless phone handsets (see Strategy in Action 8.1). In the European Union, the once-dominant Dutch company Philips has seen its market share in the customer electronics industry taken by Japan's JVC, Matsushita, and Sony.

Second, the shift from national to global markets has intensified competitive rivalry in industry after industry. National markets that once were consolidated oligopolies, dominated by three or four companies and subjected to relatively little foreign competition, have been transformed into segments of fragmented global industries in which a large number of companies battle each other for market share in country after country. This rivalry has threatened to drive down profitability and made it all the more critical for companies to maximize their efficiency, quality, customer responsiveness, and innovative ability. The painful restructuring and downsizing that has been going on at companies such as Kodak is as much a response to the increased intensity of global competition as it is to anything else. However, not all global industries are fragmented. Many remain consolidated oligopolies, except that now they are consolidated global, rather than national, oligopolies. In the gaming industry, for example, three companies are battling for global dominance: Microsoft in the United States and Nintendo and Sony in Japan. In the market for wireless handsets, Nokia of Finland does global battle against: Motorola of the United States; Samsung and LG in South Korea; Sony-Ericsson, a joint venture between Sony of Japan and Ericsson of Sweden; and, most recently, Apple with its iPhone, and Research in Motion of Canada with its BlackBerry.

Finally, although globalization has increased both the threat of entry and the intensity of rivalry within many formerly protected national markets, it has also created enormous opportunities for companies based in those markets. The steady decline in barriers to cross-border trade and investment has opened up many once protected markets to companies based outside them. Thus, for example, in recent years, western European, Japanese, and United States companies have accelerated their investments in the nations of Eastern Europe, Latin America, and Southeast Asia as they try to take advantage of growth opportunities in those areas.

## National Competitive Advantage

Despite the globalization of production and markets, many of the most successful companies in certain industries are still clustered in a small number of countries. For example, many of the world's most successful biotechnology and computer companies are based in the United States, and many of the most successful consumer electronics companies are based in Japan and South Korea. Germany is the base for many successful chemical and engineering companies. These facts suggest that the nation-state within which a company is based may have an important bearing on the competitive position of that company in the global marketplace.

## 8.1 STRATEGY IN ACTION

### Finland's Nokia

The wireless phone market is one of the great growth stories of the last decade. Starting from a very low base in 1990, annual global sales of wireless phones surged to reach 825 million units in 2005. By the end of 2008, there were more than 2 billion wireless subscribers worldwide, up from less than 10 million in 1990. Nokia is one of the dominant players in the world market for mobile phones. Nokia's roots are in Finland, not usually a country that comes to mind when one talks about leading-edge technology companies. In the 1980s, Nokia was a rambling Finnish conglomerate with activities that embraced tire manufacturing, paper production, consumer electronics, and telecommunications equipment. By 2008, it had transformed itself into a focused telecommunications equipment manufacturer with a global reach, sales of more than \$75 billion, earnings of more than \$10 billion, and a one-third share of the global market for wireless phones. How has this former conglomerate emerged to take a global leadership position in wireless telecommunications equipment? Much of the answer lies in the history, geography, and political economy of Finland and its Nordic neighbors.

In 1981, the Nordic nations cooperated to create the world's first international wireless telephone network. They had good reason to become pioneers: it cost far too much to lay down a traditional wire line telephone service in those sparsely populated and inhospitably cold countries. The same features made telecommunications all the more valuable: people driving through the Arctic winter and owners of remote northern houses needed a telephone to summon help if things went wrong. As a result, Sweden, Norway, and Finland became the first nations in the world to take wireless telecommunications seriously. They found, for example, that although it cost up to \$800 per subscriber to bring a traditional wire line service to remote locations, the same locations could be linked by wireless cellular for only \$500 per subscriber. As a consequence, 12% of people in Scandinavia owned cellular phones by 1994, compared with less than 6% in the

United States, the world's second-most developed market. This lead continued over the next decade. By the end of 2005, 90% of the population in Finland owned a wireless phone, compared with 70% in the United States.

Nokia, a long-time telecommunications equipment supplier, was well positioned to take advantage of this development from the start, but there were other forces at work that helped Nokia develop its competitive edge. Unlike virtually every other developed nation, Finland has never had a national telephone monopoly. Instead, the country's telephone services have long been provided by about 50 or so autonomous local telephone companies whose elected boards set prices by referendum (which naturally means low prices). This army of independent and cost-conscious telephone service providers prevented Nokia from taking anything for granted in its home country. With typical Finnish pragmatism, its customers were willing to buy from the lowest-cost supplier, whether that was Nokia, Ericsson, Motorola, or some other company. This situation contrasted sharply with that prevailing in most developed nations until the late 1980s and early 1990s, where domestic telephone monopolies typically purchased equipment from a dominant local supplier or made it themselves. Nokia responded to this competitive pressure by doing everything possible to drive down its manufacturing costs while staying at the leading edge of wireless technology.

The consequences of these forces are clear. Nokia is now a leader in digital wireless technology. Many now regard Finland as the lead market for wireless telephone services. If you want to see the future of wireless, you do not go to New York or San Francisco; you go to Helsinki, where Finns use their wireless handsets not just to talk to each other but also to browse the Web, execute e-commerce transactions, control household heating and lighting systems, or purchase Coke from a wireless-enabled vending machine. Nokia has gained this lead because Scandinavia started switching to digital technology five years before the rest of the world.

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**Sources:** Lessons from the Frozen North," *Economist*, October 8, 1994, 76–77; "A Finnish Fable," *Economist*, October 14, 2000; D. O'Shea and K. Fitchard, "The First 3 Billion Is Always the Hardest," *Wireless Review*, Volume 22, September 2005, 25–31. P. Taylor, "Big Names Dominate in Mobile Phones," *Financial Times*, September 29, 2006, 26; <http://www.nokia.com>.

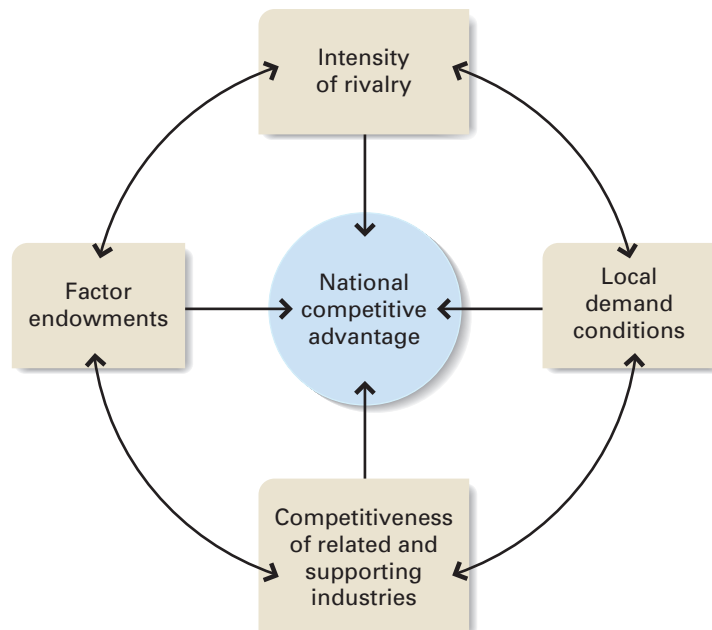
In a study of national competitive advantage, Michael Porter identified four attributes of a national or country-specific environment that have an important impact on the global competitiveness of companies located within that nation:<sup>7</sup>

1. *Factor endowments*: A nation's position in factors of production such as skilled labor or the infrastructure necessary to compete in a given industry
2. *Local demand conditions*: The nature of home demand for the industry's product or service
3. *Competitiveness of related and supporting industries*: The presence or absence in a nation of supplier industries and related industries that are internationally competitive
4. *Intensity of rivalry*: The conditions in the nation governing how companies are created, organized, and managed and the nature of domestic rivalry

Porter speaks of these four attributes as constituting the diamond, arguing that companies from a given nation are most likely to succeed in industries or strategic groups in which the four attributes are favorable (see Figure 8.1). He also argues that the diamond's attributes form a mutually reinforcing system in which the effect of one attribute is dependent on the state of others.

**Factor Endowments** Factor endowments—the cost and quality of factors of production—are prime determinants of the competitive advantage that certain countries might have in certain industries. Factors of production include basic factors, such as land, labor, capital, and raw materials, and advanced factors, such as technological

**Figure 8.1** National Competitive Advantage



**Source:** Adapted from M. E. Porter, "The Competitive Advantage of Nations," *Harvard Business Review*, March–April 1990, 77.

know-how, managerial sophistication, and physical infrastructure (roads, railways, and ports). The competitive advantage that the United States enjoys in biotechnology might be explained by the presence of certain advanced factors of production—for example, technological know-how—in combination with some basic factors, which might be a pool of relatively low-cost venture capital that can be used to fund risky start-ups in industries such as biotechnology.

**Local Demand Conditions** Home demand plays an important role in providing the impetus for “upgrading” competitive advantage. Companies are typically most sensitive to the needs of their closest customers. Thus, the characteristics of home demand are particularly important in shaping the attributes of domestically made products and creating pressures for innovation and quality. A nation’s companies gain competitive advantage if their domestic customers are sophisticated and demanding and pressure local companies to meet high standards of product quality and produce innovative products. Japan’s sophisticated and knowledgeable buyers of cameras helped stimulate the Japanese camera industry to improve product quality and introduce innovative models. A similar example can be found in the cellular phone equipment industry, where sophisticated and demanding local customers in Scandinavia helped push Nokia of Finland and Ericsson of Sweden to invest in cellular phone technology long before the demand for cellular phones took off in other developed nations. As a result, Nokia and Ericsson, together with Motorola, are significant players in the global cellular telephone equipment industry. The case of Nokia is reviewed in more depth in Strategy in Action 8.1.

**Competitiveness of Related and Supporting Industries** The third broad attribute of national advantage in an industry is the presence of internationally competitive suppliers or related industries. The benefits of investments in advanced factors of production by related and supporting industries can spill over into an industry, thereby helping it achieve a strong competitive position internationally. Swedish strength in fabricated steel products (such as ball bearings and cutting tools) has drawn on strengths in Sweden’s specialty steel industry. Switzerland’s success in pharmaceuticals is closely related to its previous international success in the technologically related dye industry. One consequence of this process is that successful industries within a country tend to be grouped into clusters of related industries. Indeed, this was one of the most pervasive findings of Porter’s study. One such cluster is the German textile and apparel sector, which includes high-quality cotton, wool, synthetic fibers, sewing machine needles, and a wide range of textile machinery.

**Intensity of Rivalry** The fourth broad attribute of national competitive advantage in Porter’s model is the intensity of rivalry of firms within a nation. Porter makes two important points here. First, different nations are characterized by different management ideologies, which either help them or do not help them build national competitive advantage. For example, Porter noted the predominance of engineers in top management at German and Japanese firms. He attributed this to these firms’ emphasis on improving manufacturing processes and product design. In contrast, Porter noted a predominance of people with finance backgrounds leading many United States firms. He linked this to United States firms’ lack of attention to improving manufacturing processes and product design. He argued that the dominance of finance led to an overemphasis on maximizing short-term financial returns. According to Porter, one consequence of these different management ideologies was

a relative loss of United States competitiveness in those engineering-based industries where manufacturing processes and product design issues are all-important (such as the automobile industry).

Porter's second point is that there is a strong association between vigorous domestic rivalry and the creation and persistence of competitive advantage in an industry. Rivalry induces companies to look for ways to improve efficiency, which makes them better international competitors. Domestic rivalry creates pressures to innovate, improve quality, reduce costs, and invest in upgrading advanced factors. All this helps to create world-class competitors. The stimulating effects of strong domestic competition are clear in the story of the rise of Nokia of Finland in the market for wireless handsets and telephone equipment (see Strategy in Action 8.1).

**Using the Framework** The framework just described can help managers identify from where their most significant global competitors are likely to come. For example, there is an emerging cluster of computer service and software companies in Bangalore, India, that includes two of the fastest-growing information technology companies in the world, Infosys and Wipro. These companies are emerging as aggressive competitors on the global stage. Indeed, there are signs that this is now happening, since both companies have recently opened up offices in the European Union and United States so they can better compete against the likes of IBM and EDS.

The framework can also be used to help managers decide where they might want to locate certain productive activities. Seeking to take advantage of United States expertise in biotechnology, many foreign companies have set up research facilities in San Diego, Boston, and Seattle, where United States biotechnology companies tend to be clustered. Similarly, in an attempt to take advantage of Japanese success in consumer electronics, many United States electronics companies have set up research and production facilities in Japan, often in conjunction with Japanese partners.

Finally, the framework can help a company assess how tough it might be to enter certain national markets. If a nation has a competitive advantage in certain industries, it might be challenging for foreigners to enter those industries. For example, the highly competitive retailing industry in the United States has proved to be a very difficult one for foreign companies to enter. Successful foreign retailers such as Britain's Marks & Spencer and IKEA from Sweden have found it tough going in the United States, precisely because the United States retailing industry is the most competitive in the world.

## INCREASING PROFITABILITY AND PROFIT GROWTH THROUGH GLOBAL EXPANSION

In this section, we look at a number of ways in which expanding globally can enable companies to increase their profitability and grow their profits more rapidly. At the most basic level, global expansion increases the size of the market a company is addressing, thereby boosting profit growth. Moreover, as we shall see, global expansion offers opportunities for reducing the cost structure of the enterprise or adding value through differentiation, thereby potentially boosting profitability.

## Expanding the Market: Leveraging Products

A company can increase its growth rate by taking goods or services developed at home and selling them internationally. Indeed, almost all multinationals started out doing just this. Procter & Gamble (P&G), for example, developed most of its best-selling products at home and then sold them around the world. Similarly, from its earliest days, Microsoft has always focused on selling its software around the world. Automobile companies like Ford, Volkswagen, and Toyota also grew by developing products at home and then selling them in international markets. The returns from such a strategy are likely to be greater if indigenous competitors in the nations a company enters lack comparable products. Thus, Toyota has grown its profits by entering the large automobile markets of North America and Europe and by offering products that are differentiated from those offered by local rivals (Ford and GM) by their superior quality and reliability.

It is important to note that the success of many multinational companies is based not only on the goods or services that they sell in foreign nations but also on the distinctive competencies (unique skills) that underlie the production and marketing of those goods or services. Toyota's success is based on its distinctive competency in manufacturing automobiles, and expanding internationally can be seen as a way of generating greater returns from this competency. Similarly, P&G's global success was based on more than its portfolio of consumer products; it was also based on the company's skills in mass-marketing consumer goods. P&G grew rapidly in international markets between 1950 and 1990 because it was one of the most skilled mass-marketing enterprises in the world and could "out-market" indigenous competitors in the nations it entered. Global expansion was thus a way of generating higher returns from its competency in marketing.

In other words, because distinctive competencies are in essence the most valuable aspects of a company's business model, the successful global expansion by manufacturing companies like Toyota and P&G was based on their ability to transfer aspects of their business models and apply them to foreign markets.

The same can be said of companies engaged in the service sectors of an economy, such as financial institutions, retailers, restaurant chains, and hotels. Expanding the market for their services often means replicating their business models in foreign nations (albeit with some changes to account for local differences, which we will discuss in more detail shortly). Starbucks, for example, is expanding rapidly outside the United States by taking the basic business model it developed at home and using that as a blueprint for establishing international operations. As detailed in the Running Case, Walmart has done the same thing, establishing stores in nine other nations since 1992, following the blueprint it developed in the United States.

## Realizing Cost Economies from Global Volume

In addition to growing profits more rapidly, by expanding its sales volume through international expansion, a company can realize cost savings from economies of scale, thereby boosting profitability. Such scale economies come from several sources. First, by spreading the fixed costs associated with developing a product and setting up production facilities over its global sales volume, a company can lower its average unit cost. Thus, Microsoft can garner significant scale economies by spreading the \$5 billion it cost to develop Windows Vista over global demand.



## RUNNING CASE

### Walmart's Global Expansion

In the early 1990s, managers at Walmart realized that the company's opportunities for growth in the United States were becoming more limited. By 1995, the company would be active in all 50 states. Management calculated that by the early 2000s, domestic growth opportunities would be constrained due to market saturation. So the company decided to expand globally. The critics scoffed. Walmart, they said, was too American a company. Although its business model was well suited to America, it would not work in other countries where infrastructure was different, consumer tastes and preferences varied, and where established retailers already dominated.

Unperturbed, in 1991, Walmart started to expand internationally with the opening of its first stores in Mexico. The Mexican operation was established as a joint venture with Cifera, the largest local retailer. Initially, Walmart made a number of missteps that seemed to prove the critics right. Walmart had problems replicating its efficient distribution system in Mexico. Poor infrastructure, crowded roads, and a lack of leverage with local suppliers, many of whom could not or would not deliver directly to Walmart's stores or distribution centers, resulted in stocking problems and raised costs and prices. Initially, prices at Walmart in Mexico were some 20% above prices for comparable products in the company's United States stores, which limited Walmart's ability to gain market share. There were also problems with merchandise selection. Many of the stores in Mexico carried items that were popular in the United States. These included ice skates, riding lawn mowers, leaf blowers, and fishing tackle. Not surprisingly, these items did not sell well in Mexico, so managers would slash prices to move inventory, only to find that the company's automated information systems would immediately order more inventory to replenish the depleted stock.

By the mid-1990s, however, Walmart had learned from its early mistakes and adapted its operations in Mexico to match the local environment. A partnership with a Mexican trucking company dramatically improved the distribution system, while more careful stocking practices meant that the Mexican stores sold merchandise that appealed more to local tastes and

preferences. As Walmart's presence grew, many of Walmart's suppliers built factories close by its Mexican distribution centers so that they could better serve the company, which helped to drive down inventory and logistics costs. In 1998, Walmart acquired a controlling interest in Cifera. Today, Mexico is a leading light in Walmart's international operations, where the company is more than twice the size of its nearest rival.

The Mexican experience proved to Walmart that it could compete outside the United States. It subsequently expanded into 15 other countries. In Canada, Britain, Germany, Japan, and South Korea, Walmart entered by acquiring existing retailers and then transferring its information systems, logistics, and management expertise. In Puerto Rico, Brazil, Argentina, and China, Walmart established its own stores (although it added to its Chinese operations with a major acquisition in 2007). As a result of these moves, by 2008, the company had more than 3,000 stores outside the United States, 600,000 associates, and generated international revenues of more than \$80 billion.

In addition to greater growth, expanding internationally has brought Walmart two other major benefits. First, Walmart has also been able to reap significant economies of scale from its global buying power. Many of Walmart's key suppliers have long been international companies; for example, GE (appliances), Unilever (food products), and P&G (personal care products) are all major Walmart suppliers that have long had their own global operations. By building international reach, Walmart has been able to use its enhanced size to demand deeper discounts from the local operations of its global suppliers, increasing the company's ability to lower prices to consumers, gain market share and ultimately earn greater profits. Second, Walmart has found that it is benefiting from the flow of ideas across the countries in which it now competes. For example, Walmart's Argentina team worked with Walmart's Mexican management to replicate a Walmart store format developed first in Mexico and to adopt the best practices in human resources and real estate that had been developed in Mexico. Other ideas, such as wine departments in its stores in Argentina, have now been integrated into layouts worldwide.

Moreover, Walmart realized that if it did not expand internationally, other global retailers would beat them to the punch. In fact, Walmart does face significant global competition from Carrefour of France, Ahold of Holland, and Tesco of the United Kingdom. Carrefour, the world's second-largest retailer, is perhaps the most global of the lot. The pioneer of the hypermarket concept now operates in 26 countries and generates more than 50% of its sales outside France. Compared to this, Walmart is a laggard with just 25% of its sales in 2008 generated from international operations. However, there is still room for significant global expansion. The global retailing market is still very fragmented. The top-25 retailers controlled only about a quarter of retail sales in 2008.

Still, for all of its success Walmart has hit some significant speed bumps in its drive for global expansion. In 2006, the company pulled out of two markets, South

Korea—where it failed to decode the shopping habits of local customers—and Germany—where it could not beat incumbent discount stores on price. It is also struggling in Japan, where the company does not seem to have grasped the market's cultural nuances. One example was Walmart's decision to sell lower-priced gift fruits at Japanese holidays. It failed because customers felt spending less would insult the recipient. Interestingly, the markets where Walmart has struggled were all developed markets that it entered through acquisitions, where it faced long-established and efficient local competitors, and where shopping habits were very different than in the United States. In contrast, many of those markets where it has done better have been developing nations that lacked strong local competitors, and where Walmart has built operations from the ground up (e.g., Mexico, Brazil, and, increasingly, China).

**Sources:** A. Lillo, "Walmart Says Global Going Good," *Home Textiles Today*, September 15, 2003, 12–13. A. de Rocha and L. A. Dib, "The Entry of Walmart into Brazil," *International Journal of Retail and Distribution Management*, Vol 30, 2002, 61–73; Anonymous, "Walmart: Mexico's Biggest Retailer," *Chain Store Age*, June 2001, 52–54; M. Flagg, "In Asia, Going to the Grocery Increasingly Means Heading for a European Retail Chain," *Wall Street Journal*, April 24, 2001, A21; "A Long Way from Bentonville," *The Economist*, September 20, 2006, 38–39; "How Walmart Should Right Itself," *The Wall Street Journal*, April 20, 2007, C1, C5. <http://www.walmart.com>

Second, by serving a global market, a company can potentially utilize its production facilities more intensively, which leads to higher productivity, lower costs, and greater profitability. For example, if Intel sold microprocessors only in the United States, it might be able to keep its factories open only for one shift, five days a week. But by serving a global market from the same factories, it might be able to utilize those assets for two shifts, seven days a week. In other words, the capital invested in those factories is used more intensively if Intel sells to a global as opposed to a national market, which translates into higher capital productivity and a higher return on invested capital.

Third, as global sales increase the size of the enterprise, so its bargaining power with suppliers increases, which may allow it to bargain down the cost of key inputs and boost profitability that way. Walmart has been able to use its enormous sales volume as a lever to bargain down the price it pays suppliers for merchandise sold through its stores.

In addition to the cost savings that come from economies of scale, companies that sell to a global as opposed to local marketplace may be able to realize further cost savings from learning effects. We first discussed learning effects in Chapter 4, in which we noted that employee productivity increases with cumulative increases in output over time. (For example, it costs considerably less to build the 100th aircraft off a Boeing assembly line than the 10th because employees learn how to perform their tasks more efficiently over time.) By selling to a global market, a company may be able to increase its sales volume more rapidly and the cumulative output from its

plants, which in turn should result in quicker learning, higher employee productivity, and a cost advantage over competitors that are growing more slowly because they lack international markets.

## Realizing Location Economies

Earlier in this chapter we discussed how countries differ from each other along a number of dimensions, including differences in the cost and quality of factors of production. These differences imply that some locations are more suited than others for producing certain goods and services.<sup>8</sup> **Location economies** are the economic benefits that arise from performing a value creation activity in the optimal location for that activity, wherever in the world that might be (transportation costs and trade barriers permitting). Locating a value creation activity in the optimal location for that activity can have one of two effects: (1) it can lower the costs of value creation, helping the company achieve a low-cost position; or (2) it can enable a company to differentiate its product offering, which gives it the option of charging a premium price or keeping price low and using differentiation as a means of increasing sales volume. Thus, efforts to realize location economies are consistent with the business-level strategies of low cost and differentiation. In theory, a company that realizes location economies by dispersing each of its value creation activities to the optimal location for that activity should have a competitive advantage over a company that bases all of its value creation activities at a single location. It should be able to differentiate its product offering better and lower its cost structure more than its single-location competitor. In a world where competitive pressures are increasing, such a strategy may well become an imperative for survival.

For an example of how this works in an international business, consider Clear Vision, a manufacturer and distributor of eyewear. Started in the 1970s by David Glassman, the firm now generates annual gross revenues of more than \$100 million. Not exactly small, but no corporate giant either, Clear Vision is a multinational firm with production facilities on three continents and customers around the world. Clear Vision began its move toward becoming a multinational in the early 1980s. The strong dollar at that time made United States-based manufacturing very expensive. Low-priced imports were taking an ever larger share of the United States eyewear market, and Clear Vision realized it could not survive unless it also began to import. Initially the firm bought from independent overseas manufacturers, primarily in Hong Kong. However, it became dissatisfied with these suppliers' product quality and delivery. As Clear Vision's volume of imports increased, Glassman decided that the best way to guarantee quality and delivery was to set up Clear Vision's own manufacturing operation overseas. Accordingly, Clear Vision found a Chinese partner, and together they opened a manufacturing facility in Hong Kong, with Clear Vision being the majority shareholder.

The choice of the Hong Kong location was influenced by its combination of low labor costs, a skilled workforce, and tax breaks given by the Hong Kong government. The firm's objective at this point was to lower production costs by locating value creation activities at an appropriate location. After a few years, however, the increasing industrialization of Hong Kong and a growing labor shortage had pushed up wage rates to the extent that it was no longer a low-cost location. In response, Glassman and his Chinese partner moved part of their manufacturing to a plant in mainland China to take advantage of the lower wage rates there. Again, the goal was to lower production costs. The parts for eyewear frames manufactured at this

plant are shipped to the Hong Kong factory for final assembly and then distributed to markets in North and South America. The Hong Kong factory now employs 80 people and the China plant between 300 and 400.

At the same time, Clear Vision was looking for opportunities to invest in foreign eyewear firms with reputations for fashionable design and high quality. Its objective was not to reduce production costs but to launch a line of high-quality, differentiated, “designer” eyewear. Clear Vision did not have the design capability in-house to support such a line, but Glassman knew that certain foreign manufacturers did. As a result, Clear Vision invested in factories in Japan, France, and Italy, holding a minority shareholding in each case. These factories now supply eyewear for Clear Vision’s Status Eye division, which markets high-priced designer eyewear.<sup>9</sup>

**Some Caveats** Introducing transportation costs and trade barriers somewhat complicates this picture. New Zealand might have a comparative advantage for low-cost car assembly operations, but high transportation costs make it an uneconomical location from which to serve global markets. Factoring transportation costs and trade barriers into the cost equation helps explain why many United States companies have been shifting their production from Asia to Mexico. Mexico has three distinct advantages over many Asian countries as a location for value creation activities: low labor costs; Mexico’s proximity to the large United States market, which reduces transportation costs; and the North American Free Trade Agreement (NAFTA), which has removed many trade barriers between Mexico, the United States, and Canada, increasing Mexico’s attractiveness as a production site for the North American market. Thus, although the relative costs of value creation are important, transportation costs and trade barriers also must be considered in location decisions.

Another caveat concerns the importance of assessing political and economic risks when making location decisions. Even if a country looks very attractive as a production location when measured against cost or differentiation criteria, if its government is unstable or totalitarian, companies are usually well advised not to base production there. Similarly, if a particular national government appears to be pursuing inappropriate social or economic policies, this might be another reason for not basing production in that location, even if other factors look favorable.

## Leveraging the Skills of Global Subsidiaries

Initially, many multinational companies develop the valuable competencies and skills that underpin their business model in their home nation and then expand internationally, primarily by selling products and services based on those competencies. However, for more mature multinational enterprises that have already established a network of subsidiary operations in foreign markets, the development of valuable skills can just as well occur in foreign subsidiaries.<sup>10</sup> Skills can be created anywhere within a multinational’s global network of operations, wherever people have the opportunity and incentive to try new ways of doing things. The creation of skills that help to lower the costs of production, or enhance perceived value and support higher product pricing, is not the monopoly of the corporate center.

Leveraging the skills created within subsidiaries and applying them to other operations within the firm’s global network may create value. For example, McDonald’s increasingly is finding that its foreign franchisees are a source of valuable new ideas. Faced with slow growth in France, its local franchisees have begun to experiment

not only with the menu but also with the layout and theme of restaurants. Gone are the ubiquitous Golden Arches; gone too are many of the utilitarian chairs and tables and other plastic features of the fast-food giant. Many McDonald's restaurants in France now have hardwood floors, exposed brick walls, and even armchairs. Half of the 930 or so outlets in France have been upgraded to a level that would make them unrecognizable to an American. The menu, too, has been changed to include premier sandwiches, such as chicken on focaccia bread, priced some 30% higher than the average hamburger. In France, at least, the strategy seems to be working. Following the change, increases in same-store sales rose from 1% annually to 3.4%. Impressed with the impact, McDonald's executives are now considering adopting similar changes at other McDonald's restaurants in markets where same-store sales growth is sluggish, including the United States.<sup>11</sup>

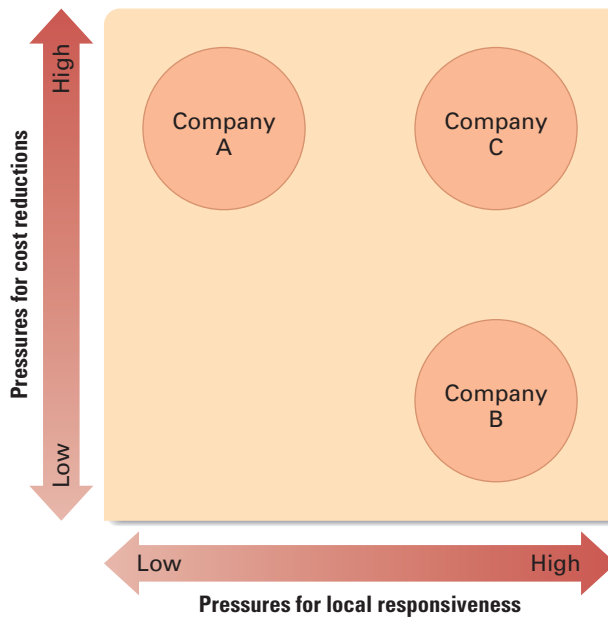
For the managers of a multinational enterprise, this phenomenon creates important new challenges. First, they must have the humility to recognize that valuable skills can arise anywhere within the firm's global network, not just at the corporate center. Second, they must establish an incentive system that encourages local employees to acquire new competencies. This is not as easy as it sounds. Creating new competencies involves a degree of risk. Not all new skills add value. For every valuable idea created by a McDonald's subsidiary in a foreign country, there may be several failures. The management of the multinational must install incentives that encourage employees to take the necessary risks, and the company must reward people for successes and not sanction them unnecessarily for taking risks that did not pan out. Third, managers must have a process for identifying when valuable new skills have been created in a subsidiary. Finally, they need to act as facilitators, helping to transfer valuable skills within the firm.

## COST PRESSURES AND PRESSURES FOR LOCAL RESPONSIVENESS

Companies that compete in the global marketplace typically face two types of competitive pressures: *pressures for cost reductions* and *pressures to be locally responsive* (see Figure 8.2).<sup>12</sup> These competitive pressures place conflicting demands on a company. Responding to pressures for cost reductions requires that a company try to minimize its unit costs. To attain this goal, it may have to base its productive activities at the most favorable low-cost location, wherever in the world that might be. It may also have to offer a standardized product to the global marketplace to realize the cost savings that come from economies of scale and learning effects. On the other hand, responding to pressures to be locally responsive requires that a company differentiate its product offering and marketing strategy from country to country in an effort to accommodate the diverse demands arising from national differences in consumer tastes and preferences, business practices, distribution channels, competitive conditions, and government policies. Because differentiation across countries can involve significant duplication and a lack of product standardization, it may raise costs.

While some companies, such as Company A in Figure 8.2, face high pressures for cost reductions and low pressures for local responsiveness, and others, such as Company B, face low pressures for cost reductions and high pressures for local responsiveness, many

**Figure 8.2** Pressures for Cost Reductions and Local Responsiveness



companies are in the position of Company C. They face high pressures for both cost reductions and local responsiveness. Dealing with these conflicting and contradictory pressures is a difficult strategic challenge, primarily because being locally responsive tends to raise costs.

### Pressures for Cost Reductions

In competitive global markets, international businesses often face pressures for cost reductions. To respond to these pressures, a firm must try to lower the costs of value creation. A manufacturer, for example, might mass-produce a standardized product at the optimal location in the world, wherever that might be, to realize economies of scale and location economies. Alternatively, it might outsource certain functions to low-cost foreign suppliers in an attempt to reduce costs. Thus, many computer companies have outsourced their telephone-based customer service functions to India, where qualified technicians who speak English can be hired for a lower wage rate than in the United States. In the same vein, a retailer such as Walmart might push its suppliers (who are manufacturers) to also lower their prices. (In fact, the pressure that Walmart has placed on its suppliers to reduce prices has been cited as a major cause of the trend among North American manufacturers to shift production to China.)<sup>13</sup> A service business, such as a bank, might move some back-office functions, such as information processing, to developing nations where wage rates are lower.

Cost reduction pressures can be particularly intense in industries producing commodity-type products where meaningful differentiation on nonprice factors is difficult and price is the main competitive weapon. This tends to be the case for products that serve universal needs. Universal needs exist when the tastes and preferences of consumers in different nations are similar if not identical, such as for bulk



chemicals, petroleum, steel, sugar, and the like. They also exist for many industrial and consumer products, such as handheld calculators, semiconductor chips, PCs, and liquid crystal display (LCD) screens. Pressures for cost reductions are also intense in industries where major competitors are based in low-cost locations, where there is persistent excess capacity, and where consumers are powerful and face low switching costs. Many commentators have argued that the liberalization of the world trade and investment environment in recent decades, by facilitating greater international competition, has generally increased cost pressures.<sup>14</sup>

### Pressures for Local Responsiveness

Pressures for local responsiveness arise from differences in consumer tastes and preferences, infrastructure and traditional practices, distribution channels, and host government demands. Responding to pressures to be locally responsive requires that a company differentiate its products and marketing strategy from country to country to accommodate these factors, all of which tend to raise a company's cost structure.

**Differences in Consumer Tastes and Preferences** Strong pressures for local responsiveness emerge when customer tastes and preferences differ significantly between countries, as they may for historic or cultural reasons. In such cases, a multinational company's products and marketing message have to be customized to appeal to the tastes and preferences of local customers. The company is then typically pressured to delegate production and marketing responsibilities and functions to a company's overseas subsidiaries.

For example, the automobile industry in the 1980s and early 1990s moved toward the creation of "world cars." The idea was that global companies such as GM, Ford, and Toyota would be able to sell the same basic vehicle the world over, sourcing it from centralized production locations. If successful, the strategy would have enabled automobile companies to reap significant gains from global scale economies. However, this strategy frequently ran aground on the hard rocks of consumer reality. Consumers in different automobile markets seem to have different tastes and preferences, and these require different types of vehicles. North American consumers show a strong demand for pickup trucks. This is particularly true in the South and West where many families have pickup trucks as second or third vehicles. But in European countries, pickup trucks are seen purely as utility vehicles and are purchased primarily by firms rather than individuals. As a consequence, the product mix and marketing message need to be tailored to take into account the different nature of demand in North America and Europe.

Some commentators have argued that customer demands for local customization are on the decline worldwide.<sup>15</sup> According to this argument, modern communications and transport technologies have created the conditions for a convergence of the tastes and preferences of customers from different nations. The result is the emergence of enormous global markets for standardized consumer products. The worldwide acceptance of McDonald's hamburgers, Coca-Cola, Gap clothes, Nokia cell phones, and Sony television sets, all of which are sold globally as standardized products, are often cited as evidence of the increasing homogeneity of the global marketplace. Others, however, consider this argument to be extreme. For example, Christopher Bartlett and Sumantra Ghoshal have observed that in the consumer electronics industry, buyers reacted to an overdose of standardized global products by showing a renewed preference for products that are differentiated to local conditions.<sup>16</sup>

**Differences in Infrastructure and Traditional Practices** Pressures for local responsiveness also arise from differences in infrastructure or traditional practices among countries, creating a need to customize products accordingly. To meet this need, companies may have to delegate manufacturing and production functions to foreign subsidiaries. For example, in North America, consumer electrical systems are based on 110 volts, whereas in some European countries 240-volt systems are standard. Thus, domestic electrical appliances have to be customized to take this difference in infrastructure into account. Traditional practices also often vary across nations. For example, in Britain, people drive on the left-hand side of the road, creating a demand for right-hand-drive cars, whereas in France (and the rest of Europe), people drive on the right-hand side of the road and need left-hand-drive cars. Obviously, automobiles have to be customized to take this difference in traditional practices into account.

Although many of the country differences in infrastructure are rooted in history, some are quite recent. For example, in the wireless telecommunications industry, different technical standards are found in different parts of the world. A technical standard known as GSM is common in Europe, and an alternative standard, CDMA, is more common in the United States and parts of Asia. The significance of these different standards is that equipment designed for GSM will not work on a CDMA network, and vice versa. Thus, companies such as Nokia, Motorola, and Ericsson, which manufacture wireless handsets and infrastructure such as switches, need to customize their product offering according to the technical standard prevailing in a given country.

**Differences in Distribution Channels** A company's marketing strategies may have to be responsive to differences in distribution channels among countries, which may necessitate delegating marketing functions to national subsidiaries. In the pharmaceutical industry, for example, the British and Japanese distribution system is radically different from the United States system. British and Japanese doctors will not accept or respond favorably to a United States-style high-pressure sales force. Thus, pharmaceutical companies have to adopt different marketing practices in Britain and Japan compared with the United States—soft sell versus hard sell.

Similarly, Poland, Brazil, and Russia all have similar per capita income on a purchasing power parity basis, but there are big differences in distribution systems across the three countries. In Brazil, supermarkets account for 36% of food retailing, in Poland for 18%, and in Russia for less than 1%.<sup>17</sup> These differences in channels require that companies adapt their own distribution and sales strategy.

**Differences in Host Government Demands** Finally, economic and political demands imposed by host country governments may require local responsiveness. For example, pharmaceutical companies are subject to local clinical testing, registration procedures, and pricing restrictions—all of which make it necessary that the manufacturing and marketing of a drug should meet local requirements. Moreover, because governments and government agencies control a significant proportion of the health care budget in most countries, they are in a powerful position to demand a high level of local responsiveness.

More generally, threats of protectionism, economic nationalism, and local content rules (which require that a certain percentage of a product should be manufactured locally) dictate that international businesses manufacture locally. As an example, consider Bombardier, the Canadian-based manufacturer of railcars, aircraft, jet boats, and snowmobiles. Bombardier has 12 railcar factories across Europe. Critics

## Ethical Dilemma

Because of low labor costs, your company has established a manufacturing subsidiary in Southern China. At the local minimum wage, employees work 10-hour days (sometimes 12-hour days due to mandatory overtime), six days a week. The factory does not adhere to the same standards for environmental protection and employee safety as those mandated in your home nation. You are concerned with the substandard working conditions and environmental protection and ask the expatriate manager heading operations if something should be done to improve conditions. He argues that he is complying with all local regulations and laws. Moreover, he notes that the company established this subsidiary to have a low-cost manufacturing base. Improving working conditions and environmental standards beyond those mandated by local laws would not be consistent with this goal. Is his position ethical? What are the potential negative consequences of continuing operations in this manner? What benefits might there be to improve conditions beyond local standards?

of the company argue that the resulting duplication of manufacturing facilities leads to high costs and helps explain why Bombardier makes lower profit margins on its railcar operations than on its other business lines. In reply, managers at Bombardier argue that in Europe, informal rules with regard to local content favor people who use local workers. To sell railcars in Germany, they claim, you must manufacture in Germany. The same goes for Belgium, Austria, and France. To try to address its cost structure in Europe, Bombardier has centralized its engineering and purchasing functions, but it has no plans to centralize manufacturing.<sup>18</sup>

## CHOOSING A GLOBAL STRATEGY

Pressures for local responsiveness imply that it may not be possible for a firm to realize the full benefits from economies of scale and location economies. It may not be possible to serve the global marketplace from a single low-cost location, producing a globally standardized product, and marketing it worldwide to achieve economies of scale. In practice, the need to customize the product offering to local conditions may work against the implementation of such a strategy. For example, automobile firms have found that Japanese, American, and European consumers demand different kinds of cars, and this necessitates producing products that are customized for local markets. In response, firms like Honda, Ford, and Toyota are pursuing a strategy of establishing top-to-bottom design and production facilities in each of these regions so that they can better serve local demands. Although such customization brings benefits, it also limits the ability of a firm to realize significant scale economies and location economies.

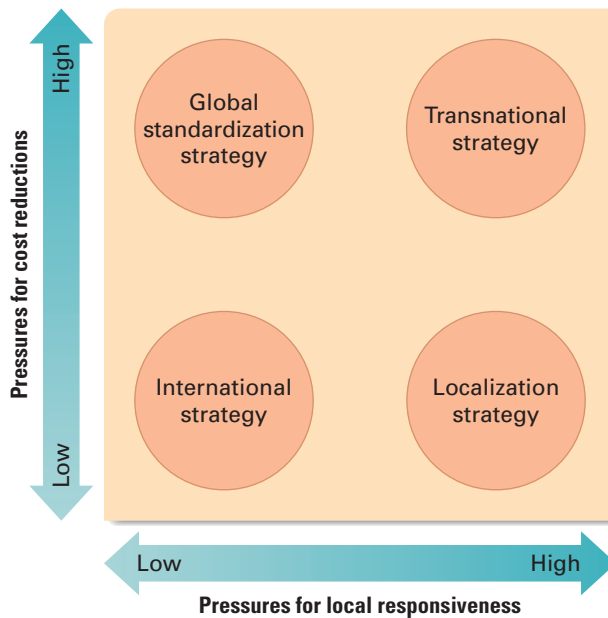
In addition, pressures for local responsiveness imply that it may not be possible to leverage skills and products associated with a firm's distinctive competencies wholesale from one nation to another. Concessions often have to be made to local conditions. Despite being depicted as "poster boy" for the proliferation of standardized global products, even McDonald's has found that it has to customize its product offerings (its menu) to account for national differences in tastes and preferences.

Given the need to balance the cost and differentiation (value) sides of a company's business model, how do differences in the strength of pressures for cost reductions versus those for local responsiveness affect the choice of a company's strategy? Companies typically choose among four main strategic postures when competing internationally: a global standardization strategy, a localization strategy, a transnational strategy, and an international strategy.<sup>19</sup> The appropriateness of each strategy varies with the extent of pressures for cost reductions and local responsiveness. Figure 8.3 illustrates the conditions under which each of these strategies is most appropriate.

### Global Standardization Strategy

Companies that pursue a **global standardization strategy** focus on increasing profitability by reaping the cost reductions that come from economies of scale and location economies; that is, their business model is based on pursuing a low-cost strategy on a global scale. The production, marketing, and R&D activities of companies pursuing a global strategy are concentrated in a few favorable locations. These companies try not to customize their product offering and marketing strategy to local conditions because customization, which involves shorter production runs and the duplication of functions, can raise costs. Instead, they prefer to market a standardized product

**Figure 8.3** Four Basic Strategies



worldwide so that they can reap the maximum benefits from economies of scale. They also tend to use their cost advantage to support aggressive pricing in world markets.

This strategy makes most sense when there are strong pressures for cost reductions, and demand for local responsiveness is minimal. Increasingly, these conditions prevail in many industrial goods industries, whose products often serve universal needs. In the semiconductor industry, for example, global standards have emerged, creating enormous demands for standardized global products. Accordingly, companies such as Intel, Texas Instruments, and Motorola all pursue a global strategy.

These conditions are not always found in many consumer goods markets, where demands for local responsiveness remain high. However, even some consumer goods companies are moving toward a global standardization strategy in an attempt to drive down their costs. P&G, which is featured in Strategy in Action 8.2, is one example of such a company.

## Localization Strategy

A **localization strategy** focuses on increasing profitability by customizing the company's goods or services so that they provide a good match to tastes and preferences in different national markets. Localization is most appropriate when there are substantial differences across nations with regard to consumer tastes and preferences and where cost pressures are not too intense. By customizing the product offering to local demands, the company increases the value of that product in the local market. On the downside, because it involves some duplication of functions and smaller production runs, customization limits the ability of the company to capture the cost reductions associated with mass-producing a standardized product for global consumption. The strategy may make sense, however, if the added value associated with local customization

## 8.2 STRATEGY IN ACTION

### The Evolution of Strategy at Procter & Gamble

Founded in 1837, Cincinnati-based Procter & Gamble has long been one of the world's most international of companies. Today P&G is a global colossus in the consumer products business with annual sales in excess of \$50 billion, some 54% of which are generated outside the United States. P&G sells more than 300 brands—including Ivory soap, Tide, Pampers, Iams pet food, Crisco, and Folgers—to consumers in 160 countries. Historically, the strategy at P&G was well established. The company developed new products in Cincinnati and then relied on semiautonomous foreign subsidiaries to manufacture, market, and distribute those products in different nations. In many cases, foreign subsidiaries had their own production facilities and tailored the packaging, brand name, and marketing message to local tastes and preferences. For years this strategy delivered a steady stream of new products and reliable growth in sales and profits. By the 1990s, however, profit growth at P&G was slowing.

The essence of the problem was simple; P&G's costs were too high because of extensive duplication of manufacturing, marketing, and administrative facilities in different national subsidiaries. The duplication of assets made sense in the world of the 1960s, when national markets were segmented from each other by barriers to cross-border trade. Products produced in Great Britain, for example, could not be sold economically in Germany due to high tariff duties levied on imports into Germany. By the 1980s, however, barriers to cross-border trade were falling rapidly worldwide, and fragmented national markets were merging into larger regional or global markets. Also, the retailers through which P&G distributed its products were growing larger and more global, such as Walmart, Tesco from the United Kingdom, and Carrefour from France. These emerging global retailers were demanding price discounts from P&G.

In the 1990s, P&G embarked on a major reorganization in an attempt to control its cost structure and recognize the new reality of emerging global markets. The company shut down 30 manufacturing plants around the globe, laid off 13,000 employees, and concentrated production in fewer plants that could better realize economies of scale and serve regional markets. It was not enough. Profit growth remained sluggish, so in 1999, P&G launched a second reorganization. The goal was to transform P&G into a truly global company. The company tore up its old organization, which was based on countries and regions, and replaced it with one based on seven self-contained global business units, ranging from baby care to food products. Each business unit was given complete responsibility for generating profits from its products, and for manufacturing, marketing, and product development. Each business unit was told to rationalize production, concentrating it in fewer larger facilities; to try to build global brands wherever possible, thereby eliminating marketing difference between countries; and to accelerate the development and launch of new products. P&G announced that as a result of this initiative, it would close another 10 factories and lay off 15,000 employees, mostly in Europe where there was still extensive duplication of assets. The annual cost savings were estimated to be about \$800 million. P&G planned to use the savings to cut prices and increase marketing spending in an effort to gain market share, and thus further lower costs through the attainment of economies of scale. This time the strategy seemed to be working. Between 2003 and 2007, P&G reported strong growth in both sales and profits. Significantly, P&G's global competitors, such as Unilever, Kimberly-Clark, and Colgate-Palmolive, were struggling in 2003 to 2007.

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**Source:** J. Neff, "P&G Outpacing Unilever in Five-Year Battle," *Advertising Age*, November 3, 2003, 1–3; G. Strauss, "Firm Restructuring into Truly Global Company," *USA Today*, September 10, 1999, B2; *Procter & Gamble 10K Report*, 2005; M. Kolbasuk McGee, "P&G Jump-Starts Corporate Change," *Information Week*, November 1, 1999, 30–34.

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supports higher pricing, which would enable the company to recoup its higher costs, or if it leads to substantially greater local demand, enabling the company to reduce costs through the attainment of some scale economies in the local market.

MTV Networks is a good example of a company that has had to pursue a localization strategy. If MTV had not localized its programming to match the demands of viewers in different nations, it would have lost market share to local competitors, its

advertising revenues would have fallen, and its profitability would have declined. Thus, even though it raised costs, localization became a strategic imperative at MTV.

At the same time, it is important to realize that companies like MTV still have to keep a close eye on costs. Companies pursuing localization strategies still need to be efficient and, whenever possible, capture some scale economies from their global reach. As noted earlier, many automobile companies have found that they have to customize some of their product offerings to local market demands—for example, by producing large pickup trucks for United States consumers and small, fuel-efficient cars for Europeans and Japanese. At the same time, these companies try to get some scale economies from their global volume by using common vehicle platforms and components across many different models and by manufacturing those platforms and components at efficiently scaled factories that are optimally located. By designing their products in this way, these companies have been able to localize their product offering, yet simultaneously capture some scale economies.

## Transnational Strategy

We have argued that a global standardization strategy makes most sense when cost pressures are intense and demands for local responsiveness limited. Conversely, a localization strategy makes most sense when demands for local responsiveness are high but cost pressures are moderate or low. What happens, however, when the company simultaneously faces both strong cost pressures and strong pressures for local responsiveness? How can managers balance out such competing and inconsistent demands? According to some researchers, the answer is by pursuing what has been called a transnational strategy.

Two of these researchers, Christopher Bartlett and Sumantra Ghoshal, argue that in today's global environment, competitive conditions are so intense that, to survive, companies must do all they can to respond to pressures for both cost reductions and local responsiveness. They must try to realize location economies and economies of scale from global volume, transfer distinctive competencies and skills within the company, and simultaneously pay attention to pressures for local responsiveness.<sup>20</sup>

Moreover, Bartlett and Ghoshal note that, in the modern multinational enterprise, distinctive competencies and skills do not reside just in the home country but can develop in any of the company's worldwide operations. Thus, they maintain that the flow of skills and product offerings should not be all one way, from home company to foreign subsidiary. Rather, the flow should also be from foreign subsidiary to home country and from foreign subsidiary to foreign subsidiary. Transnational companies, in other words, must also focus on leveraging subsidiary skills.

In essence, companies that pursue **transnational strategies** are trying to develop business models that simultaneously achieve low costs, differentiate the product offerings across geographic markets, and foster a flow of skills between different subsidiaries in the companies' global networks of operations. As attractive as this may sound, the strategy is not an easy one to pursue because it places conflicting demands on a company. Differentiating the product to respond to local demands in different geographic markets raises costs, which runs counter to the goal of reducing costs. Companies such as Ford and ABB (one of the world's largest engineering conglomerates) have tried to embrace a transnational strategy and have found it difficult to implement in practice.

Indeed, how best to implement a transnational strategy is one of the most complex questions that large global companies are grappling with today. It may be that



few if any companies have perfected this strategic posture. But some clues to the right approach can be derived from a number of companies. Consider, for example, the case of Caterpillar. The need to compete with low-cost competitors such as Komatsu of Japan forced Caterpillar to look for greater cost economies. However, variations in construction practices and government regulations across countries meant that Caterpillar also had to be responsive to local demands. Therefore, Caterpillar confronted significant pressures for both cost reductions and local responsiveness.

To deal with cost pressures, Caterpillar redesigned its products to use many identical components and invested in a few large-scale component-manufacturing facilities, sited at favorable locations, to fill global demand and realize scale economies. At the same time, the company augments the centralized manufacturing of components with assembly plants in each of its major global markets. At these plants, Caterpillar adds local product features, tailoring the finished product to local needs. Thus, Caterpillar is able to realize many of the benefits of global manufacturing while reacting to pressures for local responsiveness by differentiating its product among national markets.<sup>21</sup> Caterpillar started to pursue this strategy in 1979, and over the next 20 years it succeeded in doubling output per employee, significantly reducing its overall cost structure in the process. Meanwhile, Komatsu and Hitachi, which are still wedded to a Japan-centric global strategy, have seen their cost advantages evaporate and have been steadily losing market share to Caterpillar.

However, building an organization capable of supporting a transnational strategy is a complex and challenging task. Indeed, some would say it is too complex because the strategy implementation problems of creating a viable organizational structure and control systems to manage this strategy are immense. We will return to this issue in Chapter 13.

## International Strategy

Sometimes it is possible to identify multinational companies that find themselves in the fortunate position of being confronted with low cost pressures and low pressures for local responsiveness. Typically these enterprises are selling a product that serves universal needs, but because they do not face significant competitors, they are not confronted with pressures to reduce their cost structure. Xerox found itself in this position in the 1960s after its invention and commercialization of the photocopier. The technology underlying the photocopier was protected by strong patents, so for several years Xerox did not face competitors: it had a monopoly. Because the product was highly valued in most developed nations, Xerox was able to sell the same basic product the world over and charge a relatively high price for it. At the same time, because it did not face direct competitors, the company did not have to deal with strong pressures to minimize its costs.

Historically, companies like Xerox have followed a similar developmental pattern as they build their international operations. They tend to centralize product development functions such as R&D at home. However, they also tend to establish manufacturing and marketing functions in each major country or geographic region in which they do business. Although they may undertake some local customization of product offering and marketing strategy, this tends to be rather limited in scope. Ultimately, in most international companies, the head office retains tight control over marketing and product strategy.

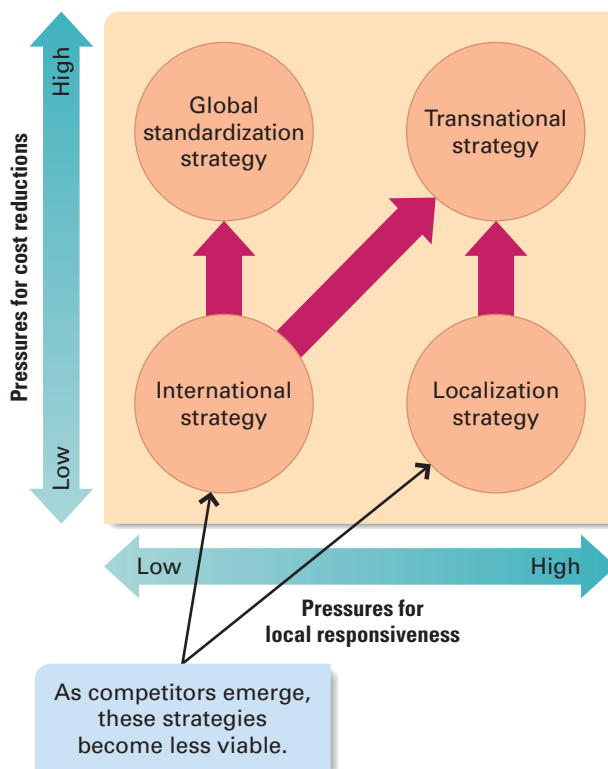
Other companies that have pursued this strategy include P&G, which historically always developed innovative new products in Cincinnati and then transferred them

wholesale to local markets. Another company that has followed a similar strategy is Microsoft. The bulk of Microsoft's product development work takes place in Redmond, Washington, where the company is headquartered. Although some localization work is undertaken elsewhere, this is limited to producing foreign-language versions of popular Microsoft programs such as Office.

### Changes in Strategy over Time

The Achilles heel of the international strategy is that, over time, competitors inevitably emerge, and if managers do not take proactive steps to reduce their cost structure, their company may be rapidly outflanked by efficient global competitors. That is exactly what happened to Xerox. Japanese companies such as Canon ultimately invented their way around Xerox's patents, produced their own photocopies in very efficient manufacturing plants, priced them below Xerox's products, and rapidly took global market share from Xerox. Xerox's demise was not due to the emergence of competitors, for ultimately that was bound to occur, but rather to its failure to proactively reduce its cost structure in advance of the emergence of efficient global competitors. The message in this story is that an international strategy may not be viable in the long term. To survive, companies that are able to pursue it need to shift toward a global standardization strategy or perhaps a transnational strategy in advance of competitors (see Figure 8.4).

**Figure 8.4** Changes over Time



The same can be said about a localization strategy. Localization may give a company a competitive edge, but if it is simultaneously facing aggressive competitors, the company will also have to reduce its cost structure, and the only way to do that may be to adopt more of a transnational strategy. Thus, as competition intensifies, international and localization strategies tend to become less viable, and managers need to orientate their companies toward either a global standardization strategy or a transnational strategy.

## THE CHOICE OF ENTRY MODE

Any firm contemplating entering a different national market has to determine the best mode or vehicle for such entry. There are five main choices of entry mode: exporting, licensing, franchising, entering into a joint venture with a host country company, and setting up a wholly owned subsidiary in the host country. Each mode has its advantages and disadvantages, and managers must weigh these carefully when deciding which mode to use.<sup>22</sup>

### Exporting

Most manufacturing companies begin their global expansion as exporters and only later switch to one of the other modes for serving a foreign market. Exporting has two distinct advantages: it avoids the costs of establishing manufacturing operations in the host country, which are often substantial, and it may be consistent with scale economies and location economies. By manufacturing the product in a centralized location and then exporting it to other national markets, the company may be able to realize substantial scale economies from its global sales volume. That is how Sony came to dominate the global television market, how many Japanese auto companies originally made inroads into the United States auto market, and how Samsung gained share in the market for computer memory chips.

There are also a number of drawbacks to exporting. First, exporting from the company's home base may not be appropriate if there are lower-cost locations for manufacturing the product abroad (that is, if the company can realize location economies by moving production elsewhere). Thus, particularly in the case of a company pursuing a global standardization or transnational strategy, it may pay to manufacture in a location where conditions are most favorable from a value creation perspective and then export from that location to the rest of the globe. This is not so much an argument against exporting as an argument against exporting from the company's home country. For example, many United States electronics companies have moved some of their manufacturing to Asia because low-cost but highly skilled labor is available there. They export from that location to the rest of the globe, including the United States.

Another drawback is that high transport costs can make exporting uneconomical, particularly in the case of bulk products. One way of getting around this problem is to manufacture bulk products on a regional basis, thereby realizing some economies from large-scale production while limiting transport costs. Many multinational chemical companies manufacture their products on a regional basis, serving several countries in a region from one facility.

Tariff barriers, too, can make exporting uneconomical, and a government's threat to impose tariff barriers can make the strategy very risky. Indeed, the implicit threat

from the United States Congress to impose tariffs on Japanese cars imported into the United States led directly to the decision by many Japanese auto companies to set up manufacturing plants in the United States.

Finally, a common practice among companies that are just beginning to export also poses risks. A company may delegate marketing activities in each country in which it does business to a local agent, but there is no guarantee that the agent will act in the company's best interest. Often foreign agents also carry the products of competing companies and thus have divided loyalties. Consequently, they may not do as good a job as the company would if it managed marketing itself. One way to solve this problem is to set up a wholly owned subsidiary in the host country to handle local marketing. In this way, the company can reap the cost advantages that arise from manufacturing the product in a single location and exercise tight control over marketing strategy in the host country.

## Licensing

International licensing is an arrangement whereby a foreign licensee buys the rights to produce a company's product in the licensee's country for a negotiated fee (normally, royalty payments on the number of units sold). The licensee then puts up most of the capital necessary to get the overseas operation going.<sup>23</sup> The advantage of licensing is that the company does not have to bear the development costs and risks associated with opening up a foreign market. Licensing therefore can be a very attractive option for companies that lack the capital to develop operations overseas. It can also be an attractive option for companies that are unwilling to commit substantial financial resources to an unfamiliar or politically volatile foreign market where political risks are particularly high.

Licensing has three serious drawbacks, however. First, it does not give a company the tight control over manufacturing, marketing, and strategic functions in foreign countries that it needs to have to realize scale economies and location economies—as companies pursuing both global standardization and transnational strategies try to do. Typically, each licensee sets up its own manufacturing operations. Hence, the company stands little chance of realizing scale economies and location economies by manufacturing its product in a centralized location. When these economies are likely to be important, licensing may not be the best way of expanding overseas.

Second, competing in a global marketplace may make it necessary for a company to coordinate strategic moves across countries so that the profits earned in one country can be used to support competitive attacks in another. Licensing, by its very nature, severely limits a company's ability to coordinate strategy in this way. A licensee is unlikely to let a multinational company take its profits (beyond those due in the form of royalty payments) and use them to support an entirely different licensee operating in another country.

A third problem with licensing is the risk associated with licensing technological know-how to foreign companies. For many multinational companies, technological know-how forms the basis of their competitive advantage, and they would want to maintain control over the use to which it is put. By licensing its technology, a company can quickly lose control over it. RCA, for instance, once licensed its color television technology to a number of Japanese companies. The Japanese companies quickly assimilated RCA's technology and then used it to enter the United States market. Now the Japanese have a bigger share of the United States market than the RCA brand does.

There are ways of reducing this risk. One way is by entering into a cross-licensing agreement with a foreign firm. Under a cross-licensing agreement, a firm might license some valuable intangible property to a foreign partner and, in addition to a royalty payment, also request that the foreign partner license some of its valuable know-how to the firm. Such agreements are reckoned to reduce the risks associated with licensing technological know-how because the licensee realizes that if it violates the spirit of a licensing contract (by using the knowledge obtained to compete directly with the licensor), the licensor can do the same to it. Put differently, cross-licensing agreements enable firms to hold each other hostage, thereby reducing the probability that they will behave opportunistically toward each other.<sup>24</sup> Such cross-licensing agreements are increasingly common in high-technology industries. For example, the United States biotechnology firm Amgen has licensed one of its key drugs, Nuprogene, to Kirin, the Japanese pharmaceutical company. The license gives Kirin the right to sell Nuprogene in Japan. In return, Amgen receives a royalty payment, and through a licensing agreement it gains the right to sell certain of Kirin's products in the United States.

## Franchising

In many respects, franchising is similar to licensing, although franchising tends to involve longer-term commitments than licensing. Franchising is basically a specialized form of licensing in which the franchiser not only sells intangible property to the franchisee (normally a trademark) but also insists that the franchisee agree to abide by strict rules as to how it does business. The franchiser will also often assist the franchisee to run the business on an ongoing basis. As with licensing, the franchiser typically receives a royalty payment, which amounts to some percentage of the franchisee revenues.

Whereas licensing is a strategy pursued primarily by manufacturing companies, franchising, which resembles it in some respects, is a strategy employed chiefly by service companies. McDonald's provides a good example of a firm that has grown by using a franchising strategy. McDonald's has established strict rules as to how franchisees should operate a restaurant. These rules extend to control over the menu, cooking methods, staffing policies, and restaurant design and location. McDonald's also organizes the supply chain for its franchisees and provides management training and financial assistance.<sup>25</sup>

The advantages of franchising are similar to those of licensing. Specifically, the franchiser does not have to bear the development costs and risks of opening up a foreign market on its own, for the franchisee typically assumes those costs and risks. Thus, using a franchising strategy, a service company can build up a global presence quickly and at a low cost.

The disadvantages are less pronounced than in the case of licensing. Because franchising is often used by service companies, there is no reason to consider the need for coordination of manufacturing to achieve experience curve and location economies. But franchising may inhibit the firm's ability to take profits out of one country to support competitive attacks in another. A more significant disadvantage of franchising is quality control. The foundation of franchising arrangements is that the firm's brand name conveys a message to consumers about the quality of the firm's product. Thus, a business traveler checking in at a Four Seasons hotel in Hong Kong can reasonably expect the same quality of room, food, and service that he or she would receive in New York. The Four Seasons name is supposed to guarantee consistent product

quality. This presents a problem in that foreign franchisees may not be as concerned about quality as they are supposed to be, and the result of poor quality can extend beyond lost sales in a particular foreign market to a decline in the firm's worldwide reputation. For example, if a business traveler has a bad experience at the Four Seasons in Hong Kong, he or she may never go to another Four Seasons hotel and may urge his or her colleagues to do likewise. The geographical distance of the firm from its foreign franchisees can make poor quality difficult to detect. In addition, the sheer numbers of franchisees—in the case of McDonald's, tens of thousands—can make quality control difficult. Due to these factors, quality problems may persist.

To reduce this problem, a company can set up a subsidiary in each country or region in which it is expanding. The subsidiary, which might be wholly owned by the company or a joint venture with a foreign company, then assumes the rights and obligations to establish franchisees throughout that particular country or region. The combination of proximity and the limited number of independent franchisees that have to be monitored reduces the quality control problem. Besides, since the subsidiary is at least partly owned by the company, the company can place its own managers in the subsidiary to ensure the kind of quality monitoring it wants. This organizational arrangement has proved very popular in practice. It has been used by McDonald's, Kentucky Fried Chicken (KFC), and Hilton Hotels Corp. to expand their international operations, to name just three examples.

## Joint Ventures

Establishing a joint venture with a foreign company has long been a favored mode for entering a new market. One of the most famous long-term joint ventures is the Fuji-Xerox joint venture to produce photocopiers for the Japanese market. The most typical form of joint venture is a 50/50 joint venture, in which each party takes a 50% ownership stake, and operating control is shared by a team of managers from both parent companies. Some companies have sought joint ventures in which they have a majority shareholding (for example, a 51% to 49% ownership split), which permits tighter control by the dominant partner.<sup>26</sup>

Joint ventures have a number of advantages. First, a company may feel that it can benefit from a local partner's knowledge of a host country's competitive conditions, culture, language, political systems, and business systems. Second, when the development costs and risks of opening up a foreign market are high, a company might gain by sharing these costs and risks with a local partner. Third, in some countries, political considerations make joint ventures the only feasible entry mode. For example, historically many United States companies found it much easier to get permission to set up operations in Japan if they went in with Japanese partners than if they tried to enter on their own. That is why Xerox originally teamed up with Fuji to sell photocopiers in Japan.

Despite these advantages, there are major disadvantages with joint ventures. First, as with licensing, a firm that enters into a joint venture risks giving control of its technology to its partner. Thus, a proposed joint venture in 2002 between Boeing and Mitsubishi Heavy Industries to build a new wide-body jet raised fears that Boeing might unwittingly give away its commercial airline technology to the Japanese. However, joint-venture agreements can be constructed to minimize this risk. One option is to hold majority ownership in the venture. This allows the dominant partner to exercise greater control over its technology. But it can be difficult to find a foreign partner who is willing to settle for minority ownership.



Another option is to “wall off” from a partner technology that is central to the core competence of the firm, while sharing other technology.

A second disadvantage is that a joint venture does not give a firm the tight control over subsidiaries that it might need to realize experience curve or location economies. Nor does it give a firm the tight control over a foreign subsidiary that it might need for engaging in coordinated global attacks against its rivals. Consider the entry of Texas Instruments (TI) into the Japanese semiconductor market. When TI established semiconductor facilities in Japan, it did so for the dual purpose of checking Japanese manufacturers’ market share and limiting their cash available for invading TI’s global market. In other words, TI was engaging in global strategic coordination. To implement this strategy, TI’s subsidiary in Japan had to be prepared to take instructions from corporate headquarters regarding competitive strategy. The strategy also required the Japanese subsidiary to run at a loss if necessary. Few if any potential joint-venture partners would have been willing to accept such conditions because it would have necessitated a willingness to accept a negative return on investment. Indeed, many joint ventures establish a degree of autonomy that would make such direct control over strategic decisions all but impossible to establish.<sup>27</sup> Thus, to implement this strategy, TI set up a wholly owned subsidiary in Japan.

### Wholly Owned Subsidiaries

A wholly owned subsidiary is one in which the parent company owns 100% of the subsidiary’s stock. To establish a wholly owned subsidiary in a foreign market, a company can either set up a completely new operation in that country or acquire an established host-country company and use it to promote its products in the host market.

Setting up a wholly owned subsidiary offers three advantages. First, when a company’s competitive advantage is based on its control of a technological competency, a wholly owned subsidiary will normally be the preferred entry mode because it reduces the company’s risk of losing this control. Consequently, many high-tech companies prefer wholly owned subsidiaries to joint ventures or licensing arrangements. Wholly owned subsidiaries tend to be the favored entry mode in the semiconductor, computer, electronics, and pharmaceutical industries. Second, a wholly owned subsidiary gives a company the kind of tight control over operations in different countries that it needs if it is going to engage in global strategic coordination—taking profits from one country to support competitive attacks in another.

Third, a wholly owned subsidiary may be the best choice if a company wants to realize location economies and the scale economies that flow from producing a standardized output from a single or limited number of manufacturing plants. When pressures on costs are intense, it may pay a company to configure its value chain in such a way that value added at each stage is maximized. Thus, a national subsidiary may specialize in manufacturing only part of the product line or certain components of the end product, exchanging parts and products with other subsidiaries in the company’s global system. Establishing such a global production system requires a high degree of control over the operations of national affiliates. Different national operations have to be prepared to accept centrally determined decisions as to how they should produce, how much they should produce, and how their output should be priced for transfer between operations. A wholly owned subsidiary would have to comply with these mandates, whereas licensees or joint venture partners would most likely shun such a subservient role.

On the other hand, establishing a wholly owned subsidiary is generally the most costly method of serving a foreign market. The parent company must bear all the costs and risks of setting up overseas operations—in contrast to joint ventures, where the costs and risks are shared, or licensing, where the licensee bears most of the costs and risks. But the risks of learning to do business in a new culture diminish if the company acquires an established host country enterprise. Acquisitions, though, raise a whole set of additional problems, such as trying to marry divergent corporate cultures, and these problems may more than offset the benefits. (The problems associated with acquisitions are discussed in Chapter 10.)

## Choosing an Entry Strategy

The advantages and disadvantages of the various entry modes are summarized in Table 8.1. Inevitably, there are tradeoffs in choosing one entry mode over another. For example, when considering entry into an unfamiliar country with a track record of nationalizing foreign-owned enterprises, a company might favor a joint venture with a local enterprise. Its rationale might be that the local partner will help it establish operations in an unfamiliar environment and speak out against nationalization should the possibility arise. But if the company's distinctive competency is based on

**Table 8.1** The Advantages and Disadvantages of Different Entry Modes

Entry Mode	Advantages	Disadvantages
Exporting	<ul style="list-style-type: none"> <li>• Ability to realize location- and scale-based economies</li> </ul>	<ul style="list-style-type: none"> <li>• High transport costs</li> <li>• Trade barriers</li> <li>• Problems with local marketing agents</li> </ul>
Licensing	<ul style="list-style-type: none"> <li>• Low development costs and risks</li> </ul>	<ul style="list-style-type: none"> <li>• Inability to realize location- and scale-based economies</li> <li>• Inability to engage in global strategic coordination</li> <li>• Lack of control over technology</li> </ul>
Franchising	<ul style="list-style-type: none"> <li>• Low development costs and risks</li> </ul>	<ul style="list-style-type: none"> <li>• Inability to engage in global strategic coordination</li> <li>• Lack of control over quality</li> </ul>
Joint ventures	<ul style="list-style-type: none"> <li>• Access to local partner's knowledge</li> <li>• Shared development costs and risks</li> <li>• Political dependency</li> </ul>	<ul style="list-style-type: none"> <li>• Inability to engage in global strategic coordination</li> <li>• Inability to realize location- and scale-based economies</li> <li>• Lack of control over technology</li> </ul>
Wholly owned subsidiaries	<ul style="list-style-type: none"> <li>• Protection of technology</li> <li>• Ability to engage in global strategic coordination</li> <li>• Ability to realize location- and scale-based economies</li> </ul>	<ul style="list-style-type: none"> <li>• High costs and risks</li> </ul>

proprietary technology, entering into a joint venture might mean risking loss of control over that technology to the joint venture partner, which would make this strategy unattractive. Despite such hazards, some generalizations can be offered about the optimal choice of entry mode.

**Distinctive Competencies and Entry Mode** When companies expand internationally to earn greater returns from their differentiated product offerings, entering markets where indigenous competitors lack comparable products, the companies are pursuing an international strategy. The optimal entry mode for such companies depends to some degree on the nature of their distinctive competency. In particular, we need to distinguish between companies with a distinctive competency in technological know-how and those with a distinctive competency in management know-how.

If a company's competitive advantage—its distinctive competency—derives from its control of proprietary technological know-how, licensing and joint venture arrangements should be avoided, if possible, to minimize the risk of losing control of that technology. Thus, if a high-tech company is considering setting up operations in a foreign country to profit from a distinctive competency in technological know-how, it should probably do so through a wholly owned subsidiary.

However, this rule should not be viewed as a hard and fast one. For instance, a licensing or joint venture arrangement might be structured in such a way as to reduce the risks that a company's technological know-how will be expropriated by licensees or joint venture partners. We consider this kind of arrangement in more detail later in the chapter when we discuss the issue of structuring strategic alliances. To take another exception to the rule, a company may perceive its technological advantage as being only transitory and expect rapid imitation of its core technology by competitors. In this situation, the company might want to license its technology as quickly as possible to foreign companies to gain global acceptance of its technology before imitation occurs.<sup>28</sup> Such a strategy has some advantages. By licensing its technology to competitors, the company may deter them from developing their own, possibly superior, technology. It also may be able to establish its technology as the dominant design in the industry (as Matsushita did with its VHS format for VCRs), ensuring a steady stream of royalty payments. Such situations apart, however, the attractions of licensing are probably outweighed by the risks of losing control of technology, and therefore licensing should be avoided.

The competitive advantage of many service companies, such as McDonald's or Hilton Hotels, is based on management know-how. For such companies, the risk of losing control of their management skills to franchisees or joint venture partners is not that great. The reason is that the valuable asset of such companies is their brand name, and brand names are generally well protected by international laws pertaining to trademarks. Given this fact, many of the issues that arise in the case of technological know-how do not arise in the case of management know-how. As a result, many service companies favor a combination of franchising and subsidiaries to control franchisees within a particular country or region. The subsidiary may be wholly owned or a joint venture. In most cases, however, service companies have found that entering into a joint venture with a local partner to set up a controlling subsidiary in a country or region works best because a joint venture is often politically more acceptable and brings a degree of local knowledge to the subsidiary.

**Pressures for Cost Reduction and Entry Mode** The greater the pressures for cost reductions are, the more likely it is that a company will want to pursue some

combination of exporting and wholly owned subsidiaries. By manufacturing in the locations where factor conditions are optimal and then exporting to the rest of the world, a company may be able to realize substantial location economies and substantial scale economies. The company might then want to export the finished product to marketing subsidiaries based in various countries. Typically, these subsidiaries would be wholly owned and have the responsibility for overseeing distribution in a particular country. Setting up wholly owned marketing subsidiaries is preferable to a joint venture arrangement or using a foreign marketing agent because it gives the company the tight control over marketing that might be required to coordinate a globally dispersed value chain. In addition, tight control over a local operation enables the company to use the profits generated in one market to improve its competitive position in another market. Hence companies pursuing global or transnational strategies prefer to establish wholly owned subsidiaries.

## GLOBAL STRATEGIC ALLIANCES

**Global strategic alliances** are cooperative agreements between companies from different countries that are actual or potential competitors. Strategic alliances run the range from formal joint ventures, in which two or more companies have an equity stake, to short-term contractual agreements, in which two companies may agree to cooperate on a particular problem (such as developing a new product).

### Advantages of Strategic Alliances

Companies enter into strategic alliances with competitors to achieve a number of strategic objectives.<sup>29</sup> First, strategic alliances may facilitate entry into a foreign market. For example, many firms feel that if they are to successfully enter the Chinese market, they need local partners who understand business conditions and who have good connections. Thus, in 2004, Warner Brothers entered into a joint venture with two Chinese partners to produce and distribute films in China. As a foreign film company, Warner found that if it wanted to produce films on its own for the Chinese market, it had to go through a complex approval process for every film and farm out distribution to a local company, which made doing business in China difficult. Due to the participation of Chinese firms, however, the joint-venture films go through a streamlined approval process, and the venture may distribute any films it produces. Moreover, the joint venture may produce films for Chinese TV, something that foreign firms are not allowed to do.<sup>30</sup>

Second, strategic alliances allow firms to share the fixed costs (and associated risks) of developing new products or processes. An alliance between Boeing and a number of Japanese companies to build Boeing's latest commercial jetliner, the 787, was motivated by Boeing's desire to share the estimated \$8 billion investment required to develop the aircraft. For another example of cost sharing, see Strategy in Action 8.3, which discusses the strategic alliances between Cisco and Fujitsu.

Third, an alliance is a way to bring together complementary skills and assets that neither company could easily develop on its own.<sup>31</sup> In 2003, for example, Microsoft and Toshiba established an alliance aimed at developing embedded microprocessors (essentially tiny computers) that can perform a variety of entertainment functions in

an automobile (e.g., run a back-seat DVD player or a wireless Internet connection). The processors will run a version of Microsoft's Windows CE operating system. Microsoft brings its software engineering skills to the alliance, while Toshiba brings its skills in developing microprocessors.<sup>32</sup> The alliance between Cisco and Fujitsu was also formed to share know-how (see Strategy in Action 8.3).

Fourth, it can make sense to form an alliance that will help the firm establish technological standards for the industry that will benefit the firm. For example, in 1999 Palm Computer, the leading maker of personal digital assistants (PDAs), entered into an alliance with Sony under which Sony agreed to license and use Palm's operating system in Sony PDAs. The motivation for the alliance was in part to help establish Palm's operating system as the industry standard for PDAs, as opposed to a rival Windows-based operating system from Microsoft.<sup>33</sup>

## 8.3 STRATEGY IN ACTION

### Cisco and Fujitsu

In late 2004, Cisco Systems, the world's largest manufacturer of Internet routers entered into an alliance with the Japanese computer, electronics, and telecommunications equipment firm, Fujitsu. The stated purpose of the alliance was to jointly develop next generation high-end routers for sales in Japan. Routers are the digital switches that sit at the heart of the Internet and direct traffic; they are, in effect, the traffic cops of the Internet. Although Cisco has long held the leading share in the market for routers—indeed, it pioneered the original router technology—it faces increasing competition from other firms, such as Juniper Technologies and China's fast growing Huawei Technologies. At the same time, demand in the market is shifting as more and more telecommunications companies adopt Internet-based telecommunications services. While Cisco has long had a strong global presence, management also felt that the company needed to have better presence in Japan, which is shifting rapidly to second generation high-speed Internet-based telecommunications networks.

By entering into an alliance with Fujitsu, Cisco feels it can achieve a number of goals. First, both firms can pool their R&D efforts, which will enable them to share complementary technology and develop products quicker, thereby gaining an advantage over competitors. Second, by combining Cisco's proprietary leading edge router technology with Fujitsu's production expertise,

the companies believe that they can produce products that are more reliable than those currently offered. Third, Fujitsu will give Cisco a stronger sales presence in Japan. Fujitsu has good links with Japan's telecommunications companies and a well-earned reputation for reliability. It will leverage these assets to sell the routers produced by the alliance, which will be co-branded as Fujitsu-Cisco products. Fourth, sales may be further enhanced by bundling the co-branded routers together with other telecommunications equipment that Fujitsu sells and marketing an entire solution to customers. Fujitsu sells many telecommunications products but lacks a strong presence in routers. Cisco is strong in routers but lacks strong offerings elsewhere. The combination of the two company's products will enable Fujitsu to offer Japan's telecommunications companies "end-to-end" communications solutions. Since many companies prefer to purchase their equipment from a single provider, this should drive sales.

The alliance introduced its first products in May 2006. If it is successful, both firms should benefit. Development costs will be lower than if they did not cooperate. Cisco will grow its sales in Japan, and Fujitsu can use the co-branded routers to fill out its product line and sell more bundles of products to Japan's telecommunications companies.

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**Sources:** "Fujitsu, Cisco Systems to Develop High-End Routers for Web Traffic," *Knight Ridder-Tribune Business News*, December 6, 2004, 1; "Fujitsu and Cisco Introduce New High Performance Routers for IP Next Generation Networks," *JCN Newswire*, May 25, 2006.

## Disadvantages of Strategic Alliances

The advantages we have discussed can be very significant. Despite this, some commentators have criticized strategic alliances on the grounds that they give competitors a low-cost route to new technology and markets.<sup>34</sup> For example, a few years ago some commentators argued that many strategic alliances between American and Japanese firms were part of an implicit Japanese strategy to keep high-paying, high-value-added jobs in Japan while gaining the project engineering and production process skills that underlie the competitive success of many United States companies.<sup>35</sup> They argued that Japanese success in the machine tool and semiconductor industries was built on United States technology acquired through strategic alliances. And they argued that American managers were aiding the Japanese by entering alliances that channel new inventions to Japan and provide an American sales and distribution network for the resulting products. Although such deals may generate short-term profits, so the argument goes, in the long run, the result is to “hollow out” United States firms, leaving them with no competitive advantage in the global marketplace.

These critics have a point; alliances have risks. Unless a firm is careful, it can give away more than it receives. But there are so many examples of apparently successful alliances between firms—including alliances between American and Japanese firms—that their position seems extreme. It is difficult to see how the Microsoft-Toshiba alliance, the Boeing-Mitsubishi alliance for the 787, or the Fujifilm-Xerox alliance fit the critics’ thesis. In these cases, both partners seem to have gained from the alliance. Why do some alliances benefit both firms while others benefit one firm and hurt the other? The next section provides an answer to this question.

## Making Strategic Alliances Work

The failure rate for international strategic alliances is quite high. For example, one study of 49 international strategic alliances found that two-thirds run into serious managerial and financial troubles within two years of their formation; although many of these problems are ultimately solved, 33% are ultimately rated as failures by the parties involved.<sup>36</sup> The success of an alliance seems to be a function of three main factors: partner selection, alliance structure, and the manner in which the alliance is managed.

**Partner Selection** One of the keys to making a strategic alliance work is to select the right kind of partner. A good partner has three principal characteristics. First, a good partner helps the company achieve strategic goals, such as achieving market access, sharing the costs and risks of new-product development, or gaining access to critical core competencies. In other words, the partner must have capabilities that the company lacks and that it values.

Second, a good partner shares the firm’s vision for the purpose of the alliance. If two companies approach an alliance with radically different agendas, the chances are great that the relationship will not be harmonious and will end in divorce.

Third, a good partner is unlikely to try to exploit the alliance opportunistically for its own ends—that is, to expropriate the company’s technological know-how while giving away little in return. In this respect, firms with reputations for fair play probably make the best partners. For example, IBM is involved in so many strategic alliances that it would not pay the company to trample over individual alliance partners (in the mid-2000s IBM reportedly had more than

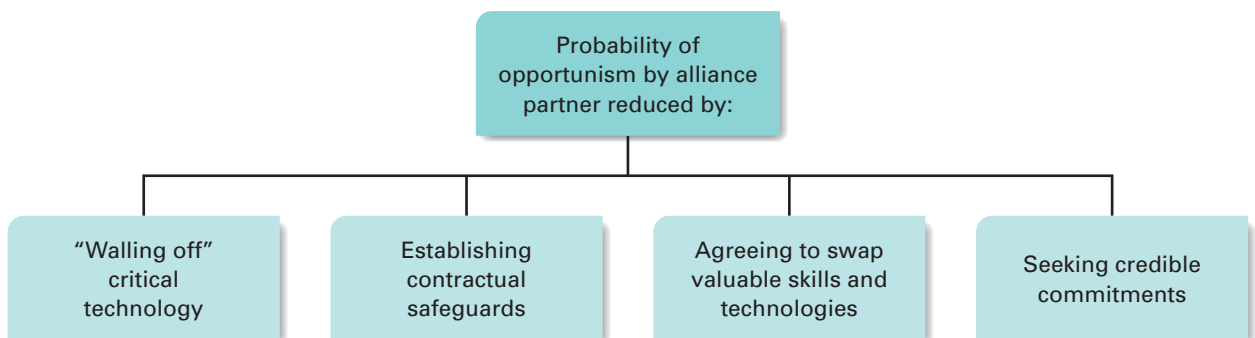


150 major strategic alliances).<sup>37</sup> This would tarnish IBM's reputation of being a good ally and would make it more difficult for IBM to attract alliance partners. Because IBM attaches great importance to its alliances, it is unlikely to engage in the kind of opportunistic behavior that critics highlight. Similarly, their reputations make it less likely (but by no means impossible) that such Japanese firms as Sony, Toshiba, and Fuji, which have histories of alliances with non-Japanese firms, would opportunistically exploit an alliance partner.

To select a partner with these three characteristics, a company needs to conduct some comprehensive research on potential alliance candidates. To increase the probability of selecting a good partner, the company should collect as much pertinent, publicly available information about potential allies as possible; collect data from informed third parties, including companies that have had alliances with the potential partners, investment bankers who have had dealings with them, and some of their former employees; and get to know potential partners as well as possible before committing to an alliance. This last step should include face-to-face meetings between senior managers (and perhaps middle-level managers) to ensure that the chemistry is right.

**Alliance Structure** Having selected a partner, the alliance should be structured so that the company's risk of giving too much away to the partner is reduced to an acceptable level. Figure 8.5 depicts the four safeguards against opportunism by alliance partners that we discuss. (**Opportunism**, which is often defined as self-interest seeking with guile, includes the "expropriation" of technology or markets.) First, alliances can be designed to make it difficult (if not impossible) to transfer technology not meant to be transferred. Specifically, the design, development, manufacture, and service of a product manufactured by an alliance can be structured so as to "wall off" sensitive technologies to prevent their leakage to the other participant. In the alliance between GE and Snecma to build commercial aircraft engines, for example, GE reduced the risk of "excess transfer" by walling off certain sections of the production process. The modularization effectively cut off the transfer of what GE regarded as key competitive technology while permitting Snecma access to final assembly. Similarly, in the alliance between Boeing and the Japanese to build the 767, Boeing walled off research, design, and marketing functions considered central to its competitive position, while allowing the Japanese to share in production technology. Boeing also walled off new technologies not required for 767 production.<sup>38</sup>

**Figure 8.5** Structuring Alliances to Reduce Opportunism



Second, contractual safeguards can be written into an alliance agreement to guard against the risk of opportunism by a partner. For example, TRW has three strategic alliances with large Japanese auto component suppliers to produce seat belts, engine valves, and steering gears for sale to Japanese-owned auto assembly plants in the United States. TRW has clauses in each of its alliance contracts that bar the Japanese firms from competing with TRW to supply American-owned auto companies with component parts. By doing this, TRW protects itself against the possibility that the Japanese companies are entering into the alliances merely as a means of gaining access to the North American market to compete with TRW in its home market.

Third, both parties to an alliance can agree in advance to swap skills and technologies that the other covets, thereby ensuring a chance for equitable gain. Cross-licensing agreements are one way to achieve this goal.

Fourth, the risk of opportunism by an alliance partner can be reduced if the firm extracts a significant credible commitment from its partner in advance. The long-term alliance between Xerox and Fuji to build photocopiers for the Asian market perhaps best illustrates this. Rather than enter into an informal agreement or a licensing arrangement (which Fuji Photo initially wanted), Xerox insisted that Fuji invest in a 50/50 joint venture to serve Japan and East Asia. This venture constituted such a significant investment in people, equipment, and facilities that Fuji Photo was committed from the outset to making the alliance work in order to earn a return on its investment. By agreeing to the joint venture, Fuji essentially made a credible commitment to the alliance. Given this, Xerox felt secure in transferring its photocopier technology to Fuji.

**Managing the Alliance** Once a partner has been selected and an appropriate alliance structure agreed on, the task facing the company is to maximize the benefits from the alliance. One important ingredient of success appears to be sensitivity to cultural differences. Many differences in management style are attributable to cultural differences, and managers need to make allowances for these in dealing with their partner. Beyond this, maximizing the benefits from an alliance seems to involve building trust between partners and learning from partners.<sup>39</sup>

Managing an alliance successfully requires building interpersonal relationships between the firms' managers, or what is sometimes referred to as *relational capital*.<sup>40</sup> This is one lesson that can be drawn from a successful strategic alliance between Ford and Mazda. Ford and Mazda set up a framework of meetings within which their managers not only discuss matters pertaining to the alliance but also have time to get to know each other better. The belief is that the resulting friendships help build trust and facilitate harmonious relations between the two firms. Personal relationships also foster an informal management network between the firms. This network can then be used to help solve problems arising in more formal contexts (such as in joint committee meetings between personnel from the two firms).

Academics have argued that a major determinant of how much acquiring knowledge a company gains from an alliance is its ability to learn from its alliance partner.<sup>41</sup> For example, in a study of 15 strategic alliances between major multinationals, Gary Hamel, Yves Doz, and C. K. Prahalad focused on a number of alliances between Japanese companies and Western (European or American) partners.<sup>42</sup> In every case in which a Japanese company emerged from an alliance stronger than its Western partner, the Japanese company had made a greater effort to learn. Few Western companies studied seemed to want to learn from their Japanese partners. They tended to

regard the alliance purely as a cost-sharing or risk-sharing device, rather than as an opportunity to learn how a potential competitor does business.

For an example of an alliance in which there was a clear learning asymmetry, consider the agreement between GM and Toyota to build the Chevrolet Nova. This alliance was structured as a formal joint venture, New United Motor Manufacturing, in which both parties had a 50% equity stake. The venture owned an auto plant in Fremont, California. According to one of the Japanese managers, Toyota achieved most of its objectives from the alliance: “We learned about United States supply and transportation. And we got the confidence to manage United States workers.” All that knowledge was then quickly transferred to Georgetown, Kentucky, where Toyota opened a plant of its own in 1988. By contrast, although GM got a new product, the Chevrolet Nova, some GM managers complained that their new knowledge was never put to good use inside GM. They say that they should have been kept together as a team to educate GM’s engineers and workers about the Japanese system. Instead, they were dispersed to different GM subsidiaries.<sup>43</sup>

When entering an alliance, a company must take some measures to ensure that it learns from its alliance partner and then puts that knowledge to good use within its own organization. One suggested approach is to educate all operating employees about the partner’s strengths and weaknesses and make clear to them how acquiring particular skills will bolster their company’s competitive position. For such learning to be of value, the knowledge acquired from an alliance has to be diffused throughout the organization—which did not happen at GM. To spread this knowledge, the managers involved in an alliance should be used as a resource in familiarizing others within the company about the skills of an alliance partner.

## SUMMARY OF CHAPTER

1. For some companies, international expansion represents a way of earning greater returns by transferring the skills and product offerings derived from their distinctive competencies to markets where indigenous competitors lack those skills. As barriers to international trade have fallen, industries have expanded beyond national boundaries, and industry competition and opportunities have increased.
2. Because of national differences, it pays a company to base each value creation activity it performs at the location where factor conditions are most conducive to the performance of that activity. This strategy is known as focusing on the attainment of location economies.
3. By building sales volume more rapidly, international expansion can help a company gain a cost advantage through the realization of economies of scale and learning effects.
4. The best strategy for a company to pursue may depend on the kind of pressures it must cope with: pressures for cost reductions or for local responsiveness. Pressures for cost reductions are greatest in industries producing commodity-type products, where price is the main competitive weapon. Pressures for local responsiveness arise from differences in consumer tastes and preferences, as well as from national infrastructure and traditional practices, distribution channels, and host government demands.
5. Companies pursuing an international strategy transfer the skills and products derived from distinctive competencies to foreign markets while undertaking some limited local customization.
6. Companies pursuing a localization strategy customize their product offering, marketing strategy, and business strategy to national conditions.

7. Companies pursuing a global standardization strategy focus on reaping the cost reductions that come from scale economies and location economies.
8. Many industries are now so competitive that companies must adopt a transnational strategy. This involves a simultaneous focus on reducing costs, transferring skills and products, and being locally responsive. Implementing such a strategy may not be easy.
9. There are five different ways of entering a foreign market: exporting, licensing, franchising, entering into a joint venture, and setting up a wholly owned subsidiary. The optimal choice among entry modes depends on the company's strategy.
10. Strategic alliances are cooperative agreements between actual or potential competitors. The advantages of alliances are that they facilitate entry into foreign markets, enable partners to share the fixed costs and risks associated with new products and processes, facilitate the transfer of complementary skills between companies, and help companies establish technical standards.
11. The drawbacks of a strategic alliance are that the company risks giving away technological know-how and market access to its alliance partner while getting very little in return.
12. The disadvantages associated with alliances can be reduced if the company selects partners carefully, paying close attention to reputation, and structures the alliance so as to avoid unintended transfers of know-how.

## DISCUSSION QUESTIONS

1. Plot the position of the following companies on Figure 8.3: Microsoft, Google, Coca-Cola, Dow Chemicals, Pfizer, and McDonald's. In each case, justify your answer.
2. Are the following global standardization industries or industries where localization is more important: bulk chemicals, pharmaceuticals, branded food products, moviemaking, television manufacturing, PCs, airline travel, and fashion retailing?
3. Discuss how the need for control over foreign operations varies with the strategy and distinctive competencies of a company. What are the implications of this relationship for the choice of entry mode?
4. Licensing proprietary technology to foreign competitors is the best way to give up a company's competitive advantage. Discuss.
5. What kind of companies stand to gain the most from entering into strategic alliances with potential competitors? Why?

## PRACTICING STRATEGIC MANAGEMENT

### Small-Group Exercise: Developing a Global Strategy

Break into groups of three to five people and discuss the following scenario. Appoint one group member as a spokesperson who will communicate your findings to the class.

You work for a company in the soft drink industry that has developed a line of carbonated fruit-based drinks. You have already established a significant presence in your home market, and now you are planning the global strategy development of the company in the soft drink industry. You need to decide the following:

1. What overall strategy to pursue: a global standardization strategy, a localization strategy, an international strategy, or a transnational strategy
2. Which markets to enter first
3. What entry strategy to pursue (e.g., franchising, joint venture, wholly owned subsidiary)
4. What information do you need to make these kinds of decisions? On the basis of what you do know, what strategy would you recommend?

### Article File 8

Find an example of a multinational company that in recent years has switched its strategy from a localization, international, or global standardization strategy to a transnational strategy. Identify why the company made the switch and any problems that the company may be encountering while it tries to change its strategic orientation.

### Strategic Management Project: Module 8

This module requires you to identify how your company might profit from global expansion, the strategy that your company should pursue globally, and the entry mode that it might favor. With the information you have at your disposal, answer the questions regarding the following two situations:

### Your Company Is Already Doing Business in Other Countries

1. Is your company creating value or lowering the costs of value creation by realizing location economies, transferring distinctive competencies abroad, or realizing cost economies from the economies of scale? If not, does it have the potential to?
2. How responsive is your company to differences among nations? Does it vary its product and marketing message from country to country? Should it?
3. What are the cost pressures and pressures for local responsiveness in the industry in which your company is based?
4. What strategy is your company pursuing to compete globally? In your opinion, is this the correct strategy, given cost pressures and pressures for local responsiveness?
5. What major foreign market does your company serve, and what mode has it used to enter this market? Why is your company active in these markets and not others? What are the advantages and disadvantages of using this mode? Might another mode be preferable?

### Your Company Is Not Yet Doing Business in Other Countries

1. What potential does your company have to add value to its products or lower the costs of value creation by expanding internationally?
2. On the international level, what are the cost pressures and pressures for local responsiveness in the industry in which your company is based? What implications do these pressures have for the strategy that your company might pursue if it chose to expand globally?
3. What foreign market might your company enter, and what entry mode should it use to enter this market? Justify your answer.

## CLOSING CASE

## MTV Networks: A Global Brand Goes Local

MTV Networks has become a symbol of globalization. Established in 1981, the United States-based TV network has been expanding outside of its North American base since 1987 when it opened MTV Europe. Now owned by media conglomerate Viacom, MTV Networks, which includes Nickelodeon and VH1, the music station for the aging baby boomers, generates more than \$2 billion in revenues outside the United States. Since 1987, MTV has become the most ubiquitous cable programmer in the world. By the late 2000s, the network reached some 450 million households, some 300 million of which were in 140 countries outside of the United States.

While the United States still leads in the number of households, the most rapid growth is elsewhere, particularly in Asia, where nearly two-thirds of the region's 3 billion people are younger than 35, the middle class is expanding quickly, and TV ownership is spreading rapidly. MTV Networks figures that every second of every day more than 2 million people are watching MTV around the world, the majority outside the United States.

Despite its international success, MTV's global expansion got off to a weak start. In 1987, when most of MTV's fare still consisted of music videos, it piped a single feed across Europe almost entirely composed of American programming with English-speaking hosts. Naively, the network's American managers thought Europeans would flock to the American programming. But while viewers in Europe shared a common interest in a handful of global superstars, who at the time included Madonna and Michael Jackson, their tastes turned out to be surprisingly local. What was popular in Germany might not be popular in Great Britain. Many staples of the American music scene left Europeans cold. MTV Networks suffered as a result. Soon local copycat stations were springing up in Europe that focused on the music scene in individual countries. They took viewers and advertisers away from MTV. As explained by Tom Freston, the former chairman of MTV Networks, "We were going for the most shallow layer of what united

viewers and brought them together. It didn't go over too well."

In 1995, MTV changed its strategy and broke Europe into regional feeds. There are approximately 25, including feeds for the United Kingdom and Ireland; another for Germany, Austria, and Switzerland; one for Italy; one for France; one for Spain; one for Holland; and one for Russia. The network adopted the same localization strategy elsewhere in the world. For example, in Asia it has 10 feeds: an English-Hindi channel for India; separate Mandarin feeds for China and Taiwan; a Korean feed for South Korea; a Bahasa-language feed for Indonesia; a Japanese feed for Japan; and so on. Digital and satellite technology have made the localization of programming cheaper and easier. MTV Networks can now beam a half-dozen feeds off one satellite transponder.

Although MTV Networks exercises creative control over these different feeds, and all the channels have the same familiar frenetic look and feel of MTV in the United States, a significant share of the programming and content is now local. When MTV opens a local station, it begins with expatriates from elsewhere in the world to do a "gene transfer" of company culture and operating principles. Once these are established, however, the network switches to local employees and the expatriates move on. The idea is to "get inside the heads" of the local population and produce programming that matches their tastes.

Although many of the programming ideas still originate in the United States, with staples such as *The Real World* having equivalents in different countries, an increasing share of programming is local in conception. In Italy, *MTV Kitchen* combines cooking with a music countdown. *Erotica* airs in Brazil and features a panel of youngsters discussing sex. The Indian channel produces 21 homegrown shows hosted by local veejays who speak "Hinglish," a city-bred blend of Hindi and English. Hit shows include *MTV Cricket in Control*, appropriate for a land where cricket is a national obsession; *MTV Housefull*, which hones in on Hindi film stars (India has



the biggest film industry outside of Hollywood); and *MTV Bakra*, which is modeled after *Candid Camera*.

This localization push reaped big benefits for MTV, allowing the network to capture viewers back from local imitators. In India, for example, ratings increased by more than 700% between 1996, when the localization push began, and 2000. In turn, localization helps MTV to capture more of those all-important advertising revenues, even from other multinationals such as Coca-Cola, whose own advertising budgets are often locally determined.<sup>44</sup>

### Case Discussion Questions

1. What strategy did MTV pursue when it initially started to expand internationally? What assumptions were managers at MTV making about foreign markets at the time?
2. Why strategy does MTV pursue today? What are the benefits of this strategy? What are the costs?
3. What must MTV do, in terms of its management and organization, to implement its current strategy?



# CORPORATE-LEVEL STRATEGY: HORIZONTAL INTEGRATION, VERTICAL INTEGRATION, AND STRATEGIC OUTSOURCING

## LEARNING OBJECTIVES

After reading this chapter, you should be able to

- Discuss how corporate-level strategy can be used to strengthen a company's business model and business-level strategies
- Define horizontal integration and discuss the main advantages and disadvantages associated with this corporate-level strategy
- Explain the difference between a company's internal value chain and the industry value chain
- Define horizontal integration and describe the main advantages and disadvantages associated with this corporate-level strategy
- Describe why, and under what conditions, cooperative relationships such as strategic alliances and outsourcing may become a substitute for vertical integration

## News Corp Forges Ahead

News Corp CEO Rupert Murdoch engineered acquisition or divestiture decisions for more than 50 years.

Murdoch has created one of the four largest and most powerful entertainment media companies in the world. What kinds of strategies did Murdoch use to create his media empire?<sup>1</sup> Murdoch was born into a newspaper family; his father owned and ran the *Adelaide News*, an Australian regional newspaper, and when his father died in 1952,

Murdoch took control. He quickly enlarged the customer base by acquiring more Australian newspapers. One of these had connections to a major British “pulp” newspaper, and Murdoch used a sensational, *National Enquirer*-like, business model to establish his new newspaper, the *Sun*, as a leading British tabloid.





Murdoch's reputation as an entrepreneur grew because he showed that he could create a much higher return (ROIC) on the media assets he controlled than his competitors. This enabled him to borrow increasing amounts of money, which he used to buy well-known newspapers such as the *British Sunday Telegraph* and then his first United States newspaper, the *San Antonio Express*. Pursuing his sensational business model further, he launched the *National Star*. His growing profits and reputation allowed him to continue to borrow money, and in 1977, he bought the *New York Post*. Four years later, in 1981, he engineered a new coup when he bought the *Times* and *Sunday Times*, Britain's leading conservative publications—a far cry from the *Sun* tabloid.

Murdoch's strategy of horizontal integration through mergers allowed him to create one of the world's biggest newspaper empires. He realized, however, that industries in the entertainment and media sector can be divided into those that provide media content or "software" (newspapers, movies, and television programs) and those that provide the media channels or "hardware" necessary to bring software to customers (movie theaters, TV channels, TV cable, and satellite broadcasting). Murdoch decided that he could create the most profit by becoming involved in both the media software and hardware industries, that is, the entire value chain of the entertainment and media sector. This strategy of vertical integration gave him control over all the different industries, joined together like links in a chain that converted inputs such as stories into finished products like newspapers, books, TV shows, and movies.

In the 1980s, Murdoch began purchasing global media companies in both the software and hardware stages of the entertainment sector. He also launched new ventures of his own.

For example, sensing the potential of satellite broadcasting, in 1983 he launched Sky, the first satellite TV channel in the United Kingdom. He also began a new strategy of horizontal integration by purchasing companies that owned television stations; for Metromedia, which owned seven stations that reached more than 20% of United States households, he paid \$1.5 billion. He scored another major coup in 1985 when he bought Twentieth Century Fox Movie Studios, a premium content provider. As a result, he had Fox's huge film library and its creative talents to make new films and TV programming.

In 1986, Murdoch decided to create the FOX Broadcasting Company and buy or create his own United States network of FOX affiliates that would show programming developed by his own FOX movie studios. After a slow start, the FOX network gained popularity with sensational shows like *The Simpsons*, which was FOX's first blockbuster program. Then, in 1994, FOX purchased the sole rights to broadcast all NFL games for more than \$1 billion, thereby shutting out NBC. FOX became the "fourth network," which has forged and, with Murdoch's sensational business model, was one of the first to create the "reality" programming that has proved so popular in the 2000s.

By 2005, Murdoch's business model, based on strategies of horizontal and vertical integration, had created a global media empire. The company's profitability has ebbed and flowed because of the massive debt needed to fund Murdoch's acquisitions, debt that has frequently brought his company near to financial ruin. However, in 2009, his company is still a market leader because he engineered many new Internet acquisitions, such as MySpace, Rotten Tomatoes, and other popular Web sites that he has used to create even more value from his media assets.<sup>2</sup>

## Overview

Over the last decades, Rupert Murdoch has acquired or started scores of companies to create a media empire, that is, a collection of businesses in different industries in the media sector. The overriding goal of managers is to maximize the value of the

company for its shareholders; Murdoch embarked on his quest because he believed that by combining all these different businesses into one entity, he could increase their profitability. Clearly, the scale of Murdoch's mission and vision for News Corp takes the issue of strategy formulation to a new level of complexity.

The News Corp story illustrates the use of corporate-level strategy to identify (1) which businesses and industries a company should compete in; (2) which value creation activities it should perform in those businesses; and (3) how it should enter or leave businesses or industries to maximize its long-run profitability. In formulating corporate-level strategy, managers must adopt a long-term perspective and consider how changes taking place in an industry and in its products, technology, customers, and competitors will affect their company's current business model and its future strategies. They then decide how to implement specific corporate-level strategies to redefine their company's business model so that it can achieve a competitive position in the changing industry environment by taking advantage of the opportunities and countering the threats. Thus the principal goal of corporate-level strategy is to enable a company to sustain or promote its competitive advantage and profitability in its present business and in any new businesses or industries that it enters.

This chapter is the first of two that deals with the role of corporate-level strategy in repositioning and redefining a company's business model. We discuss three corporate-level strategies—horizontal integration, vertical integration, and strategic outsourcing—that are primarily directed toward improving a company's competitive advantage and profitability in its present business or product market. Diversification, which entails entry into new kinds of markets or industries, is examined in the next chapter, along with guidelines for choosing the most profitable way to enter new markets or industries or to exit others. By the end of this and the next chapter, you will understand how the different levels of strategy contribute to the creation of a successful and profitable business or multibusiness model. You will also be able to differentiate between the types of corporate strategies managers use to maximize long-term company profitability.

## CORPORATE-LEVEL STRATEGY AND THE MULTIBUSINESS MODEL

The choice of corporate-level strategies is the final part of the strategy formulation process. Corporate-level strategies drive a company's business model over time and determine which types of business- and functional-level strategies managers will choose to maximize long-run profitability. The relationship between business-level strategy and functional-level strategy was discussed in Chapter 5. Strategic managers develop a business model and strategies that use their company's distinctive competencies to strive for a cost-leadership position and/or differentiate its products. Chapter 8 described how global strategy is also an extension of these basic principles. In this chapter and the next, we repeatedly emphasize that to increase profitability, a corporate-level strategy should enable a company or one or more of its business divisions or units *to perform value-chain functional activities (1) at a lower cost and/or (2) in a way that allows for differentiation*. Only when it selects the appropriate corporate-level strategies can a company choose the pricing option (lowest, average, or premium price) that will allow it to maximize profitability. In addition, corporate-level strategy will increase profitability if it helps a company reduce industry rivalry by reducing the threat of damaging price competition. In sum, a company's

corporate-level strategies should be chosen to promote the success of its business-level strategies, which allows it to achieve a sustainable competitive advantage that leads to higher profitability.

Like News Corp, many companies choose to expand their business activities beyond one market or industry and enter others. When a company decides to expand into new industries, it must construct its business model at two levels. First, it must develop a business model and strategies for each business unit or division in every industry in which it competes. Second, it must also develop a higher-level *multibusiness model* that justifies its entry into different businesses and industries, something that Rupert Murdoch did for News Corp in the opening case. This multibusiness model should explain how and why entering a new industry will allow the company to use its existing functional competencies and business strategies to increase its overall profitability. This model should also explain any other ways in which a company's involvement in more than one business or industry can increase its profitability. Dell, for example, might argue that its entry into computer consulting and into the computer printer market will enable it to offer its customers a complete line of computer products and services, which allows it to better compete with HP or IBM. News Corp used its expertise in sensational marketing that it gained from its newspaper business and applied it to its FOX network to create reality TV programs, "racy" sitcoms, and a news service accused of political bias.

This chapter first focuses on the advantages of staying inside one industry by pursuing horizontal integration. It then looks at why companies use vertical integration and expand into new industries. In the next chapter, we examine two principal corporate strategies companies use to enter new industries to increase their profitability, related and unrelated diversification, and several other strategies companies may use to enter and compete in new industries.

## HORIZONTAL INTEGRATION: SINGLE-INDUSTRY STRATEGY

Managers use corporate-level strategy to identify which industries their company should compete in to maximize its long-run profitability. For many companies, profitable growth and expansion often entail finding ways to compete successfully within a single market or industry over time. In other words, a company confines its value-creation activities to just one business or industry. Examples of such single-business companies include McDonald's, with its focus on the global fast-food business, and Walmart, with its focus on global discount retailing.

Staying inside an industry allows a company to focus its total managerial, financial, technological, and functional resources and capabilities on competing successfully in one area. This is important in fast-growing and changing industries in which demands on a company's resources and capabilities are likely to be substantial, but where the long-term profits from establishing a competitive advantage are also likely to be substantial.

A second advantage of staying inside a single industry is that a company "sticks to the knitting," meaning that it stays focused on what it knows and does best. A company does not make the mistake of entering new industries in which its existing resources and capabilities create little value and/or where a whole new set of



competitive industry forces—new competitors, suppliers, and customers—present unanticipated threats. Coca-Cola, like many other companies, has committed this strategic error. Coca-Cola once decided to expand into the movie business and acquired Columbia Pictures; it also acquired a large California winemaker. It soon found it lacked the competencies to compete successfully in these new industries and had not foreseen the strong competitive forces that existed in these industries, from movie companies such as FOX and winemakers such as Gallo. Coca-Cola concluded that entry into these new industries had reduced rather than created value and lowered its profitability; it divested or sold off these new businesses at a significant loss.

Even when a company stays in one industry, sustaining a successful business model over time can be difficult because of changing conditions in the environment, such as advances in technology that allow new competitors into the market or because of changing customer needs. A decade ago, the strategic issue facing telecommunications companies was how to shape their line of “wired” phone service products to best meet customer needs in the local and long-distance phone service market. When a new kind of product, wireless phone service, emerged and quickly gained in popularity, wired phone companies like Verizon and AT&T had to quickly change their business models and lower the price of wired phone service and merge with wireless companies to ensure their very survival.

Even inside one industry, it is all too easy for strategic managers to fail to see the “forest” (changing nature of the industry that results in new product/market opportunities) for the “trees” (focusing only on how to position current products). A focus on corporate-level strategy can help managers anticipate future trends and change their business models so as to position their companies to compete successfully in a changing environment. Strategic managers must not become so committed to improving their company’s *existing* product lines that they fail to recognize new product opportunities and threats. The task for corporate-level managers is to analyze how new emerging technologies will impact their business models, how and why these might change customer needs and customer groups in the future, and what kinds of new distinctive competencies will be needed to respond to these changes.

One corporate-level strategy that has been widely used to help managers strengthen their company’s business model is horizontal integration. **Horizontal integration** is the process of acquiring or merging with industry competitors to achieve the competitive advantages that arise from a large size and scope of operations. An **acquisition** occurs when one company uses its capital resources, such as stock, debt, or cash, to purchase another company, and a **merger** is an agreement between equals to pool their operations and create a new entity. The Opening Case discusses how Rupert Murdoch made scores of acquisitions in the newspaper industry, and then in TV, so that all his companies could take advantage of the stories written by News Corp journalists anywhere in the world, which reduced costs.

Mergers and acquisitions have occurred in many industries. In the aerospace industry, Boeing merged with McDonald Douglas to create the world’s largest aerospace company; in the pharmaceutical industry, Pfizer acquired Warner-Lambert to become the largest pharmaceutical firm; and in the computer hardware industry, Compaq acquired DEC and then itself was acquired by HP (see Closing Case). In the 2000s, the rate of mergers and acquisitions has increased as companies try to gain a global competitive advantage. Many of the largest mergers and acquisitions have been cross-border affairs as companies race to acquire overseas companies in the same industry. The result of this wave of global mergers and acquisitions has been to increase the level of concentration in a wide range of industries. The reason this has



occurred is that horizontal integration can often significantly improve the competitive advantage and profitability of companies whose managers choose to stay inside one industry and focus on managing its competitive forces.

## Benefits of Horizontal Integration

In pursuing horizontal integration, managers decide to invest their company's capital resources to purchase the assets of industry competitors to increase the profitability of its single-business model. Profitability increases when horizontal integration (1) lowers the cost structure, (2) increases product differentiation, (3) replicates the business model, (4) reduces rivalry within the industry, and (5) increases bargaining power over suppliers and buyers.

**Lower Cost Structure** Horizontal integration can lower a company's cost structure because it creates increasing *economies of scale*. Suppose five major competitors exist, each of which operates a manufacturing plant in some region of the United States, but with none of the plants operating at full capacity. If one competitor buys up another and shuts down that plant, it can operate its own plant at full capacity and so reduce its manufacturing costs. Achieving economies of scale is very important in industries that have a high fixed-cost structure. In such industries, large-scale production allows companies to spread their fixed costs over a large volume and in this way drive down average unit costs. In the telecommunications industry, for example, the fixed costs of building an advanced Internet network are enormous, and to make such an investment pay off, a large volume of customers is required. Thus companies such as AT&T and Verizon bought other telecommunications companies to acquire their customers, build their customer base, and so increase utilization rates and reduce the cost of servicing each customer. Similar considerations were involved in News Corps' acquisitions and in the pharmaceutical industry in which mergers have resulted from the need to realize scale economies in sales and marketing. The fixed costs of building a nationwide pharmaceutical sales force are very high, and pharmaceutical companies need a good portfolio of products to effectively use that sales force. Pfizer acquired Warner-Lambert because its salespeople would have more products to sell when they visited physicians, thus increasing their productivity. In 2008, Pfizer acquired Wyeth pharmaceuticals to create a prescription drug company of unprecedented scale; the combined company had more than \$70 billion in 2008.

A company can also lower its cost structure when horizontal integration allows it to *reduce the duplication of resources* between two companies, such as by eliminating the need for two sets of corporate head offices, two separate sales forces, and so on.

**Increased Product Differentiation** Horizontal integration may also increase profitability when it increases product differentiation, for example, by increasing the flow of innovative new products that a company can sell to its customers at premium prices. Desperate for new drugs to fill its pipeline, for example, Eli Lilly paid \$6.5 billion to ImClone Systems to acquire its new cancer preventing drugs; it paid such a high price to outbid Bristol-Myers Squibb, another drug company seeking innovative new drugs.

Horizontal integration may also increase differentiation when it allows a company to combine the product lines of merged companies so that it can offer customers a wider range of products that can be bundled together. **Product bundling** involves offering customers the opportunity to buy a complete range of products at a single

combined price. This increases the value of a company's product line because customers often obtain a price discount from buying a set of products and also become used to dealing with just one company and its representatives. A company may obtain a competitive advantage from increased product differentiation.

Another way to increase product differentiation is through **cross-selling**, which involves a company taking advantage of or “leveraging” its established relationship with customers by acquiring additional product lines or categories that it can sell to them. In this way, a company increases differentiation because it can provide a “total solution” and satisfy all of a customer's specific needs. Cross-selling and becoming a total solution provider is an important rationale for horizontal integration in the computer sector, where IT companies have tried to increase the value of their offerings by providing all of the hardware and service needs of corporate customers. Providing a total solution saves customers time and money because they do not have to deal with several suppliers, and a single sales team can ensure that all the different components of a customer's IT work seamlessly together. When horizontal integration increases the differentiated appeal and value of the company's products, the total solution provider gains market share. This was the business model Oracle pursued when it acquired many IT software companies and explains its current success, as discussed in Strategy in Action 9.1.

## 9.1 STRATEGY IN ACTION

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### Oracle Strives to Become the Biggest and the Best

Oracle Corporation, based in Redwood City, California, is the world's largest maker of database software and the third-largest global software company after Microsoft and IBM. This commanding position is not enough for Oracle, however, which has set its sights on becoming the global leader in the corporate applications software market. In this market, Germany's SAP, with 45% of the market, is the acknowledged leader, and Oracle, with only 19%, is a distant second. Corporate applications is a fast growing and highly profitable market, however, and Oracle has been snapping up leading companies in this segment. Its goal is to quickly build the distinctive competencies it needs to expand the range of products that it can offer to its existing customers and attract new customers to compete with SAP. Beginning in 2005, Oracle's CEO Larry Ellison spent \$19 billion to acquire 14 leading suppliers of corporate software, including two of the top five companies: PeopleSoft, a leading human resource management (HRM) software supplier it bought for \$10 billion, and Siebel Systems, a leader in customer relationship management (CRM) software, which cost Oracle \$5.8 billion.

Oracle expects several competitive advantages to result from its use of acquisitions to pursue the corporate strategy of horizontal integration. First, it is now able to meld or bundle the best software applications of these acquired companies—with Oracle's own first-class set of corporate and database software programs—to create a new integrated software suite that will allow companies to manage all their functional activities, such as accounting, marketing, sales, HRM, CRM, and supply-chain management. Second, through these acquisitions, Oracle obtained access to thousands of new customers—the companies that use the software of the companies it acquired. All these companies now become potential customers for all of Oracle's other database and corporate software offerings. Third, beyond increasing the range of its products and number of its customers, Oracle's acquisitions have consolidated the corporate software industry. By taking over some of its largest rivals, Oracle has become the second-largest supplier of corporate software and is better positioned to compete with leader SAP.

**Replicating the Business Model** Given the many ways in which horizontal integration can be used to increase product differentiation and lower cost structure, a company that can replicate its successful business model in new *market segments* within its industry can also increase its profitability. In the retail industry, for example, Walmart took its low-cost/low-price discount retail business model to enter into the even lower-priced warehouse segment by opening its chain of Sam's Clubs. It also expanded the range of products it offers customers when it entered the supermarket business and established a nationwide chain of Walmart supercenters that sell groceries as well as all the clothing, toys, and electronics sold in regular Walmart stores. It has also replicated its business model globally by acquiring supermarket chains in several countries, such as Mexico, the United Kingdom, and Japan, where it used its efficient global materials-management practices to pursue its cost-leadership strategy. In the United States, Walmart has also been experimenting with new kinds of small-size supermarkets to expand its presence in this supermarket industry segment, as the Running Case discusses.

**Reduced Industry Rivalry** Horizontal integration can help to reduce industry rivalry in two ways. First, acquiring or merging with a competitor helps to *eliminate excess capacity* in an industry, which, as we discuss in Chapter 6, often triggers price wars. By taking excess capacity out of an industry, horizontal integration creates a more benign environment in which prices might stabilize or even increase.

Second, by reducing the number of competitors in an industry, horizontal integration often makes it easier to implement *tacit price coordination* between rivals, that is, coordination reached without communication. (Explicit communication to fix prices is illegal.) In general, the larger the number of competitors in an industry, the more difficult it is to establish informal pricing agreements, such as price leadership by the dominant company, which reduces the possibility that a price war will erupt. By increasing industry concentration and creating an oligopoly, horizontal integration can make it easier to establish tacit coordination among rivals.

Both of these motives also seem to have been behind Oracle's many software acquisitions. There was significant excess capacity in the corporate software industry, and major competitors were offering customers discounted prices that had led to a price war and falling profit margins. Oracle hoped to be able to eliminate excess industry that would reduce price competition. By 2009, it was clear that the major corporate software competitors were focusing on finding ways to better differentiate their product suites to prevent a price war and continuing to make major acquisitions to help them build competitive advantage.

**Increased Bargaining Power** Finally, some companies use horizontal integration because it allows them to obtain bargaining power over suppliers or buyers and so increase their profitability at the expense of suppliers or buyers. By consolidating the industry through horizontal integration, a company becomes a much larger buyer of suppliers' products and uses this as leverage to bargain down the price it pays for its inputs, thereby lowering its cost structure. Walmart is well-known for pursuing this strategy, for example. Similarly, by acquiring its competitors, a company gains control over a greater percentage of an industry's product or output. Other things being equal, it then has more power to raise prices and profits because customers have less choice of suppliers and are more dependent on the company for their products, which is something both Oracle and SAP are striving for to protect their customer base.

## RUNNING CASE

### Walmart's Growing Chain of "Neighborhood Markets"

After its entry into the supermarket industry, Walmart soon recognized that its huge supercenters and discount stores do not serve the needs of customers who want quick and convenient shopping experiences, for example, when they want to pick up food for evening meals. It also recognized that customers spend billions of dollars shopping in local stores such as neighborhood supermarkets, drugstores, and convenience stores, and that this was potentially a highly profitable segment of the retail market. Thus, in the 2000s, Walmart decided to enter this segment by opening a new chain of Walmart "Neighborhood Markets." Each of these supermarkets is approximately 40,000 square feet, about one-quarter the size of a Walmart supercenter, and stocks 20,000 to 30,000 items compared to more than 100,000 items available in supercenters. Walmart's strategy for the new chain stores was to position them to compete directly with local supermarkets, such as those run by Kroger and Safeway. They would be open 24 hours a day to maximize responsiveness to local customers, and they would also have high-profit-margin departments such as a pharmacy, drugs, health, and beauty products to draw off trade from drugstores such as CVS and Walgreens. As a result, customers could shop for food while they waited for their prescriptions to be filled or their film to be developed.

To test whether its cost-leadership model would work at this small scale of operations, Walmart opened stores slowly in good locations. Margins are small in the supermarket business, often between 1% and 2%, which is lower than Walmart was accustomed to. To keep costs low, it located its new stores in areas where it had efficient warehouse food preparation and delivery systems. Its strategy was to prepare high-margin items like bakery goods and meat and deli products in central locations and then ship them to supermarkets in prepackaged

containers. Each neighborhood market store was also tied in by satellite to Walmart's retail link network so that food service managers would know what kind of food was selling and what was not. They could then customize the food each store sold to customer needs by changing the mix that was trucked fresh each day. Also, because the stores had no onsite butchers or bakers, costs were much lower.

As a result of these strategies, the 60-plus United States stores opened by 2004 were able to undercut the prices charged by supermarkets such as Publix, Winn-Dixie, Kroger, and Albertsons by 10%. A typical neighborhood market generates approximately \$20 million per year in sales, has a staff of 90, and obtains a 2.3% profit margin, which is significantly higher than average in the supermarket industry. Encouraged by their success, Walmart continued to open more stores and had 145 neighborhood markets in operation by 2009, most of which are the southern United States.

Walmart is continuing to experiment with new kinds of small supermarkets to increase its share of this market segment. Its "Marketside" store concept is an even smaller "corner-store" format with store size in the 300–25,000 square feet range. It is also experimenting actively with a chain of stores geared to the needs of Hispanic consumers. One experimental "Hispanic Community" store in Texas is a large-format store at about 160,000 square feet, which in addition to its focus on Hispanic food and grocery also offers a large selection of non food products tailored toward Hispanic shoppers. Walmart is also looking into small "bodega" supermarkets tailored toward this customer group. Clearly, many profitable opportunities exist in this market segment. As at the global level, Walmart's managers are developing strategies to take advantage of them.

**Sources:** [www.walmart.com](http://www.walmart.com), 2009; J. Birchall, "Walmart Looks to Hispanic Market," [ft.com](http://ft.com), March 12 2009; "Does 'Cool' Matter? A Blogger Compares Tesco and Walmart's 'Neighborhood Market' Offerings," [www.bloggers-at-large.com](http://www.bloggers-at-large.com), January 21, 2009.

When a company has greater ability to raise prices to buyers or bargain down the price paid for inputs, it has obtained increased market power.

## Problems with Horizontal Integration

Although horizontal integration can strengthen a company's business model in several ways, there are problems, limitations, and dangers associated with pursuing this corporate-level strategy. We discuss many of these dangers in detail in Chapter 10; the important point to note is that a wealth of data suggests that the majority of mergers and acquisitions *do not* create value, and many actually *reduce* value.<sup>3</sup> For example, a well-known study by KPMG, a large accounting and management consulting company, looked at 700 large acquisitions and found that while 30% of these did increase the profitability of the acquiring company, 31% reduced profitability, and the remainder had little impact on it.<sup>4</sup> The implication is that *implementing* a horizontal integration strategy is not an easy task for managers.

As we discuss in Chapter 10, there are several reasons why mergers and acquisitions may fail to result in higher profitability: problems associated with merging very different company cultures; high management turnover in the acquired company when the acquisition is a hostile one; and a tendency of managers to overestimate the benefits to be had from a merger or acquisition and underestimate the problems involved in merging their operations.

Another problem with horizontal integration is that, when a company uses it to become a dominant industry competitor, an attempt to keep using the strategy to grow even larger brings a company into conflict with the Federal Trade Commission (FTC), the government agency responsible for enforcing antitrust law. Antitrust authorities are concerned about the potential for abuse of market power; more competition is generally better for consumers than less competition. So the FTC is concerned when a few industry companies try to make acquisitions that will allow them to raise prices to consumers above the level that would exist in a more competitive situation and thus abuse their market power. The FTC also wishes to prevent dominant companies from using their market power to crush potential competitors, for example, by cutting prices when a new competitor enters the industry and so force them out of business (then they raise prices after they have eliminated the threat). Because of these concerns, any merger or acquisition thought by the FTC to create too much consolidation and the *potential* for future abuse of market power may, for antitrust reasons, be blocked. The proposed merger between the two dominant satellite radio companies Sirius and XM was held up for many months, until July 2008, because of concerns this problem would arise in radio broadcasting. The merger was approved after it became clear that customers had many other ways to obtain high-quality radio programming, for example, through their computers and cell phones, so substantial competition would still exist in the industry.

### Ethical Dilemma

Microsoft pursued a strategy of horizontal integration and has bought hundreds of small software companies to become the dominant software provider for PCs. Microsoft has often been accused of being a monopoly by overpowering (Lotus and WordPerfect) and forcing (Netscape) many rivals out of the market. Microsoft's managers have responded that product prices have actually fallen because its large size provides the opportunity to cut prices, give some products away, and dramatically improve other offerings. If you were on a committee charged with deciding if Microsoft has behaved in an unethical manner, what kind of criteria would you use to determine the outcome?

## VERTICAL INTEGRATION: ENTERING NEW INDUSTRIES TO STRENGTHEN THE "CORE" BUSINESS MODEL

Many companies that use horizontal integration to strengthen their business model and improve their competitive position also use the corporate-level strategy of vertical integration for the same purpose. In pursuing vertical integration, however,

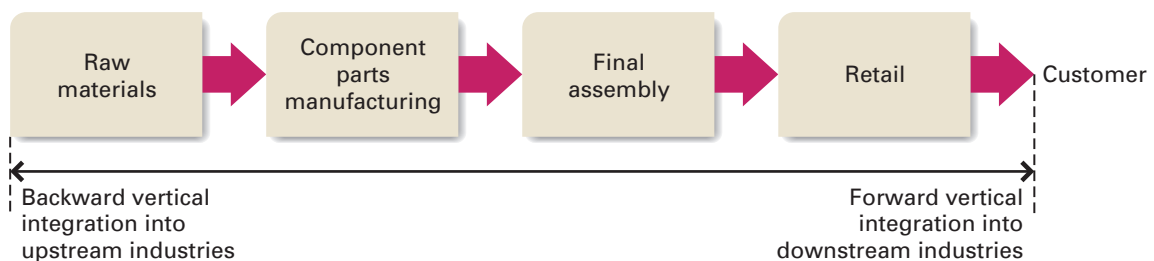
a company is entering new industries to support the business model of its “core” industry, the one that is the primary source of its competitive advantage and profitability. At this point, therefore, a company must formulate a multibusiness model that explains how entry into a new industry using vertical integration will enhance its long-term profitability. The model that justifies the pursuit of vertical integration is based on a company entering industries that *add value* to its core products because this increases product differentiation and/or lowers its cost structure, thus increasing its profitability.

A company pursuing a strategy of **vertical integration** expands its operations either backward into an industry that produces inputs for the company’s products (*backward vertical integration*) or forward into an industry that uses, distributes, or sells the company’s products (*forward vertical integration*). To enter an industry, it may establish its own operations and build the value chain needed to compete effectively in that industry; or it may acquire a company that is already in the industry. A steel company that supplies its iron ore needs from company-owned iron ore mines illustrates backward integration. A PC maker that sells its laptops through company-owned retail outlets illustrates forward integration. For example, Apple Computer entered the retail industry in 2001 when it decided to establish a chain of Apple stores to sell its PCs and iPods, something Sony and Dell have imitated. IBM is a highly vertically integrated company; it integrated backward into the chip and memory disk industry to produce the components that go into its mainframes and servers and integrated forward into the computer software and consulting services industries.

Figure 9.1 illustrates four *main* stages in a typical raw materials-to-customer value-added chain. For a company based in the final assembly stage, backward integration means moving into component parts manufacturing and raw materials production. Forward integration means moving into distribution and sales (retail). At each stage in the chain, *value is added* to the product, meaning that a company at that stage takes the product produced in the previous stage and transforms it in some way so that it is worth more to a company at the next stage in the chain and, ultimately, to the customer. It is important to note that each stage of the value-added chain is a separate industry or industries in which many different companies are competing. Moreover, within each industry, every company has a value chain composed of the value-creation activities we discussed in Chapter 3: R&D, production, marketing, customer service, and so on. In other words, we can think of a value chain that runs *across* industries, and embedded within that are the value chains of companies *within* each industry.

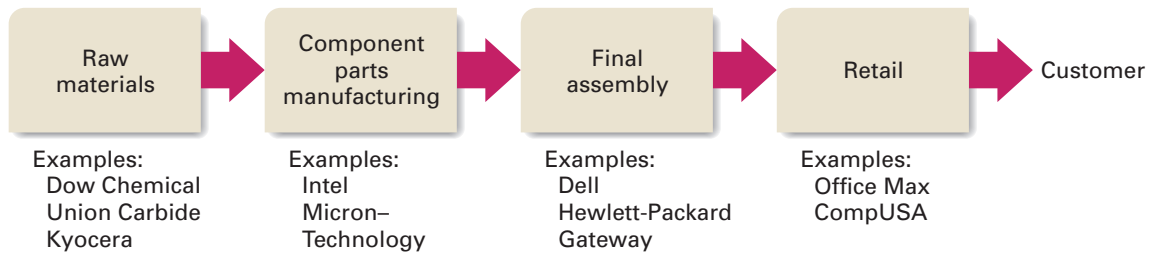
As an example of the value-added concept, consider how companies in each industry involved in the production of a PC contribute to the final product (Figure 9.2).

**Figure 9.1** Stages in the Raw-Materials-to-Customer Value-Added Chain





**Figure 9.2** The Raw-Materials-to-Customer Value-Added Chain in the PC Industry



At the first stage in the chain are the raw materials companies that make specialty ceramics, chemicals, and metal, such as Kyocera of Japan, who manufactures the ceramic substrate for semiconductors. These companies sell their products to the makers of PC component products, such as Intel and AMD, who transform the ceramics, chemicals, and metals they purchase into PC components such as microprocessors, disk drives, and memory chips. In the process, they *add value* to the raw materials they purchase. At the third stage, these components are then sold to PC makers such as Apple, Dell, and HP, who decide which of these components to purchase and assemble to *add value* to their final PCs that they either make or outsource to a contract manufacturer. At stage four, the finished PCs are then either sold directly to the final customer over the Internet or sold to retailers such as Best Buy and Staples, which distribute and sell them to the final customer. Companies that distribute and sell PCs also *add value* to the product because they make it accessible to customers and provide customer service and support.

Thus companies in different industries add value at each stage in the raw-materials-to-customer chain. Viewed in this way, vertical integration presents companies with a choice about which industries in the raw-materials-to-customer chain to operate and compete in. This choice is determined by how much establishing operations at a stage in the value chain will increase product differentiation or lower costs—and therefore increase profitability—as we discuss in the following.

### Increasing Profitability through Vertical Integration

As noted earlier, a company pursues vertical integration to strengthen the business model of its original or core business and to improve its competitive position.<sup>5</sup> Vertical integration increases product differentiation, lowers costs, or reduces industry competition when it (1) facilitates investments in efficiency-enhancing specialized assets, (2) protects product quality, and (3) results in improved scheduling.

**Facilitating Investments in Specialized Assets** A specialized asset is one that is designed to perform a specific task and whose value is significantly reduced in its next-best use.<sup>6</sup> The asset may be a piece of equipment that has a firm-specific use or the know-how or skills that a company or employees have acquired through training and experience. Companies invest in specialized assets because these assets allow them to lower their cost structure or to better differentiate their products, which facilitates premium pricing. A company might invest in specialized equipment to lower manufacturing costs, such as Toyota does, for example, or it might invest in an

advanced technology that allows it to develop better-quality products than its rivals, such as Apple does. Thus, specialized assets can help a company achieve a competitive advantage at the business level.

Just as a company invests in specialized assets in its own industry to build competitive advantage, it is often necessary that suppliers invest in specialized assets to produce the inputs that a specific company needs. By investing in these assets, a supplier can make higher-quality inputs that provide its customers with a differentiation advantage or inputs at a lower cost so it can charge its customers a lower price to keep their business. However, it is often difficult to persuade companies in adjacent stages of the raw materials-to-customer value-added chain to make investments in specialized assets. Often, to realize the benefits associated with such investments, a company has to vertically integrate and enter into adjacent industries and make the investments itself. Why does this happen?

Imagine that Ford has developed a unique energy-saving electrical engine system that will dramatically increase fuel efficiency and differentiate Ford's cars from those of its rivals, giving it a major competitive advantage. Ford has to decide whether to make the system in-house (vertical integration) or contract with a supplier such as a specialist outsourcing manufacturer to make the new engine system. Manufacturing these new systems requires a substantial investment in specialized equipment that can be used only for this purpose. In other words, because of its unique design, the equipment cannot be used to manufacture any other type of electrical engine for Ford or any other carmaker. Thus this is an investment in specialized assets.

Consider this situation from the perspective of the outside supplier deciding whether or not to make this investment. The supplier might reason that once it has made the investment, it will become dependent on Ford for business because *Ford is the only possible customer for the electrical engine made by this specialized equipment*. The supplier realizes that this puts Ford in a strong bargaining position and that Ford might use its power to demand lower prices for the engines. Given the risks involved, the supplier declines to make the investment in specialized equipment.

Now consider Ford's position. Ford might reason that if it outsources production of these systems to an outside supplier, it might become too dependent on that supplier for a vital input. Because specialized equipment is required to produce the engine systems, Ford cannot switch its order to other suppliers. Ford realizes that this increases the bargaining power of the supplier, which might use its bargaining power to demand higher prices.

The situation of *mutual dependence* that would be created by the investment in specialized assets makes Ford hesitant to allow outside suppliers to make the product, and makes suppliers hesitant to undertake such a risky investment. The problem is a lack of trust—neither Ford nor the supplier can trust the other to play fair in this situation. The lack of trust arises from the risk of **holdup**; that is, being taken advantage of by a trading partner *after* the investment in specialized assets has been made.<sup>7</sup> Because of this risk, Ford reasons that the only cost-effective way to get the new engine systems is for it to make the investment in specialized assets and manufacture them itself.

To generalize from this example, if achieving a competitive advantage requires one company to make investments in specialized assets so it can trade with another, **the risk of holdup** may serve as a deterrent, and the investment may not take place. Consequently, the potential for higher profitability from specialization will be lost. To prevent such loss, companies vertically integrate into adjacent stages in the value chain. Historically, the problems surrounding specific assets have driven automobile companies to vertically integrate backward into the production of component

parts; steel companies to vertically integrate backward into the production of iron; computer companies to vertically integrate backward into chip production; and aluminum companies to vertically integrate backward into bauxite mining. The way specific asset issues have led to vertical integration in the aluminum industry is discussed in Strategy in Action 9.2.

**Enhancing Product Quality** By entering industries at other stages of the value-added chain, a company can often enhance the quality of the products in its core business and so strengthen its differentiation advantage. For example, the ability to control the reliability and performance of complex components such as engine and transmission systems may increase a company's competitive advantage in the luxury sedan market and enable it to charge a premium price. Conditions in the banana industry also illustrate the importance of vertical integration in maintaining product quality. Historically, a problem facing food companies that import bananas has been the variable quality of delivered bananas, which often arrive on

## 9.2 STRATEGY IN ACTION

### Specialized Assets and Vertical Integration in the Aluminum Industry

The metal content and chemical composition of bauxite ore, used to produce aluminum, vary from deposit to deposit, so each type of ore requires a specialized refinery—that is, the refinery must be designed for a particular type of ore. Running one type of bauxite through a refinery designed for another type reportedly increases production costs from 20% to 100%. Thus, the value of an investment in a specialized aluminum refinery and the cost of the output produced by that refinery depend on receiving the right kind of bauxite ore.

Imagine that an aluminum company has to decide whether to invest in an aluminum refinery designed to refine a certain type of ore. Also assume that this ore is extracted by a company that owns a single bauxite mine. Using a different type of ore would raise production costs by 50%. Therefore, the value of the aluminum company's investment is dependent on the price it must pay the bauxite company for this bauxite. Recognizing this, once the aluminum company has made the investment in a new refinery, what is to stop the bauxite company from raising bauxite prices? Nothing. Once it has made

the investment, the aluminum company is locked into its relationship with its bauxite supplier. The bauxite supplier can increase prices because it knows that as long as the increase in the total production costs of the aluminum company is less than 50%, the aluminum company will continue to buy its ore. Thus, once the aluminum company has made the investment, the bauxite supplier can *hold up* the aluminum company.

How can the aluminum company reduce the risk of holdup? The answer is by purchasing the bauxite supplier. If the aluminum company can purchase the bauxite supplier's mine, it need no longer fear that bauxite prices will be increased after the investment in an aluminum refinery has been made. In other words, vertical integration, by eliminating the risk of holdup, makes the specialized investment worthwhile. In practice, it has been argued that these kinds of considerations have driven aluminum companies to pursue vertical integration to such a degree that, according to one study, more than 90% of the total volume of bauxite is transferred within vertically integrated aluminum companies.

the shelves of United States supermarkets too ripe or not ripe enough. To correct this problem, major United States food companies such as General Foods have integrated backward and now own banana plantations so they have control over the supply of bananas. As a result, they can distribute and sell bananas of a standard quality at the optimal time to better satisfy customers. Knowing they can rely on the quality of these brands, customers are also willing to pay more for them. Thus, by vertically integrating backward into plantation ownership, banana companies have built customer confidence, which in turn has enabled them to charge a premium price for their product.

The same considerations can promote forward vertical integration. Ownership of retail outlets may be necessary if the required standards of after-sales service for complex products are to be maintained. For example, in the 1920s, Kodak owned the retail outlets that distributed its photographic equipment because the company felt that few existing retail outlets had the skills necessary to sell and service its complex equipment. By the 1930s, new retailers had emerged that could provide satisfactory distribution and service for Kodak products, so it left the retail industry. McDonald's also has used vertical integration to protect product quality and increase efficiency, as Strategy in Action 9.3 relates.

## 9.3 STRATEGY IN ACTION

### McDonald's: A Leader at Vertical Integration

By the 1990s, McDonald's faced a problem: after decades of rapid growth, the fast food market was beginning to show signs of market saturation. McDonald's response to the slowdown was to expand abroad rapidly. In 1980, 28% of the chain's new restaurant openings were abroad; in 1990 it was 60%, and by 2000, 70% and today it has more than 12,000 restaurants in 110 countries outside the United States. One of the keys to McDonald's successful global expansion is to replicate the value-creation skills that spurred its growth in the countries and world regions in which it operates. McDonald's United States success was built on a formula of close relations with suppliers, nationwide marketing might, and tight control over store-level operating procedures.

McDonald's biggest global problem has been to replicate its United States supply chain in other countries. United States suppliers are fiercely loyal to McDonald's; they must be because their fortunes are closely linked to those of McDonald's. McDonald's maintains very rigorous specifications for all the raw ingredients it uses—the key to its consistency and quality control. Outside of

the United States, however, McDonald's has found suppliers far less willing to make the investments required to meet its specifications. In Great Britain, for example, McDonald's had problems getting local bakeries to produce the hamburger bun. After experiencing quality problems with two local bakeries, McDonald's had to vertically integrate backward and built its own bakeries to supply its British stores.

In a more extreme case, when McDonald's decided to operate in Russia, it found that local suppliers lacked the capability to produce ingredients of the quality it demanded. The firm was forced to vertically integrate through the local food industry on a heroic scale, importing potato seeds and bull semen and indirectly managing dairy farms, cattle ranches, and vegetable plots. It also had to construct the world's largest food-processing plant at a huge cost. In South America, McDonald's also bought huge ranches in Argentina to raise its own cattle. As a result, today, McDonald's is able to use vertical integration to protect product quality and reduce its global cost structure.

**Improved Scheduling** Sometimes important strategic advantages can be obtained when vertical integration makes it quicker, easier, and more cost-effective to plan, coordinate, and schedule the transfer of a product, such as raw materials or component parts, between adjacent stages of the value-added chain.<sup>8</sup> Such advantages can be crucial when a company wants to realize the benefits of JIT inventory systems. For example, in the 1920s, Ford profited from the tight coordination and scheduling made possible by backward vertical integration. Ford integrated backward into steel foundries, iron ore shipping, and iron ore mining. Deliveries at Ford were coordinated to such an extent that iron ore unloaded at Ford's steel foundries on the Great Lakes was turned into engine blocks within 24 hours, which lowered Ford's cost structure.

Very often, the improved scheduling that vertical integration makes possible also enables a company to respond better to sudden changes in the supply or demand for a particular product. For example, if demand drops, a company can quickly cut production of components; when demand increases, a company can quickly increase production capacity to get its products into the marketplace faster.<sup>9</sup>

### Problems with Vertical Integration

Vertical integration can often be used to strengthen a company's business model and increase profitability. However, the opposite can occur when vertical integration results in (1) an increasing cost structure, (2) disadvantages that arise when technology is changing fast, and, (3) disadvantages that arise when demand is unpredictable. Sometimes these disadvantages are so great that vertical integration, rather than increasing profitability, may actually reduce it—in which case a company **vertically disintegrates** and exits industries adjacent to its core industry in the industry value chain. For example, Ford, which was highly vertically integrated, sold all its companies involved in mining iron ore and making steel when more efficient and specialized steel producers emerged that were able to supply lower-priced steel.

**Increasing Cost Structure** Although vertical integration is often undertaken to lower a company's cost structure, it can raise costs if, over time, a company makes mistakes, such as continuing to purchase inputs from company-owned suppliers when low-cost independent suppliers that can supply the same inputs exist. For decades, for example, GM's company-owned suppliers made more than 60% of the component parts for its vehicles; this figure was far higher than any other major carmaker, which is why GM is a high-cost global carmaker. In the 2000s, it has vertically disintegrated by selling off many of its largest component operations, such as Delphi, its electrical components supplier. Thus, vertical integration can be a major disadvantage when company-owned suppliers develop a higher cost structure than those of independent suppliers. Why would a company-owned supplier develop such a high cost structure?

Company-owned or “in-house” suppliers know that they can always sell their components to the car-making divisions of their company—they have a “captive customer.” Because company-owned suppliers do not have to compete with independent, outside suppliers for orders, they have much less *incentive* to look for new ways to reduce operating costs or increase component quality. Indeed, in-house suppliers simply pass on cost increases to the car-making divisions in the form of higher **transfer prices**, the prices one division of a company charges other divisions for its products. Unlike independent suppliers, which constantly have to increase

their efficiency to protect their competitive advantage, in-house suppliers face no such competition, and the resulting rising cost structure reduces a company's profitability.

The term *bureaucratic costs* refers to the costs of solving the transaction difficulties that arise from managerial inefficiencies and the need to manage the handoffs or exchanges between business units to promote increased differentiation or to lower a company's cost structure. Bureaucratic costs become a significant component of a company's cost structure because considerable managerial time and effort must be spent to reduce or eliminate managerial inefficiencies, such as those that result when company-owned suppliers lose their incentive to increase efficiency or innovation.

**Technological Change** When technology is changing fast, vertical integration may lock a company into an old, inefficient technology and prevent it from changing to a new one that would strengthen its business model.<sup>10</sup> Consider a radio manufacturer that in the 1950s integrated backward and acquired a manufacturer of vacuum tubes to reduce costs. When transistors replaced vacuum tubes as a major component in radios in the 1960s, this company found itself locked into a technologically outdated business. However, if it had switched to transistors, the company would have had to write off its investment in vacuum tubes, and so managers were reluctant to adopt the new technology. Instead, they continued to use vacuum tubes in their radios while competitors that did not make vacuum tubes rapidly switched to the new transistor technology. As a result, the company lost its competitive advantage, and its failing business model led to a rapid loss in market share. Thus, vertical integration can pose a serious disadvantage when it prevents a company from adopting new technology or changing its suppliers or distribution systems to match the requirements of changing technology.

**Demand Unpredictability** Suppose the demand for a company's core product, such as cars or washing machines, is predictable, and a company knows how many units it needs to make each month or year. Under these conditions, vertical integration, by allowing a company to schedule and coordinate efficiently the flow of products along the industry value-added chain, may result in major cost savings. However, suppose the demand for cars or washing machines fluctuates wildly and is unpredictable. Now, if demand for cars suddenly plummets, the carmaker may find itself burdened with warehouses full of component parts it no longer needs, which is a major drain on profitability—something that has hurt major carmakers during the recent recession. Thus, vertical integration can be risky when demand is unpredictable because it is hard to manage the volume or flow of products along the value-added chain.

For example, a carmaker might vertically integrate backward to acquire a supplier of brake systems that can make exactly the number of systems the carmaker needs each month. However, if demand for cars falls because gas prices soar, the carmaker finds itself locked into a business that is now inefficient because it is not producing at full capacity. Its cost structure then starts to rise.

## The Limits of Vertical Integration

Thus, although there are many ways that vertical integration can strengthen a company's business model, it may weaken when (1) bureaucratic costs increase because company-owned suppliers lack the incentive to reduce operating costs, and



(2) changing technology or uncertain demand reduces a company's ability to change its business model to protect its competitive advantage. It is clear that strategic managers must carefully assess the advantages and disadvantages of expanding the boundaries of their company by entering adjacent industries, either backward (upstream) or forward (downstream), in the industry value-added chain. Moreover, although the decision to enter a new industry to make crucial component parts may have been profitable in the past, it may make no economic sense today because so many low-cost global component parts suppliers exist that compete for the company's business. The risks and returns on investing in vertical integration have to be continually evaluated, and companies should be as willing to vertically disintegrate, as vertically integrate, to strengthen their core business model.

## ALTERNATIVES TO VERTICAL INTEGRATION: COOPERATIVE RELATIONSHIPS

Is it possible to obtain the differentiation and cost-savings advantages associated with vertical integration without having to bear the problems and costs associated with this strategy? In other words, is there another corporate-level strategy that managers can use to obtain the advantages of vertical integration while allowing other companies to perform upstream and downstream activities? Today, companies have found that they can realize many of the benefits associated with vertical integration by entering into *long-term cooperative relationships* with companies in industries along the value-added chain. **Strategic alliances** are long-term agreements between two or more companies to jointly develop new products or processes that benefit all companies concerned. The advantages and disadvantages of strategic alliances are discussed in Chapter 8, in which we contrast the benefits of using strategic alliances against those obtained if a company decides to enter only into short-term contracts with other companies.

### Short-Term Contracts and Competitive Bidding

Many companies use short-term contracts that last for a year or less to establish the price and conditions under which they will purchase raw materials or components from suppliers or sell their final products to distributors or retailers. A classic example is the carmaker that uses a *competitive bidding strategy*, in which independent component suppliers compete to be chosen to supply a particular component, made to agreed-upon specifications, at the lowest price. For example, GM typically solicits bids from global suppliers to produce a particular component and awards a one-year contract to the supplier that submits the lowest bid. At the end of the year, the contract is once again put out for competitive bid, and once again the lowest cost supplier is most likely to win the bid.

The advantage of this strategy for GM is that suppliers are forced to compete over price, which drives down the cost of its car components. However, GM has no long-term commitment to outside suppliers—and it drives a hard bargain. For this reason, suppliers are unwilling to make the expensive long-term investment in specialized assets that are required to produce higher-quality or better-designed component parts over time. In addition, suppliers will be reluctant to agree on the tight

scheduling that makes it possible to use a JIT inventory system because this may help GM lower its costs but will increase a supplier's costs and reduce its profitability.

As a result, short-term contracting does not result in the specialized investments that are required to realize differentiation and cost advantages *because it signals a company's lack of long-term commitment to its suppliers*. Of course, this is not a problem when there is minimal need for cooperation, and specialized assets are not required to improve scheduling, product quality, or reduce costs. In this case, competitive bidding may be optimal. However, when there is a need for cooperation, something that is becoming increasingly significant today, the use of short-term contracts and competitive bidding can be a serious drawback.

Interestingly enough, in the past, GM did find itself at a competitive disadvantage when it used a competitive bidding approach to negotiate with suppliers. In 1992, the company instructed its parts suppliers to cut their prices by 10%—regardless of prior pricing agreements. In effect, GM tore up existing contracts and threatened to stop doing business with suppliers that did not agree to the price reduction. Although its action gave it a short-term benefit from lower costs, in the longer term the loss of trust and the hostility created between the company and its suppliers resulted in problems for GM from which it has never recovered. For example, several suppliers claimed that to reduce prices, they reduced the R&D spending necessary to design improved GM parts in the future, one kind of specialized investment. They also indicated that they would first share their new design knowledge with GM's competitors, such as Ford and Toyota, who both focus on forging cooperative long-term relationships with their suppliers.<sup>11</sup>

## Strategic Alliances and Long-Term Contracting

Unlike short-term contracts, strategic alliances between buyers and suppliers are long-term, cooperative relationships; both companies agree to make specialized investments and work jointly to find ways to lower costs or increase product quality so that they both gain from their relationship. A strategic alliance becomes a *substitute* for vertical integration because it creates a relatively stable long-term partnership that allows both companies to obtain the same kinds of benefits that result from vertical integration. However, it also avoids the problems (bureaucratic costs) that arise from managerial inefficiencies that result when a company owns its own suppliers, such as those that arise because of a lack of incentives, or when a company becomes locked into an old technology even when technology is changing rapidly.

Consider the cooperative relationships that often go back decades, which many Japanese carmakers have with their component suppliers (the *keiretsu* system), which exemplifies the benefits of successful long-term contracting. Japanese carmakers and suppliers cooperate to find ways to maximize the “value added” they can obtain from being in adjacent stages of the value chain. For example, they do this by jointly implementing JIT inventory systems or sharing future component-parts designs to improve quality and lower assembly costs. As part of this process, suppliers make substantial investments in specialized assets to better serve the needs of a particular carmaker, and the cost savings that result are shared. Thus, Japanese carmakers have been able to capture many of the benefits of vertical integration without having to enter the component industry.

Similarly, component suppliers also benefit because their business and profitability grow as the companies they supply grow, and they can invest their profits in investing in ever more specialized assets.<sup>12</sup> An interesting example of this is the computer

chip outsourcing giant Taiwan Semiconductor Manufacturing Company (TSMC) that makes the chips for many companies, such as Nvidia, Apple, and AMD. In 2009, the cost of investing in the machinery necessary to build a state-of-the-art chip factory can exceed \$10 billion. TSMC is able to make this huge (risky) investment because it has developed cooperative long-term relationships with its computer chip partners. All parties recognize that they will benefit from this outsourcing arrangement, which does not preclude some hard bargaining between TSMC and the chip companies, because all parties want to maximize their profits and reduce their risks.

### Building Long-Term Cooperative Relationships

How does a company create a long-term strategic alliance with another company given the fear of holdup and the possibility of being cheated that arises when one company makes a specialized investment with another company? How have companies such as Toyota managed to develop such profitable, enduring relationships with their suppliers?

There are several strategies companies can adopt to promote the success of a long-term cooperative relationship and lessen the chance one company will renege on its agreement and cheat the other. One strategy is for the company that makes the specialized investment to demand a *hostage* from its partner. Another is to establish a *credible commitment* from both companies that results in a trusting, long-term relationship.<sup>13</sup>

**Hostage Taking** Hostage taking is essentially a means of guaranteeing that a partner will keep its side of the bargain. The cooperative relationship between Boeing and Northrop illustrates this type of situation. Northrop is a major subcontractor for Boeing's commercial airline division, providing many components for its aircraft. To serve Boeing's special needs, Northrop has to make substantial investments in specialized assets, and, in theory, having made this investment, Northrop becomes dependent on Boeing, which can threaten to switch orders to other suppliers as a way of driving down Northrop's prices. In practice, Boeing is highly unlikely to do this because it is a major supplier to Northrop's defense division and provides many parts for its Stealth aircraft; it also has made major investments in specialized assets to serve Northrop's needs. Thus, the companies are *mutually dependent*; each company holds a hostage—the specialized investment the other has made. Thus, Boeing is unlikely to renege on any pricing agreements with Northrop because it knows that Northrop would respond in kind.

**Credible Commitments** A credible commitment is a believable promise or pledge to support the development of a long-term relationship between companies. Consider the way GE and IBM developed such a commitment. GE is one of the major suppliers of advanced semiconductor chips to IBM, and many of the chips are customized to IBM's requirements. To meet IBM's specific needs, GE has had to make substantial investments in specialized assets that have little other value. As a consequence, GE is dependent on IBM and faces a risk that IBM will take advantage of this dependence to demand lower prices. In theory, IBM could back up its demand by threatening to switch its business to another supplier. However, GE reduced this risk by having IBM enter into a contractual agreement that committed IBM to purchase chips from GE for a 10-year period. In addition, IBM agreed to share the costs of the specialized assets needed to develop the customized chips, thereby reducing the risks associated with GE's investment. Thus, by publicly committing itself to a long-term contract

and putting some money into the chip development process, IBM made a *credible commitment* that it would continue to purchasing chips from GE.

**Maintaining Market Discipline** Just as a company pursuing vertical integration faces the problem that its company-owned suppliers might become inefficient, so a company that forms a strategic alliance with an independent component supplier runs the risk that its alliance partner might become inefficient over time, resulting in higher component costs or lower quality. This also happens because the outside supplier knows it does not have to compete with other suppliers for the company's business. Consequently, a company seeking to form a mutually beneficial, long-term strategic alliance needs to possess some kind of power that it can use to discipline its partner—should the need arise.

A company holds two strong cards over its supplier partner. First, even long-term contracts are periodically renegotiated, usually every three to five years, so the supplier knows that if it fails to live up to its commitments, its partner may refuse to renew the contract. Second, many companies that form long-term relationships with suppliers use **parallel sourcing policies**—that is, they enter into long-term contracts with at least *two* suppliers for the *same* component (this is Toyota's policy, for example).<sup>14</sup> This arrangement protects a company against a supplier that adopts an uncooperative attitude because the supplier knows that if it fails to comply with the agreement, the company can switch *all* its business to its other supplier partner. When both the company and its suppliers recognize that the parallel sourcing policy allows a supplier to be replaced at short notice, most suppliers behave because the policy brings market discipline into their relationship.

The growing importance of JIT inventory systems as a way to reduce costs and enhance quality and differentiation is increasing the pressure on companies to form strategic alliances in a wide range of industries. The number of strategic alliances formed each year, especially global strategic alliances, is increasing, and the popularity of vertical integration is falling because so many low-cost global suppliers exist in countries like Malaysia, Korea, and China.

## STRATEGIC OUTSOURCING

Vertical integration and strategic alliances are alternative ways of managing the value chain *across industries* to strengthen a company's core business model. However, just as low-cost suppliers of component parts exist, so today many *specialized companies* exist that can perform one of a company's *own value-chain activities* in a way that contributes to a company's differentiation advantage or that lowers its cost structure. For example, one specialist chip outsourcer, Taiwanese giant TSMC was discussed earlier; two other huge global contract manufacturers are Flextronics and Jabil Circuit.

**Strategic outsourcing** is the decision to allow one or more of a company's value-chain activities or functions to be performed by independent specialist companies that focus all their skills and knowledge on just one kind of activity. The activity to be outsourced may encompass an entire function, such as the manufacturing function, or it may be just one kind of activity that a function performs. For example, many companies outsource the management of their pension systems while keeping other HRM activities within the company. When a company chooses to outsource a value-chain activity, it is choosing to focus on a *fewer* number of value-creation activities to strengthen its business model.

There has been a clear move among many companies to outsource activities that managers regard as being “noncore” or “nonstrategic,” meaning they are not a source of a company’s distinctive competencies and competitive advantage.<sup>15</sup> One survey found that some 54% of the companies polled had outsourced manufacturing processes or services in the past three years.<sup>16</sup> Another survey estimates that some 56% of all global product manufacturing is outsourced to manufacturing specialists.<sup>17</sup> Some well-known companies that outsource include Nike, which does not make its athletic shoes; Gap Inc., which does not make its jeans and clothing; and Apple, which makes none of its own product. These products are made under contract at low-cost global locations by contract manufacturers that specialize in low-cost assembly.

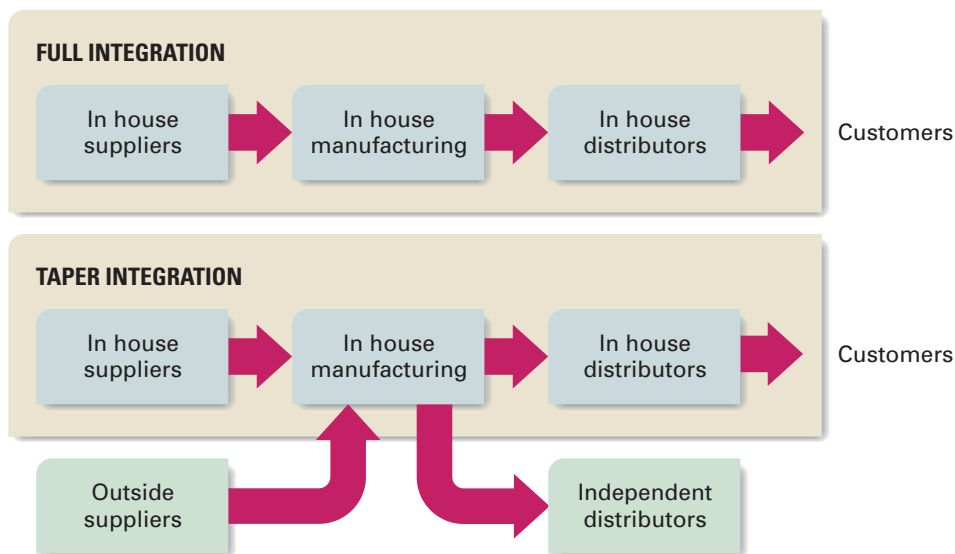
Although manufacturing is the most popular form of strategic outsourcing, as we noted earlier, many other kinds of noncore activities are also outsourced. Microsoft has long outsourced its entire customer technical support operation to an independent company, as does Dell. Both companies have extensive customer support operations in India staffed by skilled operatives paid a fraction of what their United States counterparts earn. BP outsourced almost all of its human resource function to Exult, a San Antonio company, in a five-year deal worth \$600 million; a few years later Exult won a 10-year \$1.1 billion contract to handle HRM activities for all Bank of America’s 150,000 employees. Similarly, American Express outsourced its entire IT function to IBM in a seven-year deal worth \$4 billion, and the IT outsourcing market in North America was worth more than \$250 billion by 2009.<sup>18</sup> In 2006, IBM announced it was outsourcing its purchasing function to an Indian company to save \$2 billion a year, and it has steadily increased its use of outsourcing ever since. For example, in 2009 it announced it would lay off 5,000 IT employees in the United States and move their jobs to India.<sup>19</sup>

Companies engage in strategic outsourcing to strengthen their business models and increase their profitability. The process of strategic outsourcing typically begins with strategic managers identifying the value-chain activities that form the basis of a company’s competitive advantage; these are obviously kept within the company to protect them from competitors. Managers then systematically review the noncore functions to assess whether independent companies that specialize in those activities can perform them more effectively and efficiently. Because these companies specialize in particular activities, they can perform them in ways that lower costs or improve differentiation. If managers decide there are differentiation or cost advantages, these activities are outsourced to those specialists.

This is illustrated in Figure 9.3, which shows the primary value-chain activities and boundaries of a company before and after it has pursued strategic outsourcing. In this example, the company decided to outsource its production and customer service functions to specialist companies, leaving just R&D and marketing and sales within the company. Once outsourcing has been executed, the relationships between the company and its specialists are then often structured as long-term contractual relationships, with rich information sharing between the company and the specialist organization to which it has contracted the activity. The term **virtual corporation** has been coined to describe companies that have pursued extensive strategic outsourcing.<sup>20</sup>

## Benefits of Outsourcing

Strategic outsourcing has several advantages. It can help a company to (1) lower its cost structure, (2) increase product differentiation,<sup>21</sup> and (3) focus on the distinctive competencies that are vital to its long-term competitive advantage and profitability.

**Figure 9.3** Strategic Outsourcing of Primary Value Creation Functions

**Lower Cost Structure** Outsourcing will reduce costs when the price that must be paid to a specialist company to perform a particular value-chain activity is less than what it would cost the company to internally perform that activity itself. Specialists are often able to perform an activity at a lower cost than the company, because they are able to realize scale economies or other efficiencies not available to the company. For example, performing HRM activities, such as managing pay and benefit systems, requires a significant investment in sophisticated HRM IT; purchasing these IT systems represents a considerable fixed cost for one company. But, by aggregating the HRM IT needs of many individual companies, a company that specializes in HRM, such as Exult and Paycheck, can obtain huge economies of scale in IT that any single company could not hope to achieve. Some of these cost savings are then passed to the client companies in the form of lower prices, which reduces their cost structure. A similar dynamic is at work in the contract manufacturing business. Once again, manufacturing specialists like Soletron, Flextronics, and Jabil Circuit make large capital investments to build efficient-scale manufacturing facilities, but then are able to spread those capital costs over a huge volume of output and drive down unit costs so that they can make a specific product—an Apple iPod or Motorola Krazr, for example—at a lower cost than the company.

Specialists are also likely to obtain the cost savings associated with learning effects much more rapidly than a company that performs an activity just for itself (see Chapter 4 for a review of learning effects). For example, because a company like Flextronics is manufacturing similar products for several different companies, it is able to build up *cumulative* volume more rapidly, and it learns how to manage and operate the manufacturing process more efficiently than any of its clients could. This drives down the specialists' cost structure and also allows them to charge client companies a lower price for a product than if they made it in-house.

Specialists are also often able to perform activities at lower costs than a specific company because they are based in low-cost global locations. Nike, for example,



outsources the manufacture of its running shoes to companies based in China because of the much lower wage rates. The Chinese-based specialist can assemble shoes, which is a very labor-intensive activity, at a much lower cost than if assembled in the United States. Although Nike could establish its own operations in China to manufacture running shoes, it would require a major capital investment and limit its ability to switch production to an even lower-cost location later, for example, Vietnam. So, for Nike and most other consumer goods companies, outsourcing manufacturing activity to both lower costs and give it the flexibility to switch to a more favorable location should labor costs change is the most efficient way to handle production.

**Enhanced Differentiation** A company may also be able to differentiate its final products better by outsourcing certain noncore activities to specialists. For this to occur, the *quality* of the activity performed by specialists must be greater than if that same activity was performed by the company. On the reliability dimension of quality, for example, a specialist may be able to achieve a lower error rate in performing an activity, precisely because it focuses solely on that activity and has developed a strong distinctive competency in it. Again, this is one advantage claimed for contract manufacturers. Companies like Flextronics have adopted Six Sigma methodologies (see Chapter 4) and driven down the defect rate associated with manufacturing a product. This means they can provide more reliable products to their clients, which can now differentiate their products on the basis of their superior quality.

A company can also improve product differentiation by outsourcing to specialists when they stand out on the excellence dimension of quality. For example, the excellence of Dell's United States customer service is a differentiating factor, and Dell outsources its PC repair and maintenance function to specialist companies. A customer who has a problem with a product purchased from Dell can get excellent help over the phone, and if it turns out that there is a defective part in the computer, a maintenance person will be dispatched to replace the part within a few days. The excellence of this service differentiates Dell and helps to guarantee repeat purchases, which is why HP has worked hard to match Dell's level of service quality. In a similar way, carmakers often outsource specific kinds of vehicle component design activities, such as microchips or headlights, to specialists that have earned a reputation for design excellence in this particular activity.

**Focus on the Core Business** A final advantage of strategic outsourcing is that it allows managers to focus their energies and their company's resources on performing those core activities that have the most potential to create value and competitive advantage. In other words, companies can enhance their core competencies and so are able to push out the value frontier and create more value for their customers. For example, Cisco Systems remains the dominant competitor in the Internet router industry because it has focused on building its competencies in product design, marketing and sales, and supply-chain management. Companies that focus on the core activities essential for competitive advantage in their industry are better able to drive down the costs of performing those activities and better differentiate their final products.

## Risks of Outsourcing

Although outsourcing noncore activities has many benefits, there are also risks associated with it, risks such as holdup and the possible loss of important information when an activity is outsourced. Managers must assess these risks before they decide

to outsource a particular activity, although, as we discuss following, these risks can be reduced when the appropriate steps are taken.

**Holdup** In the context of outsourcing, holdup refers to the risk that a company will become too dependent on the specialist provider of an outsourced activity and that the specialist will use this fact to raise prices beyond some previously agreed-on rate. As with strategic alliances, the risk of holdup can be reduced by outsourcing to several suppliers and pursuing a parallel sourcing policy, as Toyota and Cisco do. Moreover, when an activity can be performed well by any one of several different providers, the threat that a contract will not be renewed in the future is normally sufficient to keep the chosen provider from exercising bargaining power over the company. For example, although IBM enters into long-term contracts to provide IT services to a wide range of companies, it would be unadvisable to try to raise prices after the contract has been signed because it knows full well that such an action would reduce its chance of getting the contract renewed in the future. Moreover, the fact that IBM has many strong competitors in the IT services business, such as Accenture, Cap Gemini, and HP gives it a very strong incentive to deliver significant value to its client and not practice holdup.

**Loss of Information** A company that is not careful can lose important competitive information when it outsources an activity. For example, many computer hardware and software companies have outsourced their customer technical support function to specialists. Although this makes good sense from a cost and differentiation perspective, it may also mean that a critical point of contact with the customer, and a source of important feedback, is lost. Customer complaints can be useful pieces of information and valuable inputs into future product design, but if those complaints are not clearly communicated to the company by the specialists performing the technical support activity, the company can lose the information. Again, this is not an argument against outsourcing. Rather, it is an argument for making sure that there is good communication flow between the outsourcing specialist and the company. At Dell, for example, a great deal of attention is paid to making sure that the specialist responsible for providing technical support and onsite maintenance collects and communicates all relevant data regarding product failures and other problems to Dell, so that Dell can design better products.

## SUMMARY OF CHAPTER

1. A corporate strategy should enable a company, or one or more of its business units, to perform one or more of the value creation functions at a lower cost or in a way that allows for differentiation and a premium price.
2. The corporate-level strategy of horizontal integration is pursued to increase the profitability of a company's business model by (a) reducing costs, (b) increasing the value of the company's products through differentiation, (c) replicating the business model, (d) managing rivalry within the industry to reduce the risk of price warfare; and (e) increasing bargaining power over suppliers and buyers.
3. There are two drawbacks associated with horizontal integration: (a) the numerous pitfalls associated with making mergers and acquisitions, and (b) the fact that the strategy can bring a company into direct conflict with antitrust authorities.
4. The corporate-level strategy of vertical integration is pursued to increase the profitability of a company's "core" business model in its original

industry. Vertical integration can enable a company to achieve a competitive advantage by helping build barriers to entry, facilitating investments in specialized assets, protecting product quality, and helping to improve scheduling between adjacent stages in the value chain.

5. The disadvantages of vertical integration include increasing bureaucratic costs if a company-owned or in-house supplier becomes lazy or inefficient, and it reduces flexibility when technology is changing fast or demand is uncertain.
6. Entering into a long-term contract can enable a company to realize many of the benefits associated with vertical integration without having to bear the same level of bureaucratic

costs. However, to avoid the risks associated with becoming too dependent on its partner, it needs to seek a credible commitment from its partner or establish a mutual hostage-taking situation.

7. The strategic outsourcing of noncore value creation activities may allow a company to lower its costs, better differentiate its products, and make better use of scarce resources, while also enabling it to respond rapidly to changing market conditions. However, strategic outsourcing may have a detrimental effect if the company outsources important value creation activities or becomes too dependent on the key suppliers of those activities.

## DISCUSSION QUESTIONS

1. Under what conditions might horizontal integration be inconsistent with the goal of maximizing profitability?
2. What is the difference between a company's internal value chain and the industry value chain? What is the relationship between vertical integration and the industry value chain?
3. Why was it profitable for GM and Ford to integrate backward into component-parts manufacturing in

the past, and why are both companies now buying more of their parts from outside suppliers?

4. What value-creation activities should a company outsource to independent suppliers? What are the risks involved in outsourcing these activities?
5. What steps would you recommend that a company take to build mutually beneficial long-term cooperative relationships with its suppliers?

## PRACTICING STRATEGIC MANAGEMENT

### Small-Group Exercise: Comparing Vertical Integration Strategies

Break up into small groups of three to five people, and discuss the following scenario. Appoint one group member as a spokesperson who will communicate your findings to the class. Read the following description of the activities of Seagate Technologies and Quantum Corporation, both of which manufacture computer disk drives. On the basis of this description, outline the pros and cons of a vertical integration strategy. Which strategy do you think makes most sense in the context of the computer disk drive industry?

Quantum Corporation and Seagate Technologies are major producers of disk drives for PCs and workstations. The disk drive industry is characterized by sharp fluctuations in the level of demand, intense price competition, rapid technological change, and product life cycles of only 12 to 18 months. Quantum and Seagate have pursued very different vertical integration strategies to meet this challenge.

Seagate is a vertically integrated manufacturer of disk drives, both designing and manufacturing the bulk of its own disk drives. On the other hand, Quantum specializes in design; it outsources most of its manufacturing to a number of independent suppliers, including, most importantly, Matsushita Kotobuki Electronics (MKE) of Japan. Quantum makes only its newest and most expensive products in-house. Once a new drive is perfected and ready for large-scale manufacturing, Quantum turns over manufacturing to MKE. MKE and Quantum have cemented their partnership over eight years. At each stage in designing a new product, Quantum's engineers send the newest drawings to a production team at MKE. MKE examines the drawings and proposes changes that make new disk drives easier to manufacture. When the product is ready for manufacture, eight to ten Quantum engineers travel to MKE's plant in Japan for at least a month to work on production ramp-up.

### Article File 9

Find an example of a company whose horizontal or vertical integration strategy appears to have dissipated rather than created value. Identify why this has been the case and what the company should do to rectify the situation.

### Strategic Management Project: Module 9

This module requires you to assess the horizontal and vertical integration strategy being pursued by your company. With the information you have at your disposal, answer the questions and perform the tasks listed:

1. Has your company ever pursued a horizontal integration strategy? What was the strategic reason for pursuing this strategy?
2. How vertically integrated is your company? In what stages of the industry value-chain does it operate?
3. Assess the potential for your company to increase profitability through vertical integration. In reaching your assessment, also consider the bureaucratic costs of managing vertical integration.
4. On the basis of your assessment in question 3, do you think your company should (a) outsource some operations that are currently performed in-house or (b) bring some operations in-house that are currently outsourced? Justify your recommendations.
5. Is your company involved in any long-term cooperative relationships with suppliers or buyers? If so, how are these relationships structured? Do you think that these relationships add value to the company? Why?
6. Is there any potential for your company to enter into (additional) long-term cooperative relationships with suppliers or buyers? If so, how might these relationships be structured?

## C L O S I N G   C A S E

### Beating Dell: Why HP Acquired Compaq

In 2001, Hewlett-Packard (now HP) shocked the business world when its former CEO, Carly Fiorina, announced that rival computer-maker Compaq had agreed to be acquired by HP. The announcement came at the end of a year in which slumping demand and strong competition from Dell had buffeted both companies. The merged company would have annual revenues of about \$87.4 billion, putting it in the same league as IBM, and would be able to provide customers with a full range of computer products and services. With the exception of printers, in which HP is the market leader, there was significant product overlap between HP and Compaq.

To justify the acquisition, Fiorina claimed that it would yield a number of benefits. First, there would be significant cost savings. Some \$2.5 billion per year would be taken out of annual expenses by eliminating redundant administrative functions and laying off 15,000 employees. In addition, combining the PC businesses of HP and Compaq would enable HP to capture significant scale economies and compete more efficiently with Dell. The same would be true in the computer server and storage businesses, areas in which Dell was gaining share. Critics, however, were quick to point out that Dell's competitive advantage was based on its cost-leadership business model that was based on the efficient management of its supply chain—an area in which both HP and Compaq lagged behind Dell. Although achieving economies of scale is desirable, would the merger allow HP to reduce its cost structure, such as by increasing its supply-chain efficiency? If HP could not change its PC business model to match Dell's low costs, then the merger would not provide any real benefit.

In addition to the cost advantages of the merger, Fiorina argued that the acquisition would give HP a critical mass in the computer service and consultancy business, in which it significantly lagged behind leader IBM. By being able to offer customers a total solution to their IT needs, both hardware *and* services, Fiorina argued that HP could gain new market share among corporate clients, who would now buy its PCs as part of the total “computer package”; moreover, HP would be entering the higher-margin service business. Here too, however, critics were quick to perceive flaws. They argued that HP would

still be a minnow in the service and consultancy area, with less than 3% of market share.

In 2005, HP announced that it had achieved its cost savings target and that it was continuing to find ways to reduce the duplication of resources in the merged company. However, it also announced that Dell's entry into the printer business had hurt its profit margins, and the profit margins on the sales of its PCs were still well below those obtained by Dell. HP's stock price plunged, and its board of directors reacted by firing Fiorina and bringing in a new CEO, Mark Hurd, a person with proven skills in managing a company's cost structure. Hurd initiated another round of cost reductions by pruning HP's product line and workforce. In Spring 2006, the company astounded analysts when it announced much higher profit margins on its sales of PCs and higher profits across the company. Many of Fiorina's strategies had begun to pay off; HP's PCs were much more attractive to customers, and Dell's foray into printers had not proved highly successful against market leader HP. Neither had Dell's entry into other electronics industries such as MP3 players, televisions, and so on.

The result was that competitive advantage in the PC industry seemed to be moving away from Dell and toward HP. As a result, Dell has been forced to find ways to increase its level of differentiation to increase the attractiveness of its machines and so defend its position against HP and Apple. Dell bought the upscale PC-maker Alienware in one move to increase differentiation; it also entered into physical retailing industry when it opened Dell PC stores in major shopping malls, imitating Apple's strategy. And, to find more cost savings, Dell also began to use AMD's cheaper chips and broke its long-term exclusive tie to Intel to find more cost savings. Analysts worry these moves will increase its cost structure, and the battle has heated up in the PC industry as Dell, HP, and Apple work to find new ways to lower costs and differentiate their products to increase their profitability and ROIC.

### Case Discussion Questions

1. What kind of corporate-level strategies did HP and Dell pursue to strengthen their multibusiness models?
2. What are the advantages and disadvantages associated with these strategies?



## LEARNING OBJECTIVES

- Differentiate between multibusiness models based on related and unrelated diversification
- Explain the five main ways in which diversification can increase company profitability
- Discuss the conditions that lead managers to pursue related diversification versus unrelated

- diversification and explain why some companies pursue both strategies
- Describe the three methods companies use to enter new industries: internal new venturing, acquisitions, and joint ventures
- Discuss the advantages and disadvantages associated with each of these methods

## OPENING CASE

SE accomplished this when its pioneering CEO Lee Kun Hee decided to develop and build distinctive competences first in low-cost manufacturing, second in R&D, and then in new production in new industries.

could sell at lower prices than the Japanese companies. For example, SE decided to enter the cell phone industry and make lower-cost phones than companies such as Nokia and Motorola. SE also entered the semiconductor industry in which it worked to make the lowest-cost memory chips; soon it became the global cost leader. SE also entered other digital-product markets such as cameras, printers, and storage devices.

In essence, Samsung was pursuing the corporate-level strategy of related diversification.





Its goals were to increase its profitability by creating value by transferring and leveraging its distinctive competencies in product development and manufacturing by entering new industries and producing new products. SE's strategy was successful and profitable, but it was not playing in the same league as Sony, for example. Sony could charge premium prices for its leading electronics and continuously plow back profits into the R&D needed to make more advanced state-of-the-art electronics. CEO Hee decided to adopt new strategies that would allow his company to compete head-to-head with Japanese and European electronics companies and make it a global technology leader. SE's goal was not to copy technology innovated by Sony, Matsushita, Phillips, and Nokia but for SE's engineers to develop the research and engineering skills necessary to rapidly innovate leading-edge technologies, such as LCD displays, to create products more advanced than its competitors.

Within a decade, SE became the leading supplier of advanced flash memory chips and LCD screens, premium-priced products that it sold to other global electronics makers, including Japanese flat screen TV makers. Samsung also made the development of a new competence in global marketing an important part of its business model. For example, while Nokia was the leading cell phone innovator, Samsung was the first to realize customers wanted color screens for their phones to allow them to play games and built-in cameras to send photographs to their friends. Both of these incremental advances allowed Samsung to dramatically increase its share of the cell phone market. In 2009, it was the second-largest cell phone maker after Nokia.

By 2007, Samsung had become one of the most innovative global electronics makers with its four research divisions: semiconductors, telecommunications, digital media, and flat screen LCD displays. Because many

of its products require components developed by all four divisions, to pursue its strategy of related diversification, SE teams up researchers, designers, engineers, and marketers from all its divisions at its research facility outside Seoul. In this way, they can spur the economies of scope and leveraging of competencies its strategy of related diversification permits. At the same time, it also can transfer its manufacturing competence between its divisions and make electronic products at lower cost than competitors.

In 2008, however, SE, like most other electronics companies, was forced to restructure its business divisions because of the global recession. The problem facing SE and other global electronics companies, such as Sony, was how to pursue related diversification while simultaneously reducing its cost structure and increasing its technological edge. In 2009, Samsung's new CEO Lee Yoon Woo announced a major restructuring that would consolidate its four divisions into two to reduce costs but still speed product development. SE's semiconductor and LCD display businesses were combined into a new Device Solutions Division, and its televisions, mobile phones and other consumer electronics, such as printers and computers were placed in the Digital Media and Communications Division. Because all of SE's products use in-house chips and LCD displays, this means that while SE is pursuing related diversification, it is also using its low-cost skills to benefit from vertical integration.

In addition, it is important to note that Samsung Electronics is only one division of the Samsung Corporation, which is a huge conglomerate that also pursues unrelated diversification. The parent Samsung Corporation has dozens of divisions that are involved in industries such as shipbuilding, construction, life insurance, leisure, and so on—in fact, the Samsung empire accounts for 20% of South Korea's total exports.

## Overview

Samsung has developed a *multibusiness model* that allows each of the huge corporation's individual companies or divisions, such as Samsung Electronics, to pursue its own business model to achieve a competitive advantage in the industries in which it operates. The Opening Case discussed how Samsung's electronics division is pursuing the corporate-level strategies of related diversification and vertical integration to increase its profitability. The entire Samsung Corporation, however, is pursuing a strategy of unrelated diversification because it is involved in many industries that have no connection with each other.

In this chapter, we continue our discussion of how companies can strengthen their business models by pursuing the corporate-level strategies of related and unrelated diversification. A diversification strategy is based on a company's decision to enter one or more new industries to take advantage of its existing distinctive competencies and business model. We examine the different kinds of multibusiness models on which related and unrelated diversification are based. Then, we discuss three different ways companies can implement a diversification strategy: internal new ventures, acquisitions, and joint ventures. By the end of this chapter, you will understand the advantages and disadvantages associated with strategic managers' decisions to diversify and enter new markets and industries.

## INCREASING PROFITABILITY THROUGH DIVERSIFICATION

**Diversification** is the process of entering new industries, distinct from a company's core or original industry, to make new kinds of products that can be sold profitably to customers in these new industries. A multibusiness model based on diversification aims to find ways to use a company's existing strategies and distinctive competencies to make products that are highly valued by customers in the new industries it enters. A **diversified company** is one that makes and sells products in two or more different or distinct industries (industries *not* in adjacent stages of an industry value chain as in vertical integration). In each industry a company enters, it establishes an operating division or business unit, which is essentially a self-contained company that makes and sells products to customers in one of more industry market segments. For example, Samsung created its consumer electronics division, and that division competes in many electronic market segments, including cell phones, flat screen TVs, and PCs. As in the case of the other corporate strategies, to increase profitability, a diversification strategy should enable a company or its individual business units to perform one or more of the value-chain functions (1) at a lower cost, (2) in a way that allows for differentiation and gives the company pricing options, or (3) in a way that helps the company to manage industry rivalry better.

The managers of most companies first consider diversification when they are generating **free cash flow**, that is, cash *in excess* of that required to fund investments in the company's existing industry and to meet any debt commitments.<sup>1</sup> In other words, free cash flow is cash in excess of that which can be profitably reinvested in an existing business (*cash* is simply *capital* by another name). When a company is generating free cash flow, managers must decide whether to return that cash to

shareholders in the form of higher dividend payouts or invest it in diversification. Technically, any free cash flow belongs to the company's owners—its shareholders. So, for diversification to be a viable strategy, the return on investing free cash flow to pursue diversification opportunities, that is, the ROIC, *must* exceed the return that stockholders could get by investing that capital in a diversified portfolio of stocks and bonds. If this were not the case, it would be in the best interests of shareholders for the company to return any excess cash to them through higher dividends rather than pursue a diversification strategy. Thus, a diversification strategy is *not* consistent with maximizing returns to shareholders unless the multibusiness model managers use to justify entry into a new industry will significantly increase the value a company can create.

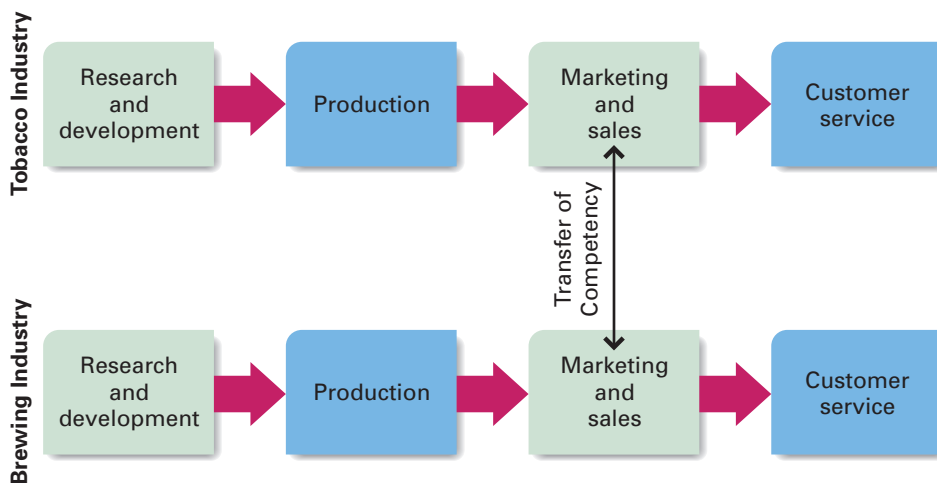
There are five main ways in which pursuing a multibusiness model based on diversification can increase company profitability. Diversification can increase profitability when strategic managers (1) transfer competencies between business units in different industries, (2) leverage competencies to create business units in new industries, (3) share resources between business units to realize economies of scope, (4) use product bundling, and (5) utilize *general* organizational competencies that increase the performance of *all* a company's business units.

### Transferring Competencies

Transferring competencies involves taking a distinctive competency developed by a business unit in one industry and implanting it in a business unit operating in another industry. The second business unit is often one a company has acquired. Companies that base their diversification strategy on transferring competencies aim to use one or more of their existing distinctive competencies in a value-chain activity—for example, in manufacturing, marketing, materials management, or R&D—to significantly strengthen the business model of the acquired business unit or company. For example, over time, Philip Morris developed distinctive competencies in product development, consumer marketing, and brand positioning that had made it a leader in the tobacco industry. Sensing a profitable opportunity, it acquired Miller Brewing, which at the time was a relatively small player in the brewing industry. Then, to create valuable new products in the brewing industry, Philip Morris transferred some of its best marketing experts to Miller, where they applied the skills acquired at Philip Morris to turn around Miller's lackluster brewing business (see Figure 10.1). The result was the creation of Miller Light, the first light beer, and a marketing campaign that helped to push Miller from the number six to the number two company in the brewing industry in terms of market share.

Companies that base their diversification strategy on transferring competencies tend to acquire new businesses *related* to their existing business activities because of commonalities between one or more of their value-chain functions. A *commonality* is some kind of skill or attribute, which when it is shared or used by two or more business units, allows them to operate more effectively and efficiently and create more value for customers.

For example, Miller Brewing was related to Philip Morris's tobacco business because it was possible to create important marketing commonalities; both beer and tobacco are mass market consumer goods in which brand positioning, advertising, and product development skills are crucial to create successful new products. In general, such competency transfers increase profitability when they either (1) lower the cost structure of one or more of a diversified company's business units or (2) enable

**Figure 10.1** Transfer of Competencies at Philip Morris

one or more of its business units to better differentiate their products, both of which give business unit pricing options to lower a product's price to increase market share or to charge a premium price.

For competency transfers to increase profitability, the competencies transferred must involve value-chain activities that become an important source of a specific business unit's competitive advantage in the future. In other words, the distinctive competency being transferred must have real strategic value. However, all too often companies assume that *any* commonality between their value chains is sufficient for creating value. When they attempt to transfer competencies, they find the anticipated benefits are not forthcoming because the different business units did not share some important attribute in common. For example, GM's acquisition of Hughes Aircraft, made simply because cars and car manufacturing were "going electronic" and Hughes was an electronics company, demonstrates the folly of overestimating the commonalities between different businesses. The acquisition failed to realize any of the anticipated gains for GM, whose competitive position did not improve, and GM subsequently sold off Hughes.

## Leveraging Competencies

Leveraging competencies involves taking a distinctive competency developed by a business unit in one industry and using it to create a *new* business unit or division in a different industry, as SE did in the Opening Case when it used its low-cost manufacturing skills to enter the cell phone industry. Once again, the multi-business model is based on the premise that the set of distinctive competencies that are the source of a company's competitive advantage in one industry might be applied to create a differentiation- or cost-based competitive advantage for a new business unit in a different industry. For example, Canon used its distinctive competencies in precision mechanics, fine optics, and electronic imaging to produce laser jet printers, which, for Canon, was a new business in a new industry. Its competitive advantage in laser printers came from the fact that its competencies enabled it to produce high-quality (differentiated) printers that could be manufactured at a low cost.

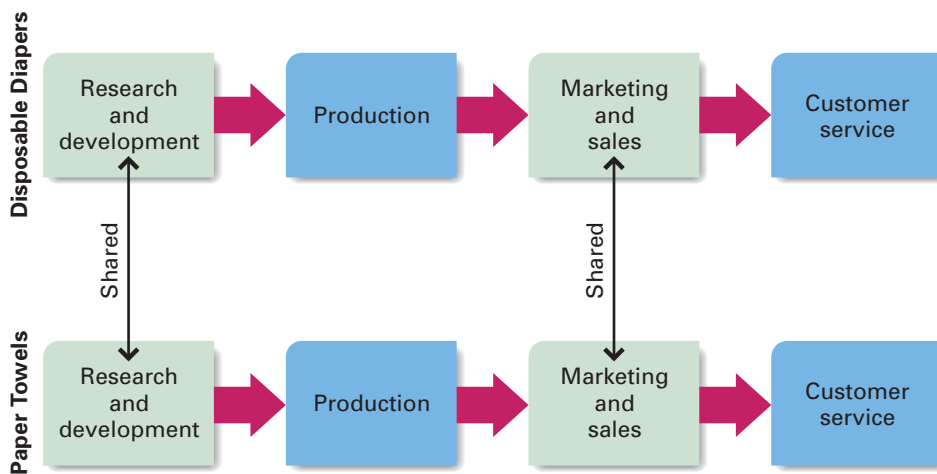
The difference between leveraging competencies and transferring competencies is that in the case of leveraging competencies, an entirely *new* business unit is being created, whereas transferring competencies involves the sharing of competencies between two *existing* businesses. This difference is important because each is based on a different multibusiness model. Companies such as 3M, SE, and Canon that leverage competencies to establish new business units tend to be *technology-based* companies that use their R&D competencies to create new business units to take advantage of opportunities in diverse industries. In contrast, companies that transfer competencies are often the leading companies in one industry that enter new industries by acquiring established companies. They then transfer their strong set of competencies to the acquired companies to increase their competitive advantage and profitability, as Philip Morris did with Miller Brewing.

Many companies have based their diversification strategy on leveraging their competencies to create new business units in different industries. Microsoft leveraged its skills in software development and marketing to create two business units in new industries, its online network MSN and Xbox video game units. Microsoft's managers believed this diversification strategy was in the best interests of shareholders because the company's competencies would enable it to attain a competitive advantage in the online and video game industries. The results of this strategy have been mixed; in 2003 when Microsoft first broke its profits down by business unit, it turned out that the software business was generating almost all its profits, and most other business units were losing money. Its competitive situation has improved somewhat since its Xbox 360 has captured more market share from Sony, although the growing popularity of the Wii has not helped it. In its online business, it made a bid to buy Yahoo! in 2008 for \$43 billion to strengthen MSN and especially to grow the popularity of its search engine because of increasing competition from Google, but it failed; the future profitability of its online businesses was in question in 2009.

## Sharing Resources and Capabilities

A third way in which two or more business units that operate in different industries can increase a diversified company's profitability is when they way they share resources and capabilities results in economies of scope.<sup>2</sup> **Economies of scope** arise when one or more of a diversified company's business units are able to realize cost-saving or differentiation advantages because they can more effectively pool, share, and utilize expensive resources or capabilities, such as skilled people, equipment, manufacturing facilities, distribution channels, advertising campaigns, and R&D laboratories. If business units in different industries can share a common resource or function, they can collectively lower their cost structure.<sup>3</sup> For example, the costs of GE's consumer products advertising, sales, and service activities are spread over a wide range of products, such as light bulbs, appliances, air conditioning, furnaces, and so on, which reduces costs. There are two major sources of these cost reductions.

First, when companies can share resources or capabilities across business units, it lowers their cost structure compared to a company that operates in only one industry and has to bear the full costs of developing resources and capabilities. For example, P&G makes disposable diapers, toilet paper, and paper towels, which are all paper-based products that customers value for their ability to absorb fluids without disintegrating. Because these products need the same attribute—absorbency—P&G can share the R&D costs associated with developing and making even more

**Figure 10.2** Sharing Resources at Proctor & Gamble

advanced absorbent paper-based products across the three distinct businesses (only two are shown in Figure 10.2). Similarly, because all these products are sold to retailers, P&G can use the same sales force to sell all their products (see Figure 10.2). In contrast, P&G competitors that make only one or two of these products cannot share these costs across industries, so their cost structure is higher. As a result, P&G has lower costs; it can use its marketing function to better differentiate its products, and it achieves a higher ROIC than companies that operate only in one or a few industries and are unable to obtain economies of scope from the ability to share resources across business units.

Once again, diversification to obtain economies of scope is possible only when there are *significant* commonalities between one or more of the value-chain functions in a company's different business units or divisions that result in increased profitability. In addition, managers need to be aware that the costs of coordination necessary to achieve economies of scope within a company sometimes may be *higher* than the value that can be created by such a strategy.<sup>4</sup> Consequently, diversification based on obtaining economies of scope should be pursued only when the sharing of competencies will result in a *significant* competitive advantage for one or more of a company's new or existing business units.

## Using Product Bundling

In the search for new ways to differentiate their products, more and more companies are entering into industries that provide customers with new products that are connected or related to their existing products. This allows a company to expand and widen the range of products it produces so as to be able to satisfy customers' needs for a complete package of related products. This is currently happening in telecommunications in which customers are increasingly seeking package prices for wired phone service, wireless phone service, high-speed access to the Internet, VOIP phone service, television programming, online gaming, video on demand, or any combination of these services. To meet this need, large phone companies such as



AT&T and Verizon have been acquiring other companies that provide one or more of these services, while cable companies such as Comcast have acquired, or formed strategic alliances, with companies that allow them to offer their customers a package of these services. The goal, once again, is to bundle products to offer customers lower prices and/or a superior set of services.

Just as manufacturing companies strive to reduce the number of their component suppliers to reduce costs and increase quality, so the final customer wants to obtain the convenience and reduced price of a bundle of related products. Another example of product bundling comes from the medical equipment industry in which companies that, in the past, made different kinds of products, such as operating theater equipment, ultrasound devices, magnetic imaging, and X-ray equipment, have merged together to provide hospitals with a complete range of medical equipment. This industry consolidation has also been driven by hospitals that wish to obtain the convenience and lower prices that often follow from forming a long-term contract with a single supplier.

## Utilizing General Organizational Competencies

General organizational competencies transcend individual functions or business units and are found at the top or corporate level of a multibusiness company. Typically, general competencies are the result of the skills of a company's top managers and functional experts. When these general competencies are present—and many times they are not—they help each business unit within a company perform at a higher level than it could if it operated as a separate or independent company—this increases the profitability of the *entire* corporation, such as with Samsung discussed in the opening case.<sup>5</sup> Three kinds of general organizational competencies help a company increase its performance and profitability: (1) entrepreneurial capabilities, (2) organizational design capabilities, and (3) strategic capabilities.

**Entrepreneurial Capabilities** A company that generates significant excess cash flow can take advantage of it only if its managers are able to identify new opportunities and act on them to create a stream of new and improved products, both in its current industry and in new industries. Some companies seem to have a greater capability to stimulate their managers to act in entrepreneurial ways than others, for example, Apple, 3M, HP, and Samsung.<sup>6</sup>

These companies are able to promote entrepreneurship because they have an organizational culture that stimulates managers to act entrepreneurially. As a result, these companies are able to create profitable new business units more quickly than other companies; this allows them to take advantage of profitable opportunities for diversification. We discuss one of the strategies required to generate profitable new businesses later in this chapter: internal new venturing. For now, it is important to note that to promote entrepreneurship, a company must (1) encourage managers to take risks, (2) give them the time and resources to pursue novel ideas, (3) not punish managers when a new idea fails, and (4) make sure that its free cash flow is not wasted in pursuing too many risky new ventures that have a low probability of generating a profitable return on investment. Strategic managers face a significant challenge in achieving all four of these objectives. On the one hand, a company must encourage risk taking, and on the other hand, it must limit the number of risky ventures it engages in.

Companies that possess strong entrepreneurial capabilities achieve this balancing act. For example, 3M's goal of generating 40% of revenues from products introduced within the past four years focuses managers' attention on the need to develop new products and enter new businesses. 3M's long-standing commitment to help its customers solve problems also ensures that ideas for new businesses are customer focused. The company's celebration of employees who have created successful new businesses helps to reinforce the norm of entrepreneurship and risk taking. Similarly, there is a norm that failure should not be punished but viewed as a learning experience.

**Capabilities in Organizational Design** Organizational design is a company's ability to create a structure, culture, and control systems that motivate and coordinate employees to perform at a high level. Organizational design is a major factor that influences a company's entrepreneurial capabilities; it is also an important determinant of a company's ability to create the functional competencies that give it a competitive advantage. The way strategic managers make organizational design decisions such as how much autonomy to give to managers lower in the hierarchy, what kinds of norms and values should be developed to create an entrepreneurial culture, and even how to design its headquarters buildings to encourage the free flow of ideas, is an important determinant of a diversified company's ability to profit from its multibusiness model. Effective organizational structure and controls create incentives that encourage business unit (divisional) managers to maximize the efficiency and effectiveness of their units. Moreover, good organizational design helps prevent strategic managers from missing out on profitable new opportunities, as happens when employees become so concerned to protect their company's competitive position in *existing* industries that they lose sight of new or improved ways to do business and profitable opportunities to enter new industries.

The last two chapters of this book take an in-depth look at organizational design. To profit from pursuing the corporate-level strategy of diversification, a company must be able to continuously manage and change its structure and culture so as to motivate and coordinate its employees to work at a high level and develop the resources and capabilities on which its competitive advantage depends. The ever-present need to align a company's structure with its strategy is a complex, never-ending task, and only top managers with superior organizational design skills can do it.

**Superior Strategic Management Capabilities** For diversification to increase profitability, a company's top managers must have superior capabilities in strategic management. They must possess the intangible, hard-to-define governance skills that are required to manage different business units in a way that enables these units to perform better than they would if they were independent companies.<sup>7</sup> These governance skills are a rare and valuable capability. However, certain CEOs and top managers seem to have them; they have developed the aptitude of managing multiple businesses simultaneously and encourage the top managers of those business units to devise strategies to achieve superior performance. Examples of CEOs who possess superior strategic management capabilities include Jeffery Immelt at GE, Steve Ballmer at Microsoft, Steve Jobs at Apple, and Larry Ellison at Oracle—and, of course, the President of the United States, Barack Obama.

An especially important governance skill in a diversified company is the ability to diagnose the underlying source of the problems of a poorly performing business unit and then to understand how to proceed to solve those problems. This might involve recommending new strategies to the existing top managers of the unit or knowing when

## Ethical Dilemma

Recently, many top managers have been convicted of illegally altering their company's financial statements or providing false information to hide the poor performance of their company from stockholders or simply for personal gain. You have been charged with the task of creating a control system for your company to ensure managers behave ethically and legally when reporting the performance of their business. To help develop the control system, you identify the five main ways managers use diversification to increase profitability—transferring and leveraging competencies, sharing resources, product bundling, and the use of general managerial competencies. How might these five methods be associated with unethical behavior? Can you determine rules or procedures that could prevent managers from behaving in an unethical way?

to replace them with a new management team that is better able to fix the problems. Top managers who have such governance skills tend to be very good at probing business unit managers for information and helping them to think through strategic problems.

Related to this skill is the ability of the top managers of a diversified company to identify inefficient and poorly managed companies in other industries and then to acquire and restructure them to improve their performance—and thus the profitability of the total corporation. There are several ways to improve the performance of the acquired company. First, the top managers of the acquired company are replaced with a more aggressive top management team. Second, the new top management team sells off expensive assets, such as underperforming divisions, executive jets, and elaborate corporate headquarters; it also terminates managers and employees to reduce the cost structure. Third, the new management team works to devise new strategies to improve the performance of the operations of the acquired business and improve its efficiency, quality, innovativeness, and customer responsiveness.

Fourth, to motivate the new top management team and the other employees of the acquired company to work toward such goals, a company-wide pay-for-performance bonus system linked to profitability is introduced to reward employees at all levels for their hard work. Fifth, the acquiring company often establishes “stretch” goals for employees at all levels; these are challenging, hard-to-obtain goals that force employees at all levels to work to increase the company's efficiency and effectiveness. Finally, the new top management team clearly understands that if they fail to increase their division's performance and meet these stretch goals within some agreed-upon amount of time, they will be replaced. In sum, the system of rewards and sanctions corporate managers of the acquiring company establish provide the new top managers of the acquired unit with strong incentive to develop strategies to improve their unit's operating performance.

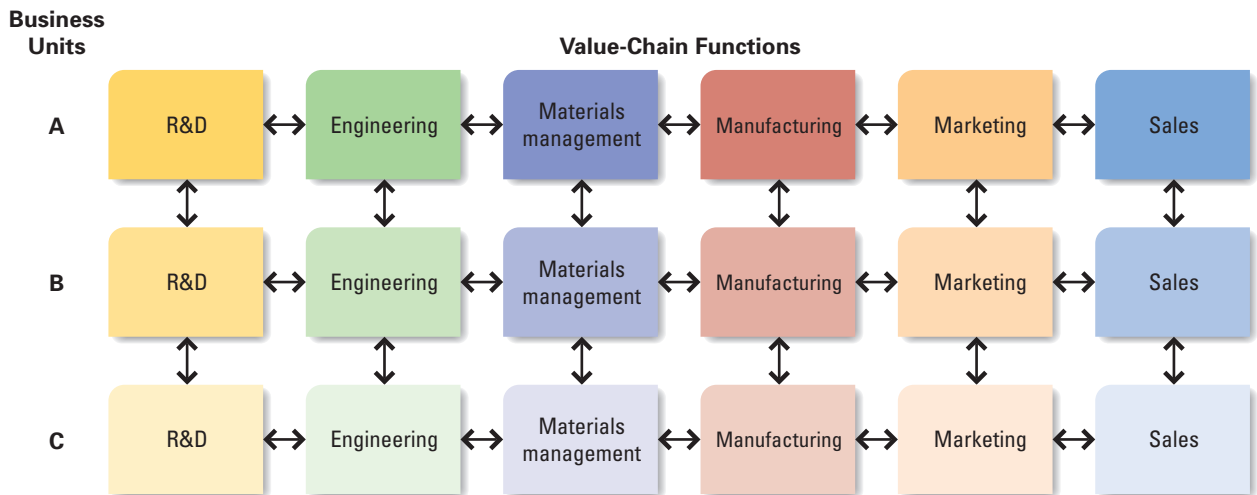
## TWO TYPES OF DIVERSIFICATION

The last section discussed five principal ways in which companies can use diversification to transfer and implant their business models and strategies in other industries to increase their long-run profitability. The two corporate strategies of *related diversification* and *unrelated diversification* can be distinguished by how they attempt to realize these five profit-enhancing benefits of diversification.<sup>8</sup>

### Related Diversification

**Related diversification** is a corporate-level strategy that is based on the goal of establishing a business unit (division) in a new industry that is *related* to a company's existing business units by some form of commonality or linkage between the value-chain functions of the existing and new business units. As you might expect, the goal of this strategy is to obtain the benefits from transferring competencies, leveraging competencies, sharing resources, and bundling products that are discussed above.

The multibusiness model of related diversification is based on taking advantage of strong technological, manufacturing, marketing, and sales commonalities between new and existing business units that can be successfully “tweaked” or modified to increase the competitive advantage of one or more business units. Figure 10.3 illustrates the commonalities or linkages possible among the different functions of three different business units or divisions. The greater the number of linkages that can be

**Figure 10.3** Commonalities between the Value Chains of Three Business Units

formed among business units, the greater the potential to realize the profit-enhancing benefits of the five reasons to diversify discussed previously.

One more advantage of related diversification is that it can also allow a company to use any general organizational competency it possesses to increase the overall performance of *all* its different industry divisions—such as the different divisions of the entire Samsung Corporation. For example, strategic managers may strive to create a structure and culture that encourages entrepreneurship across divisions as both Samsung and 3M have done; beyond these general competences, both companies have a set of distinctive competences that are shared among their different business units and which they continuously strive to improve. An example of a leading company that is increasingly pursuing related diversification is Cisco Systems, profiled in Strategy in Action 10.1.

## 10.1 STRATEGY IN ACTION

### Cisco Systems Is Entering Many New Industries

Cisco Systems is famous for developing the Internet routers and switches on which the World Wide Web (WWW) is built. In 2009, Cisco still made most of its \$10 billion yearly revenue from selling its Internet routers and switches to large companies, Internet service providers (ISPs), and the enormous data center storage companies that are emerging to satisfy the growing need for “cloud computing” or online data storage. However, the boom years of Internet building in the 1990s that allowed Cisco to make enormous profits are over; like all high-tech

companies, Cisco was hit hard by the drop in demand for Internet hardware that followed the dot.com bust and by the recession that began in 2008. However, its CEO John Chambers, who has led the company from the beginning, has a reputation for acquiring high-tech companies when their stock price is low because of hard economic times and then using their competencies to spur its future growth. And, Cisco has billions in cash available to make whatever acquisitions Chambers decides will increase its future profitability.

(continued)

Realizing that the Internet router market by itself would not generate the huge profits necessary to drive up the company's ROIC, Chambers embarked on a major strategy of related diversification. From its core Internet hardware and software business, Cisco has been rapidly expanding into the consumer electronics industry to increase profitability. Every acquisition Chambers has made, however, is related to the Internet in some way. In fact, his multi-business model is based on acquiring companies that make products in the industries that facilitate and drive up customer demand for Internet bandwidth or usage. Why? Because this increases the demand for Cisco's core products: the Internet routers and switches that provide the extra bandwidth needed by ISPs and data centers that must satisfy their business' and customers' growing demand for fast Internet service. For example, the products made by Cisco's new acquisitions encourage companies and individuals to engage in activities such as sharing personal videos online or teleconferencing. These activities result in a huge demand for Internet bandwidth to increase the speed and capacity of their Internet service; online companies such as YouTube and Facebook, ISPs, major telecommunications companies such as AT&T and Sprint, and cable companies such as Comcast, are forced to spend billions of dollars to buy Cisco's routers to keep up with ever-increasing customer demand for fast Internet service.

While driving demand for the Internet is one part of its related diversification strategy, Cisco has been a pioneer in innovating new products from the beginning; it also seeks to transfer and leverage its R&D competencies across its new businesses and make them all work seamlessly together—resulting in economies of scope. For example, in 2003 to help customers get online more easily, Cisco bought home-networking equipment-maker Linksys for \$500 million and implanted its technology in the company. Today, Linksys is the major supplier of home routers that customers use to create wireless home networks to give all family members instant access to the Web; this also drives up the need for bandwidth. The home routers share Cisco's Internet technology and work flawlessly with its routers and switches to make the Internet easier to access and use. In 2005, to increase TV viewers' ability to take advantage of the Internet to download TV shows and movies (and increase Internet usage), Chambers acquired Scientific Atlanta for \$7 billion, which made the set-top boxes bought by subscription TV providers. Today, Cisco supplies all the set-top boxes to companies such as Comcast and Time Warner; of course, the boxes also work with its other Internet products. In addition, the boxes have the ability to provide both business and home users with video conferencing, which takes up enormous amounts of bandwidth.

In 2009, Cisco announced it would pay \$590 million to purchase Pure Digital, the company that makes the colorful, pocket-sized flip video camcorders that allow people to quickly make and share their videos on the Web. Two million flips have been sold in the United States so far. Chambers claims this acquisition will help drive up demand for the next generation of entertainment and communication products, such as Wiis, iPhones, and laptops, all designed to make it easier and faster for users to access the Internet. Cisco's goal once again is to increase customer demand for fast Internet service that will force Internet-related companies to increase their bandwidth capacity and buy the networking giant's hardware and software.

In March 2009, Cisco announced that it was entering a new industry, the computer hardware industry, by internally venturing an advanced powerful computer server, code-named "Project California," that will bring it into direct competition with Dell, HP, Sun, and IBM. In 2009, to build any kind of data center, most of which are linked to the Internet, large companies have to buy three different kinds of products: computer servers linked into "racks" that combine their power, storage or memory banks, and the networking software and hardware that links them to the Internet. Different high-tech companies supply these three products; Cisco's goal is to provide all three as a unified package that can significantly reduce the server rack's complexity, power consumption, and cost. Each Cisco rack will contain seven servers powered by Intel's new powerful Nehalem chips, an integrated storage bank, and a new Cisco Internet networking switch, Nexus, which will allow the rack to deliver information that can be customized to the kind of communication technology and bandwidth requirements of any particular company. For example, many companies such as Google and IBM are competing to be the leader in online cloud computing, which allows customers to store their data in online datacenters. These datacenters require the use of thousands of racks of servers. In 2009, 50% of the eight million servers sold every year are based in Internet datacenters that use Cisco's routers. Cisco's new servers can therefore provide all the Internet hardware and software necessary to supply all the storage and bandwidth a company could ever need in a seamless way and, at a lower cost.

By 2009, Cisco's strategy of creating synergies and sharing and leveraging its competencies among all its Internet-related products has led it to enter 28 different industries, including smaller ventures into home digital music and public surveillance systems, all of which generate demand for bandwidth. Chambers announced that his goal was to come out of the 2009 recession with the products in place to make Cisco not just the global leader in communications technology but also in Internet-linked IT hardware for business and individual customers.

## Unrelated Diversification

**Unrelated diversification** is a corporate-level strategy based on a multibusiness model whose goal is to increase profitability through the use of general organizational competencies to increase the performance of *all* the company's business units. Companies pursuing this strategy are often called *conglomerates*, business organizations that operate in many diverse industries. Companies pursuing a strategy of unrelated diversification have *no* intention of transferring or leveraging competencies between business units or sharing resources. The only goal of strategic managers is to use their company's general organizational competencies to strengthen the business models of each of its individual business units or divisions. If the strategic managers of conglomerates have the special skills needed to manage many companies in diverse industries, the strategy can result in superior performance and profitability often they do not have these skills, as is discussed later in the chapter. Some companies, such as United Technologies Corporation (UTC) discussed later in the chapter in Strategy in Action 10.2, have top managers who do seem to have these special skills.

## THE LIMITS AND DISADVANTAGES OF DIVERSIFICATION

Many companies such as 3M, Samsung, UTC, and Cisco have achieved the benefits of pursuing either or both of the two diversification strategies just discussed, and they have managed to sustain their profitability over time. On the other hand, companies such as GM, Textron, and Phillips that pursued diversification failed miserably and became unprofitable. There are three principal reasons why a business model based on diversification may lead to a loss of competitive advantage: (1) changes in the industry or inside a company that occur over time, (2) diversification pursued for the wrong reasons, and (3) excessive diversification that results in increasing bureaucratic costs.

### Changes in the Industry or Company

Diversification is a complex strategy. To pursue diversification, top managers must have the ability to recognize profitable opportunities to enter new industries and to implement the strategies necessary to make diversification profitable. Over time, a company's top management team often changes; sometimes its most able executives join other companies and become their CEOs, sometimes successful CEOs decide to retire or step down. When the managers who possess the hard-to-define skills leave, they often take their visions with them. A company's new leaders may lack the competency or commitment necessary to pursue diversification successfully over time; thus, the cost structure of the diversified company increases and eliminates any gains the strategy may have produced.

In addition, the environment often changes rapidly and unpredictably over time. When new technology blurs industry boundaries, it can destroy the source of a company's competitive advantage; for example, by 2009, it was clear that Apple's iPhone had become a direct competitor with Nintendo for playing games on small mobile devices. When such a major technological change occurs in a company's



core business, the benefits it has previously achieved from transferring or leveraging distinctive competencies disappear. The company is now saddled with a collection of businesses that have all become poor performers in their respective industries because they are not based on the new technology—something that has happened to Sony. Thus, a major problem with diversification is that the future success of this strategy is hard to predict. For a company to profit from it over time, managers must be as willing to divest business units as they are to acquire them. Research suggests managers do not behave in this way, however.

### Diversification for the Wrong Reasons

As we have discussed, when managers decide to pursue diversification, they must have a clear vision of how their entry into new industries will allow them to create new products that provide more value for customers and so increase their company's profitability. Over time, however, a diversification strategy may result in falling profitability for reasons noted earlier, but managers often refuse to recognize that their strategy is failing. Although they know they should divest unprofitable businesses, managers "make up" reasons why they should keep their collection of businesses together.

In the past, for example, one widely used (and false) justification for diversification was that the strategy would allow a company to obtain the benefits of risk pooling. The idea behind risk pooling is that a company can reduce the risk of its revenues and profits rising and falling sharply (something that sharply lowers its stock price) if it acquires and operates companies in several industries that have different business cycles. The business cycle is the tendency for the revenues and profits of companies in an industry to rise and fall over time because of "predictable" changes in customer demand. For example, even in a recession, people still need to eat; the profits earned by supermarket chains will be relatively stable, and sales at Walmart actually rise as shoppers attempt to get more value for their dollars. At the same time, a recession caused the demand for cars and luxury goods to plunge. Many CEOs argued by diversifying into industries that have different business cycles, the sales and revenues of some of their divisions would be rising while those in others would be falling, so the net result is a more stable stream of revenue and profits over time. An example of risk pooling occurred when U.S. Steel diversified into the oil and gas industry in an attempt to offset the adverse effects of cyclical downturns in the steel industry.

This argument ignores two important facts. First, stockholders can eliminate the risk inherent in holding an individual stock by diversifying their *own* portfolios, and they can do so at a much lower cost than a company can. Thus, attempts to pool risks through diversification represent an unproductive use of resources; instead, profits should be returned to shareholders in the form of increased dividends. Second, research suggests that corporate diversification is not an effective way to pool risks because the business cycles of different industries are *inherently difficult to predict*, so it is likely that a diversified company will find that an economic downturn affects *all* its industries simultaneously. If this happens, the company's profitability plunges.<sup>9</sup>

When a company's core business is in trouble, another mistaken justification for diversification is that entry into new industries will rescue it and lead to long-term growth and profitability. An example of a company that made this mistake is Kodak. In the 1980s, increased competition from low-cost Japanese competitors like Fuji, combined with the beginnings of the digital revolution, soon led its revenues and

profits to plateau and then fall. Its managers should have done all they could to reduce its cost structure; instead they took its still huge free cash flow and spent tens of billions of dollars to enter new industries, such as health care, biotechnology, and computer hardware, in a desperate and mistaken attempt to find ways to increase profitability.

This was a disaster because every industry Kodak entered was populated by strong companies such as 3M, Canon, and Xerox. Also, Kodak's corporate managers lacked any general competencies to give their new business units a competitive advantage. Moreover, the more industries they entered, the greater the range of threats they encountered and the more time they had to spend dealing with these threats. As a result, they could spend much less time improving the performance of their core film business that continued to decline.

In reality, Kodak's diversification was just for growth itself, but *growth does not create value for stockholders*; growth is just the byproduct, not the objective, of a diversification strategy. However, in desperation, companies diversify for reasons of growth alone rather than to gain any well-thought-out strategic advantage.<sup>10</sup> In fact, a large number of academic studies suggest that *extensive* diversification tends to reduce rather than improve company profitability.<sup>11</sup> Many studies conclude that the corporate diversification strategies pursued by many companies can dissipate value instead of creating it.<sup>12</sup>

## The Bureaucratic Costs of Diversification

A major reason why diversification often fails to boost profitability is that very often the *bureaucratic costs* of diversification exceed the benefits created by the strategy (that is, the increased profit that results when a company makes and sells a wider range of differentiated products and/or lower its cost structure). As we mention in the previous chapter, **bureaucratic costs** are the costs associated with solving the transaction difficulties that arise between a company's business units, and between business units and corporate headquarters, as the company attempts to obtain the benefits from transferring, sharing, and leveraging competencies. They also include the costs associated with using general organizational competencies to solve managerial and functional inefficiencies. The level of bureaucratic costs in a diversified organization is a function of two factors: (1) the number of business units in a company's portfolio and (2) the degree to which coordination is required between these different business units to realize the advantages of diversification.

**Number of Businesses** The greater the number of business units in a company's portfolio, the more difficult it is for corporate managers to remain informed about the complexities of each business. Managers simply do not have the time to assess the business model of each unit. This problem began to occur at GE in the 1970s when its growth-hungry CEO Reg Jones acquired many new businesses. As Jones commented,

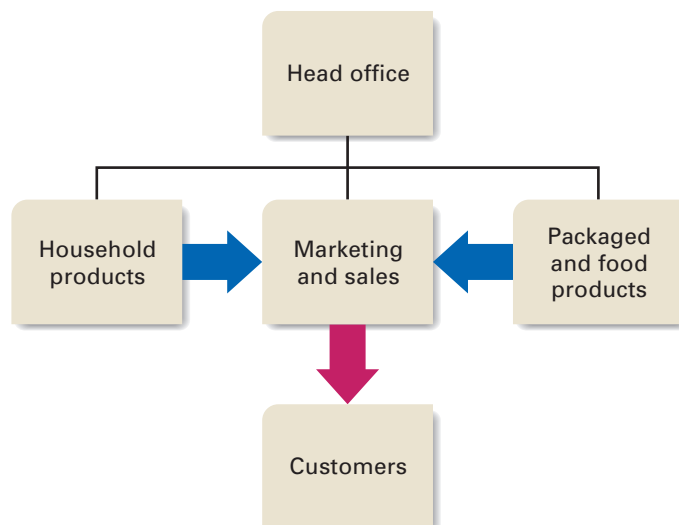
I tried to review each plan [of each business unit] in great detail. This effort took untold hours and placed a tremendous burden on the corporate executive office. After a while I began to realize that no matter how hard we would work, we could not achieve the necessary in-depth understanding of the 40-odd business unit plans.<sup>13</sup>

The inability of top managers in extensively diversified companies to maintain control over their multibusiness model over time often leads them to base important

resource allocation decisions on only the most superficial analysis of each business unit's competitive position. For example, a promising business unit may be starved of investment funds, while other business units receive far more cash than they can profitably reinvest in their operations. Furthermore, because they are distant from the day-to-day operations of the business units, corporate managers may find that business unit managers try to hide information on poor performance to save their own jobs. For example, business unit managers might blame poor performance on difficult competitive conditions, even when it is the result of their inability to craft a successful business model. As such organizational problems increase, top managers have to spend an enormous amount of time and effort to solve them. This increases bureaucratic costs and cancels out the profit-enhancing advantages of pursuing diversification, such as those obtained from sharing or leveraging competencies.

**Coordination among Businesses** The amount of coordination required to realize value from a diversification strategy based on transferring, sharing, or leveraging competencies is a major source of bureaucratic costs. The bureaucratic mechanisms needed to oversee and manage this coordination and handoffs between units, such as cross-business-unit teams and management committees, are a major source of these costs. A second source of bureaucratic costs arises because of the enormous amount of managerial time and effort required to accurately measure the performance and unique profit contribution of a business unit that is transferring or sharing resources with another. Consider a company that has two business units, one making household products (such as liquid soap and laundry detergent) and another making packaged food products. The products of both units are sold through supermarkets. To lower the cost structure, the parent company decides to pool the marketing and sales functions of each business unit, using an organizational structure similar to that illustrated in Figure 10.4. The company is organized into three divisions: a household products division, a food products division, and a marketing division.

**Figure 10.4** Coordination among Related Business Units



Although such an arrangement may significantly lower operating costs, it can also give rise to substantial control problems and hence bureaucratic costs. For example, if the performance of the household products business begins to slip, identifying who is to be held accountable—managers in the household products division or managers in the marketing division—may prove difficult. Indeed, each may blame the other for poor performance. Although these kinds of problems can be resolved if corporate management performs an in-depth audit of both divisions, the bureaucratic costs (managers' time and effort) involved in doing so may once again cancel out any value achieved from diversification.

In sum, while diversification can be a highly profitable strategy to pursue, it is also the most complex and difficult strategy to manage because it is based on a complex multibusiness model. Even when a company has pursued this strategy successfully in the past, changing conditions both in the industry environment and inside a company may quickly reduce the profit-creating advantages of pursuing this strategy. For example, such changes may result in one or more business units losing their competitive advantage, as happened to Sony. Or, changes may cause the bureaucratic costs associated with pursuing diversification to rise sharply and cancel out its advantages. Thus, the existence of bureaucratic costs places a limit on the amount of diversification that a company can profitably pursue. It makes sense for a company to diversify only when the profit-enhancing advantages of this strategy *exceed* the bureaucratic costs of managing the increasing number of business units required when a company expands and enters new industries.

## CHOOSING A STRATEGY

### Related versus Unrelated Diversification

Because related diversification involves more sharing of competencies, one might think it can boost profitability in more ways than unrelated diversification and so is the better diversification strategy. However, some companies, such as UTC, can create as much or more value from pursuing unrelated diversification, so that strategy must also have some substantial benefits. An unrelated company does *not* have to achieve coordination between business units; it has to cope only with the bureaucratic costs that arise from the number of businesses in its portfolio. In contrast, a related company has to achieve coordination *among* business units if it is to realize the gains that come from utilizing its distinctive competencies. Consequently, it has to cope with the bureaucratic costs that arise *both* from the number of business units in its portfolio *and* from coordination among business units. Thus, although it is true that related diversified companies can create value and profit in more ways than unrelated companies, they also have to bear higher bureaucratic costs to do so. These higher costs may cancel out the higher benefits, making the strategy no more profitable than one of unrelated diversification.

How then does a company choose between these strategies? The choice depends on a comparison of the benefits of each strategy against the bureaucratic costs of pursuing it. It pays a company to pursue related diversification when (1) the company's competencies can be applied across a greater number of industries, and (2) the company has superior strategic capabilities that allow it to keep bureaucratic costs under close control—perhaps by encouraging entrepreneurship or by developing a value-creating organizational culture.

Using the same logic, it pays a company to pursue unrelated diversification when (1) each business unit's functional competencies have few useful applications across industries, but the company's top managers are skilled at raising the profitability of poorly run businesses; and (2) the company's managers use their superior strategic management competencies to improve the competitive advantage of their business units and keep bureaucratic costs under control. Some well-managed companies, such as UTC, discussed in Strategy in Action 10.2, have managers who can successfully pursue unrelated diversification and reap its rewards.

## 10.2 STRATEGY IN ACTION

### United Technologies Has an "ACE" in Its Pocket

United Technologies Corporation (UTC), based in Hartford, Connecticut, is a *conglomerate*, a company that owns a wide variety of other companies that operate separately in many different businesses and industries. Some of the companies in UTC's portfolio are better known than UTC itself, such as Sikorsky Aircraft Corporation; Pratt & Whitney, the aircraft engine and component maker; Otis Elevator Company; Carrier Air Conditioning; and Chubb, the security and lock maker that UTC acquired in 2003. Today, investors frown on companies like UTC that own and operate companies in widely different industries. There is a growing perception that managers can better manage a company's business model when the company operates as an independent or stand-alone entity. How can UTC justify holding all these companies together in a conglomerate? Why would this lead to a greater increase in total profitability than if they operated as independent companies? In the last decade, the boards of directors and CEOs of many conglomerates, such as Greyhound-Dial, ITT Industries, and Textron, have realized that by holding diverse companies together they were reducing, not increasing, the profitability of their companies. As a result, many conglomerates have been broken up, and their companies spun off to allow them to operate as separate, independent entities.

UTC's CEO George David claims that he has created a unique and sophisticated multibusiness model that adds value across UTC's diverse businesses. David joined Otis Elevator as an assistant to its CEO in 1975, but within one year, Otis was acquired by UTC. The 1970s was a decade when a "bigger is better" mindset ruled corporate America, and mergers and acquisitions of whatever kind were seen as the best way to grow profits. UTC sent David to manage its South American operations and later gave him responsibility for its Japanese operations.

Otis had formed an alliance with Matsushita to develop an elevator for the Japanese market, and the resulting "Elevonic 401," after being installed widely in Japanese buildings, proved to be a disaster. It broke down much more often than elevators made by other Japanese companies, and customers were concerned about its reliability and safety.

Matsushita was extremely embarrassed about the elevator's failure and assigned one of its leading total quality management (TQM) experts, Yuzuru Ito, to head a team of Otis engineers to find out why it performed so poorly. Under Ito's direction, all the employees—managers, designers, and production workers—who had produced the elevator analyzed why the elevators were malfunctioning. This intensive study led to a total redesign of the elevator, and when their new and improved elevator was launched worldwide, it met with great success. Otis's share of the global elevator market increased dramatically, and one result was that David was named president of UTC in 1992. He was given the responsibility to cut costs across the entire corporation, including its important Pratt & Whitney division, and his success in reducing UTC's cost structure and increasing its ROIC led to his appointment as CEO in 1994.

Now responsible for all of UTC's diverse companies, David decided that the best way to increase UTC's profitability, which had been declining, was to find ways to improve efficiency and quality in *all* its constituent companies. He convinced Ito to move to Hartford and take responsibility for championing the kinds of improvements that had by now transformed the Otis division, and Ito began to develop UTC's TQM system, which is known as "Achieving Competitive Excellence," or ACE.

ACE is a set of tasks and procedures that are used by employees from the shop floor to top managers

to analyze all aspects of the way a product is made. The goal is to find ways to improve *quality and reliability*, to *lower the costs* of making a product, and especially to find ways to make the next generation of a particular product perform better—in other words, to encourage *technological innovation*. David makes every employee in every function and at every level personally responsible for achieving the incremental, step-by-step gains that result in state-of-the-art innovative and efficient products that allow a company to dominate its industry.

David calls these techniques “process disciplines,” and he has used them to increase the performance of all UTC companies. Through these techniques, he has created the extra value for UTC that justifies it owning and operating such a diverse set of businesses. David’s success can be seen in the performance that his company has achieved in the decade since he took control: he has quadrupled UTC’s earnings per share, and its sales and profits have soared. UTC has been in the top three performers of the companies that make up the Dow Jones industrial average for most

the 2000s, and the company has consistently outperformed GE, another huge conglomerate, in its return to investors.

David and his managers believe that the gains that can be achieved from UTC’s process disciplines are never-ending because its own R&D—in which it invests more than \$2.5 billion a year—is constantly producing product innovations that can help all its businesses. Indeed, recognizing that its skills in creating process improvements are specific to manufacturing companies, UTC’s strategy is to only acquire companies that make products that can benefit from the use of its ACE program—hence its Chubb acquisition. At the same time, David invests only in companies that have the potential to remain leading companies in their industries and so can charge above-average prices. His acquisitions strengthen the competencies of UTC’s existing businesses. For example, he acquired a company called Sundstrand a leading aerospace and industrial systems company, and combined it with UTC’s Hamilton aerospace division to create Hamilton Sundstrand which is now a major supplier to Boeing and makes products that command premium prices.

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**Source:** <http://www.utc.com>, 2009.

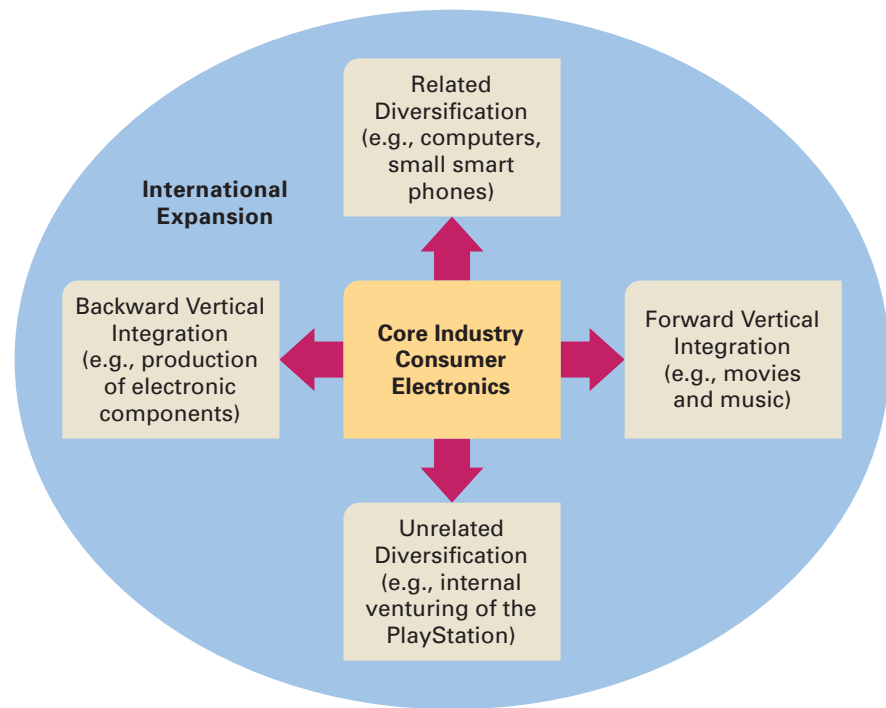
## The Web of Corporate-Level Strategy

Finally, it is important to note that while some companies may choose to pursue a strategy of related or unrelated diversification, there is nothing that stops them from pursuing both strategies at the same time—*as well as all the other corporate-level strategies we have discussed*. The purpose of corporate-level strategy is to increase long-term profitability. A company should pursue any and all strategies as long as strategic managers have weighed the advantages and disadvantages of those strategies and arrived at a multibusiness model that justifies them. The opening case discusses how Samsung pursues many different corporate-level strategies simultaneously; Figure 10.5 illustrates how Sony uses a web of corporate strategies to compete in many industries.

First, Sony’s core business is its electronic consumer products business, which is well known for its innovative products that have made it one of the best-known brand names in the world. To protect the quality of its electronic products, Sony manufactures a high percentage of the component parts for its televisions, DVD players, and so on, and has pursued a strategy of backward vertical integration. Sony also engages in forward vertical integration: after acquiring Columbia Pictures and MGM in 2004, it now operates in the movie industry and has opened a chain of Sony stores in shopping malls. Sony also shared and leveraged its distinctive competencies by developing its own business units that operate in the computer and smartphone industries, a strategy of related diversification. Finally, when it decided to enter the home video game industry and develop its PlayStation to compete with Nintendo, it was pursuing a strategy of unrelated diversification. Today, this division contributes more to Sony’s total profits than its core electronics business.



**Figure 10.5** Sony's Web of Corporate-Level Strategy



Although Sony has had enormous success pursuing these strategies in the past, in the 2000s its profitability has fallen dramatically. Analysts claim its multibusiness model led its managers to diversify into too many industries, in each of which the focus was on innovating high-quality product. This is very expensive, and, as a result, its cost structure increased so much that it swallowed up all the profits its businesses were generating. They also claim that its strategy of giving each business unit great autonomy has led each unit to pursue its own goals at the expense of the company's multibusiness model. Sony's escalating bureaucratic costs drained its profitability. Also, because its different divisions did not share their knowledge and expertise, it allowed competitors like Samsung to catch up and overtake it in areas such as cell phones and flat-screen LCDs. Sony has been responding to these problems. It has taken major steps to reduce bureaucratic costs, improve divisional cooperation to speed innovation, and lower its cost structure, including exiting industries such as PDAs. The next few years will show whether these changes will help the company better manage its web of corporate strategies to improve its profitability.

## ENTERING NEW INDUSTRIES: INTERNAL NEW VENTURES

We have discussed all the corporate-level strategies managers use to formulate the multibusiness model. From this point, we can examine the three main methods managers employ to enter new industries: internal new ventures, acquisitions, and joint

ventures. In this section, we consider the pros and cons of using internal new ventures. In the following sections, we look at acquisitions and joint ventures.

## The Attractions of Internal New Venturing

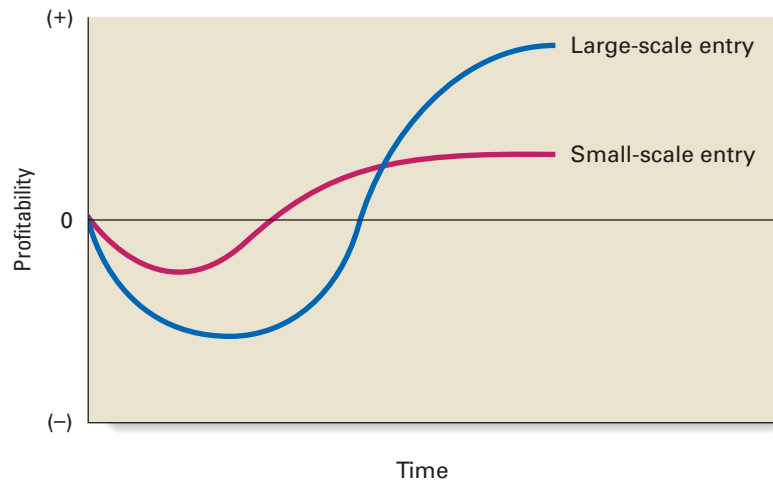
Internal new venturing is typically used to implement corporate-level strategies when a company possesses one or more distinctive competencies in its core business model that can be leveraged or recombined to enter a new industry. **Internal new venturing** is the process of transferring resources to and creating a new business unit or division in a new industry. Internal venturing is used most by companies whose business model is based on using their technology to innovate new kinds of products and enter related markets or industries. Thus, technology-based companies that pursue related diversification, like DuPont, which has created new markets with products such as cellophane, nylon, Freon, and Teflon, are most likely to use internal new venturing. 3M has a near-legendary knack for creating new or improved products from internally generated ideas and then establishing new business units to create the business model that enables it to dominate a new market. Similarly, HP entered into the computer and printer industries by using internal new venturing.

A company may also use internal venturing to enter a newly emerging or embryonic industry—one in which no company has yet developed the competencies or business model that gives it a dominant position in that industry. This was Monsanto's situation in 1979 when it contemplated entering the biotechnology field to produce herbicides and pest-resistant crop seeds. The biotechnology field was young at that time, and there were no incumbent companies focused on applying biotechnology to agricultural products. Accordingly, Monsanto internally ventured a new division to develop the required competencies necessary to enter and establish a strong competitive position in this newly emerging industry.

## Pitfalls of New Ventures

Despite the popularity of internal new venturing, there is a high risk of failure. Research suggests that somewhere between 33% and 60% of all new products that reach the marketplace do not generate an adequate economic return,<sup>14</sup> and most of these products were the result of internal new ventures. Three reasons are often put forward to explain the relatively high failure rate of internal new ventures: (1) market entry on too small a scale, (2) poor commercialization of the new-venture product, and (3) poor corporate management of the new venture division.<sup>15</sup>

**Scale of Entry** Research suggests that large-scale entry into a new industry is often a critical precondition for the success of a new venture. In the short run, this means that a substantial capital investment must be made to support large-scale entry; thus, there is a risk of major losses if the new venture fails. But, in the long run, which can be as long as five to twelve years depending on the industry, such a large investment results in far greater returns than if a company chooses to enter on a small scale to limit its investment to reduce potential losses.<sup>16</sup> Large-scale entrants can more rapidly realize scale economies, build brand loyalty, and gain access to distribution channels in the new industry, all of which increase the probability of a new venture's success. In contrast, small-scale entrants may find themselves handicapped by high costs due to a lack of scale economies and a lack of market presence limits their ability to build brand loyalty and gain access to distribution channels. These scale effects are particularly

**Figure 10.6** Scale of Entry and Profitability

significant when a company is entering an *established* industry in which incumbent companies possess scale economies, brand loyalty, and access to distribution channels. In that case, the new entrant has to make a major investment to succeed.

Figure 10.6 plots the relationship between scale of entry and profitability over time for successful small-scale and large-scale ventures. The figure shows that successful small-scale entry is associated with lower initial losses, but in the long run, large-scale entry generates greater returns. However, because of the high costs and risks associated with large-scale entry, many companies make the mistake of choosing a small-scale entry strategy, which often means they fail to build the market share necessary for long-term success.

**Commercialization** Many internal new ventures are driven by the opportunity to use a new or advanced technology to make better products for customers and outperform competitors. But, to be commercially successful, the products under development must be tailored to meet the needs of customers. Many internal new ventures fail when a company ignores the needs of customers in a market. Its managers become so focused on the technological possibilities of a new product that customer requirements are forgotten.<sup>17</sup> Thus, a new venture may fail because it is marketing a product based on a technology for which there is no demand, or the company fails to position or differentiate the product correctly in the market to attract customers.

For example, consider the desktop PC marketed by NeXT, the company started by the founder of Apple, Steve Jobs. The NeXT system failed to gain market share because the PC incorporated an array of expensive technologies that consumers simply did not want, such as optical disk drives and hi-fidelity sound. The optical disk drives, in particular, turned off customers because they made it tough to switch work from PC with floppy drives to NeXT machines with optical drives. In other words, NeXT failed because its founder was so dazzled by leading-edge technology that he ignored customer needs. However, Jobs redeemed himself when he successfully

commercialized Apple's iPod, which dominates the MP3 player market, and iPhone, which has set the standard in the smartphone market.

**Poor Implementation** Managing the new-venture process, and controlling the new venture division, creates many difficult managerial and organizational problems.<sup>18</sup> For example, one common mistake some companies make to try to increase their chances of making successful products is to establish *too many* different internal new-venture divisions at the same time. Managers attempt to spread the risks of failure by having many divisions, but this places enormous demands on a company's cash flow. Sometimes, companies are forced to reduce the funding each division receives to keep the whole company profitable, and this can result in the most promising ventures being starved of the cash they need to succeed.<sup>19</sup> Another common mistake is when corporate managers fail to do the extensive advanced planning necessary to ensure that the new venture's business model is sound and contains all the elements that will be needed later if it is to succeed. Sometimes corporate managers leave this process to the scientists and engineers championing the new technology. Focused on the new technology, they may innovate new products that have little strategic or commercial value. Corporate managers and scientists must work together to clarify how and why a new venture will lead to a product that has a competitive advantage, and jointly establish strategic objectives and a timetable to manage the venture until the product reaches the market.

The failure to anticipate the time and costs involved in the new-venture process constitutes a further mistake. Many companies have unrealistic expectations regarding the time frame and expect profits to flow in quickly. Research suggests that some companies operate with a philosophy of killing new businesses if they do not turn a profit by the end of the third year, which is clearly unrealistic given that it can take five years or more before a new venture generates substantial profits.

## Guidelines for Successful Internal New Venturing

To avoid these pitfalls, a company should adopt a well-thought-out, structured approach to manage internal new venturing. New venturing is based on R&D. It begins with the *exploratory research* necessary to advance basic science and technology (the "R" in R&D), and *development research* to identify, develop, and perfect the commercial applications of a new technology (the "D" in R&D). Companies with strong track records of success at internal new venturing excel at both kinds of R&D: they help to advance basic science and discover important commercial applications for it.<sup>20</sup> To advance basic science, it is important for companies to have strong links with universities where much of the scientific knowledge that underlies new technologies is discovered. It is also important to make sure that research funds are being controlled by scientists who understand the importance of both "R" and "D" research. If the "D" is lacking, no matter how well a company does basic research, it will probably generate few successful commercial ventures. Companies can take a number of steps to ensure that good science ends up with good, commercially viable products.

First, many companies must place the funding for research in the hands of business unit managers who have the skill or know-how to narrow down and then select the best set of research projects—those that have the best chance of a significant commercial payoff. Second, to make effective use of its R&D competency, a company's top managers must work with its R&D scientists to continually develop and

improve the business model and strategies that guide their efforts and make sure *all* its scientists and engineers understand what they have to do to make it succeed.<sup>21</sup>

Third, a company must also foster close links between R&D and marketing to increase the probability that a new product will be a commercial success in the future. When marketing works to identify the most important customer requirements for a new product and then communicates these requirements to scientists, it ensures that research projects meet the needs of their intended customers. Fourth, a company should also foster close links between R&D and manufacturing to ensure that it has the ability to make a proposed new product in a cost-effective way. Many companies successfully integrate the activities of the different functions by creating cross-functional project teams to oversee the development of new products from their inception to market introduction. This approach can significantly reduce the time it takes to bring a new product to market. For example, while R&D is working on design, manufacturing is setting up facilities, and marketing is developing a campaign to show customers how much the new product will benefit them.

Finally, because large-scale entry often leads to greater long-term profits, a company can promote the success of internal new venturing by “thinking big.” Well in advance of a product’s introduction, a company should construct efficient-scale manufacturing facilities and give marketing a large budget to develop a future campaign that will build market presence and brand loyalty quickly. And, corporate managers should not panic when customers are slow to adopt the new product. They need to accept the fact there will be initial losses and recognize that as long as market share is expanding, the product will eventually succeed.

## ENTERING NEW INDUSTRIES: ACQUISITIONS

In Chapter 9, we explained that acquisitions are the main vehicle that companies use to implement a horizontal integration strategy. They are also a principal way companies enter new industries to pursue vertical integration and diversification, so it is necessary to understand both the benefits and risks associated with using acquisitions to implement a corporate-level strategy.

### The Attraction of Acquisitions

In general, acquisitions are used to pursue vertical integration or diversification when a company lacks the distinctive competencies necessary to compete in a new industry, so it uses its financial resources to purchase an established company that has those competencies. A company is particularly likely to use acquisitions when it needs to move fast to establish a presence in an industry, commonly an embryonic or growth industry. Entering a new industry through internal venturing is a relatively slow process; acquisition is a much quicker way for a company to establish a significant market presence. A company can purchase a leading company with a strong competitive position in months, rather than waiting years to build a market leadership position by engaging in internal venturing. Thus, when speed is particularly important, acquisition is the favored entry mode. Intel, for example, used acquisitions to build its communications chip business because it sensed that the market was developing very quickly, and it would take too long to develop the required competencies.

In addition, acquisitions are often perceived as being less risky than internal new ventures because they involve less commercial uncertainty. Because of the risks of failure associated with internal new venturing, it is difficult to predict its future success and profitability. By contrast, when a company makes an acquisition, it acquires a company with an already established reputation, and it knows exactly how big is that company's market share and profitability.

Finally, acquisitions are an attractive way to enter an industry that is protected by high barriers to entry. Recall from Chapter 2 that barriers to entry arise from factors such as product differentiation that leads to brand loyalty and high market share that leads to economies of scale. When entry barriers are high, it may be very difficult for a company to enter an industry through internal new venturing because it will have to construct large-scale manufacturing facilities and invest in a massive advertising campaign to establish brand loyalty—difficult goals that require huge capital expenditures. In contrast, if a company acquires a company already established in the industry, possibly the market leader, it can circumvent most entry barriers because that company has already achieved economies of scale and obtained brand loyalty. In general, the higher the barriers to entry, the more likely it is that acquisitions will be method used to enter the industry.

## Acquisition Pitfalls

For these reasons, acquisitions have long been the most common method that companies use to pursue diversification. However, as we mentioned earlier, research suggests that many acquisitions fail to increase the profitability of the acquiring company and may result in losses. For example, a study of 700 large acquisitions found that although 30% of these resulted in higher profits, 31% led to losses, and the remainder had little impact.<sup>22</sup> Research suggests that many acquisitions fail to realize their anticipated benefits.<sup>23</sup> One study of the post-acquisition performance of acquired companies found that the profitability and market share of an acquired company often declines afterward, suggesting that many acquisitions destroy rather than create value.<sup>24</sup>

Acquisitions may fail to raise the performance of the acquiring companies for four reasons: (1) companies frequently experience management problems when they attempt to integrate a different company's organizational structure and culture into their own; (2) companies often overestimate the potential economic benefits from an acquisition; (3) acquisitions tend to be so expensive that they do not increase future profitability; and (4) companies are often negligent in screening their acquisition targets and fail to recognize important problems with their business models.

**Integrating the Acquired Company** Once an acquisition has been made, the acquiring company has to integrate the acquired company and combine it with its own organizational structure and culture. Integration involves the adoption of common management and financial control systems, the joining together of operations from the acquired and the acquiring company, the establishment of bureaucratic mechanisms to share information and personnel, and the need to create a common culture. Experience has shown that many problems can occur as companies attempt to integrate their activities.

After an acquisition, many acquired companies experience high management turnover because their employees do not like the acquiring company's way of operating—its structure and culture.<sup>25</sup> Research suggests that the loss of management



talent and expertise, to say nothing of the damage from constant tension between the businesses, can materially harm the performance of the acquired unit.<sup>26</sup> Moreover, companies often have to take on an enormous amount of debt to fund acquisition and they frequently are unable to pay it once these management problems and sometimes the weaknesses of the acquired company's business model become clear.

**Overestimating Economic Benefits** Even when companies find it easy to integrate their activities, they often overestimate how much future profitability can be increased by combining the different businesses. Managers often overestimate the competitive advantages that will derive from the acquisition and so pay more for the acquired company than it is worth. One reason is that top managers typically overestimate their own personal general competencies to create valuable new products from an acquisition. Why? The very fact that they have risen to the top of a company gives them an exaggerated sense of their own capabilities and importance that distorts their strategic decision making.<sup>27</sup> Coca-Cola's acquisition of a number of medium-sized wine-making companies illustrates this. Reasoning that a beverage is a beverage, Coca-Cola's then-CEO decided he would be able to mobilize his company's talented marketing managers to develop the strategies needed to dominate the United States wine industry. After buying three wine companies and enduring seven years of marginal profits because of failed marketing campaigns, he subsequently decided that wine and soft drinks are very different products; in particular they have different kinds of appeal, pricing systems, and distribution networks. So, he eventually sold the wine operations to Joseph E. Seagram and took a substantial loss.<sup>28</sup>

**The Expense of Acquisitions** Perhaps the most important reason for the failure of acquisitions is that acquiring a company whose stock is publicly traded tends to be very expensive—and the expense of the acquisition can more than wipe out the value of the stream of future profits that are expected from the acquisition. One reason is that the top managers of a company that is “targeted” for acquisition are likely to resist any takeover attempt unless the acquiring company agrees to pay a substantial premium above its current market value. These premiums are often 100% above the usual value of a company's stock. Similarly, the stockholders of the target company are unlikely to sell their stocks unless they are paid major premiums over its market value prior to a takeover bid. To pay such high premiums, the acquiring company must be certain it can use its acquisition to generate the stream of future profits that justifies the high price of the target company. This is frequently a difficult thing to do, given how fast the industry environment can change and the other problems discussed earlier, such as integrating the acquired company. This is a major reason why acquisitions are frequently unprofitable for the acquiring company.

The reason why the acquiring company has to pay such a high premium is that the stock price of the acquisition target increases enormously during the acquisition process as investors speculate on the final price the acquiring company will pay to capture it. In the case of a contested bidding contest, where two or more companies simultaneously bid to acquire the target company, its stock price may rocket. Also, when many acquisitions are occurring in a particular industry, investors speculate that the value of the remaining industry companies that have *not* been acquired has increased and that a bid for these companies will be made at some future point. This also drives up their stock price and increases the cost of making acquisitions. This happened in the telecommunications sector when, to make sure they could meet the needs of customers who were demanding leading-edge equipment, many

large companies went on acquisition “binges.” Nortel, Corning, and Alcatel-Lucent engaged in a race to buy up smaller, innovative companies developing new telecommunications equipment. The result was that the stock prices for these companies were bid up by investors, and they were bought at a hugely inflated price. When the telecommunications boom turned to bust, the acquiring companies found that they had vastly overpaid for their acquisitions and had to take enormous accounting write-downs; the stock price of Nortel and Alcatel-Lucent plunged, and in 2009 they are fighting to survive.

**Inadequate Preacquisition Screening** As the problems of these companies suggest, top managers often do a poor job of preacquisition screening, that is, evaluating how much a potential acquisition may increase future profitability. Researchers have discovered that one important reason for the failure of an acquisition is that managers make the decision to acquire other companies without thoroughly analyzing potential benefits and costs.<sup>29</sup> In many cases, after an acquisition has been completed, many acquiring companies discover that instead of buying a well-managed business with a strong business model, they have bought a troubled organization. Obviously, the managers of the target company may manipulate company information or the balance sheet to make their financial condition look much better than it is. The acquiring company has to watch out and do extensive research. In 2009, IBM was in negotiations to purchase chip maker Sun Microsystems. After spending one week examining its books, IBM reduced its offer price by 10% after its negotiators had examined Sun’s books and found its customer base was not as solid as they had expected.

## Guidelines for Successful Acquisition

To avoid these pitfalls and make successful acquisitions, companies need to follow an approach to targeting and evaluating potential acquisitions that is based on four main steps: (1) target identification and preacquisition screening, (2) bidding strategy, (3) integration, and (4) learning from experience.<sup>30</sup>

**Identification and Screening** Thorough preacquisition screening increases a company’s knowledge about a potential takeover target and lessens the risk of purchasing a problem company—one with a weak business model. It also leads to a more realistic assessment of the problems involved in executing a particular acquisition so that a company can plan how to integrate the new business and blend organizational structures and cultures. The screening process should begin with a detailed assessment of the strategic rationale for making the acquisition, an identification of the kind of company that would make an ideal acquisition candidate, and an extensive analysis of the strengths and weaknesses of its business model by comparing it to other possible acquisition targets.

Indeed, an acquiring company should select a set of top potential acquisition targets and evaluate each company using a set of criteria that focus on revealing (1) its financial position, (2) its distinctive competencies and competitive advantage, (3) changing industry boundaries, (4) its management capabilities, and (5) its corporate culture. Such an evaluation helps the acquiring company perform a detailed SWOT analysis that identifies the best target, for example, by measuring the potential economies of scale and scope that can be achieved between the acquiring company and each target company. This analysis also helps reveal the potential integration

problems that might exist when it is necessary to integrate the corporate cultures of the acquiring and acquired companies. For example, Microsoft and SAP, the world's leading provider of enterprise resource planning software, sat down together to discuss a possible acquisition by Microsoft. Both companies decided that even though there was a strong strategic rationale for a merger—together they could dominate the software computing market that satisfies the need of large global companies—the problems of creating an organizational structure that could successfully integrate their hundreds of thousands of employees throughout the world, and blend two very different cultures, were insurmountable.

Once a company has reduced the list of potential acquisition candidates to the most favored one or two, it needs to contact expert third parties, such as investment bankers like Goldman Sachs and Merrill Lynch. These companies' business models are based on providing valuable insights about the attractiveness of a potential acquisition, current industry competitive conditions, and handling the many other issues surrounding an acquisition, such as how to select the optimal bidding strategy for acquiring the target company's stock to keep the purchase price as low as possible.

**Bidding Strategy** The objective of the bidding strategy is to reduce the price that a company must pay for the target company. The most effective way a company can acquire another is to make a friendly takeover bid, which means the two companies work out an amicable way to merge the two companies that satisfies the needs of each company's stockholders and top managers. A friendly takeover prevents speculators from bidding up stock prices. By contrast, in a hostile bid, such as the ones between Oracle and PeopleSoft, and between Microsoft and Yahoo!, the price of the target company often gets bid up by speculators who expect that the offer price will be raised by the acquirer or by another company that might come in with a higher counteroffer.

Another essential element of a good bidding strategy is timing. For example, Hanson PLC, one of the most successful companies to pursue unrelated diversification, searched for essentially sound companies suffering from short-term problems because of the business cycle or because its performance was being seriously impacted by one underperforming division. Such companies are often undervalued by the stock market, so they can be acquired without paying a high stock premium. With good timing, a company can make a bargain purchase.

**Integration** Despite good screening and bidding, an acquisition will fail unless the acquiring company possesses the essential organizational design skills needed to integrate the acquired company into its operations and quickly develop a viable multibusiness model. Integration should center on the source of the potential strategic advantages of the acquisition, for instance, opportunities to share marketing, manufacturing, R&D, financial, or management resources. Integration should also involve steps to eliminate any duplication of facilities or functions. In addition, any unwanted business units of the acquired company should be divested.

**Learning from Experience** Research suggests companies that acquire many companies over time become expert in this process and so can generate significant value from their experience of the acquisition process.<sup>31</sup> Their past experience enables them to develop a “playbook,” a clever plan that they can follow to execute an acquisition most efficiently and effectively. Tyco International, profiled in the Closing Case, did not make hostile acquisitions; it audited the accounts of the target company in detail,

acquired companies to help it achieve a critical mass in an industry, moved quickly to realize cost savings after an acquisition, promoted managers one or two layers down to lead the newly acquired entity, and introducing profit-based incentive pay systems in the acquired unit.<sup>32</sup>

## ENTERING NEW INDUSTRIES: JOINT VENTURES

Joint ventures are most commonly used to enter an embryonic or growth industry. Suppose a company is contemplating creating a new venture division in an embryonic industry, such a move involves substantial risks and costs because the company must make the huge investment necessary to develop the set of value-chain activities required to make and sell products in the new industry. On the other hand, an acquisition can be a dangerous proposition because there is rarely an established leading company in an emerging industry; even if there is it will be extremely expensive to purchase.

In this situation, a joint venture frequently becomes the most appropriate method to enter a new industry because it allows a company to share the risks and costs associated with establishing a business unit in the new industry with another company. This is especially true when the companies share *complementary* skills or distinctive competencies because this increases the probability of a joint venture's success. Consider the 50/50 equity joint venture formed between UTC and Dow Chemical to build plastic-based composite parts for the aerospace industry. UTC was already involved in the aerospace industry (it builds Sikorsky helicopters), and Dow Chemical had skills in the development and manufacture of plastic-based composites. The alliance called for UTC to contribute its advanced aerospace skills and Dow to contribute its skills in developing and manufacturing plastic-based composites. Through the joint venture, both companies became involved in new product markets. They were able to realize the benefits associated with related diversification without having to merge their activities into one company or bear the costs and risks of developing new products on their own. Thus, both companies enjoyed the profit-enhancing advantages of entering new markets without having to bear the increased bureaucratic costs.

Although joint ventures usually benefit both partner companies, under some conditions they may result in problems. First, while a joint venture allows companies to share the risks and costs of developing a new business, it also requires that they share in the profits if it succeeds. So, if it turns out later that one partner's skills are more important than the other partner's skills, that partner will have to "give away" profits to the other party because of the 50/50 agreement. This can create conflict and sour the working relationship as time goes on. Second, the joint venture partners may have different business models or time horizons, and problems can arise if they start to come into conflict about how to run the joint venture. The problems can tear it apart and result in business failure. Third, a company that enters into a joint venture runs the risk of giving away important company-specific knowledge to its partner, which might then use that knowledge to compete with its other partner in the future. For example, having gained access to Dow's expertise in plastic-based composites, UTC might have dissolved the alliance and produced these materials on its own. As the previous

chapter discussed, this risk can be minimized if Dow gets a *credible commitment* from UTC, which is what it did. UTC had to make an expensive asset-specific investment to make the products the joint venture was formed to create.

## RESTRUCTURING

Many companies expand into new industries to increase profitability. Sometimes, however, they need to exit industries to increase their profitability and spin-off and split apart their existing businesses into separate, independent companies. **Restructuring** is the process of reorganizing and divesting business units and exiting industries to refocus on a company's core business and rebuild its distinctive competencies.<sup>33</sup> Why are so many companies restructuring and how do they do it?

### Why Restructure?

One main reason that diversified companies have restructured in recent years is that the stock market has valued their stock at a **diversification discount**, meaning that the stock of highly diversified companies is valued lower, relative to their earnings, than the stock of less-diversified companies.<sup>34</sup> Investors see highly diversified companies as less attractive investments for four reasons. First, as we discuss earlier, investors often feel these companies no longer have multibusiness models that justify their participation in many different industries. Second, the complexity of the financial statements of highly diversified enterprises disguises the performance of its individual business units; thus, investors cannot identify if their multibusiness models are succeeding. The result is that investors perceive the company as being riskier than companies that operate in one industry whose competitive advantage and financial statements are more easily understood. Given this situation, restructuring can be seen as an attempt to boost the returns to shareholders by splitting up a multibusiness company into separate and independent parts.

The third reason for the diversification discount is that many investors have learned from experience that managers often have a tendency to pursue too much diversification or do it for the wrong reasons: their attempts to diversify *reduce* profitability.<sup>35</sup> For example, some CEOs pursue growth for its own sake; they are empire builders who expand the scope of their companies to the point where fast-increasing bureaucratic costs become greater than the additional value their diversification strategy creates. Restructuring thus becomes a response to declining financial performance brought about by overdiversification.

A final factor leading to restructuring is that innovations in strategic management have diminished the advantages of vertical integration or diversification. For example, a few decades ago, there was little understanding of how long-term cooperative relationships or strategic alliances between a company and its suppliers could be a viable alternative to vertical integration. Most companies considered only two alternatives for managing the supply chain: vertical integration or competitive bidding. As we discuss in Chapter 9, in many situations, long-term cooperative relationships can create the most value, especially because they avoid the need to incur bureaucratic costs or dispense with market discipline. As this strategic innovation has spread throughout global business, the relative advantages of vertical integration have declined.

## SUMMARY OF CHAPTER

1. Strategic managers often pursue diversification when their companies are generating free cash flow, that is, financial resources they do not need to maintain a competitive advantage in the company's core industry that can be used to fund profitable new business ventures.
2. A diversified company can create value by (a) transferring competencies among existing businesses, (b) leveraging competencies to create new businesses, (c) sharing resources to realize economies of scope, (d) using product bundling, and (e) taking advantage of general organizational competencies that enhance the performance of all business units within a diversified company. The bureaucratic costs of diversification rise as a function of the number of independent business units within a company and the extent to which managers have to coordinate the transfer of resources between those business units.
3. Diversification motivated by a desire to pool risks or achieve greater growth often results in falling profitability.
4. There are three methods companies use to enter new industries: internal new venturing, acquisition, and joint ventures.
5. Internal new venturing is used to enter a new industry when a company has a set of valuable competencies in its existing businesses that can be leveraged or recombined to enter a new business or industry.
6. Many internal ventures fail because of entry on too small a scale, poor commercialization, and poor corporate management of the internal venture process. Guarding against failure involves a carefully planned approach toward project selection and management, integration of R&D and marketing to improve the chance new products will be commercially successful, and entry on a scale large enough to result in competitive advantage.
7. Acquisitions are often the best way to enter a new industry when a company lacks the competencies required to compete in a new industry, and it can purchase a company that does have those competencies at a reasonable price. Acquisitions are also the method chosen to enter new industries when there are high barriers to entry and a company is unwilling to accept the time frame, development costs, and risks associated with pursuing internal new venturing.
8. Acquisitions are unprofitable when strategic managers (a) underestimate the problems associated with integrating an acquired company, (b) overestimate the profit that can be created from an acquisition, (c) pay too much for the acquired company, and (d) perform inadequate pre-acquisition screening to ensure the acquired company will increase the profitability of the whole company. Guarding against acquisition failure requires careful preacquisition screening, a carefully selected bidding strategy, effective organizational design to successfully integrate the operations of the acquired company into the whole company, and managers who develop a general managerial competency by learning from their experience of past acquisitions.
9. Joint ventures are used to enter a new industry when (a) the risks and costs associated with setting up a new business unit are more than a company is willing to assume on its own, and (b) a company can increase the probability that its entry into a new industry will result in a successful new business by teaming up with another company that has skills and assets that complement its own.
10. Restructuring is often required to correct the problems that result from (a) a business model that no longer creates competitive advantage, (b) the inability of investors to assess the competitive advantage of a highly diversified company from its financial statements, (c) excessive diversification because top managers who desire to pursue empire building that results in growth without profitability, and (d) innovations in strategic management such as strategic alliances and outsourcing that reduce the advantages of vertical integration and diversification.



## DISCUSSION QUESTIONS

1. When is a company likely to choose (a) related diversification and (b) unrelated diversification?
2. What factors make it most likely that (a) acquisitions or (b) internal new venturing will be the preferred method to enter a new industry?
3. Imagine that IBM has decided to diversify into the telecommunications business to provide online “cloud computing” data services and broadband access for businesses and individuals. What method would you recommend that IBM pursue to enter this industry? Why?
4. Under which conditions are joint ventures a useful way to enter new industries?
5. Identify Honeywell’s ([www.honeywell.com](http://www.honeywell.com)) portfolio of businesses that can be found by exploring its Web site. How many different industries is Honeywell involved in? Would you describe Honeywell as a related or unrelated diversification company? Has Honeywell’s diversification strategy increased profitability over time?

## PRACTICING STRATEGIC MANAGEMENT

### Small-Group Exercise: Visiting General Electric

Break up into groups of three to five and using either your own laptops, or following the instructor on the classroom PC, explore GE’s Web site ([www.ge.com](http://www.ge.com)) to answer the questions following. Then appoint one member of the group as spokesperson who will communicate the group’s findings to the class.

1. Review GE’s portfolio of major businesses. What multibusiness model is this portfolio of business based on? How profitable has that model been in past?
2. Has GE’s multibusiness model been changing? Has its CEO, Jeffrey Immelt, announced any new strategic initiatives?
3. What kinds of changes would you make to its multibusiness model to boost its profitability?

### Article File 10

Find an example of a diversified company that made an acquisition that apparently failed to create any value. Identify and critically evaluate

the rationale that top management used to justify the acquisition when it was made. Explain why the acquisition subsequently failed.

### Strategic Management Project: Module 10

This module requires you to assess your company’s use of acquisitions, internal new ventures, and joint ventures as ways to enter a new business or restructure its portfolio of businesses.

#### A. Your Company Has Entered a New Industry During the Past Decade

1. Pick one new industry that your company has entered during the past 10 years.
2. Identify the rationale for entering this industry.
3. Identify the strategy used to enter this industry.
4. Evaluate the rationale for using this particular entry strategy. Do you think that this was the best entry strategy to use? Why?
5. Do you think that the addition of this business unit to the company increased or reduced profitability? Why?

**B. Your Company Has Restructured its Corporate Portfolio During the Past Decade**

1. Identify the rationale for pursuing a restructuring strategy.
2. Pick one industry that your company has exited from during the past 10 years.
3. Identify the strategy used to exit from this particular industry. Do you think that this was the best exit strategy to use? Why?
4. In general, do you think that exiting from this industry has been in the company's best interest?

**C L O S I N G   C A S E****Tyco's Changing Corporate-Level Strategies**

Tyco has experienced success and failure as its multibusiness model has changed over time. In the 1990s, Tyco's success was attributed to the way its top managers used a multibusiness model to pursue unrelated diversification that was based on several consistent strategies. First, Tyco used acquisitions to become the dominant competitor in the industries it entered. For example, Tyco became one of the largest providers of security systems, basic medical supplies, and electronic components in the United States. In essence, through its acquisitions Tyco was able to consolidate fragmented industries and attain economies of scale that give it a cost-based advantage over smaller rivals.<sup>36</sup>

Second, Tyco sought out companies that made basic, low-tech products that commanded a large market share but had been underperforming their competitors, something that indicated there was a good opportunity to improve their performance. Once Tyco identified a potential target, it approached the company's top managers to see if they supported the idea of being acquired. If, after its auditors had carefully examined the target's books and decided the company had potential, Tyco made a formal bid. When the acquisition was completed, Tyco's top managers then worked to find ways to strengthen its business model and improve the performance of the acquired unit. Corporate overhead and the company's workforce were typically slashed, and the old top management team was retired and replaced by Tyco's managers. Also, unprofitable product lines were sold off or

closed down, and manufacturing plants and sales forces were merged with Tyco's existing operations to reduce costs and obtain scale economies. For example, within months of acquiring AMP for \$12 billion, the world's largest manufacturer of electronic components, Tyco had identified \$1 billion in cost savings that could be obtained by closing unprofitable plants and reducing its workforce by 8,000. Once the new management team costs had reduced the cost structure, Tyco's corporate managers then established challenging performance goals to achieve, and strong financial incentives were used to motivate them to boost profitability.

Throughout the 1990s, this business model worked well, and Tyco's stock soared, but by 2000 the situation had changed. Tyco's most recent acquisitions had not contributed much to the company's total profitability; the company was growing, but its performance was deteriorating. Then industry analysts began to criticize the company's top managers for using inappropriate accounting methods to disguise the fact Tyco's business model was failing. Critics argued that Tyco's then CEO Dennis Kozlowski and its CFO Mark Swartz had illegally altered its financial reports to artificially increase the profitability of its business units and disguise its poor performance. They were forced to resign in 2003, and in 2005, these accusations were borne out when both men were sentenced to prison for grand larceny, securities fraud, falsifying business records, and conspiring to defraud Tyco of hundreds of millions of dollars to fund lavish lifestyles.

Tyco was a ship adrift in the mid-2000s. It seemed that there was no longer a rationale for keeping its empire together. Its business model was a failure, and its stock price plummeted. The company's stock traded with a "diversification discount" because investors found it impossible to evaluate the profitability of its individual business units. Thus, its new CEO, Edward Breen, decided that the best way to increase value to shareholders was to reverse the business model developed by Kozlowski.<sup>37</sup>

In 2006, Breen announced that he had decided to pursue a new "nondiversified" business model, and the different businesses Tyco owns will be able to create more value if they were split into three separate companies, each of which would be managed by its own top management team. Breen believed that each of the new companies would then be better positioned in their respective industries to maintain and grow market share and improve their profit margins. Essentially, Breen decided to abandon Tyco's strategy of unrelated diversification and "de-diversify" to increase the profitability of each company and thus returns to shareholders.

Tyco's electronics and health care units would be spun off in tax-free transactions, and Breen would continue to run its remaining operations, including its well-known ADT home-alarm systems and

equipment security, fire-protection, and its pump and valve businesses. Breen believed that the managers of each independent company would be better positioned to develop the most successful business model for their industries. He also believed that the returns they will eventually generate will exceed those provided by Tyco's old multibusiness model that had resulted in growth without increased profitability.

The spinoff of these companies took place in 2007, and today Tyco International, Tyco Electronics, and Covidien, its old healthcare unit, operate as independent companies.<sup>38</sup> By 2009, it seemed that all three companies had developed the strong business models needed to boost their profitability in the way Breen had foreseen. However, the recession that began in 2008 is hurting the performance of all three companies, so the jury is still out.

### Case Discussion Questions

1. In what ways has Tyco's multibusiness model changed over time? Why did its top managers make these changes?
2. Collect some recent information on the current performance of the three new companies that were created in 2007. What corporate strategies does each pursue? How well are they currently performing?

# CORPORATE PERFORMANCE, GOVERNANCE, AND BUSINESS ETHICS

## LEARNING OBJECTIVES

After reading this chapter, you should be able to

- Understand the relationship between stakeholder management and corporate performance
- Explain why maximizing returns to stockholders is often viewed as the preeminent goal in many corporations
- Describe the various governance mechanisms that are used to align the interest of stockholders and managers
- Explain why these governance mechanisms do not always work as intended
- Identify the main ethical issues that arise in business and the causes of unethical behavior
- Identify what managers can do to improve the ethical climate of their organization and make sure that business decisions do not violate good ethical principles

## The Fall of John Thain

When John Thain arrived as the new CEO at the beleaguered investment bank Merrill Lynch in November 2007, he was viewed as a potential savior.

Merrill Lynch was staggering under enormous losses related to America's mortgage crisis. The company had a large portfolio of collateralized debt obligations (CDOs), which are complex financial derivatives that were created to insure bonds backed by home mortgages against the possibility of default. The former CEO, Stan O'Neal, had taken Merrill Lynch into the CDOs when trading these instruments was very profitable. But as real estate prices collapsed in

America and mortgage defaults soared, their value could not be accurately determined; they could not be resold, and companies like Merrill Lynch had to write billions off their balance sheets. O'Neal was fired by the board of directors and replaced by Thain.

Thain was recruited from the New York Stock Exchange, which he had led since 2004. At the NYSE, Thain followed hot on the heels of Richard Grasso, who had been dismissed





from the NYSE in a scandal over excessive executive compensation (in one year Grasso had received more than \$130 million in pay). Under Thain's leadership, the NYSE prospered, with its stock price rising 600% between 2004 and 2007, and Thain's reputation rose.

At Merrill Lynch, Thain found himself confronted by enormous challenges. Thain was able to raise additional capital for Merrill Lynch, helping to stave off bankruptcy. He also cut costs, laying off thousands of employees and exiting several businesses. To the employees that remained, he preached the virtues of tight cost control, telling them that miscellaneous personal expenses had to be reduced to a minimum. Ultimately, though, Thain recognized that Merrill Lynch could not survive as an independent entity. Although the federal government had already committed \$10 billion in additional capital as part of its financial rescues package for the banking sector, Merrill Lynch needed more. In the fall of 2008, he engineered the sale of the company to Bank of America. The acquisition was to close in early 2009. For all of these actions, Thain received overwhelmingly positive press. Under the acquisition agreement, Thain was to continue working at Bank of America, reporting directly to CEO Ken Lewis. It was at this point that things started to go terribly wrong for him.

First, it was revealed that at the same time he was cutting jobs and preaching the virtues of cost controls, Thain also personally authorized spending of \$1.2 million to redecorate his office at Merrill Lynch. He spent \$800,000 to hire a well-known designer, \$87,000 on an area rug, four pairs of curtains for \$28,000, a pair of guest chairs for \$87,000, and so on. If that was

not bad enough, it was soon discovered that he had accelerated 2008 bonus payments at Merrill Lynch by several weeks, thereby allowing executives to collect bonuses *before* the acquisition by Bank of America closed. Many wondered why Merrill Lynch was granting any bonuses, given that the firm was booking large losses, the stock had lost over 80% of its value, and the government was lending \$10 billion to the troubled company. Compensation and benefits at Merrill Lynch totaled \$15 billion in 2008, including \$2 billion in bonuses. The total compensation was down only 6% from the prior year. How, some asked, could this possibly be justified given the enormous destruction of stockholder wealth at Merrill Lynch? Moreover, newspapers were reporting that Thain had personally lobbied the compensation committee of the board of directors for a multimillion bonus for 2008, arguing that he had effectively saved the company by engineering a sale and should be rewarded for it. When this information became public, an embarrassed Thain quickly switched his position and stated that he would take no bonus for 2008.

Things came to a head in December 2008 when Thain revealed to Ken Lewis that Merrill Lynch's losses in the fourth quarter would be much bigger than previously thought, totaling some \$15.3 billion. Lewis, who was reportedly furious at being misled, almost scuttled the buyout but was pressured to proceed by the federal government, which had already loaned money to Bank of America, and now committed another \$20 billion in capital to help it with Merrill Lynch's losses. Three weeks after the deal closed, however, Bank of America announced that Thain would leave the company. Effectively, he had been fired.<sup>1</sup>

## Overview

The story of John Thain detailed in the Opening Case illustrates some of the issues that we will deal with in this chapter. Thain arrived at Merrill Lynch as a highly regarded executive. He left with his reputation in tatters. Thain's decision to spend \$1.2 million on his personal office at a time when Merrill Lynch was losing billions

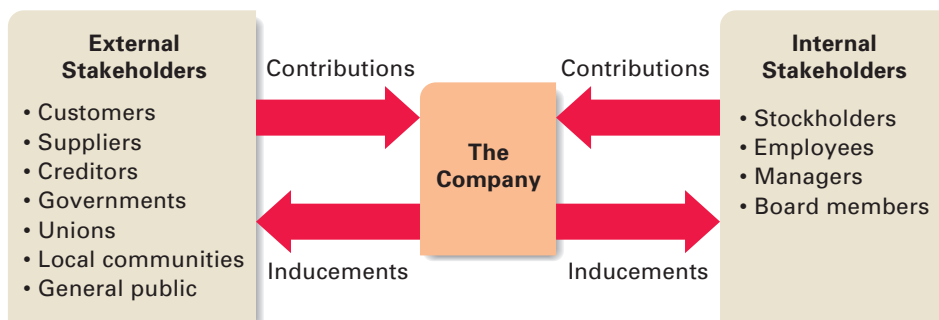
and laying off thousands of employees is, at best, an example of bad judgment and, at worst, an illustration of poor business ethics. His decision to accelerate bonuses, paying out some \$4 billion at the loss-making enterprise, is also ethically suspect and suggests that Thain may not have been acting in shareholders' best interests, for few of them would have agreed to such extravagance amid mounting losses and a plunging stock price. His lobbying for a large bonus for himself indicates to the cynical that Thain was a man looking after his own best interests rather than those of the corporation and its shareholders. Finally, the failure to reveal, until very late in the acquisition process, that Merrill Lynch's losses were much bigger than previously thought suggests to some that Thain was trying to hide the true state of affairs from Ken Lewis for as long as possible for fear that it might derail the acquisition.

In this chapter, we take a close look at the governance mechanisms that shareholders put in place to make sure that managers are acting in their interests and pursuing strategies that maximize shareholder value. We also discuss how managers need to pay attention to other stakeholders as well, such as employees, suppliers, and customers. Balancing the needs of different stakeholder groups is in the long-run interests of the company's owners, its shareholders. Good governance mechanisms recognize this truth. In addition, we will spend some time reviewing the ethical implications of strategic decisions, and we will discuss how managers can make sure that their strategic decisions are founded on strong ethical principles, something that John Thain arguably did not do.

## STAKEHOLDERS AND CORPORATE PERFORMANCE

A company's **stakeholders** are individuals or groups with interests, claims, or stakes in the company, in what it does, and in how well it performs.<sup>2</sup> They include stockholders, creditors, employees, customers, the communities in which the company does business, and the general public. Stakeholders can be divided into internal stakeholders and external stakeholders (see Figure 11.1). **Internal stakeholders** are stockholders and employees, including executive officers, other managers, and board members. **External stakeholders** are all other individuals and groups that have some

**Figure 11.1** Stakeholders and the Enterprise





claim on the company. Typically, this group is comprised of customers, suppliers, creditors (including banks and bondholders), governments, unions, local communities, and the general public.

All stakeholders are in an exchange relationship with the company. Each of the stakeholder groups listed in Figure 11.1 supplies the organization with important resources (or contributions), and, in exchange, each expects its interests to be satisfied (by inducements).<sup>3</sup> Stockholders provide the enterprise with risk capital and, in exchange, expect management to try to maximize the return on their investment. Creditors, and particularly bondholders, also provide the company with capital in the form of debt, and they expect to be repaid on time with interest. Employees provide labor and skills and, in exchange, expect commensurate income, job satisfaction, job security, and good working conditions. Customers provide a company with its revenues and, in exchange, want high-quality, reliable products that represent value for money. Suppliers provide a company with inputs and, in exchange, seek revenues and dependable buyers. Governments provide a company with rules and regulations that govern business practice and maintain fair competition. In exchange, they want companies to adhere to these rules. Unions help to provide a company with productive employees, and, in exchange, they want benefits for their members in proportion to their contributions to the company. Local communities provide companies with local infrastructure and, in exchange, want companies that are responsible citizens. The general public provides companies with national infrastructure and, in exchange, seeks some assurance that the quality of life will be improved as a result of the company's existence.

A company must take these claims into account when formulating its strategies, or else stakeholders may withdraw their support. For example, stockholders may sell their shares, bondholders may demand higher interest payments on new bonds, employees may leave their jobs, and customers may buy elsewhere. Suppliers may seek more dependable buyers. Unions may engage in disruptive labor disputes. Government may take civil or criminal action against the company and its top officers, imposing fines and, in some cases, jail terms. Communities may oppose the company's attempts to locate its facilities in their area, and the general public may form pressure groups, demanding action against companies that impair the quality of life. Any of these reactions can have a damaging impact on an enterprise.

## Stakeholder Impact Analysis

A company cannot always satisfy the claims of all stakeholders. The goals of different groups may conflict; in practice, few organizations have the resources to manage all stakeholders.<sup>4</sup> For example, union claims for higher wages can conflict with consumer demands for reasonable prices and stockholder demands for acceptable returns. Often, the company must make choices. To do so, it must identify the most important stakeholders and give highest priority to pursuing strategies that satisfy their needs. Stakeholder impact analysis can provide such identification. Typically, stakeholder impact analysis follows these steps:

1. Identify stakeholders.
2. Identify stakeholders' interests and concerns.
3. Identify what claims stakeholders are likely to make on the organization.
4. Identify the stakeholders who are most important from the organization's perspective.
5. Identify the resulting strategic challenges.<sup>5</sup>

Such an analysis enables a company to identify the stakeholders most critical to its survival and make sure that the satisfaction of their needs is paramount. Most companies that have gone through this process quickly come to the conclusion that three stakeholder groups must be satisfied above all others if a company is to survive and prosper: customers, employees, and stockholders.

## The Unique Role of Stockholders

A company's stockholders are usually put in a different class from other stakeholder groups, and for good reason. Stockholders are legal owners and the providers of **risk capital**, a major source of the capital resources that allow a company to operate its business. The capital that stockholders provide to a company is seen as risk capital because there is no guarantee that stockholders will ever recoup their investment and or earn a decent return.

Recent history demonstrates all too clearly the nature of risk capital. For example, many investors who bought shares in Washington Mutual, the large Seattle-based bank and home loan lender, believed that they were making low risk investments. The company had been around for decades and paid a solid dividend, which it increased every year. It had a large branch network and billions in deposits. However, during the 2000s, Washington Mutual was also making increasingly risky mortgage loans, reportedly giving mortgages to people without ever properly verifying if they had the funds to pay back those loans on time. By 2008, many of the borrowers were starting to default on their loans, and Washington Mutual had to take multi-billion dollar write-downs on the value of its loan portfolio, effectively destroying its once-strong balance sheet. The losses were so large that people with deposits at the bank started to worry about its stability; those people withdrew some \$16 billion in November 2008 from accounts at Washington Mutual. The stock price collapsed from approximately \$40 at the start of 2008 to less than \$2 a share. With the bank teetering on the brink of collapse, the federal government stepped in, seized the bank's assets, and engineered a sale to JP Morgan. What did Washington Mutual's shareholders get? Absolutely nothing; they were wiped out.

Over the past decade, maximizing returns to stockholders has taken on added importance as more and more employees have become stockholders in the company for which they work through employee stock ownership plans (ESOP). At Walmart, for example, all employees who have served for more than one year are eligible for the company's ESOP. Under an ESOP, employees are given the opportunity to purchase stock in their company, sometimes at a discount to the market value of the stock. The company may also contribute to a certain proportion of the purchase price. By making employees stockholders, ESOPs tend to increase the already strong emphasis on maximizing returns to stockholders, for they now help to satisfy two key stakeholder groups: stockholders and employees.

## Profitability, Profit Growth, and Stakeholder Claims

Because of the unique position assigned to stockholders, managers normally seek to pursue strategies that maximize the returns that stockholders receive from holding shares in the company. As we noted in Chapter 1, stockholders receive a return on their investment in a company's stock in two ways: from dividend payments and from capital appreciation in the market value of a share (that is, by increases in stock market prices). The best way for managers to generate the funds for future dividend

payments and keep the stock price appreciating is for them to pursue strategies that maximize the company's long-run profitability (as measured by the ROIC) and grow the profits of the company over time.<sup>6</sup>

As we saw in Chapter 3, ROIC is an excellent measure of the profitability of a company. It tells managers how efficiently they are using the capital resources of the company (including the risk capital provided by stockholders) to generate profits. A company that is generating a positive ROIC is covering all of its ongoing expenses and has money left over, which is then added to shareholders' equity, thereby increasing the value of a company and thus the value of a share of stock in the company. The value of each share will increase further if a company can grow its profits over time because then the profit that is attributable to every share (that is, the company's earning per share) will also grow. As we have described in this book, to grow their profits, companies must be doing one or more of the following: (1) participating in a market that is growing; (2) taking market share from competitors; (3) consolidating the industry through horizontal integration; and (4) developing new markets through international expansion, vertical integration, or diversification.

Although managers should strive for profit growth if they are trying to maximize shareholder value, the relationship between profitability and profit growth is a complex one because attaining future profit growth may require investments that reduce the current rate of profitability. The task of managers is to find the right balance between profitability and profit growth.<sup>7</sup> Too much emphasis on current profitability at the expense of future profitability and profit growth can make an enterprise less attractive to shareholders. Too much emphasis on profit growth can reduce the profitability of the enterprise and have the same effect. In an uncertain world, finding the right balance between profitability and profit growth is certainly as much art as it is science, but it is something that managers must try to do.

In addition to maximizing returns to stockholders, boosting a company's profitability and profit growth rate is also consistent with satisfying the claims of several other key stakeholder groups. When a company is profitable and its profits are growing, it can pay higher salaries to productive employees and also afford benefits such as health insurance coverage, all of which help to satisfy employees. In addition, companies with a high level of profitability and profit growth have no problem meeting their debt commitments, which provides creditors, including bondholders, with a measure of security. More profitable companies are also better able to undertake philanthropic investments, which can help to satisfy some of the claims that local communities and the general public place on a company. Pursuing strategies that maximize the long-run profitability and profit growth of the company is therefore generally consistent with satisfying the claims of various stakeholder groups.

There is an important cause-and-effect relationship here. Pursuing strategies to maximize profitability and profit growth helps a company to better satisfy the demands that several stakeholder groups place on it, not the other way around. The company that overpays its employees in the current period, for example, may have very happy employees for a short while, but such action will raise the company's cost structure and limit its ability to attain a competitive advantage in the marketplace, thereby depressing its long-run profitability and hurting its ability to award future pay increases. As far as employees are concerned, the way many companies deal with this situation is to make future pay increases contingent on improvements in labor productivity. If labor productivity goes up, labor costs as a percentage of revenues

will fall, profitability will rise, and the company can afford to pay its employees more and offer greater benefits.

Of course, not all stakeholder groups want the company to maximize its long-run profitability and profit growth. Suppliers are more comfortable about selling goods and services to profitable companies because they can be assured that the company will have the funds to pay for those products. Similarly, customers may be more willing to purchase from profitable companies because they can be assured that those companies will be around in the long run to provide after-sales services and support. But neither suppliers nor customers want the company to maximize its profitability at their expense. Rather, they would like to capture some of these profits from the company in the form of higher prices for their goods and services (in the case of suppliers) or lower prices for the products they purchase from the company (in the case of customers). Thus, the company is in a bargaining relationship with some of its stakeholders, which was a phenomenon we discussed in Chapter 2.

Moreover, despite the argument that maximizing long-run profitability and profit growth is the best way to satisfy the claims of several key stakeholder groups, a company must do so within the limits set by the law and in a manner consistent with societal expectations. The unfettered pursuit of profit can lead to behaviors that are outlawed by government regulations, opposed by important public constituencies, or simply unethical. Governments have enacted a wide range of regulations to govern business behavior, including antitrust laws, environmental laws, and laws pertaining to health and safety in the workplace. It is incumbent on managers to make sure that the company is in compliance with these laws when pursuing strategies.

Unfortunately, there is plenty of evidence that managers can be tempted to cross the line between the legal and illegal in their pursuit of greater profitability and profit growth. For example, in mid-2003, the United States Air Force stripped Boeing of \$1 billion in contracts to launch satellites when it was discovered that Boeing had obtained thousand of pages of proprietary information from rival Lockheed Martin. Boeing had used that information to prepare its winning bid for the satellite contract. This was followed by the revelation that Boeing's CFO, Mike Sears, had offered a government official, Darleen Druyun, a lucrative job at Boeing while Druyun was still involved in evaluating whether Boeing should be awarded a \$17 billion contract to build tankers for the Air Force. Boeing won the contract against strong competition from Airbus, and Druyun was hired by Boeing. It was clear that the job offer may have had an impact on the Air Force decision. Boeing fired Sears and Druyun; shortly afterward, Boeing CEO Phil Condit resigned in a tacit acknowledgment that he bore responsibility for the ethics violations that had occurred at Boeing during his tenure as leader.<sup>8</sup> In another case, the CEO of Archer Daniels Midland, one of the world's largest producers of agricultural products, was sent to jail after an FBI investigation revealed that the company had systematically tried to fix the price for lysine by colluding with other manufacturers in the global marketplace. In another example of price fixing, the 76-year-old chairman of Sotheby's auction house was sentenced to a jail term and the former CEO to house arrest for fixing prices with rival auction house Christie's over a six-year period (see Strategy in Action 11.1).

Examples such as these beg the question of why managers would engage in such risky behavior. A body of academic work collectively known as *agency theory* provides an explanation for why managers might engage in behavior that is either illegal or, at the very least, not in the interest of the company's shareholders.

### Ethical Dilemma

You work for a US-based textile company struggling with overseas competitors that have access to low-cost labor. While you pay your factory workers \$14 an hour plus benefits, you know that a similar textile mill in Vietnam is paying its employees about \$0.50 an hour, and the mill does not have to comply with the same safety and environmental regulations that your company does. Although your mill is marginally profitable, the Vietnamese factory clearly has a cost advantage. Your CEO wants to move production to Central America or Southeast Asia where labor and compliance costs are lower, resulting in mill closure and employee layoffs. Your mill is the only large employer in a small community. Many of the employees have worked there their entire working lives. What is the right action to take for stockholders? What is the most ethical course of action? Is there a conflict here?

## 11.1 STRATEGY IN ACTION

### Price Fixing at Sotheby's and Christie's

Sotheby's and Christie's are the two largest fine art auction houses in the world. In the mid-1990s, the two companies controlled 90% of the fine art auction market, which at the time was worth some \$4 billion a year. Traditionally, auction houses make their profit by the commission they charge on auction sales. In good times, these commissions can range as high as 10% on some items, but in the early 1990s, the auction business was in a slump, with the supply of art for auction drying up. With Sotheby's and Christie's desperate for works of art, sellers played the two houses off against each other, driving commissions down to 2% or even lower.

To try to control this situation, Sotheby's CEO, Dede Brooks, met with the CEO at Christie's, Christopher Davidge, in a series of clandestine meetings held in car parking lots that began in 1993. Brooks claims that she was acting on behalf of her boss, Alfred Taubman, the chairman and controlling shareholder of Sotheby's. According to Brooks, Taubman had agreed with the chairman of Christie's, Anthony Tennant, to work together in the weak auction market and limit price competition. In their meetings, Brooks and Davidge agreed to a fixed and nonnegotiable commission structure. Based on a sliding scale, the commission structure would range from 10% on a \$100,000 item to 2% on a \$5 million item. In effect, Brooks and Davidge were agreeing to

eliminate price competition between them, thereby guaranteeing both auction houses higher profits. The price-fixing agreement started in 1993 and continued unabated for six years until federal investigators uncovered the arrangement and brought charges against Sotheby's and Christie's.

With the deal out in the open, lawyers filed several class action lawsuits on behalf of sellers who had been defrauded by Sotheby's and Christie's. Ultimately, some 100,000 sellers signed on to the class action lawsuits, which the auction houses settled with a \$512 million payment. The auction houses also pleaded guilty to price fixing and paid \$45 million in fines to United States anti-trust authorities. As for the key players, the chairman of Christie's, as a British subject, was able to avoid prosecution in the United States (price fixing is not an offense for which someone can be extradited). Christie's CEO, Davidge, struck a deal with prosecutors and in return for amnesty, handed over incriminating documents to the authorities. Brooks also cooperated with federal prosecutors and avoided jail (in April 2002, she was sentenced to three years' probation, six months' home detention, 1,000 hours of community service, and a \$350,000 fine). Taubman, ultimately isolated by all his former co-conspirators, was sentenced to a year in jail and fined \$7.5 million.

**Sources:** S. Tully, "A House Divided," *Fortune*, December 18, 2000, 264–275; J. Chaffin, "Sotheby's Ex CEO Spared Jail Sentence," *Financial Times*, April 30, 2002, 10; T. Thorncroft, "A Courtroom Battle of the Vanities," *Financial Times*, November 3, 2001, 3.

## AGENCY THEORY

Agency theory looks at the problems that can arise in a business relationship when one person delegates decision-making authority to another. It offers a way of understanding why managers do not always act in the best interests of stakeholders and why they might sometimes behave unethically and perhaps also illegally.<sup>9</sup> Although agency theory was originally formulated to capture the relationship between management and stockholders, the basic principles have also been extended to cover the relationship with other key stakeholders, such as employees, as well as relationships between different layers of management within a corporation.<sup>10</sup> While the focus of attention in this section is on the relationship between senior management and stockholders, some of the same language can be applied to the relationship between other stakeholders and top managers and between top management and lower levels of management.



## Principal-Agent Relationships

The basic propositions of agency theory are relatively straightforward. First, an agency relationship arises whenever one party delegates decision-making authority or control over resources to another. The principal is the person delegating authority, and the agent is the person to whom authority is delegated. The relationship between stockholders and senior managers is a classic example of an agency relationship. Stockholders, who are the principals, provide the company with risk capital, but they delegate control over that capital to senior managers, and particularly the CEO, who as their agent is expected to use that capital in a manner that is consistent with the best interests of stockholders. As we have seen, this means using that capital to maximize the company's long-run profitability and profit growth rate.

The agency relationship continues on down within the company. For example, in the large, complex, multibusiness company, top managers cannot possibly make all the important decisions, so they delegate some decision-making authority and control over capital resources to business unit (divisional) managers. Thus, just as senior managers such as the CEO are the agents of stockholders, business unit managers are the agents of the CEO (and in this context, the CEO is the principal). The CEO entrusts business unit managers to use the resources over which they have control in the most effective manner so that they maximize the performance of their units, which helps the CEO make sure that he or she maximizes the performance of the entire company, thereby discharging agency obligation to stockholders. More generally, whenever managers delegate authority to managers below them in the hierarchy and give them the right to control resources, an agency relation is established.

## The Agency Problem

While agency relationships often work well, problems may arise if agents and principals have different goals and if agents take actions that are not in the best interests of their principals. Agents may be able to do this because there is an **information asymmetry** between the principal and the agent: agents almost always have more information about the resources they are managing than the principal does. Unscrupulous agents can take advantage of any information asymmetry to mislead principals and maximize their own interests at the expense of principals.

In the case of stockholders, information asymmetry arises because they delegate decision-making authority to the CEO, their agent, who by virtue of his or her position inside the company is likely to know far more than stockholders do about the company's operations. Indeed, there may be certain information about the company that the CEO is unwilling to share with stockholders because it would also help competitors. In such a case, withholding some information from stockholders may be in their best interests. More generally, the CEO, involved in the day-to-day running of the company, is bound to have an information advantage over stockholders, just as the CEO's subordinates may well have an information advantage over the CEO with regard to the resources under their control.

The information asymmetry between principals and agents is not necessarily a bad thing, but it can make it difficult for principals to measure how well an agent is performing, thus, holding the agent accountable for how well he or she is using the entrusted resources. There is a certain amount of performance ambiguity inherent in the relationship between a principal and agent. Principals cannot know for sure if the agents are acting in their best interests. They cannot know for sure if the



agents are using the resources to which they have been entrusted as effectively and efficiently as possible. To an extent, principals have to trust the agents to do the right thing.

Of course, this trust is not blind. Principals put mechanisms in place whose purpose is to monitor agents, evaluate their performance, and, if necessary, take corrective action. As we shall see shortly, the board of directors is one such mechanism, for the board exists in part to monitor and evaluate senior managers on behalf of stockholders. Other mechanisms serve a similar purpose. In the United States, publicly owned companies must regularly file detailed financial statements with the Securities and Exchange Commission (SEC) that are in accordance with generally accepted accounting principles (GAAP). This requirement exists to give stockholders consistent and detailed information about how well management is using the capital with which it has been entrusted. Similarly, internal control systems within a company are there to help the CEO make sure that subordinates are using the resources with which they have been entrusted as efficiently and effectively as possible.

Despite the existence of governance mechanisms and comprehensive measurement and control systems, a degree of information asymmetry will always remain between principals and agents, and there is always an element of trust involved in the relationship. Unfortunately, not all agents are worthy of this trust. A minority will deliberately mislead principals for personal gain, sometimes behaving unethically or breaking laws in the process. The interests of principals and agents are not always the same; they diverge, and some agents may take advantage of information asymmetries to maximize their own interests at the expense of principals and engage in behaviors that the principals would never condone.

For example, some authors have argued that, like many other people, senior managers are motivated by desires for status, power, job security, and income.<sup>11</sup> By virtue of their position within the company, certain managers, such as the CEO, can use their authority and control over corporate funds to satisfy these desires at the cost of returns to stockholders. CEOs might use their position to invest corporate funds in various perks that enhance their status—executive jets, lavish offices, and expense-paid trips to exotic locations—rather than investing those funds in ways that increase stockholder returns. Economists have termed such behavior **on-the-job consumption**.<sup>12</sup> John Thain is an example of a CEO who appeared to engage in excessive on-the-job consumption (see the Opening Case)

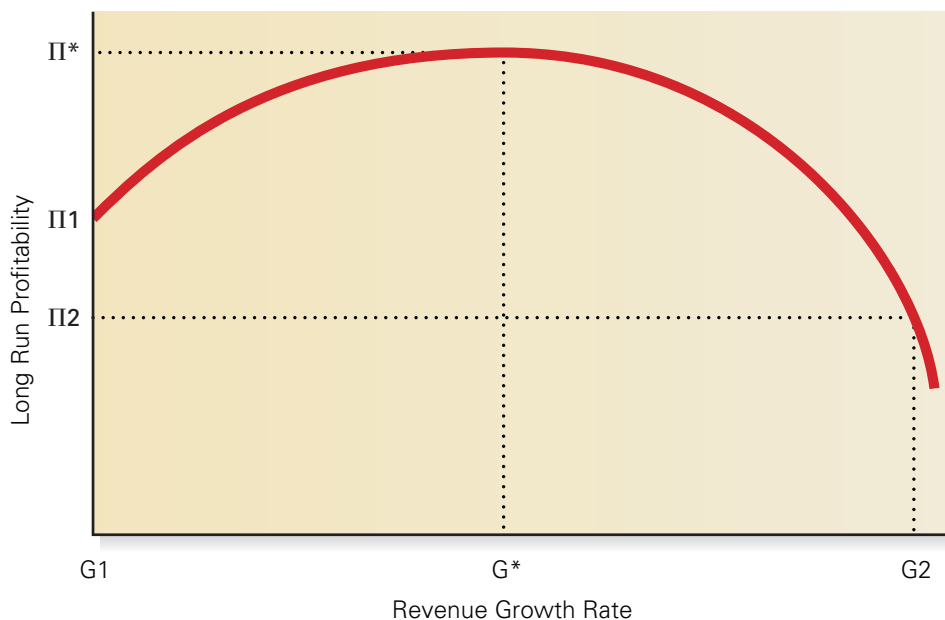
Besides engaging in on-the-job consumption, CEOs, along with other senior managers, might satisfy their desires for greater income by using their influence or control over the board of directors to get the compensation committee of the board to grant pay increases. Critics of United States industry claim that extraordinary pay has now become an endemic problem and that senior managers are enriching themselves at the expense of stockholders and other employees. They point out that CEO pay has been increasing far more rapidly than the pay of average workers, primarily because of very liberal stock option grants that enable a CEO to earn huge pay bonuses in a rising stock market, even if the company underperforms the market and competitors.<sup>13</sup> In 1980, the average CEO in *Business Week*'s survey of CEO's of the largest 500 American companies earned 42 times what the average blue-collar worker earned. By 1990, this figure had increased to 85 times. Today, the average CEO in the survey earns more than 350 times the pay of the average blue-collar worker.<sup>14</sup>

What rankles critics is the size of some CEO pay packages and their apparent lack of relationship to company performance.<sup>15</sup> For example, in 2006 shareholders of Home Depot complained bitterly about the compensation package for CEO Bob Nardelli at

the company's annual meeting. Nardelli, who was appointed in 2000, had received \$124 million in compensation, despite mediocre financial performance at Home Depot and a 12% decline in the company's stock price since he joined. When unexercised stock options were included, his compensation exceeded \$250 million.<sup>16</sup> Critics feel that the size of pay awards such as these is out of proportion to the achievement of the CEOs. If so, this represents a clear example of the agency problem.

A further concern is that in trying to satisfy a desire for status, security, power, and income, a CEO might engage in empire building, buying many new businesses in an attempt to increase the size of the company through diversification.<sup>17</sup> Although such growth may depress the company's long-run profitability and thus stockholder returns, it increases the size of the empire under the CEO's control and, by extension, the CEO's status, power, security, and income (there is a strong relationship between company size and CEO pay). Instead of trying to maximize stockholder returns by seeking the right balance between profitability and profit growth, some senior managers may trade long-run profitability for greater company growth by buying new businesses. Figure 11.2 graphs long-run profitability against the rate of growth in company revenues. A company that does not grow is probably missing out on some profitable opportunities.<sup>18</sup> A moderate revenue growth rate of  $G^*$  allows a company to maximize long-run profitability, generating a return of  $\Pi^*$ . Thus, a growth rate of  $G_1$  in Figure 11.2 is not consistent with maximizing profitability ( $\Pi_1 < \Pi^*$ ). By the same token, however, attaining growth in excess of  $G_2$  requires diversification into areas that the company knows little about. Consequently, it can be achieved only by sacrificing profitability; that is, past  $G^*$ , the investment required to finance further growth does not produce an adequate return, and the company's profitability declines. Yet  $G_2$  may be the growth rate favored by an empire-building CEO, for it

**Figure 11.2** The Tradeoff Between Profitability and Revenue Growth Rates



will increase his or her power, status, and income. At this growth rate, profitability is equal only to  $\Pi_2$ . Because  $\Pi^* > \Pi_2$ , a company growing at this rate is clearly not maximizing its long-run profitability or the wealth of its stockholders.

Just how serious agency problems could be was emphasized in the early 2000s when a series of scandals swept through the corporate world, many of which could be attributed to self-interest seeking by senior executives and a failure of corporate governance mechanisms to hold the largess of those executives in check. Between 2001 and 2004, accounting scandals unfolded at a number of major corporations, including Enron, WorldCom, Tyco, Computer Associates, HealthSouth, Adelphia Communications, Dynegy, Royal Dutch Shell, and the major Italian food company Parmalat. At Enron, some \$27 billion in debt was hidden from shareholders, employees, and regulators in special partnerships that were kept off the balance sheet. At Parmalat, managers apparently “invented” some \$8 to \$12 billion in assets to shore up the company’s balance sheet—assets that never existed. In the case of Royal Dutch Shell, senior managers knowingly inflated the value of the company’s oil reserves by one-fifth, which amounted to 4 billion barrels of oil that never existed, making the company appear much more valuable than it actually was. At the other companies, earnings were systematically overstated, often by hundreds of millions of dollars, or even billions of dollars in the case of Tyco and WorldCom, which understated its expenses by \$3 billion in 2001. Strategy in Action 11.2 discusses accounting fraud at Computer Associates. In all of these cases, the prime motivation seems to have been an effort to present a more favorable view of corporate affairs to shareholders than was actually the case, thereby securing senior executives significantly higher pay packets.<sup>19</sup>

It is important to remember that the agency problem is not confined to the relationship between senior managers and stockholders. It can also bedevil the relationship between the CEO and subordinates and between them and their subordinates. Subordinates might use control over information to distort the true performance of their unit to enhance their pay, increase their job security, or make sure their unit gets more than its fair share of company resources.

Confronted with agency problems, the challenge for principals is to (1) shape the behavior of agents so that they act in accordance with the goals set by principals, (2) reduce the information asymmetry between agents and principals, and (3) develop mechanisms for removing agents who do not act in accordance with the goals of principals and mislead them. Principals try to deal with these challenges through a series of governance mechanisms.

## GOVERNANCE MECHANISMS

Governance mechanisms are mechanisms that principals put in place to align incentives between principals and agents and monitor and control agents. The purpose of governance mechanisms is to reduce the scope and frequency of the agency problem—to help ensure that agents act in a manner that is consistent with the best interests of their principals. In this section, the primary focus is on the governance mechanisms that exist to align the interests of senior managers (as agents) with their principals—stockholders. It should not be forgotten, however, that governance mechanisms also exist to align the interests of business unit managers with those of their superiors and so on down within the organization.

Following, we look at four main types of governance mechanisms for aligning stockholder and management interests: the board of directors, stock-based

## 11.2 STRATEGY IN ACTION

### Self-Dealing at Computer Associates

Computer Associates is one of the world's largest software companies. During the 1990s, its stock price appreciated at a rapid rate, driven in large part by surging revenues and a commensurate rise in profits. Because its revenues were growing more rapidly than those of rivals during the late 1990s, investors assumed that the company was gaining market share and that high profitability would follow, so they bid up the price of the company's stock. The senior managers of Computer Associates were major beneficiaries of this process. Under a generous incentive program given to the company's three top managers by the board of directors—Charles Wang, then CEO and chairman of the board, Sanjay Kumar, the chief operating officer, and Russell Artzt, the chief technology officer—if the stock price stayed above \$53.13 for 60 days, they would receive a special incentive stock award amounting to some 20 million shares. In May 1998, Kumar announced that Computer Associates had “record” revenues and earnings for the quarter. The stock price surged over the \$53.13 trigger and stayed there long enough for all three to receive the special incentive stock award, then valued at \$1.1 billion.

In late July 1998, after all three had received the award, Kumar announced that the effect of Asian economic turmoil and the year 2000 bug “leads us to believe that our revenue and earnings growth will slow over the next few quarters.” The stock price promptly fell from the high 50s to less than \$40 a share. What followed was a series of class action lawsuits, undertaken on behalf of stockholders, who claimed management had misled stockholders to enrich themselves. As a result of the lawsuits, the three were compelled to give back some of their gains, and the size of the award was reduced to 4.5 million shares. Wang stepped down as CEO, although he retained his position as chairman of the board, and Kumar became the CEO.

This was not the end of matters, however, for Computer Associates had attracted the attention of both the Justice Department and the SEC, which launched a joint investigation into the company's accounting practices. By 2002, they were reportedly focusing on a little-noticed action the company had taken in May 2000 to reduce its revenues by 10%, or \$1.76 billion, below what it had previously reported for the three fiscal years that ended March 2000. The downward revisions, detailed in the company's 10-K filings with the SEC, retroactively took

hundreds of millions of dollars away from the top line in the 14 months preceding the May 1998 stock award to senior managers, including some \$513 million for the year ending March 1998. According to the company, earnings were unaffected by the revision because the lost revenue was offset by a commensurate downward revision of expenses. The downward revision reportedly came at the urging of auditor KPMG, which replaced Ernst & Young as the company's accountant in June 1999.

The implication that some observers were drawing was that Computer Associates deliberately overstated its revenues in the period prior to May 1998 to enrich the three top managers. The losers in this process were stockholders who purchased shares at the inflated price and longer-term shareholders who saw the value of their holdings diluted by the stock awarded to Wang, Kumar, and Artzt. In a statement issued after a report of the ongoing investigation was published in the *Wall Street Journal*, Computer Associates stated that it changed how it classified revenue and expenses at the advice of its auditors. “We continue to believe CA has acted appropriately,” the company spokesperson said. “This change in presentation had no impact on reported earnings, earnings per share, or cash flows.”

By 2004, it was clear that Computer Associates had been acting anything but appropriately. According to the SEC investigation, between 1998 and 2000, the company adopted a policy of backdating contracts to boost revenues. For example, in January 2000, Computer Associates negotiated a \$300 million contract with a customer but backdated the contract so that the revenues appeared in 1999. Although initially this may have been done to help secure the \$1.1 billion special stock award, by 2000 the practice represented an increasingly desperate attempt to meet financial projects that the company was routinely missing. Under increasing pressure, in 2002 Charles Wang stepped down as chairman, and in 2004 Kumar was forced to resign as CEO by the board of Computer Associates, which had belatedly come to recognize that the company's financial statements were fraudulent. In late 2004, in a deal with federal regulators, the company admitted to \$2.2 billion in fraud. As part of the deal, Kumar was indicted by federal prosecutors on charges of obstruction of justice and securities fraud. In November 2006, Kumar was sentenced to 12 years in jail for his part in the fraud.

**Sources:** J. Guidera, “Probe of Computer Associates Centers on Firm's Revenues,” *Wall Street Journal*, May 20, 2002, A3, 15; Ronna Abramson, “Computer Associates Probe Focus on 1998, 1999 Revenue,” *The Street.Com*, May 20, 2002; C. Forelle, M. Maremont, and G. Fields, “U.S. Indicts Sanjay Kumar for Fraud, Lies,” *Wall Street Journal*, September 23, 2004, N. Varchaver, “Long Island Confidential,” *Fortune*, November 27, 2006, 172–178.

compensation, financial statements, and the takeover constraint. The section closes with a discussion of governance mechanisms within a company to align the interest of senior and lower-level managers.

## The Board of Directors

The board of directors is the centerpiece of the corporate governance system. Board members are directly elected by stockholders, and under corporate law they represent the stockholders' interests in the company. Hence, the board can be held legally accountable for the company's actions. Its position at the apex of decision making within the company allows it to monitor corporate strategy decisions and ensure that they are consistent with stockholder interests. If the board's sense is that corporate strategies are not in the best interest of stockholders, it can apply sanctions, such as voting against management nominations to the board of directors or submitting its own nominees. In addition, the board has the legal authority to hire, fire, and compensate corporate employees, including, most importantly, the CEO.<sup>20</sup> The board is also responsible for making sure that audited financial statements of the company present a true picture of its financial situation. Thus, the board exists to reduce the information asymmetry between stockholders and managers and monitor and control management actions on behalf of stockholders.

The typical board of directors is composed of a mix of inside and outside directors. **Inside directors** are senior employees of the company, such as the CEO. They are required on the board because they have valuable information about the company's activities. Without such information, the board cannot adequately perform its monitoring function. But because insiders are full-time employees of the company, their interests tend to be aligned with those of management. Hence, outside directors are needed to bring objectivity to the monitoring and evaluation processes. **Outside directors** are not full-time employees of the company. Many of them are full-time professional directors who hold positions on the boards of several companies. The need to maintain a reputation as competent outside directors gives them an incentive to perform their tasks as objectively and effectively as possible.<sup>21</sup>

There is little doubt that many boards perform their assigned functions admirably. For example, when the board of Sotheby's discovered that the company had been engaged in price fixing with Christie's, board members moved quickly to oust both the CEO and the chairman of the company (see Strategy in Action 11.1). But not all boards perform as well as they should. The board of now bankrupt, large energy company Enron signed off on that company's audited financial statements, which were later shown to be grossly misleading.

Critics of the existing governance system charge that inside directors often dominate the outsiders on the board. Insiders can use their position within the management hierarchy to exercise control over what kind of company-specific information the board receives. Consequently, they can present information in a way that puts them in a favorable light. In addition, because insiders have intimate knowledge of the company's operations and because superior knowledge and control over information are sources of power, they may be better positioned than outsiders to influence boardroom decision making. The board may become the captive of insiders and merely rubber-stamp management decisions instead of guarding stockholder interests.

Some observers contend that many boards are dominated by the company CEO, particularly when the CEO is also the chairman of the board.<sup>22</sup> To support this view,

they point out that both inside and outside directors are often the personal nominees of the CEO. The typical inside director is subordinate to the CEO in the company's hierarchy and therefore unlikely to criticize the boss. Because outside directors are frequently the CEO's nominees as well, they can hardly be expected to evaluate the CEO objectively. Thus, the loyalty of the board may be biased toward the CEO, not the stockholders. Moreover, a CEO who is also chairman of the board may be able to control the agenda of board discussions in such a manner as to deflect any criticisms of his or her leadership.

In the aftermath of a wave of corporate scandals that hit the corporate world in the early 2000s, there are clear signs that many corporate boards are moving away from merely rubber-stamping top management decisions and are beginning to play a much more active role in corporate governance. In part, they have been prompted by new legislation, such as the 2002 Sarbanes-Oxley Act in the United States, which tightened rules governing corporate reporting and corporate governance. Also important has been a growing trend on the part of the courts to hold directors liable for corporate misstatements. Powerful institutional investors such as pension funds have also been more aggressive in exerting their power, often pushing for more outside representation on the board of directors and for a separation between the roles of chairman and CEO, with the chairman role going to an outsider. Partly as a result, more than 50% of big companies had outside directors in the chairman's role by the late 2000s, up from less than half of that number in 1990. Separating the role of chairman and CEO limits the ability of corporate insiders, and particularly that of the CEO, to exercise control over the board. Still, when all is said and done, it must be recognized that boards of directors do not work as well as they should in theory, and other mechanisms are need to align the interests of stockholders and managers.

## Stock-Based Compensation

According to agency theory, one of the best ways to reduce the scope of the agency problem is for principals to establish incentives for agents to behave in their best interest through pay-for-performance systems. In the case of stockholders and top managers, stockholders can encourage top managers to pursue strategies that maximize a company's long-run profitability and profit growth, and thus the gains from holding its stock, by linking the pay of those managers to the performance of the stock price.

The most common pay-for-performance system has been to give managers **stock options**: the right to buy the company's shares at a predetermined (strike) price at some point in the future, usually within 10 years of the grant date. Typically, the strike price is the price that the stock was trading at when the option was originally granted. The idea behind stock options is to motivate managers to adopt strategies that increase the share price of the company, for in doing so they will also increase the value of their own stock options. Another stock-based pay for performance system is to grant managers stock if they attain predetermined performance targets.

Several academic studies suggest that stock-based compensation schemes for executives, such as stock options and stock grants, can align management and stockholder interests. For instance, one study found that managers were more likely to consider the effects of their acquisition decisions on stockholder returns if they themselves were significant shareholders.<sup>23</sup> According to another study, managers who were significant stockholders were less likely to pursue strategies that would maximize the size of the company rather than its profitability.<sup>24</sup> More generally, it



is difficult to argue with the proposition that the chance to get rich from exercising stock options is the primary reason for the 14-hour days and six-day workweeks that many employees of fast-growing companies put in.

However, the practice of granting stock options has become increasingly controversial. Many top managers often earn huge bonuses from exercising stock options that were granted several years previously. While not denying that these options motivate managers to improve company performance, critics claim that they are often too generous. A particular cause for concern is that stock options are often granted at such low strike prices that the CEO can hardly fail to make a significant amount of money by exercising them, even if the company underperforms the stock market by a significant margin. Indeed, a serious example of the agency problem emerged in 2005 and 2006 when the SEC started to investigate a number of companies in which stock options granted to senior executives had apparently been “backdated” to a time when the stock price was lower, enabling the executives to earn more money than if those options had simply been dated on the day they were granted.<sup>25</sup> By late 2006, the SEC was investigating some 130 companies for possible fraud relating to stock option dating. Included in the list were major corporations, including Apple Computer, Jabil Circuit, United Health, and Home Depot.<sup>26</sup>

Other critics of stock options, including the famous investor Warren Buffett, complain that huge stock option grants increase the outstanding number of shares in a company and therefore dilute the equity of stockholders; accordingly, they should be shown in company accounts as an expense against profits. Under accounting regulations that were in force until 2005, stock options, unlike wages and salaries, were not expensed. However, this has now changed, and as a result, many companies are starting to reduce their use of options. At Microsoft, for example, which had long given generous stock option grants to high performing employees, stock options were replaced with stock grants in 2005.

## Financial Statements and Auditors

Publicly trading companies in the United States are required to file quarterly and annual reports with the SEC that are prepared according to Generally Agreed Accounting Principals (GAAP). The purpose of this requirement is to give consistent, detailed, and accurate information about how efficiently and effectively the agents of stockholders—the managers—are running the company. To make sure that managers do not misrepresent this financial information, the SEC also requires that the accounts be audited by an independent and accredited accounting firm. Similar regulations exist in most other developed nations. If the system works as intended, stockholders can have a lot of faith that the information contained in financial statements accurately reflects the state of affairs at a company. Among other things, such information can enable a stockholder to calculate the profitability (ROIC) of a company in which he or she invests and compare its ROIC against that of competitors.

Unfortunately, in the United States at least, this system has not always worked as intended. Although the vast majority of companies do file accurate information in their financial statements and although most auditors do a good job of reviewing that information, there is substantial evidence that a minority of companies have abused the system, aided in part by the compliance of auditors. This was clearly an issue at Enron, where the CFO and others misrepresented the true financial state of the company to investors by creating off-balance-sheet partnerships that hid the true state of Enron’s indebtedness from public view. Enron’s auditor, Arthur Andersen,

also apparently went along with this deception, in direct violation of its fiduciary duty. Arthur Anderson also had lucrative consulting contracts with Enron that it did not want to jeopardize by questioning the accuracy of the company's financial statements. The losers in this mutual deception were shareholders, who had to rely on inaccurate information to make their investment decisions.

There have been numerous examples in recent years of managers' gaming financial statements to present a distorted picture of their company's finances to investors. The typical motive has been to inflate the earnings or revenues of a company, thereby generating investor enthusiasm and propelling the stock price higher, which gives managers an opportunity to cash in stock option grants for huge personal gain, obviously at the expense of stockholders who have been misled by the reports (see Strategy in Action 11.2 for an example).

The gaming of financial statements by companies such as Enron and Computer Associates raises serious questions about the accuracy of the information contained in audited financial statements. In response, in 2002, the United States passed the Sarbanes-Oxley bill into law, which represents the biggest overhaul of accounting rules and corporate governance procedures since the 1930s. Among other things, Sarbanes-Oxley set up a new oversight board for accounting firms, required CEOs and CFOs to endorse their company's financial statements, and barred companies from hiring the same accounting firm for auditing and consulting services.

## The Takeover Constraint

Given the imperfections in corporate governance mechanisms, it is clear that the agency problem may still exist at some companies. However, stockholders still have some residual power, for they can always sell their shares. If they start doing so in large numbers, the price of the company's shares will decline. If the share price falls far enough, the company might be worth less on the stock market than the book value of its assets. At this point, it may become an attractive acquisition target and runs the risk of being purchased by another enterprise, against the wishes of the target company's management.

The risk of being acquired by another company is known as the **takeover constraint**. The takeover constraint limits the extent to which managers can pursue strategies and take actions that put their own interests above those of stockholders. If they ignore stockholder interests and the company is acquired, senior managers typically lose their independence and probably their jobs as well. So the threat of takeover can constrain management action and limit the worst excesses of the agency problem.

During the 1980s and early 1990s, the threat of takeover was often enforced by corporate raiders—individuals or corporations that buy up large blocks of shares in companies that they think are pursuing strategies inconsistent with maximizing stockholder wealth. Corporate raiders argue that if these underperforming companies pursued different strategies, they could create more wealth for stockholders. Raiders buy stock in a company either to take over the business and run it more efficiently or to precipitate a change in the top management, replacing the existing team with one more likely to maximize stockholder returns. Raiders are motivated not by altruism but by gain. If they succeed in their takeover bid, they can institute strategies that create value for stockholders, including themselves. Even if a takeover bid fails, raiders can still earn millions, for their stockholdings will typically be bought out by the defending company for a hefty premium. Called **greenmail**, this source of gain stirred much

controversy and debate about its benefits. While some claim that the threat posed by raiders has had a salutary effect on enterprise performance by pushing corporate management to run their companies better, others claim there is little evidence of this.<sup>27</sup>

Although the incidence of hostile takeover bids has fallen off significantly since the early 1990s, this should not be taken to imply that the takeover constraint is no longer operating. Unique circumstances existed in the early 2000s that have made it more difficult to execute hostile takeovers. The boom years of the 1990s left many corporations with excessive debt (corporate America entered the new century with record levels of debt on its balance sheets), which limits the ability of companies to finance acquisitions, particularly hostile acquisitions, which are often particularly expensive. In addition, the market valuations of many companies got so out of line with underlying fundamentals during the stock market bubble of the 1990s that even after a substantial fall in certain segments of the stock market, such as the technology sector, valuations are still high relative to historic norms, making the hostile acquisition of even poorly run and unprofitable companies expensive. However, takeovers tend to go in cycles, and it seems likely that once excesses are worked out of the stock market and worked off corporate balance sheets, the takeover constraint will begin to reassert itself. It should be remembered that the takeover constraint is the governance mechanism of last resort and is often invoked only when other governance mechanisms have failed.

## Governance Mechanisms inside a Company

Thus far, this section has focused on the governance mechanisms designed to reduce the agency problem that potentially exists between stockholders and managers. Agency relationships also exist within a company, and the agency problem can thus arise between levels of management. In this section, we explore how the agency problem can be reduced within a company by using two complementary governance mechanisms to align the incentives and behavior of employees with those of upper-level management: strategic control systems and incentive systems.

**Strategic Control Systems** Strategic control systems are the primary governance mechanisms established within a company to reduce the scope of the agency problem between levels of management. These systems are the formal target setting, measurement, and feedback systems that allow managers to evaluate whether a company is executing the strategies necessary to maximize its long-run profitability and, in particular, whether the company is achieving superior efficiency, quality, innovation, and customer responsiveness. These are discussed in more detail in other chapters.

The purpose of strategic control systems is to (1) establish standards and targets against which performance can be measured, (2) create systems for measuring and monitoring performance on a regular basis, (3) compare actual performance against the established targets, and (4) evaluate results and take corrective action if necessary. In governance terms, their purpose is to make sure that lower-level managers, as the agents of top managers, are acting in a way that is consistent with top managers' goals, which should be to maximize the wealth of stockholders, subject to legal and ethical constraints.

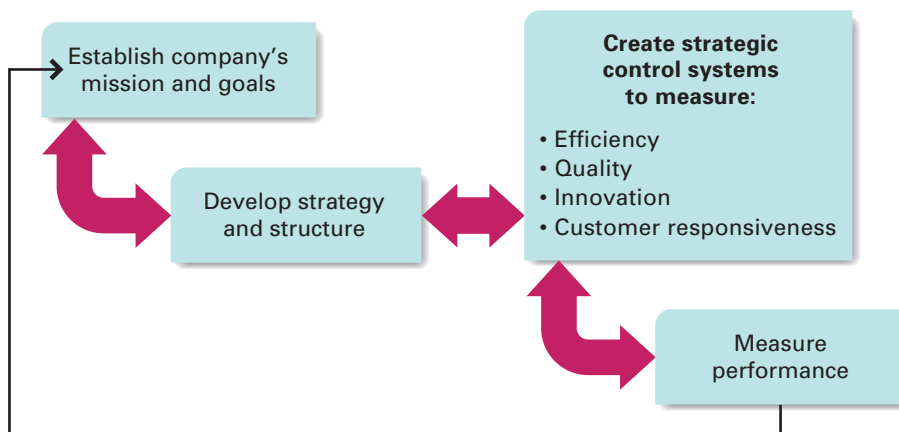
One increasingly influential model that guides managers through the process of creating the right kind of strategic control systems to enhance organizational performance is the balanced scorecard model.<sup>28</sup> According to the balanced scorecard model, traditionally managers have primarily used financial measures of performance such as ROIC to measure and evaluate organizational performance. Financial

information is extremely important, but it is not enough by itself. If managers are to obtain a true picture of organizational performance, financial information must be supplemented with performance measures that indicate how well an organization has been achieving the four building blocks of competitive advantage: efficiency, quality, innovation, and responsiveness to customers. This is so because financial results simply inform strategic managers about the results of decisions they have already taken; the other measures balance this picture of performance by informing managers about how accurately the organization has in place the building blocks that drive future performance.<sup>29</sup>

One version of the way the balanced scorecard operates is presented in Figure 11.3. Based on an organization's mission and goals, strategic managers develop a set of strategies to build competitive advantage to achieve these goals. They then establish an organizational structure to use resources to obtain a competitive advantage.<sup>30</sup> To evaluate how well the strategy and structure are working, managers develop specific performance measures that assess how well the four building blocks of competitive advantage are being achieved:

1. *Efficiency* can be measured by the level of production costs, the productivity of labor (such as the employee hours needed to make a product), the productivity of capital (such as revenues per dollar invested in property, plant, and equipment), and the cost of raw materials.
2. *Quality* can be measured by the number of rejects, the number of defective products returned from customers, and the level of product reliability over time.
3. *Innovation* can be measured by the number of new products introduced, the percentage of revenues generated from new products in a defined period, the time taken to develop the next generation of new products versus the competition, and the productivity of R&D (how much R&D spending is required to produce a successful product).
4. *Responsiveness to customers* can be measured by the number of repeat customers, customer defection rates, level of on-time delivery to customers, and level of customer service.

**Figure 11.3** A Balanced Scorecard Approach



As Kaplan and Norton, the developers of this approach, suggest, “Think of the balanced scorecard as the dials and indicators in an airplane cockpit. For the complex task of navigating and flying an airplane, pilots need detailed information about many aspects of the flight. They need information on fuel, air speed, altitude, learning, destination, and other indicators that summarize the current and predicted environment. Reliance on one instrument can be fatal. Similarly, the complexity of managing an organization today requires that managers be able to view performance in several areas simultaneously.”<sup>31</sup>

The way in which managers’ ability to build a competitive advantage translates into organizational performance is then measured using financial measures, such as the ROIC, the return on sales, and the capital turnover ratio (see Chapter 3). Based on an evaluation of the complete set of measures in the balanced scorecard, strategic managers are in a good position to reevaluate the company’s mission and goals and take corrective action to rectify problems, limit the agency problem, or exploit new opportunities by changing the organization’s strategy and structure—which is the purpose of strategic control.

**Employee Incentives** Control systems alone may not be sufficient to align incentives between stockholders, senior management, and the rest of the organization. To help do this, positive incentive systems are often put into place to motivate employees to work toward goals that are central to maximizing long-run profitability. As already noted, employee stock ownership plans (ESOPs) are one form of positive incentive, as are stock option grants. In the 1990s, ESOPs and stock ownership grants were pushed down deep within many organizations. The logic behind such systems is straightforward: recognizing that the stock price, and therefore their own wealth, is dependent on the profitability of the company, employees will work toward maximizing profitability.

In addition to stock-based compensation systems, employee compensation can also be tied to goals that are linked to the attainment of superior efficiency, quality, innovation, and customer responsiveness. For example, the bonus pay of a manufacturing employee might depend on attaining quality and productivity targets, which if reached will lower the costs of the company, increase customer satisfaction, and boost profitability. Similarly, the bonus pay of a salesperson might be dependent on surpassing sales targets and that of an R&D employee on the success of new products he or she had a hand in developing.

## ETHICS AND STRATEGY

The term **ethics** refers to accepted principles of right or wrong that govern the conduct of a person, the members of a profession, or the actions of an organization. **Business ethics** are the accepted principles of right or wrong governing the conduct of businesspeople. Ethical decisions are in accordance with those accepted principles, whereas unethical decisions violate accepted principles. This is not as straightforward as it sounds. Managers may be confronted with **ethical dilemmas**, situations in which there is no agreement over exactly what the accepted principles of right and wrong are or where none of the available alternatives seems ethically acceptable.

In our society, many accepted principles of right and wrong are not only universally recognized but also codified into law. In the business arena, there are laws governing product liability (tort laws), contracts and breaches of contract (contract law), the protection of intellectual property (intellectual property law), competitive

behavior (antitrust law), and the selling of securities (securities law). Not only is it unethical to break these laws, it is illegal.

In this book, we argue that the preeminent goal of managers in a business should be to pursue strategies that maximize the long-run profitability and profit growth of the enterprise, thereby boosting returns to stockholders. Strategies, of course, must be consistent with the laws that govern business behavior: managers must act legally while seeking to maximize the long-run profitability of the enterprise. Unfortunately, as we have already seen in this chapter, there are examples of managers breaking the law. Moreover, managers may take advantage of ambiguities and gray areas in the law, of which there are many in our common law system, to pursue actions that are at best legally suspect and, in any event, clearly unethical. It is important to realize, however, that behaving ethically goes beyond staying within the bounds of the law. For example, see Strategy in Action 11.3, which discusses Nike's use of "sweatshop labor" in developing nations to make sneakers for consumers in the developed world. While Nike was not breaking any laws by using inexpensive laborers who worked long hours for poor pay in poor working conditions, and neither were its subcontractors, many considered it unethical to use subcontractors who by Western standards clearly exploited their workforce. In this section, we take a closer look at the ethical issues that managers may confront when developing strategy and at the steps managers can take to ensure that strategic decisions are not only legal but also ethical.

## Ethical Issues in Strategy

The ethical issues that strategic managers confront cover a wide range of topics, but most are due to a potential conflict between the goals of the enterprise, or the goals of individual managers, and the fundamental rights of important stakeholders, including stockholders, customers, employees, suppliers, competitors, communities, and the general public. Stakeholders have basic rights that should be respected, and it is unethical to violate those rights.

Stockholders have the right to timely and accurate information about their investment (in accounting statements), and it is unethical to violate that right. Customers have the right to be fully informed about the products and services they purchase, including the right to information about how those products might cause harm to them or others, and it is unethical to restrict their access to such information. Employees have the right to safe working conditions, fair compensation for the work they perform, and just treatment by managers. Suppliers have the right to expect contracts to be respected, and the firm should not take advantage of a power disparity between itself and a supplier to opportunistically rewrite a contract. Competitors have the right to expect that the firm will abide by the rules of competition and not violate the basic principles of antitrust laws. Communities and the general public, including their political representatives in government, have the right to expect that a firm will not violate the basic expectations that society places on enterprises, for example, by dumping toxic pollutants into the environment or overcharging for work performed on government contracts.

Those who take the stakeholder view of business ethics often argue that it is in the enlightened self-interest of managers to behave in an ethical manner that recognizes and respects the fundamental rights of stakeholders because doing so will ensure the support of stakeholders and thus ultimately benefit the firm and its managers. Others go beyond this instrumental approach to ethics to argue that, in many cases, acting ethically is simply the right thing to do. They argue that businesses need



## 11.3 STRATEGY IN ACTION

### Nike: The Sweatshop Debate

Nike is in many ways the quintessential global corporation. Established in 1972 by former University of Oregon track star Phil Knight, Nike is now one of the leading marketers of athletic shoes and apparel in the world. By 2004, the company had more than \$12 billion in annual revenues, an ROIC of 17.5%, and sold its products in some 140 countries. Nike does not do any manufacturing. Rather, it designs and markets its products and contracts for their manufacture from a global network of 600 factories owned by subcontractors scattered around the globe that together employ some 550,000 people. This huge corporation has made founder Phil Knight into one of the richest people in America. Nike's marketing phrase, "Just Do It!" has become as recognizable in popular culture as its "swoosh" logo or the faces of its celebrity sponsors, such as Tiger Woods.

For all of its successes, however, the company has been dogged by repeated and persistent accusations that its products are made in "sweatshops," where workers, many of them children, slave away in hazardous conditions for wages that are below subsistence level. Nike's wealth, its detractors claim, has been built on the backs of the world's poor. Many see Nike as a symbol of the evils of globalization: a rich Western corporation exploiting the world's poor to provide expensive shoes and apparel to the pampered consumers of the developed world. Nike's "Niketown" stores have become standard targets for antiglobalization protestors. Several non-governmental organizations, such as San Francisco-based Global Exchange, a human rights organization dedicated to promoting environmental, political, and social justice around the world, have targeted Nike for repeated criticism and protests. News programs such as CBS' *48 Hours*, hosted by Dan Rather, have run exposés on working conditions in foreign factories that supply Nike. And students on the campuses of several major United States universities with which Nike has lucrative sponsorship deals have protested against those deals, citing Nike's use of sweatshop labor.

Typical of the allegations were those detailed on *48 Hours* in 1996. The report painted a picture of young women at a Vietnamese subcontractor who worked six days a week, in poor working conditions with toxic materials, for only 20 cents an hour. The report also stated that a living wage in Vietnam was at least \$3 a day, an income that could

not be achieved without working substantial overtime. Nike was not breaking any laws, and nor were its subcontractors, but this report and others like it raised questions about the ethics of using "sweatshop labor" to make what were essentially fashion accessories. It may have been legal; it may have helped the company to increase its profitability, but was it ethical to use subcontractors who by Western standards clearly exploited their workforce? Nike's critics thought not, and the company found itself the focus of a wave of demonstrations and consumer boycotts.

Adding fuel to the fire, in November 1997, Global Exchange obtained and leaked a confidential report by Ernst & Young of an audit that Nike had commissioned of a Vietnam factory owned by a Nike subcontractor. The factory had 9,200 workers and made 400,000 pairs of shoes a month. The Ernst & Young report painted a dismal picture of thousands of women, most younger than 25, laboring 10.5 hours a day, six days a week, in excessive heat and noise and foul air, for slightly more than \$10 a week. The report also found that workers with skin or breathing problems had not been transferred to departments free of chemicals. More than half the workers who dealt with dangerous chemicals did not wear protective masks or gloves. The report stated that, in some parts of the plant, workers were exposed to carcinogens that exceeded local legal standards by 177 times, and 77% of the employees suffered from respiratory problems.

These exposés surrounding Nike's use of subcontractors forced the company to reexamine its policies. Realizing that its subcontracting policies were perceived as unethical, Nike's management took a number of steps. These included establishing a code of conduct for Nike subcontractors and setting up a scheme whereby all subcontractors would be monitored annually by independent auditors. Nike's code of conduct required that all employees at footwear factories be at least 18 years old and that exposure to potentially toxic materials would not exceed the permissible exposure limits established by the U.S. Occupational Safety and Health Administration (OSHA) for workers in the United States. In short, Nike concluded that behaving ethically required going beyond the requirements of the law. It required the establishment and enforcement of rules that adhere to accepted moral principles of right and wrong.

**Sources:** "Boycott Nike," CBS News *48 Hours*, October 17, 1996; D. Jones, "Critics Tie Sweatshop Sneakers to 'Air Jordan,'" *USA Today*, June 6, 1996, 1B; "Global Exchange Special Report: Nike Just Don't Do It," available at <http://www.globalexchange.org/education/publications/newsltr6.97p2.html#nike>; S. Greenhouse, "Nike Shoe Plant in Vietnam Is Called Unsafe for Workers," *New York Times*, November 8, 1997; V. Dobnik, "Chinese Workers Abused Making Nikes, Reeboks," *Seattle Times*, September 21, 1997, A4.

to recognize their *noblesse oblige* and give something back to the society that made their success possible. *Noblesse oblige* is a French term that refers to honorable and benevolent behavior that is considered the responsibility of people of high (noble) birth. In a business setting, it is taken to mean benevolent behavior that is the moral responsibility of successful enterprises.

Unethical behavior often arises in a corporate setting when managers decide to put the attainment of their own personal goals, or the goals of the enterprise, above the fundamental rights of one or more stakeholder groups (in other words, unethical behavior may arise from agency problems). The most common examples of such behavior involve self-dealing; information manipulation; anticompetitive behavior; opportunistic exploitation of other players in the value chain in which the firm is embedded (including suppliers, complement providers, and distributors); the maintenance of substandard working conditions; environmental degradation; and corruption.

**Self-dealing** occurs when managers find a way to feather their own nests with corporate monies, and we have already discussed several examples in this chapter (such as Computer Associates). **Information manipulation** occurs when managers use their control over corporate data to distort or hide information to enhance their own financial situation or the competitive position of the firm. As we have seen, many of the recent accounting scandals involved the deliberate manipulation of financial information. Information manipulation can also occur with regard to nonfinancial data. This occurred when managers at the tobacco companies suppressed internal research that linked smoking to health problems, violating the rights of consumers to accurate information about the dangers of smoking. When evidence of this came to light, lawyers brought class action suits against the tobacco companies, claiming that they had intentionally caused harm to smokers: they had broken tort law by promoting a product that they knew did serious harm to consumers. In 1999, the tobacco companies settled a lawsuit brought by the states who sought to recover health care costs associated with tobacco-related illnesses; the total payout to the states was \$260 billion.

**Anticompetitive behavior** covers a range of actions aimed at harming actual or potential competitors, most often by using monopoly power, and thereby enhancing the long-run prospects of the firm. For example, in the 1990s, the Justice Department claimed that Microsoft used its monopoly in operating systems to force PC manufacturers to bundle Microsoft's Web browser, Internet Explorer, with Windows and to display Internet Explorer prominently on the computer desktop (the screen seen when starting PCs). Microsoft reportedly told PC makers that it would not supply them with Windows unless they did this. Since the PC makers had to have Windows to sell their machines, this was a powerful threat. The alleged aim of the action, an example of "tie-in-sales," which is illegal under antitrust laws, was to drive a competing browser maker, Netscape, out of business. The courts ruled that Microsoft was indeed abusing its monopoly power in this case, and under a 2001 consent decree, the company agreed to stop the practice.

Putting the legal issues aside, action such as that allegedly undertaken by managers at Microsoft is unethical on at least three counts. First, it violates the rights of end-users by unfairly limiting their choice; second, it violates the rights of downstream participants in the industry value chain, in this case PC makers, by forcing them to incorporate a particular product in their design; and third, it violates the rights of competitors to free and fair competition.

**Opportunistic exploitation** of other players in the value chain in which the firm is embedded is another example of unethical behavior. Exploitation of this kind

typically occurs when the managers of a firm seek to unilaterally rewrite the terms of a contract with suppliers, buyers, or complement providers in a way that is more favorable to the firm, often using their power to force the revision through. For example, in the late 1990s, Boeing entered into a \$2 billion contract with Titanium Metals Corporation to buy certain amounts of titanium annually for 10 years. In 2000, after Titanium Metals had already spent \$100 million to expand its production capacity to fulfill the contract, Boeing demanded that the contract be renegotiated, asking for lower prices and an end to minimum purchase agreements. As a major purchaser of titanium, managers at Boeing probably thought they had the power to push this contract revision through, and the investment by Titanium Metals meant that they would be unlikely to walk away from the deal. Titanium Metals promptly sued Boeing for breach of contract. The dispute was settled out of court, and under a revised agreement Boeing agreed to pay monetary damages to Titanium Metals (reported to be in the \$60 million range) and entered into an amended contract to purchase titanium.<sup>32</sup> Irrespective of the legality of this action, it was arguably unethical because it violated the rights of suppliers to have buyers who deal with them in a fair and open way.

**Substandard working conditions** arise when managers underinvest in working conditions, or pay employees below-market rates, to reduce their costs of production. The most extreme examples of such behavior occur when a firm establishes operations in countries that lack the workplace regulations found in developed nations such as the United States. The example of Nike (see Strategy in Action 11.3) falls into this category. In another recent example, The Ohio Art company ran into an ethical storm when newspaper reports alleged that it had moved production of its popular Etch A Sketch toy from Ohio to a supplier in Shenzhen province where employees, mostly teenagers, worked long hours for 24 cents per hour, below the legal minimum wage of 33 cents an hour in Shenzhen province. Moreover, production reportedly started at 7:30 a.m. and continued until 10 p.m., with breaks only for lunch and dinner. Saturdays and Sundays are treated as normal workdays. This translates into a workweek of seven 12-hour days, or 84 hours a week, well above the standard 40-hour week set by authorities in Shenzhen. Such working conditions clearly violate the rights of employees in China, as specified by local regulations (which are poorly enforced). Is it ethical for the Ohio Art company to use such a supplier? Many would say not.<sup>33</sup> As the next Running Case documents, Walmart has come under fire for having substandard working conditions, something that it is now trying hard to correct.

**Environmental degradation** occurs when a firm takes actions that directly or indirectly result in pollution or other forms of environmental harm. Environmental degradation can violate the rights of local communities and the general public for such things as clean air and water, land that is free from pollution by toxic chemicals, and properly managed forests (because forests absorb rainfall, improper deforestation results in land erosion and floods).

Finally, **corruption** can arise in a business context when managers pay bribes to gain access to lucrative business contracts. For example, it was alleged that Halliburton was part of a consortium that paid some \$180 million in bribes to win a lucrative contract to build a natural gas plant in Nigeria.<sup>34</sup> Corruption is clearly unethical because it violates a bundle of rights, including the right of competitors to a level playing field when bidding for contracts, when government officials are involved, the right of citizens to expect that government officials act in the best interest of the local community or nation, and not in response to corrupt payments that feather their own nests.

## RUNNING CASE

### Working Conditions at Walmart

When Sam Walton founded Walmart, one of his core values was that if the company treated employees with respect, tied compensation to the performance of the enterprise, trusted them with important information and decisions, and provided ample opportunities for advancement, they would repay the company with dedication and hard work. For years the formula seemed to work. Employees were called “associates” to reflect their status within the company, even the lowest hourly employee was eligible to participate in profit-sharing plans and could use profit-sharing bonuses to purchase company stock at a discount to its market value. The company made a virtue of promoting from within (two-thirds of managers at Walmart started as hourly employees). At the same time, Walton and his successors always demanded loyalty and hard work from employees—managers for example, were expected to move to a new store on very short notice—and base pay for hourly workers was very low. Still, as long as the up side was there, little grumbling was heard from employees.

However, more recently the relationships between the company and its employees has been strained by a succession of lawsuits claiming that Walmart pressures hourly employees to work overtime without compensating them; systematically discriminates against women; and knowingly uses contractors who hire undocumented immigrant workers to clean its stores, paying them below minimum wage.

For example, a class-action lawsuit in Washington State claimed that Walmart routinely (1) pressured hourly employees not to report all their time worked; (2) failed to keep true time records, sometimes shaving hours from employee logs; (3) failed to give employees full rest or meal breaks; (4) threatened to fire or demote employees who would not work off the clock; and (5) required workers to attend unpaid meetings and computer training. Moreover, the suit claimed that Walmart has a strict “no overtime” policy, punishing employees who work more than 40 hours a week, yet the company also gives employees more work than can be completed in a 40-hour week. The Washington suit is one of more than 30 suits that have been filed around the nation in recent years.

With regard to discrimination against women, complaints date back to a 1996, when an assistant manager in a California store, Stephanie Odle, came across the W-2 of a male assistant manager who worked in the same store. The W-2 showed that he was paid \$10,000 more than Odle. When she asked her boss to explain the disparity, she was told that her coworker had “a wife and kids to support.” When Odle, a single mother, protested, she was asked to submit a personal household budget. She was then granted a \$2,080 raise. Subsequently, Odle was fired, she claims for speaking up. In 1998, she filed a discrimination suit against the company. Others began to file suits around the same time, and by 2004 the legal action had evolved into a class action suit that covered 1.6 million current and former female employees at Walmart. The suit claims that Walmart did not pay female employees the same as their male counterparts and did not provide them with equal opportunities for promotion.

In the case of both undocumented overtime and discrimination, Walmart admits to no wrongdoing. The company does recognize that with more than 2 million employees, some problems are bound to arise, but it claims that there is no systematic company-wide effort to get hourly employees to work without pay or to discriminate against women. Indeed, the company claims that this could not be the case because hiring and promotion decisions are made at the store level.

For their part, critics charge that while the company may have no policies that promote undocumented overtime or discrimination, the hard driving cost containment culture of the company had created an environment in which abuses can thrive. Store managers, for example, are expected to meet challenging performance goals, and, in an effort to do so, they may be tempted to pressure subordinates to work additional hours without pay. Similarly, company policy requiring managers to move to different stores at short notice unfairly discriminates against women, who lack the flexibility to uproot their families and move them to another state at short notice.

While the lawsuits are ongoing and may take years to resolve, Walmart has taken steps to change

*(continued)*

its employment practices. For example, the company has created a director of diversity, a diversity compliance team, and restructured its pay scales to promote equal pay regardless of gender. Walmart has also taken action to stop employees working

overtime without pay. For example, it programmed cash registers to shut down after an employee had exceeded a certain number of hours, and has told managers to make sure that employees take lunch and rest breaks.

**Sources:** S. Holt, "Walmart Workers Suit Wins Class Action Status," *Seattle Times*, October 9, 2004, E1, E4; C. Daniels, "Women versus Walmart," *Fortune*, July 21, 2003, 79–82; C. R. Gentry, "Off the Clock," *Chain Store Age*, February 2003, 33–36; M. Grimm, "Wal-Mart Uber Alles," *American Demographic*, October 2003, 38–42; S. Rosenbloom and M. Barbaro, "Green Light Specials, Now at Walmart," *New York Times*, January 25, 2009, B1, B4

## The Roots of Unethical Behavior

Why do some managers behave unethically? What motivates them to engage in actions that violate accepted principles of right and wrong, trample on the rights of one or more stakeholder groups, or simply break the law? While there is no simple answer to this question, a few generalizations can be made.<sup>35</sup> First, it is important to recognize that business ethics are not divorced from **personal ethics**, which are the generally accepted principles of right and wrong governing the conduct of individuals. As individuals, we are taught that it is wrong to lie and cheat and right to behave with integrity and honor and stand up for what we believe to be right and true. The personal ethical code that guides our behavior comes from a number of sources, including our parents, our schools, our religion, and the media. Our personal ethical codes will exert a profound influence on the way we behave as businesspeople. An individual with a strong sense of personal ethics is less likely to behave in an unethical manner in a business setting; in particular, he or she is less likely to engage in self-dealing and more likely to behave with integrity.

Second, many studies of unethical behavior in a business setting have come to the conclusion that businesspeople sometimes do not realize that they are behaving unethically, primarily because they simply fail to ask the relevant question: Is this decision or action ethical? Instead, they apply a straightforward business calculation to what they perceive to be a business decision, forgetting that the decision may also have an important ethical dimension.<sup>36</sup> The fault here lies in processes that do not incorporate ethical considerations into business decision making. This may have been the case at Nike when managers originally made subcontracting decisions (see Strategy in Action 11.3). Those decisions were probably made on the basis of good economic logic. Subcontractors were probably chosen on the basis of business variables such as cost, delivery, and product quality, and key managers simply failed to ask, "How does this subcontractor treat its workforce?" If they thought about the question at all, they probably reasoned that it was the subcontractors' concern, not theirs.

Unfortunately, the climate in some businesses does not encourage people to think through the ethical consequences of business decisions. This brings us to the third cause of unethical behavior in businesses: an organizational culture that de-emphasizes business ethics and considers all decisions to be purely economic ones. A related fourth cause of unethical behavior may be pressure from top management to meet performance goals that are unrealistic, which can be attained only by cutting corners or acting in an unethical manner.

An organizational culture can “legitimize” behavior that society would judge as unethical, particularly when this is mixed with a focus on unrealistic performance goals, such as maximizing short-term economic performance regardless of the costs. In such circumstances, there is a greater-than-average probability that managers will violate their own personal ethics and engage in behavior that is unethical. By the same token, an organizational culture can do just the opposite and reinforce the need for ethical behavior. At HP, for example, Bill Hewlett and David Packard, the company’s founders, propagated a set of values known as “The HP Way.” These values, which shape the way business is conducted both within and by the corporation, have an important ethical component. Among other things, they stress the need for confidence in and respect for people, open communication, and concern for the individual employee.

This brings us to a fifth root cause of unethical behavior: *unethical leadership*. Leaders help to establish the culture of an organization, and they set the example that others follow. Other employees in a business often take their cues from business leaders, and if those leaders do not behave in an ethical manner, employees might not either. It is not what leaders say that matters, but what they do. A good example is Ken Lay, the former CEO of Enron. While constantly referring to Enron’s code of ethics in public statements, Lay simultaneously engaged in behavior that was ethically suspect. Among other things, he failed to discipline subordinates who had inflated earnings by engaging in corrupt energy trading schemes. Such behavior sent a very clear message to Enron’s employees: unethical behavior would be tolerated if it boosted earnings.

## Behaving Ethically

What is the best way for managers to ensure that ethical considerations are taken into account? In many cases, there is no easy answer to this question, for many of the most vexing ethical problems involve very real dilemmas and suggest no obvious right course of action. Nevertheless, managers can and should do at least seven things to ensure that basic ethical principles are adhered to and that ethical issues are routinely considered when making business decisions. They can (1) favor hiring and promoting people with a well-grounded sense of personal ethics, (2) build an organizational culture that places a high value on ethical behavior, (3) make sure that leaders within the business not only articulate the rhetoric of ethical behavior but also act in a manner that is consistent with that rhetoric, (4) put decision-making processes in place that require people to consider the ethical dimension of business decisions, (5) use ethics officers, (6) put strong governance processes in place, and (7) act with moral courage.

**Hiring and Promotion** It seems obvious that businesses should strive to hire people who have a strong sense of personal ethics and would not engage in unethical or illegal behavior. Similarly, one would rightly expect a business to not promote people, and perhaps fire people, whose behavior does not match generally accepted ethical standards. But doing so is actually very difficult. How do you know that someone has a poor sense of personal ethics? In our society, if someone lacks personal ethics, he or she may hide this fact to retain people’s trust.

Is there anything that businesses can do to make sure that they do not hire people who turn out to have poor personal ethics, particularly given that people have an incentive to hide this from public view (indeed, unethical people may well lie about



their nature)? Businesses can give potential employees psychological tests to try to discern their ethical predisposition, and they can check with prior employers regarding someone's reputation, such as by asking for letters of reference and talking to people who have worked with the prospective employee. The latter approach is certainly not uncommon and does indeed influence the hiring process. As for promoting people who have displayed poor ethics, it should not occur in a company in which the organizational culture values ethical behavior and where leaders act accordingly.

**Organizational Culture and Leadership** To foster ethical behavior, businesses need to build an organizational culture that places a high value on ethical behavior. Three actions are particularly important. First, businesses must explicitly articulate values that place a strong emphasis on ethical behavior. Many companies now do this by drafting a **code of ethics**, a formal statement of the ethical priorities a business adheres to. Others have incorporated ethical statements into documents that articulate the values or mission of the business. For example, the food and consumer products giant Unilever has a code of ethics that includes the following points: "We will not use any form of forced, compulsory, or child labor" and "No employee may offer, give, or receive any gift or payment which is, or may be construed as being, a bribe. Any demand for, or offer of, a bribe must be rejected immediately and reported to management."<sup>37</sup> Unilever's principles send a very clear message to managers and employees within the organization.

Having articulated values in a code of ethics or some other document, it is important that leaders in the business give life and meaning to those words by repeatedly emphasizing their importance and then acting on them. This means using every relevant opportunity to stress the importance of business ethics and making sure that key business decisions not only make good economic sense but also are ethical. Many companies have gone a step further and hired independent firms to audit them and make sure that they are behaving in a manner consistent with their ethical code. Nike, for example, has in recent years hired independent auditors to make sure that its subcontractors are living up to Nike's code of conduct.

Finally, building an organizational culture that places a high value on ethical behavior requires incentive and reward systems, including promotion systems that reward people who engage in ethical behavior and sanction those who do not.

**Decision-Making Processes** In addition to establishing the right kind of ethical culture in an organization, businesspeople must be able to think through the ethical implications of decisions in a systematic way. To do this, they need moral compasses, and both rights theories and Rawls's theory of justice help to provide such compasses. Beyond these theories, some experts on ethics have proposed a straightforward practical guide, or ethical algorithm, to determine whether a decision is ethical. A decision is acceptable on ethical grounds if a businessperson can answer "yes" to each of these questions:

1. Does my decision fall within the accepted values or standards that typically apply in the organizational environment (as articulated in a code of ethics or some other corporate statement)?
2. Am I willing to see the decision communicated to all stakeholders affected by it—for example, by having it reported in newspapers or on television?
3. Would the people with whom I have a significant personal relationship, such as family members, friends, or even managers in other businesses, approve of the decision?

**Ethics Officers** To make sure that businesses behave in an ethical manner, a number of firms now have ethics officers. These individuals are responsible for making sure that all employees are trained to be ethically aware, that ethical considerations enter the business decision-making process, and that the company's code of ethics is adhered to. Ethics officers may also be responsible for auditing decisions to make sure that they are consistent with this code. In many businesses, ethics officers act as internal ombudspersons with responsibility for handling confidential inquiries from employees, investigating complaints from employees or others, reporting findings, and making recommendations for change.

United Technologies (UTC), a large aerospace company with worldwide revenues of more than \$28 billion, has had a formal code of ethics since 1990. There are now some 160 "business practice officers" within UTC (this is the company's name for ethics officers) who are responsible for making sure that the code is adhered to. UTC also established an ombudsperson program in 1986 that allows employees to inquire anonymously about ethics issues. The program has received some 56,000 inquiries since 1986, and 8,000 cases have been handled by an ombudsperson.<sup>38</sup>

**Strong Corporate Governance** Strong corporate governance procedures are needed to make sure that managers adhere to ethical norms, in particular, that senior managers do not engage in self-dealing or information manipulation. The key to strong corporate governance procedures is an independent board of directors that is willing to hold top managers to account for self-dealing and is able to question the information provided to them by managers. If companies like Tyco, WorldCom, and Enron had had a strong board of directors, it is unlikely that they would have been racked by accounting scandals or that top managers would have been able to view the funds of these corporations as their own personal treasuries.

There are five cornerstones of strong governance. The first is a board of directors composed of a majority of outside directors who have no management responsibilities in the firm, are willing and able to hold top managers to account, and do not have business ties with important insiders. The outside directors should be individuals of high integrity whose reputation is based on their ability to act independently. The second cornerstone is a board in which the positions of CEO and chairman are held by separate individuals, with the chairman as an outside director. When the CEO is also chairman of the board of directors, he or she can control the agenda, thereby furthering his or her own personal agenda (which may include self-dealing) or limiting criticism against current corporate policies. The third cornerstone is a compensation committee formed by the board composed entirely of outside directors. It is the compensation committee that sets the level of pay for top managers, including stock option grants and the like. By making sure that the compensation committee is independent of managers, one reduces the scope of self-dealing. Fourth, the audit committee of the board, which reviews the financial statements of the firm, should also be composed of outsiders, thereby encouraging vigorous independent questioning of the firm's financial statements. Finally, the board should use outside auditors who are truly independent and do not have a conflict of interest. This was not the case in many recent accounting scandals, where the outside auditors were also consultants to the corporation and therefore less likely to ask hard questions of management for fear that doing so would jeopardize lucrative consulting contracts.

**Moral Courage** It is important to recognize that sometimes managers and others need significant moral courage. It is moral courage that enables managers to walk

away from a decision that is profitable but unethical, that gives employees the strength to say no to superiors who instruct them to behave unethically, and that gives employees the integrity to go to the media and blow the whistle on persistent unethical behavior in a company. Moral courage does not come easily; there are well-known cases in which individuals have lost their jobs because they blew the whistle on corporate behaviors.

Companies can strengthen the moral courage of employees by committing themselves to not take retribution on employees that exercise moral courage, say no to superiors, or otherwise complain about unethical actions. For example, Unilever's code of ethics includes the following:

Any breaches of the Code must be reported in accordance with the procedures specified by the Joint Secretaries. The Board of Unilever will not criticize management for any loss of business resulting from adherence to these principles and other mandatory policies and instructions. The Board of Unilever expects employees to bring to their attention, or to that of senior management, any breach or suspected breach of these principles. Provision has been made for employees to be able to report in confidence and no employee will suffer as a consequence of doing so.<sup>39</sup>

This statement gives “permission” to employees to exercise moral courage. Companies can also set up ethics hotlines that allow employees to anonymously register complaints with a corporate ethics officer.

**Final Words** The steps discussed in this chapter can help to ensure that, when managers make business decisions, they are fully cognizant of the ethical implications and do not violate basic ethical prescripts. At the same time, not all ethical dilemmas have clean and obvious solutions—that is why they are dilemmas. At the end of the day, there are clearly things that a business should not do, and there are things that they should do, but there are also actions that present managers with true dilemmas. In these cases, a premium is placed on the ability of managers to make sense out of complex, messy situations and to make balanced decisions that are as just as possible.

## SUMMARY OF CHAPTER

1. Stakeholders are individuals or groups that have an interest, claim, or stake in the company, in what it does, and in how well it performs.
2. Stakeholders are in an exchange relationship with the company. They supply the organization with important resources (or contributions) and in exchange expect their interests to be satisfied (by inducements).
3. A company cannot always satisfy the claims of all stakeholders. The goals of different groups may conflict. The company must identify the most important stakeholders and give highest priority to pursuing strategies that satisfy their needs.
4. A company's stockholders are its legal owners and the providers of risk capital, a major source of the capital resources that allow a company to operate its business. As such, they have a unique role among stakeholder groups.
5. Maximizing long-run profitability and profit growth is the route to maximizing returns to stockholders, and it is also consistent with satisfying the claims of several other key stakeholder groups.
6. When pursuing strategies that maximize profitability, a company has an obligation to do so within the limits set by the law and in a manner consistent with societal expectations.

7. An agency relationship arises whenever one party delegates decision-making authority or control over resources to another.
8. The essence of the agency problem is that the interests of principals and agents are not always the same, and some agents may take advantage of information asymmetries to maximize their own interests at the expense of principals.
9. Several governance mechanisms serve to limit the agency problem between stockholders and managers, including the board of directors, stock-based compensation schemes, financial statements and auditors, and the threat of a takeover.
10. The term *ethics* refers to accepted principles of right or wrong that govern the conduct of a person, the members of a profession, or the actions of an organization. Business ethics are the accepted principles of right or wrong governing the conduct of businesspeople, and an ethical strategy is one that does not violate these accepted principles.
11. Unethical behavior is rooted in poor personal ethics—the inability to recognize that ethical issues are at stake, as when there are psychological and geographical distances between a foreign subsidiary and the home office: a failure to incorporate ethical issues into strategic and operational decision making; a dysfunctional culture; and failure of leaders to act in an ethical manner.
12. To make sure that ethical issues are considered in business decisions, managers should (a) favor hiring and promoting people with well-grounded senses of personal ethics; (b) build an organizational culture that places a high value on ethical behavior; (c) make sure that leaders within the business not only articulate the rhetoric of ethical behavior but also act in a manner that is consistent with that rhetoric; (d) put decision-making processes in place that require people to consider the ethical dimension of business decisions; (e) use ethics officers; (f) have strong corporate governance procedures; and (g) be morally courageous and encourage others to be the same.

## DISCUSSION QUESTIONS

1. How prevalent has the agency problem been in corporate America during the last decade? During the late 1990s, there was a boom in initial public offerings of Internet companies (dot-com companies). The boom was supported by sky-high valuations often assigned to Internet start-ups that had no revenues or earnings. The boom came to an abrupt end in 2001 when the NASDAQ stock market collapsed, losing almost 80% of its value. Who do you think benefited most from this boom: investors (stockholders) in those companies, managers, or investment bankers?
2. Why is maximizing ROIC consistent with maximizing returns to stockholders?
3. How might a company configure its strategy-making processes to reduce the probability that managers will pursue their own self-interest at the expense of stockholders?
4. In a public corporation, should the CEO of the company also be allowed to be the chairman of the board (as allowed for by the current law)? What problems might this give rise to?
5. Under what conditions is it ethically defensible to outsource production to producers in the developing world who have much lower labor costs when such actions involve laying off long-term employees in the firm's home country?
6. Is it ethical for a firm faced with a shortage of labor to employ illegal immigrants as labor?

## PRACTICING STRATEGIC MANAGEMENT

### Small-Group Exercise: Evaluating Stakeholder Claims

Break up into groups of three to five people and appoint one group member as a spokesperson who will communicate your findings to the class. Discuss the following:

1. Identify the key stakeholders of your educational institution. What claims do they place on the institution?
2. Strategically, how is the institution responding to those claims? Do you think the institution is pursuing the correct strategies in view of those claims? What might it do differently, if anything?
3. Prioritize the stakeholders in order of their importance for the survival and health of the institution. Do the claims of different stakeholder groups conflict with each other? If claims conflict, whose should be tackled first?

### Article File 11

Find an example of a company that ran into trouble because it failed to take into account the rights of one of its stakeholder groups when making an important strategic decision.

### Strategic Management Project: Module 11

This module deals with the relationships your company has with its major stakeholder groups. With the information you have at your disposal, perform the tasks and answer the questions that follow:

1. Identify the main stakeholder groups in your company. What claims do they place on the company? How is the company trying to satisfy those claims?
2. Evaluate the performance of the CEO of your company from the perspective of (a) stockholders, (b) employees, (c) customers, and (d) suppliers. What does this evaluation tell you about the ability of the CEO and the priorities that he or she is committed to?
3. Try to establish whether the governance mechanisms that operate in your company do a good job of aligning the interests of top managers with those of stockholders.
4. Pick a major strategic decision made by your company in recent years and try to think through the ethical implications of that decision. In the light of your review, do you think that the company acted correctly?

## CLOSING CASE

### The Rise and Fall of Dennis Kozlowski

Under the leadership of Dennis Kozlowski, who became CEO of Tyco in 1990, the company's revenues expanded from \$3.1 billion to almost \$40 billion. Most of this growth was due to a series of acquisitions that took Tyco into a diverse range of unrelated businesses. Kozlowski was initially lauded in the business press as a great manager who bought undervalued assets and then enhanced their value

by imposing tight financial controls at the acquired companies. Certainly both profits and the stock price advanced at a healthy clip during much of the 1990s.

Tyco financed the acquisitions by taking on significant debt commitments, which by 2002 exceeded \$23 billion. As Tyco expanded, some questioned the company's ability to service its debt commitments.

Others claimed that management was engaging in “accounting tricks” to pad its books and make the company appear significantly more profitable than it actually was. Tyco’s defenders pointed out that its accounts were independently audited every year, and the outside accountants had detected no problems. These criticisms, which were ignored for some time, were finally shown to have some validity in 2002 when Kozlowski was forced out by the board and subsequently charged with tax evasion by federal authorities.

Among other charges, authorities claimed that Kozlowski treated Tyco as his personal treasury, drawing on company funds to purchase an expensive Manhattan apartment and a world-class art collection that he obviously thought were befitting of the CEO of a major corporation. Kozlowski even used company funds to help pay for an expensive birthday party for his wife—which included toga-clad ladies, gladiators, a naked-woman-with-exploding-breasts birthday cake and a version of Michelangelo’s *David* that peed vodka! Kozlowski was replaced by a company outsider, Edward Breen. In 2003, after a special audit requested by Breen, Tyco took a \$1.5 billion charge against earnings for accounting errors made during the Kozlowski era (i.e., Tyco’s profits had been overstated by \$1.5 billion during Kozlowski’s tenure). Breen also set about dismantling parts of the empire that Kozlowski had built, divesting several businesses.

After a lengthy criminal trial in June 2005, Dennis Kozlowski and Mark Swartz, the former

chief financial officer of Tyco, were convicted of 23 counts of grand larceny, conspiracy, securities fraud, and falsifying business records in connection with what prosecutors described as the systematic looting of millions of dollars from the conglomerate (Kozlowski was found guilty of looting \$90 million from Tyco). Both were sentenced to jail for a minimum of eight years. As for Tyco, in 2006, CEO Ed Breen announced that the company would be broken up into three parts, a testament to the strategic incoherence of the conglomerate that Kozlowski built.<sup>40</sup>

### Case Discussion Questions

1. Under the leadership of Dennis Kozlowski, Tyco grew rapidly for a decade. Why do you think Kozlowski pursued his growth through acquisition strategy? How did it benefit Tyco? How did it benefit Kozlowski?
2. What do you think leads top managers to engage in accounting manipulations to pad earnings, as apparently happened at Tyco?
3. During the period when Tyco’s profits were apparently overstated to the tune of \$1.5 billion, its accounts were audited every year by a major independent accounting firm that signed off on them. Why do you think that the accounting firm did not catch the manipulations at Tyco?
4. Why do you think Kozlowski and Swartz, both bright successful businessmen, engaged in the behavior that they did? What motivated them to take such risks? How risky do you think they thought their behavior was?



# IMPLEMENTING STRATEGY IN COMPANIES THAT COMPETE IN A SINGLE INDUSTRY

## LEARNING OBJECTIVES

After reading this chapter, you should be able to

- Understand how organizational design requires strategic managers to select the right combination of organizational structure, control, and culture
- Discuss how effective organizational design enables a company to increase product differentiation, reduce its cost structure, and build competitive advantage
- Explain why it is so important that strategic managers keep the organizational hierarchy as flat as possible and what factors determine the way they to decide to centralize or decentralize authority
- Explain the many advantages of a functional structure and why and when it becomes necessary to move to a more complex form of organizational structure
- Differentiate between the more complex forms of organizational structure managers adopt to implement specific kinds of business-level strategies

## A New Look for Liz Claiborne

Liz Claiborne, like other well-known apparel makers, embarked on a major product expansion strategy in the 1990s when it acquired many smaller-branded clothing and accessory companies and internally ventured new brands of its own.

The company's goal was to achieve greater operating efficiencies so that rising sales would also result in rising profits. By 2005, it had grown to 36 different brands, but while revenues had soared from \$2 billion to more than \$5 billion, its profits had not kept pace. In fact, profits were falling because costs were rising due to the enormous complexity and expense involved in managing so many brands. Also, in the 2000s, clothing

retailers like Walmart, Macy's, and Target were increasingly offering their own private-label brands; this put pressure on apparel makers to reduce their prices if they wished to keep selling their brands in these store chains.<sup>1</sup>

Liz Claiborne recruited a new CEO, William McComb, to turn around the troubled company. Within months, he decided to reverse course, shrink the company, and move to a new



form of organizational structure that would reduce the problems associated with managing its 36 different brands and once again allow it to grow, but this time with increasing profitability. McComb believed the company had developed a “culture of complexity” that had gotten out of control. Liz Claiborne’s core merchandising culture that had made it so successful had been lost because of its rapid growth and overly complex organizational structure.

Liz Claiborne’s former top managers had created five different apparel divisions to manage its 36 brands; brands were grouped into different divisions according to nature of the clothing or accessories they made. For example, luxury designer lines such as Ellen Tracy were grouped into one division; clothes for working women such as its signature Liz Claiborne and Dana Buchman brands were in a second division; trendy, hip clothing directed at young customers such as its Juicy Couture line were in a third division, and so on. Each division was controlled by a separate management team, and each division performed all the functional activities that marketing and design needed to support its brands. The problem was that over time it had become increasingly difficult both to differentiate between apparel brands in *each* division, as well as between the brands of *different* divisions, because fashion styles change quickly in response to changing customer tastes. Also, costs were rising because of the duplication of activities between divisions, and, as noted earlier, increasing industry competition was pressuring the company to lower prices to retail stores to protect its sales.

McComb decided to streamline and change Liz Claiborne’s organizational structure to meet the changing needs of customers and increasing competition in the retailing industry. First, he decided the company would either sell, license, or close down 16 of its 36 brands and focus on the remaining 20 brands that had the most chance of generating good future profits.<sup>2</sup> To better manage these 20 brands, he reorganized the company’s structure and reduced its five divisions to just two. This eliminated an entire level of top management. It also eliminated the duplication in marketing, distribution, and retail

functions across the original five divisions. The result was a huge drop in operating costs and a simpler organization to manage.

The two remaining divisions were now its retail division called “direct brands” and its wholesale division called “partnered brands.” Its new structure was intended to bring focus, energy, and clarity to the way each division operated. The retail division, for example, was responsible for the brands that were sold primarily through Liz Claiborne’s retail store chains, such as its Kate Spade, Lucky Brand Jeans, and Juicy Couture chains. The goal of grouping together its fastest growing brands was to allow divisional managers to make better marketing and distribution decisions to differentiate its products and attract more customers.<sup>3</sup> On the other hand, the problem in the wholesale division, which sells branded apparel lines such as Liz Claiborne and Dana Buchman directly to department stores and other retailers, is to reduce costs to slow down the growing threat from private labels. For example, sales of Macy’s private labels increased from 15% in 2005 to 18% in 2007. If managers of the wholesale division could find ways to reduce costs by turning inventory over more quickly, sharing marketing costs, and so forth, it could offer stores such as Macy’s lower prices for its clothing, encouraging them to stick with its brands and still make higher profits.

McComb realized that to reduce complexity and allow each division to build the right merchandising culture, it was necessary to change Liz Claiborne’s organizational structure. From grouping clothing brands into divisions according to their quality or price, he changed to two divisions in which clothing brands were grouped according to the needs of each division’s customers—either the people in its stores or the retail chains that buy its clothes to resell to individual customers. The real problem is that each division faces a quite different set of strategic and operational problems; with its new structure, managers in each division can focus on solving a specific set of problems to achieve the best performance from their particular brands. McComb’s hope is that the company’s sales will grow rapidly, but this time its new structure will lead to rising profitability.

## Overview

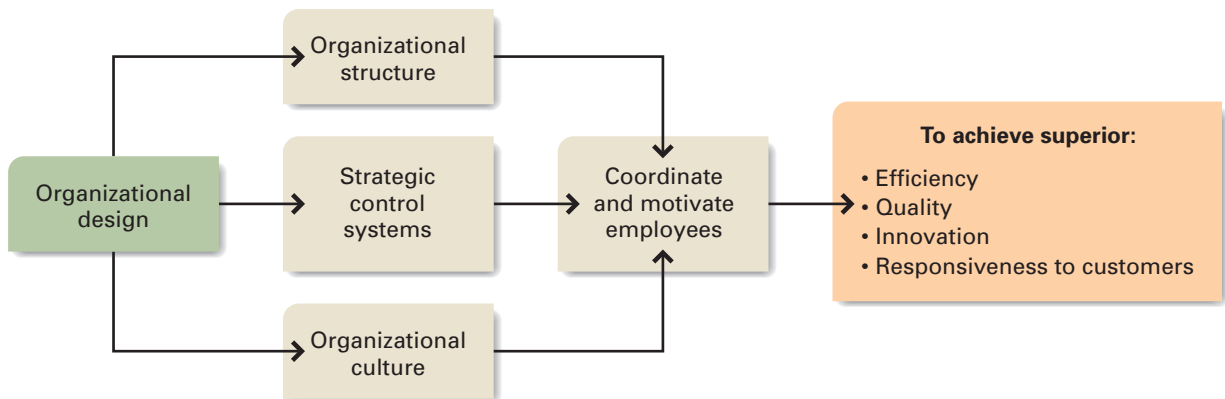
As the story of Liz Claiborne suggests, organizational structure and culture can have a direct bearing on a company's profits. This chapter examines how managers can best implement their strategies through their organization's structure and culture to achieve a competitive advantage and superior performance. A well-thought-out business model becomes profitable only if it can be implemented successfully. In practice, however, implementing strategy through structure and culture is a difficult, challenging, and never-ending task. Managers cannot just create an organizing framework for a company's value-chain activities and then assume it will keep working efficiently and effectively over time—just as they cannot select strategies and assume that these strategies will still work in a future in a changing competitive environment.

We begin by discussing the main elements of organizational design and the way they work together to create an organizing framework that allows a company to implement its strategy. We also discuss how strategic managers can use structure, control, and culture to pursue functional-level strategies that create and build distinctive competencies. The discussion then moves to the industry level and the implementation issues facing managers in a single industry. The next chapter takes up where this one leaves off and examines strategy implementation across industries and countries, that is, corporate and global strategy. By the end of this chapter and the next, you will understand why the fortunes of a company often rest on its managers' ability to design and manage its structure, control systems, and culture to best implement its business model.

## IMPLEMENTING STRATEGY THROUGH ORGANIZATIONAL DESIGN

Strategy implementation involves the use of **organizational design**, the process of deciding how a company should create, use, and combine organizational structure, control systems, and culture to pursue a business model successfully. **Organizational structure** assigns employees to specific value creation tasks and roles and specifies how these tasks and roles are to be linked together in a way that increases efficiency, quality, innovation, and responsiveness to customers—the distinctive competencies that build competitive advantage. The purpose of organizational structure is to *coordinate and integrate* the efforts of employees at all levels—corporate, business, and functional—and across a company's functions and business units so that they work together in a way that will allow it to achieve the specific set of strategies in its business model.

Organizational structure does not, by itself, provide the set of incentives through which people can be *motivated* to make it work. Hence, there is a need for control systems. The purpose of a **control system** is to provide managers with (1) a set of incentives to motivate employees to work toward increasing efficiency, quality, innovation, and responsiveness to customers and (2) specific feedback on how well an organization and its members are performing and building competitive advantage so that managers can continuously take action to strengthen a company's business model. Structure provides an organization with a skeleton; control gives it the muscles, sinews, nerves, and sensations that allow managers to regulate and govern its activities.

**Figure 12.1** Implementing Strategy Through Organizational Design

**Organizational culture**, the third element of organizational design, is the specific collection of values, norms, beliefs, and attitudes that are shared by people and groups in an organization and that control the way they interact with each other and with stakeholders outside the organization.<sup>4</sup> Organizational culture is a company's way of doing something: it describes the characteristic ways—"this is the way we do it around here"—in which members of an organization get the job done. Top managers, because they can influence which kinds of beliefs and values develop in an organization, are an important determinant of how organizational members will work toward achieving organizational goals, as we discuss later.<sup>5</sup>

Figure 12.1 sums up the discussion so far. Organizational structure, control, and culture are the means by which an organization motivates and coordinates its members to work toward achieving the building blocks of competitive advantage.

Top managers who wish to find out why it takes a long time for people to make decisions in a company, why there is a lack of cooperation between sales and manufacturing, or why product innovations are few and far between need to understand how the design of a company's structure and control system, and the values and norms in its culture, affect employee motivation and behavior. *Organizational structure, control, and culture shape people's behaviors, values, and attitudes and determine how they will implement an organization's business model and strategies.*<sup>6</sup> On the basis of such an analysis, top managers can devise a plan to reorganize or change their company's structure, control systems, and culture to improve coordination and motivation. Effective organizational design allows a company to obtain a competitive advantage and achieve above-average profitability.

## BUILDING BLOCKS OF ORGANIZATIONAL STRUCTURE

After formulating a company's business model and strategies, managers must make designing an organizational structure their next priority. The value creation activities of organizational members are meaningless unless some type of structure is used to



assign people to tasks and connect the activities of different people and functions.<sup>7</sup> Managers must make three basic choices:

1. How best to group tasks into functions and to group functions into business units or divisions to create distinctive competencies and pursue a particular strategy
2. How to allocate authority and responsibility to these functions and divisions
3. How to increase the level of coordination or integration between functions and divisions as a structure evolves and becomes more complex

We first discuss basic issues and then revisit them when considering appropriate choices of structure at different levels of strategy.

## Grouping Tasks, Functions, and Divisions

Because an organization's tasks are, to a large degree, a function of its strategy, the dominant view is that companies choose a form of structure to match their organizational strategy. Perhaps the first person to address this issue formally was the Harvard business historian Alfred D. Chandler.<sup>8</sup> After studying the organizational problems experienced in large United States corporations such as DuPont and GM as they grew in the early decades of the 20th century, Chandler reached two conclusions: (1) in principle, organizational structure follows the range and variety of tasks that the organization chooses to pursue; and (2) structures of United States companies' structures change as their strategy changes in a predictable way over time.<sup>9</sup> In general, this means that most companies first group people and tasks into functions and then functions into divisions.<sup>10</sup>

As we discussed earlier, a *function* is a collection of people who work together and perform the same types of tasks or hold similar positions in an organization.<sup>11</sup> For example, the salespeople in a car dealership belong to the sales function. Together, car sales, car repair, car parts, and accounting are the set of functions that allow a car dealership to sell and maintain cars.

As organizations grow and produce a wider range of products, the amount and complexity of the *handoffs*, that is, the work exchanges or transfers among people, functions, and subunits, increase. The communications and measurement problems and the managerial inefficiencies surrounding these transfers or handoffs are a major source of *bureaucratic costs*, which we discussed in Chapter 10. Recall that these are the costs associated with monitoring and managing the functional exchanges necessary to add value to a product as it flows along a company's value chain to the final customer.<sup>12</sup> We discuss why bureaucratic costs increase as companies pursue more complex strategies later in the chapter.

For now, it is important to note that managers group tasks into functions and then group functions into a business unit or division to reduce bureaucratic costs. For example, as Liz Claiborne started to produce an increasing number of clothing brands, it created five separate divisions, each with its own marketing, sales, and accounting functions. A *division* is a way of grouping functions to allow an organization to better produce and transfer its goods and services to customers. In developing an organizational structure, managers must decide how to group an organization's activities by function and division in a way that achieves organizational goals effectively.<sup>13</sup>

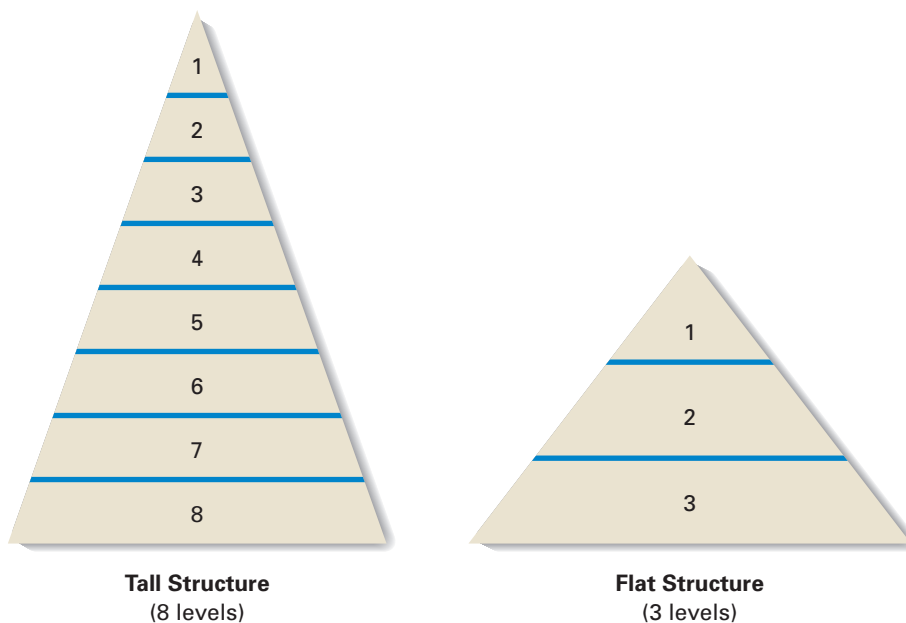
Top managers can choose from among many kinds of structures to group their activities. The choice is made on the basis of the structure's ability to implement the company's business models and strategies successfully.

## Allocating Authority and Responsibility

As organizations grow and produce a wider range of goods and services, the size and number of their functions and divisions increase. The number of handoffs or transfers between employees also increases. To economize on bureaucratic costs and effectively coordinate the activities of people, functions, and divisions, managers must develop a clear and unambiguous **hierarchy of authority**, or chain of command, that defines each manager's relative authority, from the CEO down through the middle managers and first-line managers, to the nonmanagerial employees who actually make goods or provide services.<sup>14</sup> Every manager, at every level of the hierarchy, supervises one or more subordinates. The term **span of control** refers to the number of subordinates who report directly to a manager. When managers know exactly what their authority and responsibilities are, information distortion problems that promote managerial inefficiencies are kept to a minimum, and handoffs or transfers can be negotiated and monitored to economize on bureaucratic costs. For example, managers are less likely to risk invading another manager's turf and thus can avoid the costly fights and conflicts that inevitably result from such encroachments.

**Tall and Flat Organizations** Companies choose the number of hierarchical levels they need on the basis of their strategy and the functional tasks necessary to create distinctive competencies.<sup>15</sup> As an organization grows in size or complexity (measured by the number of its employees, functions, and divisions), its hierarchy of authority normally lengthens, making the organizational structure taller. A **tall structure** has many levels of authority relative to company size; a **flat structure** has fewer levels relative to company size (see Figure 12.2). As the hierarchy becomes taller, problems that make the organization's structure less flexible and slow managers' response to

**Figure 12.2** Tall and Flat Structures





changes in the competitive environment may result. It is vital that managers understand how these problems arise so they know how to change a company's structure to respond to them.

First, communication problems may arise. When an organization has many levels in the hierarchy, it can take a long time for the decisions and orders of top managers to reach managers farther down in the hierarchy, and it can take a long time for top managers to learn how well their decisions worked out. Feeling out of touch, top managers may want to verify that lower-level managers are following orders and may require written confirmation from them. Lower-level managers, who know they will be held strictly accountable for their actions, start devoting more time to the process of making decisions to improve their chances of being right. They might even try to avoid responsibility by making top managers decide what actions to take.

A second communication problem that can result is the distortion of commands and orders as they are transmitted up and down the hierarchy, which causes managers at different levels to interpret what is happening differently. Accidental distortion of orders and messages occurs when different managers interpret messages from their own narrow functional perspectives. Intentional distortion can occur because managers lower in the hierarchy decide to interpret information to increase their own personal advantage.

A third problem with tall hierarchies is that they usually indicate that an organization is employing too many managers, and managers are expensive. Managerial salaries, benefits, offices, and secretaries are a huge expense for organizations. Large companies such as IBM, GM, and Dell pay their managers billions of dollars a year. In the recent recession, millions of middle and lower managers were laid off as companies strived to survive by reorganizing and simplifying their structures and downsizing their workforce to reduce their cost structure.

**The Minimum Chain of Command** To ward off the problems that result when an organization becomes too tall and employs too many managers, top managers need to ascertain whether they are employing the right number of top, middle, and first-line managers and see whether they can redesign their hierarchies to reduce the number of managers. Top managers might well follow a basic organizing principle: the **principle of the minimum chain of command**, which states that a company should choose the hierarchy with the *fewest* levels of authority necessary to use organizational resources efficiently and effectively.

Effective managers constantly scrutinize their hierarchies to see whether the number of levels can be reduced—for example, by eliminating one level and giving the responsibilities of managers at that level to managers above and empowering employees below. This practice has become increasingly common as companies battle with low-cost overseas competitors and search for ways to reduce costs. One manager who is constantly trying to empower employees and keep the hierarchy flat is Colleen C. Barrett, the number-two executive of Southwest.<sup>16</sup> Barrett, the highest-ranking woman in the airline industry, is well known for continually reaffirming Southwest's message that employees should feel free to go above and beyond their prescribed roles to provide better customer service. Her central message is that Southwest values and trusts its employees, who are empowered to take responsibility. Southwest employees are encouraged not to look to their superiors for guidance but rather to take responsibility to find ways to do the job better themselves. As a result, Southwest keeps the number of its middle managers to a minimum.

When companies become too tall and the chain of command too long, strategic managers tend to lose control over the hierarchy, which means they lose control over their strategies. Disaster often follows because a tall organizational structure decreases, rather than promotes, motivation and coordination between employees and functions, and bureaucratic costs escalate as a result. Strategy in Action 12.1 discusses how this happened at Walt Disney.

**Centralization or Decentralization?** One important way to reduce the problems associated with too-tall hierarchies and reduce bureaucratic costs is to *decentralize authority*—that is, vest authority in managers at lower levels in the hierarchy as well as at the top. Authority is *centralized* when managers at the upper levels of a company's hierarchy retain the authority to make the most important decisions. When authority is decentralized, it is delegated to divisions, functions, and employees at lower levels in the company. Delegating authority in this fashion reduces bureaucratic costs because it avoids the communication and coordination problems that arise when information has to be constantly sent up the hierarchy, sometimes to the top of the organization, for decisions to be made and then back down again. There are three advantages to decentralization.

First, when top managers delegate operational decision-making responsibility to middle- and first-level managers, they reduce information overload and so are able to spend more time on positioning the company competitively and strengthening

## 12.1 STRATEGY IN ACTION

### Bob Iger Flattens Disney

In 2006, Bob Iger, who had been COO of Disney under its then-CEO Michael Eisner, took control of the troubled company. For several years, Disney had been plagued by slow decision making, and analysts claimed it had made many mistakes in putting its new strategies into action. Its Disney stores were losing money; its Internet properties were not getting many "hits," and even its theme parks seemed to have lost their luster as few new rides or attractions had been introduced.

Iger believed that one of the main reasons for Disney's declining performance was that it had become too tall and bureaucratic and its top managers were following financial rules that did not lead to innovative strategies. So, one of Iger's first moves to turn around the performance of the poorly performing company was to dismantle Disney's central strategic planning office. In this office, several levels of managers were responsible for

sifting through all the new ideas and innovations sent up by Disney's different business divisions, such as theme parks, movies, gaming, and then deciding which ones to present to the CEO. Iger saw the strategic planning office as a bureaucratic bottleneck that actually reduced the number of ideas coming from below. So he dissolved the office and reassigned its managers back to the different business units.

The result of cutting out an unnecessary layer in Disney's hierarchy has been that more new ideas are being generated by its different business units. The level of innovation has increased because managers are more willing to speak out and champion their ideas when they know they are dealing directly with the CEO and a top management team searching for innovative new ways to improve performance rather than a layer of strategic planning "bureaucrats" only concerned for the bottom line.

**Sources:** J. McGregor, "The World's Most Innovative Companies," [http://www.businessweek.com/innovate/content/May2007/id20070504\\_051674.htm](http://www.businessweek.com/innovate/content/May2007/id20070504_051674.htm), May 4, 2007; R. Nakashima, "Iger: Disney to Reap \$1 Billion Online," <http://www.sfgate.com/cgi-bin/article.cgi?f=/n/a/2008/03/10/financial/f165821D16.DTL&type=tech>, March 11, 2008.

its business model. Second, when managers in the bottom layers of the company become responsible for implementing strategies to suit local conditions, their motivation and accountability increase. The result is that decentralization promotes flexibility and reduces bureaucratic costs because lower-level managers are authorized to make on-the-spot decisions; handoffs are not needed. The third advantage is that when lower-level employees are given the right to make important decisions, fewer managers are needed to oversee their activities and tell them what to do—a company can flatten its hierarchy.

If decentralization is so effective, why don't all companies decentralize decision making and avoid the problems of tall hierarchies? The answer is that centralization has its advantages, too. Centralized decision making allows for easier coordination of the organizational activities needed to pursue a company's strategy. If managers at all levels can make their own decisions, overall planning becomes extremely difficult, and the company may lose control of its decision making.

Centralization also means that decisions fit broad organization objectives. When its branch operations were getting out of hand, for example, Merrill Lynch increased centralization by installing more information systems to give corporate managers greater control over branch activities. Similarly, HP centralized R&D responsibility at the corporate level to provide a more directed corporate strategy. Furthermore, in times of crisis, centralization of authority permits strong leadership because authority is focused on one person or group. This focus allows for speedy decision making and a concerted response by the whole organization. How to choose the right level of centralization for a particular strategy is discussed later. Strategy in Action 12.2, however, discusses one company that benefits from centralizing authority and one company that benefits from decentralizing authority.

## Integration and Integrating Mechanisms

Much coordination takes place among people, functions, and divisions through the hierarchy of authority. Often, however, as a structure becomes complex, this is not enough, and top managers need to use various **integrating mechanisms** to increase communication and coordination among functions and divisions. The greater the complexity of an organization's structure, the greater is the need for coordination among people, functions, and divisions to make the organizational structure work efficiently.<sup>17</sup> We discuss three kinds of integrating mechanisms that illustrate the kinds of issues involved.<sup>18</sup> Once again, these mechanisms are employed to economize on the information distortion problems that commonly arise when managing the handoffs or transfers among the ideas and activities of different people, functions, and divisions.

**Direct Contact** Direct contact among managers creates a context within which managers from different functions or divisions can work together to solve mutual problems. However, several problems are associated with establishing this contact. Managers from different functions may have different views about what must be done to achieve organizational goals. But if the managers have equal authority (as functional managers typically do), the only manager who can tell them what to do is the CEO. If functional managers cannot reach agreement, no mechanism exists to resolve the conflict apart from the authority of the boss. In fact, one sign of a poorly performing organizational structure is the number of problems sent up the hierarchy for top managers to solve. The need to solve everyday conflicts and handoff or transfer problems raises bureaucratic costs. To reduce such conflicts and solve transfer

## 12.2 STRATEGY IN ACTION

### To Centralize or Decentralize? That Is the Question

Union Pacific (UP), one of the biggest rail freight carriers in the United States, was experiencing a crisis in the 1990s. An economic boom had led to a record increase in the amount of freight the railroad had to transport—but, at the same time, the railroad was experiencing record delays in moving the freight. UP's customers were irate and complaining bitterly about the problem, and the delays were costing the company millions of dollars in penalty payments. The problem stemmed from UP's decision to centralize authority high in the organization to cut costs. All scheduling and route planning were handled centrally at its headquarters to promote operating efficiency. The job of regional managers was largely to ensure the smooth flow of freight through their regions. Now, recognizing that efficiency had to be balanced by the need to be responsive to customers, UP's CEO Dick Davidson announced a sweeping reorganization. In the future, regional, not top managers, would have the authority to make operational decisions; they could alter scheduling and routing to accommodate customer requests even if it raised costs. The goal of the organization was to "return to excellent performance by simplifying our processes and becoming easier to deal with." In deciding to decentralize authority, UP was following the lead of its competitors who had already decentralized their operations; its managers, would continue to "decentralize decision making into the field, while fostering improved customer responsiveness, operational excellence, and personal accountability."

Yahoo!, on the other hand, has been forced by circumstances to pursue a different approach to decentralization. In 2009, after the failed merger between Yahoo! and Microsoft, the company's stock price plunged.

Jerry Wang, one of the company's founders, who had come under intense criticism for preventing the merger, resigned as CEO and was replaced by Carol Bartz. Bartz, with a long history of success in managing online companies, had to move quickly to find ways to reduce Yahoo!'s cost structure and simplify its operations to maintain its strong online brand identity. Intense competition from the growing popularity of new online companies such as Facebook, Twitter, and established companies such as Google and Microsoft were threatening its popularity.

Bartz decided the best way to rebuild Yahoo!'s business model was to recentralize authority. To both gain more control over its different business units and reduce operating costs, she decided to centralize functions that had been previously performed by Yahoo!'s different business units, such as product development and marketing activities. For example, all the company's publishing and advertising functions were centralized and put under the control of Hilary Schneider. The control over Yahoo!'s European, Asian, and emerging markets divisions was centralized and another top Yahoo! executive took control. Her goal was to find out how she could make the company work better. While she was centralizing authority, she was also holding many "town hall" meetings. Bartz was asking Yahoo!'s employees, across all departments, "What would you do if you were me?" Even as she centralized authority to help Yahoo! recover its dominant industry position, she was looking for the input of employees at any level in the hierarchy. Once Yahoo! has regained its competitive advantage, she will likely decentralize authority to increase Yahoo!'s profitability, given her general managerial competences.

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**Source:** <http://www.unionpacific.com>, 2009.

problems, top managers use more complex integrating mechanisms to increase coordination among functions and divisions.

**Liaison Roles** Managers can increase coordination among functions and divisions by establishing liaison roles. When the volume of contacts between two functions increases, one way to improve coordination is to give one manager in each function or division the responsibility for coordinating with the other. These managers may meet daily, weekly, monthly, or as needed to solve handoff issues and transfer problems. The responsibility for coordination is part of the liaison's full-time job, and

usually an informal relationship forms between the people involved, greatly easing strains between functions. Furthermore, liaison roles provide a way of transmitting information across an organization, which is important in large organizations where employees may know no one outside their immediate function or division.

**Teams** When more than two functions or divisions share many common problems, direct contact and liaison roles may not provide sufficient coordination. In these cases, a more complex integrating mechanism, the **team**, may be appropriate. One manager from each relevant function or division is assigned to a team that meets to solve a specific mutual problem; team members are responsible for reporting back to their subunits on the issues addressed and the solutions recommended. Teams are increasingly being used at all organizational levels.

## STRATEGIC CONTROL SYSTEMS

Strategic managers choose the organizational strategies and structure they hope will allow the organization to use its resources most effectively to pursue its business model and create value and profit. Then they create **strategic control systems**, tools that allow them to monitor and evaluate whether, in fact, their strategy and structure are working as intended, how they could be improved, and how they should be changed if they are not working.

Strategic control is not just about monitoring how well an organization and its members are performing currently or about how well the firm is using its existing resources. It is also about how to create the incentives to keep employees motivated and focused on the important problems that may confront an organization in the future so that they work together to find solutions that can help an organization perform better over time.<sup>19</sup> To understand the vital importance of strategic control, consider how it helps managers obtain superior efficiency, quality, innovation, and responsiveness to customers—the four basic building blocks of competitive advantage:

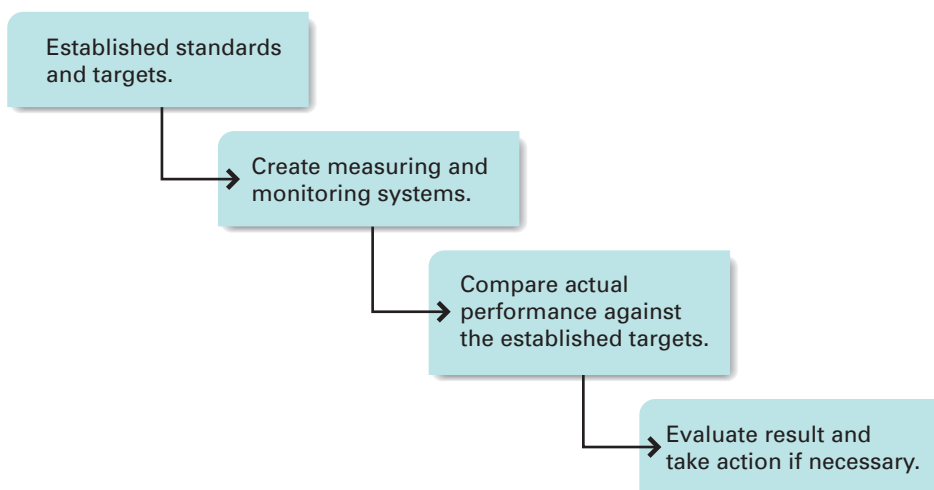
1. *Control and efficiency.* To determine how *efficiently* they are using organizational resources, managers must be able to measure accurately how many units of inputs (raw materials, human resources, and so on) are being used to produce a unit of output. They must also be able to measure the number of units of outputs (goods and services) they produce. A control system contains the measures or yardsticks that allow managers to assess how efficiently they are producing goods and services. Moreover, if managers experiment to find a more efficient way to produce goods and services, these measures tell managers how successful they have been. Without a control system in place, managers have no idea how well their organizations are performing and how they can make it perform better, something that is becoming increasingly important in today's highly competitive environment.<sup>20</sup>
2. *Control and quality.* Today, competition often revolves around increasing the *quality* of goods and services. In the car industry, for example, within each price range, cars compete against one another in terms of their features, design, and reliability. So whether a customer buys a Ford 500, a GM Impala, a Chrysler 300, a Toyota Camry, or a Honda Accord depends significantly on the quality of each company's product. Strategic control is important in determining the quality of goods and services because it gives managers feedback on product quality. If managers consistently measure the number of customers' complaints

and the number of new cars returned for repairs, they have a good indication of how much quality they have built into their product.

3. *Control and innovation.* Strategic control can help to raise the level of *innovation* in an organization. Successful innovation takes place when managers create an organizational setting in which employees feel empowered to be creative and in which authority is decentralized to employees so that they feel free to experiment and take risks, such as at Apple, 3M, and Nvidia. Deciding on the appropriate control systems to encourage risk taking is an important management challenge. As discussed later in the chapter, an organization's culture becomes important in this regard.
4. *Control and responsiveness to customers.* Finally, strategic managers can help make their organizations more *responsive to customers* if they develop a control system that allows them to evaluate how well employees with customer contact are performing their jobs. Monitoring employees' behavior can help managers find ways to help increase employees' performance level, perhaps by revealing areas in which skills training can help employees or by finding new procedures that allow employees to perform their jobs better. When employees know their behaviors are being monitored, they may have more incentive to be helpful and consistent in the way they act toward customers.

**Strategic control systems** are the formal target-setting, measurement, and feedback systems that allow strategic managers to evaluate whether a company is achieving superior efficiency, quality, innovation, and customer responsiveness and implementing its strategy successfully. An effective control system should have three characteristics. It should be *flexible* enough to allow managers to respond as necessary to unexpected events; it should provide *accurate information*, thus giving a true picture of organizational performance; and it should supply managers with the information in a *timely manner* because making decisions on the basis of outdated information is a recipe for failure.<sup>21</sup> As Figure 12.3 shows, designing an effective strategic control system requires four steps: establishing standards and targets, creating measuring and monitoring systems, comparing performance against targets, and evaluating the result.

**Figure 12.3** Steps in Designing an Effective Strategic Control System





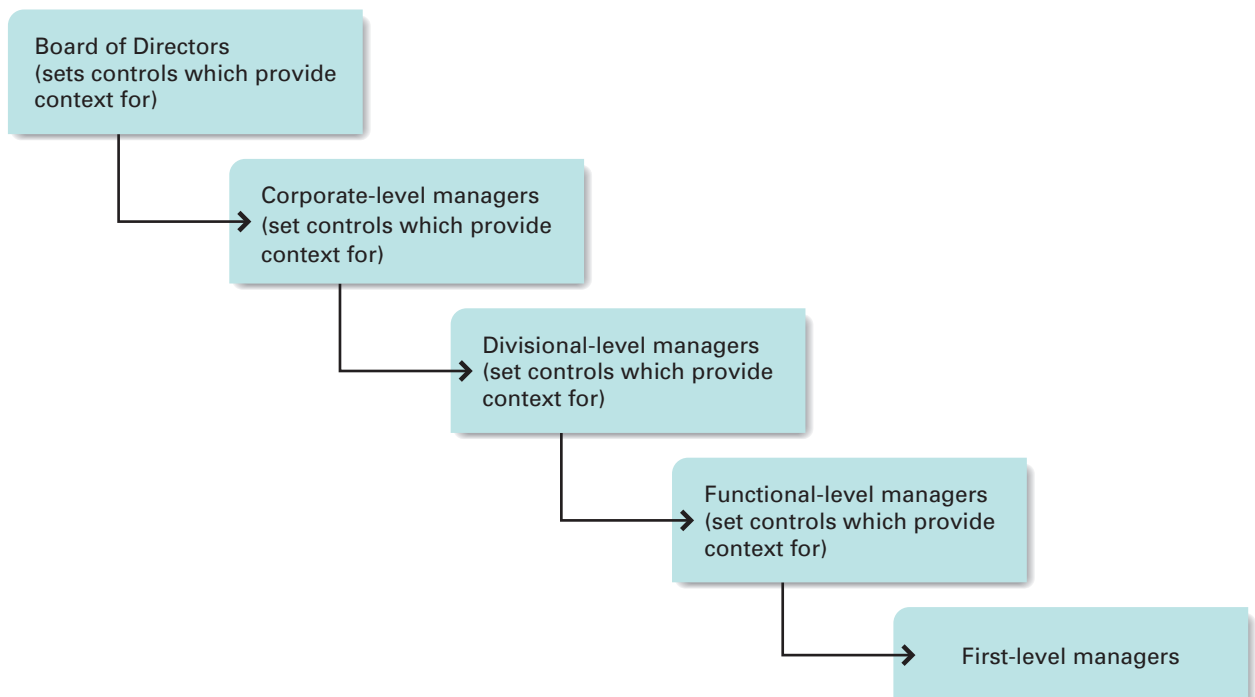
## Levels of Strategic Control

Strategic control systems are developed to measure performance at four levels in a company: corporate, divisional, functional, and individual. Managers at all levels must develop the most appropriate set of measures to evaluate corporate-, business-, and functional-level performance. As the balanced scorecard approach discussed in Chapter 11 suggests, these measures should be tied as closely as possible to the goals of developing distinctive competencies in efficiency, quality, innovativeness, and responsiveness to customers. Care must be taken, however, to ensure that the standards used at each level do not cause problems at the other levels—for example, that a division's attempts to improve its performance do not conflict with corporate performance. Furthermore, controls at each level should provide the basis on which managers at lower levels design their control systems. Figure 12.4 illustrates these links.

## Types of Strategic Control Systems

In Chapter 11, the balanced scorecard approach was discussed as a way to ensure that managers complement the use of ROIC with other kinds of strategic controls to ensure they are pursuing strategies that maximize long-run profitability. In this chapter, we consider three more types of control systems: *personal control*, *output control*, and *behavior control*.

**Figure 12.4** Levels of Organizational Control



**Personal Control** Personal control is the desire to shape and influence the behavior of a person in a *face-to-face interaction* in the pursuit of a company's goals. The most obvious kind of personal control is direct supervision from a manager farther up in the hierarchy. The personal approach is useful because managers can question and probe subordinates about problems or new issues they are facing to get a better understanding of the situation, as well as to ensure that subordinates are performing their work effectively and not hiding any information that could cause problems down the line. Personal control also can come from a group of peers, such as when people work in teams. Once again, personal control at the group level means that there is more possibility for learning to occur and competencies to develop, as well as greater opportunities to prevent free-riding or shirking.

**Output Control** Output control is a system in which strategic managers estimate or forecast appropriate performance goals for each division, department, and employee and then measure actual performance relative to these goals. Often a company's reward system is linked to performance on these goals, so output control also provides an incentive structure for motivating employees at all levels in the organization. Goals keep managers informed about how well their strategies are creating a competitive advantage and building the distinctive competencies that lead to future success. Goals exist at all levels in an organization.

Divisional goals state corporate managers' expectations for each division concerning performance on dimensions such as efficiency, quality, innovation, and responsiveness to customers. Generally, corporate managers set challenging divisional goals to encourage divisional managers to create more effective strategies and structures in the future. At Liz Claiborne, for example, each division is given clear performance goals to achieve, and divisional managers are given considerable autonomy to formulate a strategy to meet these goals.

Output control at the functional and individual levels is a continuation of control at the divisional level. Divisional managers set goals for functional managers that will allow the division to achieve its goals. As at the divisional level, functional goals are established to encourage the development of generic competencies that provide the company with a competitive advantage, and functional performance is evaluated by how well a function develops a competency. In the sales function, for example, goals related to efficiency (such as cost of sales), quality (such as number of returns), and customer responsiveness (such as the time needed to respond to customer needs) can be established for the whole function.

Finally, functional managers establish goals that individual employees are expected to achieve to allow the function to achieve its goals. Sales personnel, for example, can be given specific goals (related to functional goals) that they are required to achieve. Functions and individuals are then evaluated on the basis of achieving or not achieving their goals; in sales, compensation is commonly pegged to achievement. The achievement of these goals is a sign that the company's strategy is working and meeting organizational objectives.

The inappropriate use of output control can promote conflict among divisions. In general, setting across-the-board output targets, such as ROIC targets for divisions, can lead to destructive results if divisions single-mindedly try to maximize divisional ROIC at the expense of corporate ROIC. Moreover, to reach output targets, divisions may start to distort the numbers and engage in strategic manipulation of the figures to make their divisions look good—which increases bureaucratic costs.<sup>22</sup>

**Behavior Control** Behavior control is control through the establishment of a comprehensive system of rules and procedures to direct the actions or behavior of divisions, functions, and individuals.<sup>23</sup> The intent of behavior controls is not to specify the *goals* but to standardize the *way or means* of reaching them. Rules standardize behavior and make outcomes predictable. If employees follow the rules, then actions are performed and decisions are handled the same way time and time again. The result is predictability and accuracy, the aim of all control systems. The main kinds of behavior controls are operating budgets, standardization, and rules and procedures.

Once managers at each level have been given a goal to achieve, they establish operating budgets that regulate how managers and workers are to attain those goals. An **operating budget** is a blueprint that states how managers intend to use organizational resources to most efficiently achieve organizational goals. Most commonly, managers at one level allocate to managers at a lower level a specific amount of resources to use in the production of goods and services. Once they have been given a budget, lower-level managers must decide how they will allocate certain amounts of money for different organizational activities. They are then evaluated on the basis of their ability to stay inside the budget and make the best use of it. For example, managers at GE's washing machine division might have a budget of \$50 million to develop and sell a new line of washing machines; they have to decide how much money to allocate to R&D, engineering, sales, and so on, so that the division generates the most revenue and hence makes the biggest profit. Most commonly, large companies treat each division as a stand-alone profit center, and corporate managers evaluate each division's performance by its relative contribution to corporate profitability, something discussed in detail in the next chapter.

**Standardization** refers to the degree to which a company specifies how decisions are to be made so that employees' behavior becomes predictable.<sup>24</sup> In practice, there are three things an organization can standardize: *inputs*, *conversion activities*, and *outputs*.

When managers standardize, they screen *inputs* according to preestablished criteria, or standards that determine which inputs to allow into the organization. If employees are the input in question, for example, then one way of standardizing them is to specify which qualities and skills they must possess and then select only applicants who possess them. If the inputs in question are raw materials or component parts, the same considerations apply. The Japanese are renowned for the high quality and precise tolerances they demand from component parts to minimize problems with the product at the manufacturing stage. JIT inventory systems also help standardize the flow of inputs.

The aim of standardizing *conversion activities* is to program work activities so that they are done the same way time and time again. The goal is predictability. Behavior controls, such as rules and procedures, are among the chief means by which companies can standardize throughputs. Fast-food restaurants such as McDonald's and Burger King standardize all aspects of their restaurant operations; the result is consistent fast food.

The goal of standardizing *outputs* is to specify what the performance characteristics of the final product or service should be—the dimensions or tolerances the product should conform to, for example. To ensure that their products are standardized, companies apply quality control and use various criteria to measure this standardization. One criterion might be the number of goods returned from customers or the number of customers' complaints. On production lines, periodic sampling of products can indicate whether they are meeting performance characteristics.

As with other kinds of controls, the use of behavior control is accompanied by potential pitfalls that must be managed if the organization is to avoid strategic problems. Top management must be careful to monitor and evaluate the usefulness of behavior controls over time. Rules constrain people and lead to standardized, predictable behavior. However, rules are always easier to establish than to get rid of, and over time the number of rules an organization uses tends to increase. As new developments lead to additional rules, often the old rules are not discarded, and the company becomes overly bureaucratized. Consequently, the organization and the people in it become inflexible and are slow to react to changing or unusual circumstances. Such inflexibility can reduce a company's competitive advantage by lowering the pace of innovation and reducing its responsiveness to customers.

### Using Information Technology

Information technology is playing an increasing role in strategy implementation at all organizational levels. In fact, it is making it much easier for organizations to cost-effectively develop output and behavior controls that give strategic managers much more and much better information to monitor the many aspects of their strategies and respond appropriately. IT, which provides a way of standardizing behavior through the use of a consistent, often cross-functional software platform, is a form of behavior control. IT is also a form of output control; when all employees or functions use the same software platform to provide up-to-date information on their activities, it codifies and standardizes organizational knowledge and makes it easier to monitor progress toward strategic objectives. IT is also a kind of integrating mechanism; it provides people at all levels in the hierarchy and across all functions with more of the information and knowledge they need to perform their roles effectively. For example, today functional-level employees are able to access information easily from other functions using cross-functional software systems that keep them all informed about changes in product design, engineering, manufacturing schedules, and marketing plans having an impact on their activities. In this sense, IT overlays the structure of tasks and roles that is normally regarded as the “real” organizational structure.

As an example of how IT can help a company change quickly to respond to changing industry conditions, consider the fast-moving semiconductor business organization in which Cypress Semiconductor CEO T. J. Rodgers was facing a problem. How could he exert effective control over his 2,000 employees without developing a bureaucratic management hierarchy? Rodgers believes that a tall hierarchy hinders the ability of an organization to adapt to changing conditions. He is committed to maintaining a flat and decentralized organizational structure with a minimum of management layers. At the same time, he wants to control his employees to ensure that they performed in a manner consistent with company goals. The solution Rodgers adopted was to implement an IT information system that allows him to monitor what every employee and team is doing in his decentralized organization. Each employee maintains a list of 10 to 15 goals, such as “Meet with marketing for new product launch” or “Make sure to check with customer X.” Also noted is when each goal is agreed on, its progress, and when it is completed. Rodgers can use IT to review the goals of all employees in hours, and he does so each week. He can achieve this because he “manages by exception.” He looks only for employees who seem to be falling behind and then he contacts them, not to scold, but to ask if there is anything he can do to help them get their jobs done. His control system allows Rodgers

to exercise control over his organization without resorting to the expensive layers of a management hierarchy.<sup>25</sup>

## Strategic Reward Systems

Organizations strive to control employees' behavior by linking reward systems to their control systems.<sup>26</sup> Based on a company's strategy (cost leadership or differentiation, for example), strategic managers must decide which behaviors to reward. They then create a control system to measure these behaviors and link the reward structure to them. Determining how to relate rewards to performance is a crucial strategic decision because it determines the incentive structure that affects the way managers and employees behave at all levels in the organization. As Chapter 11 pointed out, top managers can be encouraged to work in shareholders' interests by being rewarded with stock options linked to a company's long-term performance. Companies such as Kodak and GM require managers to buy company stock. When managers become shareholders, they are more motivated to pursue long-term rather than short-term goals. Similarly, in designing a pay system for salespeople, the choice is whether to motivate them through straight salary or salary plus a bonus based on how much they sell. Neiman Marcus, the luxury retailer, pays employees a straight salary because it wants to encourage high-quality service and discourage a hard-sell approach. Thus, there are no incentives based on quantity sold. On the other hand, the pay system for rewarding car salespeople encourages high-pressure selling; it typically contains a large bonus based on the number and price of cars sold.

## ORGANIZATIONAL CULTURE

The third element that goes into successful strategy implementation is managing *organizational culture*, the specific collection of values and norms shared by people and groups in an organization.<sup>27</sup> Organizational values are beliefs and ideas about what kinds of goals the members of an organization should pursue and about the appropriate kinds or standards of behavior organizational members should use to achieve these goals. Bill Gates is famous for the set of organizational values that he created for Microsoft: entrepreneurship, ownership, creativity, honesty, frankness, and open communication. By stressing entrepreneurship and ownership, he strives to get his employees to feel that Microsoft is not one big bureaucracy but a collection of smaller and very adaptive companies run by the members. Gates emphasizes that lower-level managers should be given autonomy and encouraged to take risks—to act like entrepreneurs, not corporate bureaucrats.<sup>28</sup>

From organizational values develop organizational norms, guidelines, or expectations that prescribe appropriate kinds of behavior by employees in particular situations and control the behavior of organizational members toward one another. The norms of behavior for software programmers at Microsoft include working long hours and weekends, wearing whatever clothing is comfortable (but never a suit and tie), consuming junk food, and communicating with other employees by e-mail and the company's state-of-the-art intranet.

Organizational culture functions as a kind of control because strategic managers can influence the kind of values and norms that develop in an organization—values and norms that specify appropriate and inappropriate behaviors and that shape and

influence the way its members behave.<sup>29</sup> Strategic managers such as Gates deliberately cultivate values that tell their subordinates how they should perform their roles; at Microsoft and Nokia, innovation and creativity are stressed. These companies establish and support norms that tell employees they should be innovative and entrepreneurial and should experiment even if there is a significant chance of failure.

Other managers might cultivate values that tell employees they should always be conservative and cautious in their dealings with others, consult with their superiors before they make important decisions, and record their actions in writing so they can be held accountable for what happens. Managers of organizations such as chemical and oil companies, financial institutions, and insurance companies—any organization in which great caution is needed—may encourage a conservative, vigilant approach to making decisions.<sup>30</sup> In a bank or mutual fund, for example, the risk of losing investors' money makes a cautious approach to investing highly appropriate. Thus, we might expect that managers of different kinds of organizations will deliberately try to cultivate and develop the organizational values and norms that are best suited to their strategy and structure.

*Organizational socialization* is the term used to describe how people learn organizational culture. Through socialization, people internalize and learn the norms and values of the culture so that they become organizational members.<sup>31</sup> Control through culture is so powerful that once these values have been internalized, they become part of the individual's values, and the individual follows organizational values without thinking about them.<sup>32</sup> Often the values and norms of an organization's culture are transmitted to its members through the stories, myths, and language that people in the organization use, as well as by other means.

## Culture and Strategic Leadership

Organizational culture is created by the strategic leadership provided by an organization's founder and top managers. The organization's founder is particularly important in determining culture because the founder imprints his or her values and management style on the organization. Walt Disney's conservative influence on the company he established continued well after his death. Managers were afraid to experiment with new forms of entertainment because they were afraid "Walt Disney wouldn't like it." It took the installation of a new management team under Michael Eisner to turn around the company's fortunes and allow it to deal with the realities of the new entertainment industry.

The leadership style established by the founder is transmitted to the company's managers; as the company grows, it typically attracts new managers and employees who share the same values. Moreover, members of the organization typically recruit and select only those who share their values. Thus, a company's culture becomes more and more distinct as its members become more similar. The virtue of these shared values and common culture is that they *increase integration and improve coordination among organizational members*. For example, the common language that typically emerges in an organization because people share the same beliefs and values facilitates cooperation among managers. Similarly, rules and procedures and direct supervision are less important when shared norms and values control behavior and motivate employees. When organizational members buy into cultural norms and values, they feel a bond with the organization and are more committed to finding new ways to help it succeed. The Running Case on Walmart profiles how its founder Sam Walton built a strong culture.



## RUNNING CASE

### Sam Walton Created Walmart's Culture

Walmart, headquartered in Bentonville, Arkansas, is the largest retailer in the world. In 2009, it sold more than \$700 billion worth of products. A large part of Walmart's success is due to the nature of the culture that its founder, the late Sam Walton, established for the company. Walton wanted all his managers and workers to take a hands-on approach to their jobs and be totally committed to Walmart's main goal, which he defined as total customer satisfaction. To motivate his employees, Walton created a culture that gave all employees, called "associates," continuous feedback about their performance and the company's performance.

To involve his associates in the business and encourage them to develop work behaviors focused on providing quality customer service, Walton established strong cultural values and norms for his company. One of the norms associates are expected to follow is the "10-foot attitude." This norm encourages associates, in Walton's words, to "promise that whenever you come within 10 feet of a customer, you will look him in the eye, greet him, and ask him if you can help him." The "sundown rule" states that employees should strive to answer customer requests by sundown of the day they are made. The Walmart cheer ("Give me a W, give me an A," and so on) is used in all its stores.

The strong customer-oriented values that Walton created are exemplified in the stories Walmart members tell one another about associates' concern for customers. They include stories like the one about Sheila, who risked her own safety when she jumped in front of a car to prevent a little boy from being struck; about Phyllis, who administered CPR to a customer who had suffered a heart attack in her store; and about

Annette, who gave up the Power Ranger she had on layaway for her own son to fulfill the birthday wish of a customer's son. The strong Walmart culture helps to control and motivate employees to achieve the stringent output and financial targets the company sets for itself.

A notable way Walmart builds its culture is through its annual stockholders' meeting, its extravagant ceremony celebrating the company's success. Every year, Walmart flies thousands of its highest performers to its annual meeting its corporate headquarters in Arkansas for a show featuring famous singers, rock bands, and comedians. Walmart feels that expensive entertainment is a reward its employees deserve and that the event reinforces the company's high-performance values and culture. The proceedings are even broadcast live to all of Walmart's stores so that employees can celebrate the company's achievements together.

Since Sam Walton's death, public attention to Walmart, which has more than 1 million employees, has revealed the "hidden side" of its culture. Critics claim that few Walmart employees receive reasonably priced health care or other benefits, and the company pays employees at little above the minimum wage. They also contend that employees do not question these policies because managers have convinced them into believing that this has to be the case—that the only way Walmart can keep its prices low is by keeping their pay and benefits low. In 2009, Walmart was threatened by proposed changes to health care laws that would force it to pay a much higher percentage of employee benefits. Will its loyal employees decide to follow Sam Walton's 10-foot-attitude rule in the future?

**Sources:** <http://www.walmart.com>, 2009; "Associates Keystone to Structure," *Chain Store Age*, December, 1999, 17; M. Troy, "The Culture Remains the Constant," *Discount Store News*, June 8, 1998, 95–98; S. Voros, "3D Management," *Management Review*, January 2000, 45–47; "Neurosis, Arkansas-Style," *Fortune*, April 17, 2000, 36.

Strategic leadership also affects organizational culture through the way managers design organizational structure, that is, the way they delegate authority and divide task relationships. Thus, the way an organization designs its structure affects the cultural norms and values that develop within the organization. Managers need to be aware of this fact when implementing their strategies. Michael Dell, the founder

of Dell Computer, for example, has always kept his company as flat as possible. He has decentralized authority to lower-level managers and employees and made them responsible for getting as close to the customer as possible. As a result, he has created a cost-conscious customer service culture at Dell, and employees strive to provide high-quality customer service.

## Traits of Strong and Adaptive Corporate Cultures

Few environments are stable for a prolonged period of time. If an organization is to survive, managers must take actions that enable it to adapt to environmental changes. If they do not take such action, they may find themselves faced with declining demand for their products.

Managers can try to create an **adaptive culture**, one that is innovative and that encourages and rewards middle- and lower-level managers for taking the initiative.<sup>33</sup> Managers in organizations with adaptive cultures are able to introduce changes in the way the organization operates, including changes in its strategy and structure that allow it to adapt to changes in the external environment. Organizations with adaptive cultures are more likely to survive in a changing environment and indeed should have higher performance than organizations with inert cultures.

Several scholars in the field have tried to uncover the common traits that strong and adaptive corporate cultures share and find out whether there is a particular set of values that dominates adaptive cultures that is missing from weak or inert ones. An early but still influential attempt is T. J. Peters and R. H. Waterman's account of the values and norms characteristic of successful organizations and their cultures.<sup>34</sup> They argue that adaptive organizations show three common value sets. First, successful companies have values promoting a *bias for action*. The emphasis is on autonomy and entrepreneurship, and employees are encouraged to take risks—for example, to create new products—even though there is no assurance that these products will be winners. Managers are closely involved in the day-to-day operations of the company and do not simply make strategic decisions isolated in some ivory tower. Employees have a hands-on, value-driven approach.

The second set of values stems from the *nature of the organization's mission*. The company must stick with what it does best and develop a business model focused on its mission. A company can easily get sidetracked into pursuing activities outside its area of expertise just because they seem to promise a quick return. Management should cultivate values so that a company “sticks to its knitting,” which means strengthening its business model. A company must also establish close relationships with customers as a way of improving its competitive position. After all, who knows more about a company's performance than those who use its products or services? By emphasizing customer-oriented values, organizations are able to identify customer needs and improve their ability to develop products and services that customers desire. All of these management values are strongly represented in companies such as McDonald's, Walmart, and Toyota, which are sure of their mission and continually take steps to maintain it.

The third set of values bears on *how to operate the organization*. A company should try to establish an organizational design that will motivate employees to do their best. Inherent in this set of values is the belief that productivity is obtained through people and that respect for the individual is the primary means by which a company can create the right atmosphere for productive behavior. An emphasis on entrepreneurship and respect for the employee leads to the establishment of a

### Ethical Dilemma

Suppose a poorly performing organization has decided to terminate hundreds of middle managers. Top managers making the termination decisions might choose to keep subordinates that they like rather than the best performers or terminate the most highly paid subordinates even if they are top performers. Remembering that organizational structure and culture affects all company stakeholders, which ethical principles about equality, fairness, and justice would you use to redesign the organization hierarchy? Keep in mind that some employees may feel to have as strong a claim on the organization as some of its stockholders, even claiming to “own” their jobs from contributions to past successes. Do you think this is an ethical claim? How would it factor into your design?

structure that gives employees the latitude to make decisions and motivates them to succeed. Because a simple structure and a lean staff best fit this situation, the organization should be designed with only the number of managers and hierarchical levels that are necessary to get the job done. The organization should also be sufficiently decentralized to permit employees’ participation but centralized enough for management to make sure that the company pursues its strategic mission and that cultural values are followed.

In summary, these three main sets of values are at the heart of an organization’s culture, and management transmits and maintains them through strategic leadership. Strategy implementation continues as managers build strategic control systems that help perpetuate a strong adaptive culture, further the development of distinctive competencies, and provide employees with the incentive to build a company’s competitive advantage. Finally, organizational structure contributes to the implementation process by providing the framework of tasks and roles that reduces transaction difficulties and allows employees to think and behave in ways that enable a company to achieve superior performance.

## BUILDING DISTINCTIVE COMPETENCIES AT THE FUNCTIONAL LEVEL

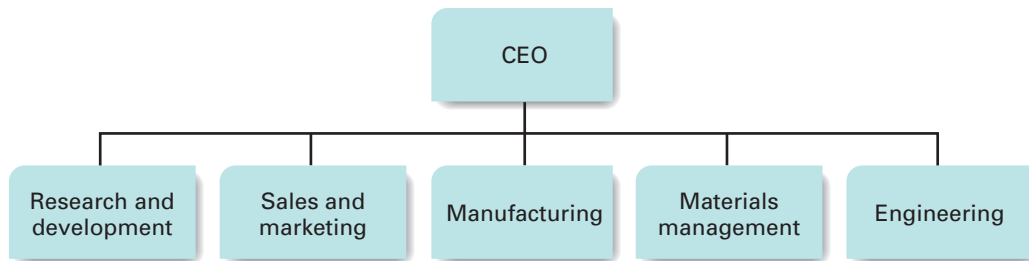
In this section, we turn to the issue of creating specific kinds of structures, control systems, and cultures to implement a company’s business model. The first level of strategy to examine is the functional level because, as Chapters 3 and 4 discussed, a company’s business model is implemented through the functional strategies managers adopt to develop the distinctive competencies that allow a company to pursue a particular business model.<sup>35</sup> What is the best kind of structure to use to group people and tasks to build competencies? The answer for most companies is to group them by function and create a functional structure.

### Functional Structure: Grouping by Function

In the quest to deliver a final product to the customer, two related value chain management problems increase. First, the range of value chain activities that must be performed expands, and it quickly becomes clear that a company lacks the expertise needed to perform them effectively. For example, in a new company, it quickly becomes apparent that the expertise necessary to perform them effectively is lacking. It becomes apparent, perhaps, that the services of a professional accountant, a production manager, or a marketing expert are needed to take control of specialized tasks as sales increase. Second, it also becomes clear that a single person cannot successfully perform more than one value chain activity without becoming overloaded. The new company’s founder, for instance, who may have been performing many value chain activities, realizes that he or she can no longer simultaneously make and sell the product. As most entrepreneurs discover, they have to decide how to group new employees to perform the various value chain activities most efficiently. Most choose the functional structure.

**Functional structures** group people on the basis of their common expertise and experience or because they use the same resources.<sup>36</sup> For example, engineers are

**Figure 12.5** Functional Structure



grouped in a function because they perform the same tasks and use the same skills or equipment. Figure 12.5 shows a typical functional structure. Each of the rectangles represents a different functional specialization—R&D, sales and marketing, manufacturing, and so on—and each function concentrates on its own specialized task.<sup>37</sup>

Functional structures have several advantages. First, if people who perform similar tasks are grouped together, they can learn from one another and become more specialized and productive at what they do. This can create capabilities and competencies in each function. Second, they can monitor each other to make sure that all are performing their tasks effectively and not shirking their responsibilities. As a result, the work process becomes more efficient, reducing manufacturing costs and increasing operational flexibility. A third important advantage of functional structures is that they give managers greater control of organizational activities. As already noted, many difficulties arise when the number of levels in the hierarchy increases. If people are grouped into different functions, each with their own managers, then *several different hierarchies are created*, and the company can avoid becoming too tall. There will be one hierarchy in manufacturing, for example, and another in accounting and finance. Managing the business is much easier when different groups specialize in different organizational tasks and are managed separately.

## The Role of Strategic Control

An important element of strategic control is to design a system that sets ambitious goals and targets for all managers and employees and then develops performance measures that *stretch and encourage managers and employees* to excel in their quest to raise performance. A functional structure promotes this goal because it increases the ability of managers and employees to monitor and make constant improvements to operating procedures. The structure also encourages organizational learning because managers, working closely with subordinates, can mentor them and help develop their technical skills.

Grouping by function also makes it easier to apply output control. Measurement criteria can be developed to suit the needs of each function to encourage members to stretch themselves. Each function knows how well it is contributing to overall performance and, indeed, the part it plays in reducing the cost of goods sold or the gross margin. Managers can look closely to see if they are following the principle of the minimum chain of command and whether they need several levels of middle managers. Perhaps, instead of using middle managers, they could practice **management by objectives**, a system in which employees are encouraged to help set their own goals so

that managers, like Cypress's Rodgers, *manage by exception*, intervening only when they sense something is not going right. Given this increase in control, a functional structure also makes it possible to institute an effective strategic reward system in which pay can be closely linked to performance, and managers can accurately assess the value of each person's contributions.

### Developing Culture at the Functional Level

Often functional structures offer the easiest way for managers to build a strong, cohesive culture. We discussed earlier how Sam Walton worked hard to create values and norms that are shared by Walmart's employees. To understand how structure, control, and culture can help create distinctive competencies, think about how they affect the way these three functions operate: manufacturing, R&D, and sales.

**Manufacturing** In manufacturing, functional strategy usually centers on improving efficiency and quality. A company must create an organizational setting in which managers can learn how to economize on costs and lower the cost structure. Many companies today follow the lead of Japanese companies like Toyota and Honda that have strong capabilities in manufacturing because they pursue TQM and flexible manufacturing systems (see Chapter 4).

Pursuing TQM, the inputs and involvement of all employees in the decision-making process are necessary to improve production efficiency and quality. Thus, it becomes necessary to decentralize authority to motivate employees to improve the production process. In TQM, work teams are created, and workers are given the responsibility and authority to discover and implement improved work procedures. Managers assume the role of coach and facilitator, and team members jointly take on the supervisory burdens. Work teams are often given the responsibility to control and discipline their own members and even decide who should work in their team. Frequently, work teams develop strong norms and values, and work-group culture becomes an important means of control; this type of control matches the new decentralized team approach. Quality control circles are created to exchange information and suggestions about problems and work procedures. A bonus system or employee stock ownership plan (ESOP) is frequently established to motivate workers and to allow them to share in the increased value that TQM often produces.

Nevertheless, to move down the experience curve quickly, most companies still exercise tight control over work activities and create behavior and output controls that standardize the manufacturing process. For example, human inputs are standardized through the recruitment and training of skilled personnel; the work process is programmed, often by computers; and quality control is used to make sure that outputs are being produced correctly. In addition, managers use output controls such as operating budgets to continuously monitor costs and quality. The extensive use of output controls and the continuous measurement of efficiency and quality ensure that the work team's activities meet the goals set for the function by management. Efficiency and quality increase as new and improved work rules and procedures are developed to raise the level of standardization. The aim is to find the match between structure and control and a TQM approach so that manufacturing develops the distinctive competency that leads to superior efficiency and quality.

**R&D** The functional strategy for an R&D department is to develop distinctive competencies in innovation and quality as excellence that result in products that fit

customers' needs. Consequently, the R&D department's structure, control, and culture should provide the coordination necessary for scientists and engineers to bring high-quality products quickly to market. Moreover, these systems should motivate R&D scientists to develop innovative products.

In practice, R&D departments typically have a flat, decentralized structure that gives their members the freedom and autonomy to experiment and be innovative. Scientists and engineers are also grouped into teams because their performance can typically be judged only over the long term (it may take several years for a project to be completed). Consequently, extensive supervision by managers and the use of behavior control are a waste of managerial time and effort.<sup>38</sup> By letting teams manage their own transfer and handoff issues rather than using managers and the hierarchy of authority to coordinate work activities, managers avoid the information distortion problems that cause bureaucratic costs. Strategic managers take advantage of scientists' ability to work jointly to solve problems and enhance each other's performance. In small teams, too, the professional values and norms that highly trained employees bring to the situation promote coordination. A culture for innovation frequently emerges to control employees' behavior, as it did at Nokia, Intel, and Microsoft, where the race to be first energizes the R&D teams. To create an innovative culture and speed product development, Intel uses a team structure in its R&D function. Intel has many work teams that operate side by side to develop the next generation of chips. So, when it makes mistakes, as it has recently, it can act quickly to join each team's innovations together to make a state-of-the-art chip that does meet customer needs, such as for multimedia chips. At the same time, to sustain its leading-edge technology, the company creates healthy competition between teams to encourage its scientists and engineers to champion new product innovations that will allow Intel to control the technology of tomorrow.<sup>39</sup>

To spur teams to work effectively, the reward system should be linked to the performance of the team and company. If scientists, individually or in a team, do not share in the profits a company obtains from its new products, they may have little motivation to contribute wholeheartedly to the team. To prevent the departure of their key employees and encourage high motivation, companies such as Merck, Intel, and Microsoft give their researchers stock options, stock, and other rewards that are tied to their individual performance, their team's performance, and the company's performance.

**Sales** Salespeople work directly with customers, and when they are dispersed in the field, these employees are especially difficult to monitor. The cost-effective way to monitor their behavior and encourage high responsiveness to customers is usually to develop sophisticated output and behavior controls. Output controls, such as specific sales goals or goals for increasing responsiveness to customers, can be easily established and monitored by sales managers. These controls can then be linked to a bonus reward system to motivate salespeople. Behavior controls, such as detailed reports that salespeople file describing their interactions with customers, can also be used to standardize behavior and make it easier for supervisors to review performance.<sup>40</sup>

Usually, few managers are needed to monitor salespeople's activities, and a sales director and regional sales managers can oversee large sales forces because outputs and behavior controls are employed. Frequently, however, and especially when salespeople deal with complex products such as pharmaceutical drugs or even luxury clothing, it becomes important to develop shared employee values and norms about the importance of patient safety or high-quality customer service; managers spend considerable time training and educating employees to create such norms.



Similar considerations apply to the other functions, such as accounting, finance, engineering, and human resource management. Managers must implement functional strategy through the combination of structure, control, and culture to allow each function to create the competencies that lead to superior efficiency, quality, innovation, and responsiveness to customers. Strategic managers must also develop the incentive systems that motivate and align employees' interests with those of their companies.

## Functional Structure and Bureaucratic Costs

No matter how complex their strategies become, most companies always retain a functional orientation because of its many advantages. Whenever different functions work together, however, bureaucratic costs inevitably arise because of information distortions that lead to the communications and measurement problems discussed in Chapter 10. These problems often arise from the transfers or handoffs across different functions that are necessary to deliver the final product to the customer.<sup>41</sup> Indeed, the need to economize on the bureaucratic costs of solving such problems leads managers to adopt new organizational arrangements that reduce the scope of information distortions. Usually, companies divide their activities according to more complex plans to match their business models and strategies in discriminating ways. These more complex structures are discussed later in the chapter. First, we review five areas in which information distortions can arise: communications, measurement, customers, location, and strategy.

**Communication Problems** As separate functional hierarchies evolve, functions can grow more remote from one another, and it becomes increasingly difficult to communicate across functions and coordinate their activities. This communication problem stems from *differences in goal orientations*—the various functions develop distinct outlooks or understandings of the strategic issues facing a company.<sup>42</sup> For example, the pursuit of different competencies can often lead to different time or goal orientations. Some functions, such as manufacturing, have a short time frame and concentrate on achieving short-run goals, such as reducing manufacturing costs. Others, such as R&D, have a long-term point of view; their product development goals may have a time horizon of several years. These factors may cause each function to develop a different view of the strategic issues facing the company. Manufacturing, for example, may see the strategic issue as the need to reduce costs, sales may see it as the need to increase customer responsiveness, and R&D may see it as the need to create new products. These communication and coordination problems among functions increase bureaucratic costs.

**Measurement Problems** Often a company's product range widens as it develops new competencies and enters new market segments. When this happens, a company may find it difficult to gauge or measure the contribution of a product or a group of products to its overall profitability. Consequently, the company may turn out some unprofitable products without realizing it and may also make poor decisions about resource allocation. This means that the company's measurement systems are not complex enough to serve its needs.

**Customer Problems** As the range and quality of an organization's goods and services increase, often more and different kinds of customers are attracted to its products. Servicing the needs of more customer groups and tailoring products to suit new kinds of customers result in increasing handoff problems among functions. It becomes increasingly difficult to coordinate the activities of value chain functions across the growing product range. Also, functions such as production, marketing,

and sales have little opportunity to differentiate products and increase value for customers by specializing in the needs of particular customer groups. Instead, they are responsible for servicing the complete product range. Thus, the ability to identify and satisfy customer needs may fall short in a functional structure.

**Location Problems** Being in a particular location or geographical region may also hamper coordination and control. Suppose a growing company in the Northeast begins to expand and sell its products in many different regional areas. A functional structure will not be able to provide the flexibility needed for managers to respond to the different customer needs or preferences in the various regions.

**Strategic Problems** The combined effect of all these factors is that long-term strategic considerations are frequently ignored because managers are preoccupied with solving communication and coordination problems. The result is that a company may lose direction and fail to take advantage of new strategic opportunities—thus bureaucratic costs escalate.

Experiencing one or more of these problems is a sign that bureaucratic costs are increasing. In that case, managers must change and adapt their organization's structure, control systems, and culture to economize on bureaucratic costs, build new distinctive competencies, and strengthen the company's business model. These problems indicate that the company has outgrown its structure and that managers need to develop a more complex structure that can meet the needs of their competitive strategy. An alternative, however, is to reduce these problems by adopting the outsourcing option.

## The Outsourcing Option

Rather than move to a more complex, expensive structure, companies are increasingly turning to the outsourcing option (discussed in Chapter 9) and solving the organizational design problem by contracting with other companies to perform specific functional tasks. Obviously, it does not make sense to outsource activities in which a company has a distinctive competency, because this would lessen its competitive advantage. But it does make sense to outsource and contract with companies to perform particular value chain activities in which they specialize and therefore have a competitive advantage.

Thus, one way of avoiding the kinds of communication and measurement problems that arise when a company's product line becomes complex is to reduce the number of functional value chain activities it performs. This allows a company to focus on those competencies that are at the heart of its competitive advantage and to economize on bureaucratic costs. Today, responsibility for activities such as a company's marketing, pension and health benefits, materials management, and information systems is being increasingly outsourced to companies that specialize in the needs of a company in a particular industry. More outsourcing options, such as using a global network structure, are considered in Chapter 13.

## IMPLEMENTING STRATEGY IN A SINGLE INDUSTRY

Building capabilities in organizational design that allow a company to develop a competitive advantage starts at the functional level. However, to pursue its business

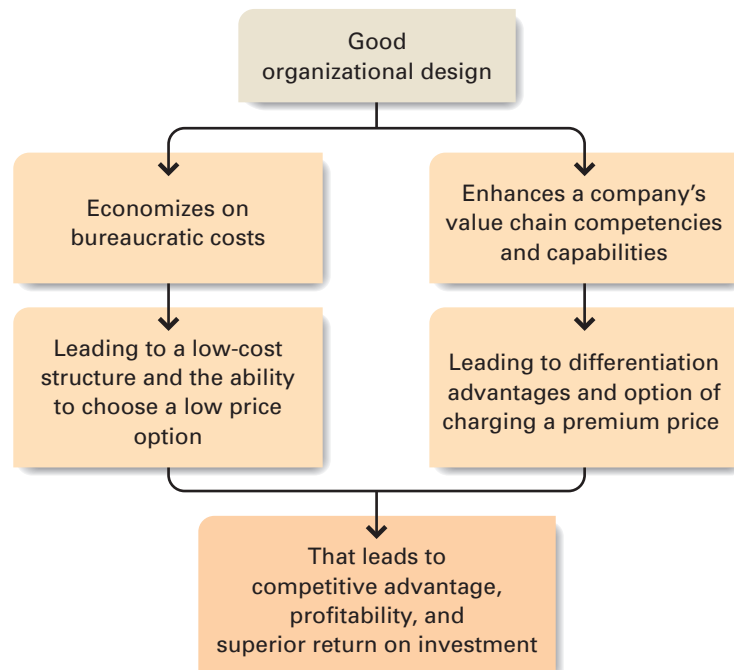
model successfully, managers must find the right combination of structure, control, and culture that *links and combines* the competencies in a company's value chain functions so that it enhances its ability to differentiate products or lower the cost structure. Therefore, it is important to coordinate and integrate across functions and business units or divisions. In organizational design, managers must consider two important issues: one concerns the revenue side of the profit equation and the other concerns the cost side, as Figure 12.6 illustrates.

First, effective organizational design improves the way in which people and groups choose the business-level strategies that lead to increasing differentiation, more value for customers, and the opportunity to charge a premium price. For example, capabilities in managing its structure and culture allow a company to more rapidly and effectively combine its distinctive competencies or transfer or leverage competencies across business units to create new and improved, differentiated products.

Second, effective organizational design reduces the bureaucratic costs associated with solving the measurement and communications problems that derive from factors such as transferring a product in progress between functions or a lack of cooperation between marketing and manufacturing or between business units. A poorly designed or inappropriate choice of structure or control system or a slow-moving bureaucratic culture (for example, a structure that is too centralized, an incentive system that causes functions to compete instead of cooperate, or a culture in which value and norms have little impact on employees) can cause the motivation, communication, measurement, and coordination problems that lead to high bureaucratic costs.

Effective organizational design often means moving to a more complex structure that economizes on bureaucratic costs. A more-complex structure will cost more to

**Figure 12.6** How Organizational Design Increases Profitability



operate because additional, experienced, and more highly paid managers will be needed; a more expensive IT system will be required; there may be a need for extra offices and buildings; and so on. However, these are simply costs of doing business, and a company will happily bear this extra expense provided its new structure leads to increased revenues from product differentiation and/or new ways to lower its *overall* cost structure by obtaining economies of scale or scope from its expanded operations.

In the following sections, we first examine the implementation and organizational design issues involved in pursuing a cost-leadership or differentiation business model. Then we describe different kinds of organizational structures that allow companies to pursue business models oriented at (1) managing a wide range of products; (2) being responsive to customers; (3) expanding nationally; (4) competing in a fast-changing, high-tech environment; and (5) focusing on a narrow product line.

## Implementing Cost Leadership

The aim of a company pursuing cost leadership is to become the lowest-cost producer in the industry, and this involves reducing costs across *all* functions in the organization, including R&D and sales and marketing.<sup>43</sup> If a company is pursuing a cost-leadership strategy, its R&D efforts probably focus on product and process development rather than on the more expensive product innovation, which carries no guarantee of success. In other words, the company stresses competencies that improve product characteristics or lower the cost of making existing products. Similarly, a company tries to decrease the cost of sales and marketing by offering a standard product to a mass market rather than different products aimed at different market segments, which is also more expensive.<sup>44</sup>

To implement cost leadership, a company chooses a combination of structure, control, and culture compatible with lowering its cost structure while preserving its ability to attract customers. In practice, the functional structure is the most suitable provided that care is taken to select integrating mechanisms that will reduce communication and measurement problems. For example, a TQM program can be effectively implemented when a functional structure is overlaid with cross-functional teams because team members can now search for ways to improve operating rules and procedures that lower the cost structure or standardize and raise product quality.<sup>45</sup>

Cost leadership also requires that managers continuously monitor their structures and control systems to find ways to restructure or streamline them so that they operate more effectively. For example, managers need to be alert to ways of using IT to standardize operations and lower costs. To reduce costs further, cost leaders use the cheapest and easiest forms of control available: output controls. For each function, a cost leader adopts output controls that allow it to closely monitor and evaluate functional performance. In the manufacturing function, for example, the company imposes tight controls and stresses meeting budgets based on production, cost, or quality targets.<sup>46</sup> In R&D, the emphasis also falls on the bottom line; to demonstrate their contribution to cost savings, R&D teams focus on improving process technology. Cost leaders are likely to reward employees through generous incentive and bonus plans to encourage high performance. Their culture is often based on values that emphasize the bottom line, such as those of Dell, Walmart, and McDonald's.

## Implementing Differentiation

Effective strategy implementation can improve a company's ability to add value and to differentiate its products. To make its product unique in the eyes of the customer,

for example, a differentiated company must design its structure, control, and culture around the *particular source* of its competitive advantage.<sup>47</sup> Specifically, differentiators need to design their structures around the source of their distinctive competencies, the differentiated qualities of their product, and the customer groups they serve. Commonly, in pursuing differentiation, a company starts to produce a wider range of products to serve more market segments, which means it has to customize its products for different groups of customers. These factors make it more difficult to standardize activities and usually increase the bureaucratic costs associated with managing the handoffs or transfers between functions. Integration becomes much more of a problem; communications, measurement, location, and strategic problems increasingly arise; and the demands on functional managers increase.

To respond to these problems, strategic managers develop more sophisticated control systems, increasingly make use of IT, focus on developing cultural norms and values that overcome problems associated with differences in functional orientations and focus on cross-functional objectives. The control systems used to match the structure should be geared to a company's distinctive competencies. For successful differentiation, it is important that the various functions do not pull in different directions; indeed, cooperation among the functions is vital for cross-functional integration. However, when functions work together, output controls become much harder to use. In general, it is much more difficult to measure the performance of people in different functions when they are engaged in cooperative efforts. Consequently, a differentiator must rely more on behavior controls and shared norms and values.

This explains why companies pursuing differentiation often have a markedly different kind of culture from those pursuing cost leadership. Because human resources—scientists, designers, or marketing employees—are often the source of differentiation, these organizations have a culture based on professionalism or collegiality that emphasizes the distinctiveness of the human resources rather than the high pressure of the bottom line.<sup>48</sup> HP, Motorola, and Coca-Cola, all of which emphasize some kind of distinctive competency, exemplify companies with professional cultures.

In practice, the implementation decisions that confront managers who must simultaneously strive for differentiation and a low cost structure are dealt with together as strategic managers move to implement new, more complex kinds of organizational structure. As a company's business model and strategies evolve, strategic managers usually start to *superimpose* a more complex divisional grouping of activities on its functional structure to better coordinate value chain activities. This is especially true of companies seeking to become *broad differentiators*—companies that have the ability to both increase differentiation and lower their cost structures. These companies are the most profitable in their industry, and they have to be especially adept at organizational design. This is a major source of a differentiation and cost advantage (see Figure 12.6). No matter what their business model, however, more complex structures cost more to operate than a simple functional structure. Managers are willing to bear this extra cost, however, as long as the new structure makes better use of functional competencies, increases revenues, and lowers the overall cost structure.

### Product Structure: Implementing a Wide Product Line

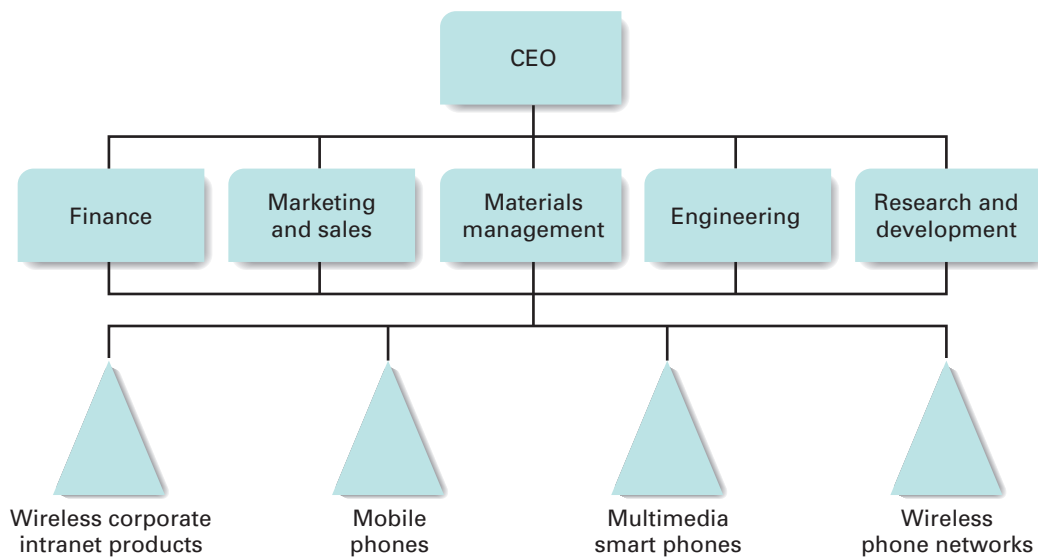
The structure that organizations most commonly adopt to solve the control problems that result from producing many different kinds of products for many different market segments is the *product structure*. The intent is to break up a company's growing

product line into a number of smaller, more manageable subunits to reduce bureaucratic costs due to communication, measurement, and other problems. Nokia moved to a product structure as it grew in size; its structure is shown in Figure 12.7.

An organization that chooses a product structure first divides its overall product line into product groups or categories (see Figure 12.7). Each product group focuses on satisfying the needs of a particular customer group and is managed by its own team of managers. Second, to keep costs as low as possible, value chain support functions such as basic R&D, marketing, materials, and finance are centralized at the top of the organization, and the different product groups share their services. Each support function, in turn, is divided into product-oriented teams of functional specialists who focus on the needs of one particular product group. This arrangement allows each team to specialize and become expert in managing the needs of its product group. Because all of the R&D teams belong to the same centralized function, however, they can share knowledge and information with each other and build their competence over time.

Strategic control systems can now be developed to measure the performance of each product group separately from the others. Thus, the performance of each product group is easy to monitor and evaluate, and corporate managers at the center can move more quickly to intervene if necessary. Also, the strategic reward system can be linked more closely to the performance of each product group, although top managers can still decide to make rewards based on corporate performance an important part of the incentive system. Doing so will encourage the different product groups to share ideas and knowledge and promote the development of a corporate culture, as well as the product group culture that naturally develops inside each product group. A product structure is commonly used by food processors, furniture makers, personal and health products companies, and large electronics companies like Nokia.

**Figure 12.7** Nokia's Product Structure





## Market Structure: Increasing Responsiveness to Customer Groups

Suppose the source of competitive advantage in an industry depends on the ability to meet the needs of distinct and important sets of customers or different customer groups. What is the best way of implementing strategy now? Many companies develop a **market structure** that is conceptually quite similar to the product structure except that the focus is on customer groups instead of product groups.

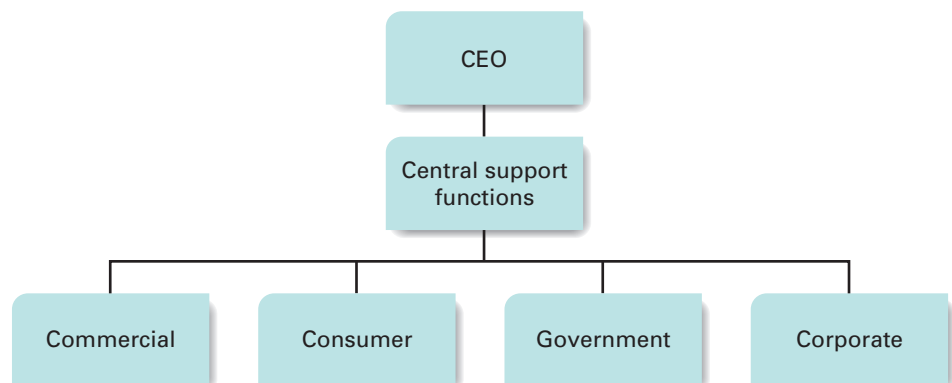
For a company pursuing a strategy based on increasing responsiveness to customers, it is vital that the nature and needs of each different customer group be identified. Then, employees and functions are grouped by customer or market segment. A different set of managers becomes responsible for developing the products that each group of customers wants and tailoring or customizing products to the needs of each particular customer group. In other words, to promote superior responsiveness to customers, a company will design a structure around its customers, and a market structure is adopted. A typical market structure is shown in Figure 12.8.

A market structure brings customer group managers and employees closer to specific groups of customers. These people can then take their detailed knowledge and feed it back to the support functions, which are kept centralized to reduce costs. For example, information about changes in customer preferences can be quickly fed back to R&D and product design so that a company can protect its competitive advantage by supplying a constant stream of improved products for its installed customer base. This is especially important when a company serves well-identified customer groups such as Fortune 500 companies or small businesses. The Opening Case describes how Liz Claiborne uses a market structure to maximize its responsiveness to important customer groups while at the same time keeping its overall cost structure as low as possible.

## Geographic Structure: Expanding Nationally

Suppose a company starts to expand nationally through internal expansion or by engaging in horizontal integration and merging with other companies to expand its geographical reach. A company pursuing this competitive approach frequently

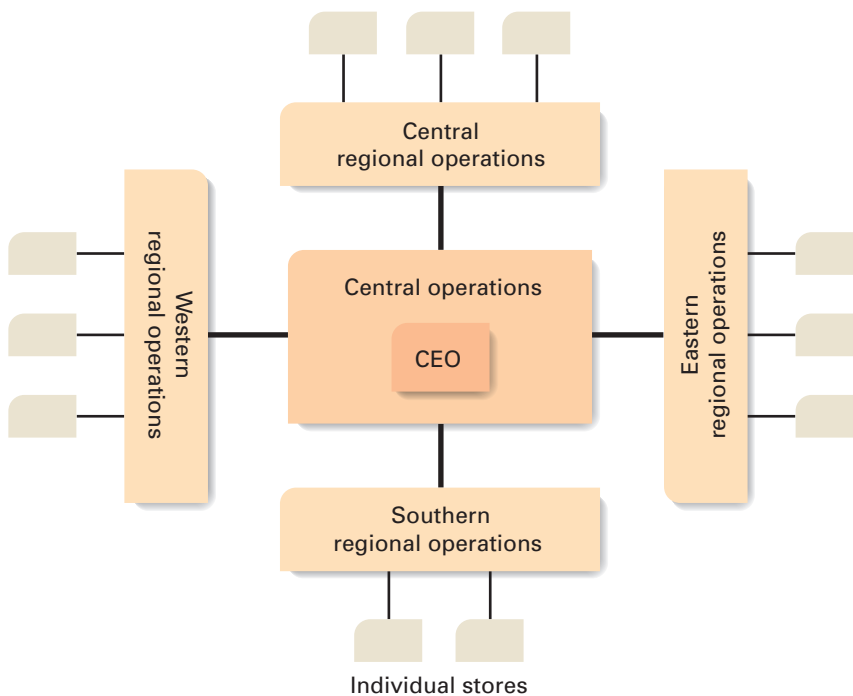
**Figure 12.8** Market Structure



moves to a **geographic structure** in which geographic regions become the basis for the grouping of organizational activities (see Figure 12.9). A company may divide its manufacturing operations and establish manufacturing plants in different regions of the country, for example. This allows it to be responsive to the needs of regional customers and reduces transportation costs. Similarly, as a service organization such as a store chain or bank expands beyond one geographic area, it may begin to organize sales and marketing activities on a regional level to better serve the needs of customers in different regions.

A geographic structure provides more coordination and control than a functional structure does because several regional hierarchies are created to take over the work, just as in a product structure, where several product group hierarchies are created. A company such as FedEx clearly needs to operate a geographic structure to fulfill its corporate goal: next-day delivery. Large merchandising organizations, such as Neiman Marcus, Dillard's Department Stores, and Walmart, also moved to a geographic structure as they started building stores across the country. With this type of structure, different regional clothing needs (for example, sun wear in the South, down coats in the Midwest) can be handled as required. At the same time, because the information systems, purchasing, distribution, and marketing functions remain centralized, they can leverage their skills across all the regions. Thus, in using a geographic structure, a company can achieve economies of scale in buying, distributing, and selling and lower its cost structure while at the same time being more responsive (differentiated) to customer needs.

**Figure 12.9** Geographic Structure



## 12.3 STRATEGY IN ACTION

### Macy's Changes Its Geographic Structure

Since the recession started in 2008, all companies have been searching for ways to reduce their cost structure to remain profitable or reduce their losses. Macy's, the national department store chain, is one company that has been forced to take major steps to reduce its cost structure. To become a national retail chain, Macy's acquired many regional department store chains, but during this process its managers paid attention only to the differentiation side of the equation. They focused their efforts on making their clothes appealing to customers and had thought through the issue of how to combine and streamline the functional operations of the acquired companies, for example, how to merge all the regional purchasing and shipping operations of the acquired store chains to increase efficiency and reduce its cost structure. As a result, when the recession struck in 2008, Macy's sales plunged due to its high cost structure, and it was soon losing billions of dollars.

To survive, Macy's CEO decided that a major change in organizational structure was needed to cut operating costs. The operations of all four of Macy's regional head-

quarters offices were centralized at its New York headquarters. This level in the hierarchy was eliminated, as were the jobs of 7,000 (40%) executives, mainly at the regional level. However, once it had eliminated these four large regional offices, realizing that it had to maintain effective control over its hundreds of stores and be responsive to the needs of customers in different geographic regions, Macy's established eight new, much smaller regional offices in Chicago, Houston, Miami, Los Angeles, New York, Pittsburgh, San Francisco, and Washington, DC, to manage these activities.

All its major functions such as purchasing and shipping will still be centralized in New York. The new regional executives communicate customer needs to New York and work to increase the efficiency of its regional and district store operations. This change in operating structure is expected to save Macy's \$400 million a year. It will also allow it to find ways to improve its functional competences so, for example, it can cut back on the level of store inventory, a major cost for a retailer, and move clothing and other products faster to stores.

Neiman Marcus developed a geographic structure similar to the one shown in Figure 12.9 to manage its nationwide chain of stores. In each region, it established a team of regional buyers to respond to the needs of customers in each geographic area, for example, the western, central, eastern, and southern regions. The regional buyers then fed their information to the central buyers at corporate headquarters, who coordinated their demands to obtain purchasing economies and ensure that Neiman Marcus's high-quality standards, on which its differentiation advantage depends, were maintained nationally. In 2009, Macy's reorganized its geographic structure, as Strategy in Action 12.3 discusses.

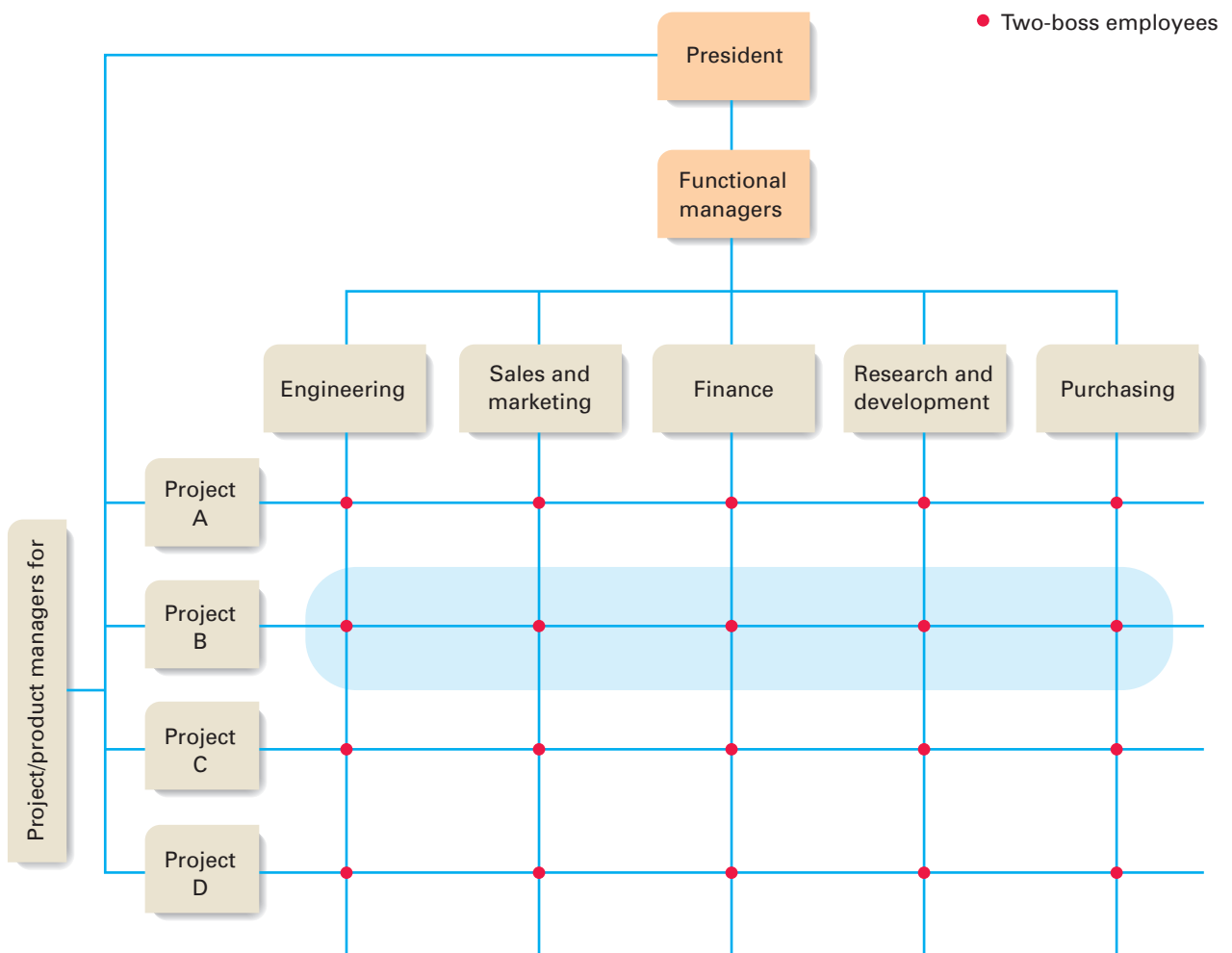
### Matrix and Product-Team Structures: Competing in Fast-Changing, High-Tech Environments

The communication and measurement problems that lead to bureaucratic costs escalate quickly when technology is rapidly changing and industry boundaries are blurring. Frequently, competitive success depends on fast mobilization of a company's skills and resources, and managers face complex strategy implementation issues. A new grouping of people and resources becomes necessary, often one that is based on fostering a company's distinctive competencies in R&D. Managers need to make structure, control, and culture choices around the R&D function. At the

same time, they need to ensure that implementation will result in new products that cost-effectively meet customer needs and will not result in products so expensive that customers will not wish to buy them.

**Matrix Structure** To address these problems, many companies choose a matrix structure.<sup>49</sup> In a **matrix structure**, value chain activities are grouped in two ways (see Figure 12.10). First, activities are grouped vertically by *function* so that there is a familiar differentiation of tasks into functions such as engineering, sales and marketing, and R&D. In addition, superimposed on this vertical pattern is a horizontal pattern based on grouping by *product or project* in which people and resources are grouped to meet ongoing product development needs. The resulting network of reporting relationships among projects and functions is designed to make R&D the focus of attention.

**Figure 12.10** Matrix Structure



Matrix structures are flat and decentralized, and employees inside a matrix have two bosses: a *functional boss*, who is the head of a function, and a *product or project boss*, who is responsible for managing the individual projects. Employees work on a project team with specialists from other functions and report to the project boss on project matters and the functional boss on matters relating to functional issues. All employees who work on a project team are called **two-boss employees** and are responsible for managing coordination and communication among the functions and projects.

Implementing a matrix structure promotes innovation and speeds product development because this type of structure permits intensive cross-functional integration. Integrating mechanisms such as teams help transfer knowledge among functions and are designed around the R&D function. Sales, marketing, and production targets are geared to R&D goals, marketing devises advertising programs that focus on technological possibilities, and salespeople are evaluated on their understanding of new-product characteristics and their ability to inform potential customers about them.

Matrix structures were first developed by companies in high-technology industries such as aerospace and electronics, for example, TRW and Hughes. These companies were developing radically new products in uncertain, competitive environments, and the speed of product development was the crucial consideration. They needed a structure that could respond to this need, but the functional structure was too inflexible to allow the complex role and task interactions that are necessary to meet new-product development requirements. Moreover, employees in these companies tend to be highly qualified and professional and perform best in autonomous, flexible working conditions. The matrix structure provides such conditions.

This structure requires a minimum of direct hierarchical control by supervisors. Team members control their own behavior, and participation in project teams allows them to monitor other team members and to learn from each other. Furthermore, as the project goes through its different phases, different specialists from various functions are required. For example, at the first stage, the services of R&D specialists may be called for; at the next stage, engineers and marketing specialists may be needed to make cost and marketing projections. As the demand for the type of specialist changes, team members can be moved to other projects that require their services. Thus, the matrix structure can make maximum use of employees' skills as existing projects are completed and new ones come into existence. The freedom given by the matrix not only provides the autonomy to motivate employees but also leaves top management free to concentrate on strategic issues because they do not have to become involved in operating matters. On all these counts, the matrix is an excellent tool for creating the flexibility necessary for quick reactions to competitive conditions.

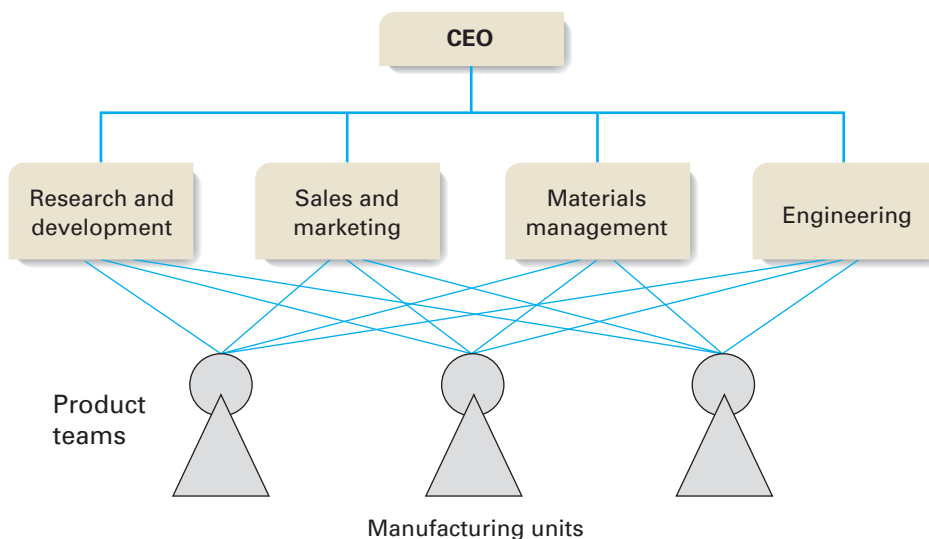
In terms of strategic control and culture, the development of norms and values based on innovation and product excellence is vital if a matrix structure is to work effectively.<sup>50</sup> The constant movement of employees around the matrix means that time and money are spent establishing new team relationships and getting the project off the ground. The two-boss employee's role, balancing as it does the interests of the project with the function, means that cooperation among employees is problematic, and conflict between different functions and between functions and projects is possible and must be managed. Furthermore, the changing composition of product teams, the ambiguity arising from having two bosses, and the greater difficulty of monitoring and evaluating the work of teams increase the problems of coordinating task activities. A strong and cohesive culture with unifying norms and values can

mitigate these problems, as can a strategic reward system based on a group- and organizational-level reward system.

**Product-Team Structure** A major structural innovation in recent years has been the **product-team structure**. Its advantages are similar to those of a matrix structure, but it is much easier and far less costly to operate because of the way people are organized into permanent cross-functional teams, as Figure 12.11 illustrates. In the product-team structure, as in the matrix structure, tasks are divided along product or project lines. However, instead of being assigned only *temporarily* to different projects, as in the matrix structure, functional specialists become part of a *permanent* cross-functional team that focuses on the development of one particular range of products, such as luxury cars or computer workstations. As a result, the problems associated with coordinating cross-functional transfers or handoffs are much lower than in a matrix structure, in which tasks and reporting relationships change rapidly. Moreover, cross-functional teams are formed at the beginning of the product development process so that any difficulties that arise can be ironed out early, before they lead to major redesign problems. When all functions have direct input from the beginning, design costs and subsequent manufacturing costs can be kept low. Moreover, the use of cross-functional teams speeds innovation and customer responsiveness because, when authority is decentralized, team decisions can be made more quickly.

A product-team structure groups tasks by product, and each product group is managed by a cross-functional product team that has all the support services necessary to bring the product to market. This is why it is different from the product structure, in which support functions remain centralized. The role of the product team is to protect and enhance a company's differentiation advantage and at the same time coordinate with manufacturing to lower costs.

**Figure 12.11** Product-Team Structure





## Focusing on a Narrow Product Line

As Chapter 5 discussed, a focused company concentrates on developing a narrow range of products aimed at one or two market segments, which may be defined by type of customer or location. As a result, a focuser tends to have a higher cost structure than a cost leader or differentiator, because output levels are lower, making it harder to obtain substantial scale economies. For this reason, a focused company must exercise cost control. On the other hand, some attribute of its product gives the focuser its distinctive competency—possibly its ability to provide customers with high-quality, personalized service. For both reasons, the structure and control system adopted by a focused company has to be inexpensive to operate but flexible enough to allow a distinctive competency to emerge.

A company using a focus strategy normally adopts a functional structure to meet these needs. This structure is appropriate because it is complex enough to manage the activities necessary to make and sell a narrow range of products for one or a few market segments. At the same time, the handoff problems are likely to be relatively easy to solve because a focuser remains small and specialized. Thus, a functional structure can provide all the integration necessary, provided that the focused firm has a strong, adaptive culture, which is vital to the development of some kind of distinctive competency.<sup>51</sup> Additionally, because such a company's competitive advantage is often based on personalized service, the flexibility of this kind of structure allows the company to respond quickly to customers' needs and change its products in response to customers' requests.

## RESTRUCTURING AND REENGINEERING

To improve performance, a single business company often employs restructuring and reengineering. **Restructuring** a company involves two steps: (1) streamlining the hierarchy of authority and reducing the number of levels in the hierarchy to a minimum and (2) reducing the number of employees to lower operating costs. Restructuring and downsizing become necessary for many reasons.<sup>52</sup> Sometimes a change in the business environment occurs that could not have been foreseen; perhaps a shift in technology made the company's products obsolete. Sometimes an organization has excess capacity because customers no longer want the goods and services it provides; perhaps the goods and services are outdated or offer poor value for the money. Sometimes organizations downsize because they have grown too tall and inflexible and bureaucratic costs have become much too high. Sometimes they restructure even when they are in a strong position simply to build and improve their competitive advantage and stay on top.

All too often, however, companies are forced to downsize and lay off employees because they fail to monitor and control their basic business operations and have not made the incremental changes to their strategies and structures over time that allow them to adjust to changing conditions. Advances in management, such as the development of new models for organizing work activities, or IT advances offer strategic managers the opportunity to implement their strategies in more effective ways.

One way of helping a company operate more effectively is to use **reengineering**, which involves the “fundamental rethinking and radical redesign of business

processes to achieve dramatic improvements in critical, contemporary measures of performance, such as cost, quality, service, and speed.”<sup>53</sup> As this definition suggests, strategic managers who use reengineering must completely rethink how they organize their value chain activities. Instead of focusing on how a company’s *functions* operate, strategic managers make business *processes* the focus of attention.

A **business process** is any activity that is vital to delivering goods and services to customers quickly or that promotes high quality or low costs (such as IT, materials management, or product development). It is not the responsibility of any one function but *cuts across functions*. Because reengineering focuses on business processes, not on functions, a company that reengineers always has to adopt a different approach to organizing its activities. Companies that take up reengineering deliberately ignore the existing arrangement of tasks, roles, and work activities. They start the reengineering process with the customer (not the product or service) and ask, “How can we reorganize the way we do our work—our business processes—to provide the best quality and the lowest-cost goods and services to the customer?”

Frequently, when companies ask this question, they realize that there are more effective ways to organize their value chain activities. For example, a business process that encompasses members of 10 different functions working sequentially to provide goods and services might be performed by one person or a few people at a fraction of the cost. Often individual jobs become increasingly complex, and people are grouped into cross-functional teams as business processes are reengineered to reduce costs and increase quality.

Hallmark Cards, for example, reengineered its card design process with great success. Before the reengineering effort, artists, writers, and editors worked separately in different functions to produce all kinds of cards. After reengineering, these same artists, writers, and editors were put on cross-functional teams, each of which now works on a specific type of card, such as birthday, Christmas, or Mother’s Day. The result is that the time it takes to bring a new card to market dropped from years to months, and Hallmark’s performance increased dramatically.

Reengineering and TQM, discussed in Chapter 4, are highly interrelated and complementary. After reengineering has taken place and value chain activities have been altered to speed the product to the final customer, TQM takes over, with its focus on how to continue to improve and refine the new process and find better ways of managing task and role relationships. Successful organizations examine both issues simultaneously and continuously attempt to identify new and better processes for meeting the goals of increased efficiency, quality, and customer responsiveness. Thus, they are always seeking to improve their visions of their desired future.

Another example of reengineering is the change program that took place at IBM Credit, a wholly owned division of IBM that manages the financing and leasing of IBM computers, particularly mainframes, to IBM’s customers. Before reengineering took place, a financing request arrived at the division’s headquarters in Old Greenwich, Connecticut, and went through a five-step approval process that involved the activities of five different functions. First, the IBM salesperson called the credit department, which logged the request and recorded details about the potential customer. Second, this information was taken to the credit-checking department, where a credit check on the potential customer was done. Third, when the credit check was complete, the request was taken to the contracts department, which wrote the contract. Fourth, from the contracts department, it went to the pricing department, which determined the actual financial details of the loan, such as the interest rate and the term of the

loan. Finally, the whole package of information was assembled by the dispatching department and delivered to the sales representative, who gave it to the customer.

This series of cross-functional activities took an average of seven days to complete, and sales representatives constantly complained that this delay resulted in a low level of customer responsiveness that reduced customer satisfaction. Also, potential customers were tempted to shop around for financing and even to look at competitors' machines. The delay in closing the deal caused uncertainty for all concerned.

The change process began when two senior IBM credit managers reviewed the finance approval process. They found that the time spent by different specialists in the different functions actually processing a loan application was only ninety minutes. The seven-day approval process was caused by the delay in transmitting information and requests between departments. Managers also learned that the activities taking place in each department were not complex; each department had its own computer system containing its own work procedures, but the work done in each department was routine.

Armed with this information, IBM managers realized that the approval process could be reengineered into one overarching process handled by one person with a computer system containing all the necessary information and work procedures to perform the five loan-processing activities. If the application were complex, a team of experts stood ready to help process it, but IBM found that, after the reengineering effort, a typical application could be done in four hours rather than the previous seven days. A sales representative could go back to the customer the same day to close the deal, and all the uncertainty surrounding the transaction was removed.

As reengineering consultants Hammer and Champy note, this dramatic performance increase was brought about by a radical change to the process as a whole. Change through reengineering requires managers to go back to the basics and pull apart each step in the work process to identify a better way to coordinate and integrate the activities necessary to provide customers with goods and services. As this example makes clear, the introduction of new IT is an integral aspect of reengineering. IT also allows a company to restructure its hierarchy because it provides more and better-quality information. IT today is an integral part of the strategy implementation process.

## SUMMARY OF CHAPTER

1. Implementing a company's business model and strategies successfully depends on organizational design, the process of selecting the right combination of organizational structure, control systems, and culture. Companies need to monitor and oversee the organizational design process to achieve superior profitability.
2. Effective organizational design can increase profitability in two ways. First, it economizes on bureaucratic costs and helps a company lower its cost structure. Second, it enhances the ability of a company's value creation functions to achieve superior efficiency, quality, innovativeness, and customer responsiveness and obtain the advantages of differentiation.
3. The main issues in designing organizational structure are how to group tasks, functions, and divisions; how to allocate authority and responsibility (whether to have a tall or flat organization or to have a centralized or decentralized structure); and how to use integrating mechanisms to improve coordination between functions (such as direct contacts, liaison roles, and teams).

4. Strategic control provides the monitoring and incentive systems necessary to make an organizational structure work as intended and extends corporate governance down to all levels inside the company. The main kinds of strategic control systems are personal control, output control, and behavior control. IT is an aid to output and behavior control, and reward systems are linked to every control system.
5. Organizational culture is the set of values, norms, beliefs, and attitudes that help to energize and motivate employees and control their behavior. Culture is a way of doing something, and a company's founder and top managers help determine which kinds of values emerge in an organization.
6. At the functional level, each function requires a different combination of structure and control system to achieve its functional objectives.
7. To successfully implement a company's business model, structure, control, and culture must be combined in ways that increase the relationships among all functions to build distinctive competencies.
8. Cost leadership and differentiation each require a structure and control system that strengthens the business model that is the source of their competitive advantage. Managers have to use organizational design in a way that balances pressures to increase differentiation against pressures to lower the cost structure.
9. Other specialized kinds of structures include the product, market, geographic, matrix, and product-team structures. Each has a specialized use and is implemented as a company's strategy warrants.
10. Restructuring and reengineering are two ways of implementing a company's business model more effectively.

## DISCUSSION QUESTIONS

1. What is the relationship among organizational structure, control, and culture? Give some examples of when and under what conditions a mismatch among these components might arise.
2. What kind of structure best describes the way your (a) business school and (b) university operate? Why is the structure appropriate? Would another structure fit better?
3. When would a company choose a matrix structure? What are the problems associated with managing this structure, and why might a product-team structure be preferable?
4. For each of the structures discussed in the chapter, outline the most suitable control systems.
5. What kind of structure, controls, and culture would you be likely to find in (a) a small manufacturing company, (b) a chain store, (c) a high-tech company, and (d) a Big Four accounting firm?

## PRACTICING STRATEGIC MANAGEMENT

### Small-Group Exercise: Deciding on an Organizational Structure

Break up into groups of three to five people and discuss the following scenario. You are a group of managers of a major soft drink company that is going head-to-head with Coca-Cola to increase market share. Your business model is based on increasing your product range to offer a soft drink in every segment of the market to attract customers. Currently you have a functional structure. What you are trying to work out now is how best to implement your business model to launch your new products. Should you move to a more complex kind of product structure and, if so, which one? Alternatively, should you establish new-venture divisions and spin off each kind of new soft drink into its own company so that it can focus its resources on its market niche? Thinking strategically, debate the pros and cons of the possible organizational structures and decide which structure you will implement.

### Article File 12

Find an example of a company that competes in one industry and has recently changed the way it implements its business model and strategies. What changes did it make? Why did it make these changes? What effect did these changes have on the behavior of people and functions?

### Strategic Management Project: Module 12

This module asks you to identify how your company implements its business model and strategy. For this part of your project, you need to obtain information about your company's structure, control systems, and culture. This information may be hard to obtain unless you can interview managers directly. But you can make many inferences about the company's structure from the nature of its activities, and if you write to the company, it may provide you with an organizational chart and other

information. Also, published information, such as compensation for top management, is available in the company's annual reports or 10-K reports. If your company is well known, magazines such as *Fortune* and *Business Week* frequently report on corporate culture or control issues. Nevertheless, you may be forced to make some bold assumptions to complete this part of the project.

1. How large is the company as measured by the number of its employees? How many levels in the hierarchy does it have from the top to the bottom? Based on these two measures and any other information you may have, would you say your company operates with a relatively tall or flat structure? Does your company have a centralized or decentralized approach to decision making?
2. What changes (if any) would you make to the way the company allocates authority and responsibility?
3. Draw an organizational chart showing the main way in which your company groups its activities. Based on this chart, decide what kind of structure (functional, product, or divisional) your company is using.
4. Why did your company choose this structure? In what ways is it appropriate for its business model? In what ways is it not?
5. What kind of integration or integration mechanisms does your company use?
6. What are the main kinds of control systems your company is using? What kinds of behaviors is the organization trying to (a) shape and (b) motivate through the use of these control systems?
7. What role does the top management team play in creating the culture of your organization? Can you identify the characteristic norms and values that describe the way people behave in your organization? How does the design of the organization's structure affect its culture?

8. What are the sources of your company's distinctive competencies? Which functions are most important to it? How does your company design its structure, control, and culture to enhance its (a) efficiency, (b) quality, (c) innovativeness, and (d) responsiveness to customers?
9. How does it design its structure and control systems to strengthen its business model? For example, what steps does it take to further cross-functional integration? Does it have a functional, product, or matrix structure?
10. How does your company's culture support its business model? Can you determine any ways in which its top management team influences its culture?
11. Based on this analysis, would you say your company is coordinating and motivating its people and subunits effectively? Why or why not? What changes (if any) would you make to the way your company's structure operates? What use could it make of restructuring or reengineering?

## CLOSING CASE

### Strategy Implementation at Dell Computer

Dell Computer was one of the fastest-growing companies of the 1990s, and its stock price increased at the rate of 100% per year, delighting its stockholders. Achieving this high return has been a constant challenge for Michael Dell. One of his biggest battles has been to manage and change Dell's organizational structure, control systems, and culture as his company grows.

Michael Dell was 19 in 1984, when he took \$1,000 and spent it on the computer parts he assembled into PCs that he sold over the phone. Increasing demand for his PCs meant that within a few weeks, he needed to hire people to help him. Soon he found himself supervising three employees who worked together around a six-foot table to assemble computers while two more employees took orders over the phone.<sup>54</sup>

By 1993, Dell employed 4,500 workers and was hiring more than 100 new workers each week just to keep pace with the demand for the computers. When he found himself working 18-hour days managing the company, he realized that he could not lead the company single-handedly. The company's growth had to be managed, and he knew that he had to recruit and hire strategic managers who had experience in managing different functional areas, such as marketing, finance, and manufacturing. He recruited executives

from IBM and Compaq. With their help, he created a functional structure, one in which employees were grouped by their common skills or tasks they performed, such as sales or manufacturing, to organize the value chain activities necessary to deliver his PCs to customers. As a part of this organizing process, Dell's structure also became taller, with more levels in the management hierarchy, to ensure that he and his managers had sufficient control over the different activities of his growing business. Michael Dell delegated authority to control Dell's functional value chain activities to his managers, which gave him the time he needed to perform his entrepreneurial task of finding new opportunities for the company.

Dell's functional structure worked well and, under its new management team, the company's growth continued to soar. Moreover, Dell's new structure had given functional managers the control they needed to squeeze out costs, and Dell had become the lowest-cost PC maker. Analysts also reported that Dell had developed a lean organizational culture, meaning that employees had developed norms and values that emphasized the importance of working hard to help each other find innovative new ways of making products to keep costs low and increase their reliability. Indeed, Dell rose to the top of the customer satisfaction rankings for PC makers because few customers



complained about its products. Its employees became known for the excellent customer service they gave to PC buyers who were experiencing problems with setting up their computers.

However, Michael Dell realized that new and different kinds of problems were arising. Dell was now selling huge numbers of computers to different kinds of customers, for example, home, business, and educational customers and different branches of government. Because customers were demanding computers with different features or more computing power, the company's product line broadened rapidly. It became more difficult for employees to meet the needs of these customers efficiently because each employee needed information about all product features or all of Dell's thousands of different sales offers across its product range.

By the late 1990s, Michael Dell moved to change his company to a market structure and created separate divisions, each geared to the needs of a different group of customers: a consumer division, a business division, and so on. In each division, teams of employees specialized in servicing the needs of one of these customer groups. This move to a more complex structure also allowed each division to develop a unique subculture that suited its tasks, and employees were able to obtain in-depth knowledge about the needs of their market that helped them to respond better to their customers' needs. So successful was this change in structure and culture that by 2000, Dell's revenues were more than \$35 billion and its profits in excess of \$3 billion, a staggering increase from 1984.<sup>55</sup>

Michael Dell has continued to change his company's structure in the 2000s to respond to changing customer needs and increasing competitive challenges from Apple and HP. For example, Michael Dell realized that he could leverage his company's strengths in materials management, manufacturing,

and Internet sales over a wider range of computer hardware products. He decided to begin assembling servers, workstations, and storage devices to compete with IBM, Sun, and HP. The increasing importance of the Internet also led him to pay more attention to more specialized groups of customers and find the best way to customize its approach to best meet each group's specific needs over the Internet. Today, for example, Dell can offer large and small companies and private buyers a complete range of computers, workstations, and storage devices that can be customized to their needs.

To help coordinate its growing activities, Dell is increasingly making use of its corporate Intranet to standardize activities across divisions and integrate its activities across functions to reduce costs. Dell's hierarchy is shrinking as managers increasingly delegate decision making to employees who use its advanced IT to access the information they need to provide excellent customer service. To reduce costs, Dell has also outsourced most of its customer service function to India.<sup>56</sup> As a result of these moves, Dell's smaller United States workforce has become even more committed to maintain a low-cost advantage. Its cost-conscious culture is more than ever an important factor affecting its competitive advantage that has been threatened by the many cost-saving moves made by competitors such as Apple and HP that have imitated and even improved on its cost-saving strategies.<sup>57</sup>

### Case Discussion Questions

1. Why has Dell moved to different kinds of organizational structures over time?
2. Has Dell's performance been improved?
3. Search the Internet to find out how Dell has been trying to increase its performance and how its competitors such as Apple and HP have also been working to improve theirs.

# IMPLEMENTING STRATEGY IN COMPANIES THAT COMPETE ACROSS INDUSTRIES AND COUNTRIES

## LEARNING OBJECTIVES

After reading this chapter, you should be able to

- Discuss the reasons why companies pursuing different corporate strategies need to implement these strategies using different combinations of organizational structure, control, and culture
- Describe the advantages and disadvantages of a multidivisional structure
- Explain why companies that pursue different kinds of global expansion strategies choose different kinds of global structures and control systems to implement them
- Discuss the strategy implementation problems associated with the three main methods used to enter new industries: internal new venturing, joint ventures, and mergers
- Identify the ways in which advanced IT may reduce bureaucratic costs and allow a company to more effectively implement its business model

## Avon Is Calling for a New Global Structure

After a decade of profitable growth under its CEO Andrea Jung, Avon's global sales suddenly began to fall in the mid-2000s in developing markets in Central Europe, Russia, and China, which had been major contributors to its rising sales, as well as in the United States and Mexico.

Avon's stock price plunged in 2006, and Jung was shocked by the turn of events. For the first time as CEO, she was in the position of having to find ways to solve Avon's problems—rather than ways to add to its success.<sup>1</sup>

After several months jetting around the globe to visit the managers of Avon's divisions,

she came to a surprising conclusion. Avon's rapid global expansion had given these global managers *too* much autonomy and authority to control operations in their respective countries and world regions. As a result, they made decisions that benefitted their own global divisions, but these decisions had hurt the performance



of the whole company. Avon's country-level managers from Poland to Mexico ran their own factories, made their own product development decisions, and developed their own advertising campaigns. Many of these decisions had been based on poor marketing knowledge, with little concern for operating costs, because their goal was to increase their division's sales as fast as possible. When too much authority is decentralized to managers lower in an organization's hierarchy, the managers often recruit more managers to help them build their country "empires." The result was that Avon's global organizational hierarchy had exploded: it had risen from 7 to 15 levels of managers in a decade as tens of thousands of extra managers were hired around the globe!<sup>2</sup> Because Avon's profits were rising fast, Jung and her top management team had not paid enough attention to the way Avon's organizational structure was becoming taller—just as it was getting wider as it entered more countries to expand cosmetics sales.

This was a nightmare scenario. Jung had to confront the need to lay off thousands of global managers and restructure the organizational hierarchy to reduce costs and boost profitability. She embarked on a program to take away the authority of Avon's country-level managers and transfer authority to regional and corporate headquarters managers to streamline decision making and reduce costs. She cut out seven levels of management and eliminated 25% of its global managers in its 114 worldwide markets. Then, using teams of expert managers from corporate headquarters, she embarked on a detailed examination of all of Avon's functional activities, country by country, to find out why costs had risen so quickly and what could be done to bring them under control. The duplication of marketing efforts in countries around the world was one source of these high costs. In Mexico, one team found that country managers' desire to expand their empires had led to the development of a staggering 13,000 different products. Not only

had this caused product development costs to soar, it had led to major marketing problems. How could Avon's Mexican sales reps learn all about the 13,000 products—and then find an easy way to tell customers about them?

In Avon's new structure, all new major product development is now centralized in the United States. While the input from global managers is used to customize products to the likes of each country, for example, fragrance, packaging and so on, the more than 1,000 new products a year Avon introduces are developed in its United States R&D laboratories. Similarly, to reduce costs, all marketing campaigns targeted toward the average "global" customer are developed by Avon's United States marketing function. Then they can be easily customized to a particular country or world region by, for example, using the appropriate language or the nationality of the models to market the product. Other initiatives have been to increase the money spent on global marketing, which had not kept pace with its rapid global expansion, and a major push to increase the number of Avon salespeople in developing nations, who number in the millions, to attract more customers.<sup>3</sup>

Country-level managers now are responsible for managing this army of Avon reps and for making sure that marketing dollars are being directed toward the right channels for maximum impact. However, they no longer have the authority to engage in major product development or build new manufacturing capacity—or hire new managers without the permission of regional or corporate level managers who are now focused on reducing Avon's cost structure. The major changes Jung made to Avon's organizational structure and culture has totally changed the balance of power and changed the way the company implements its web of global strategies. Today, Jung and all her managers are focusing on developing strategies that strengthen the business model of the entire company, not just its individual global divisions.

## Overview

The story of Andrea Jung's efforts to develop a new organizational structure and culture to compete effectively in countries around the world suggests how complex strategic thinking becomes at the corporate level. Companies have to continuously examine and improve the way they implement their business and multibusiness models to increase their long-run profitability. If they fail to, like Avon, the result can be a nightmare. This chapter begins where the last one ends; it examines how to implement strategy when a company decides to enter and compete in new industries or in new countries when it expands globally. The strategy implementation issue remains the same: how to use organizational design and combine organizational structure, control, and culture to strengthen a company's multibusiness model and increase its profitability.

Once a company decides to compete across industries and countries, it confronts a new set of problems; however, some of them continuations of the organizational problems we discussed in Chapter 12, and some of them are a direct consequence of the decision to enter and compete in overseas markets and new industries. As a result, strategic managers have to make a new series of organizational design decisions to successfully implement their company's new global multibusiness model. By the end of the chapter, you will appreciate the many complex issues that confront global multibusiness companies and understand why effective strategy implementation is an integral part of achieving competitive advantage and superior performance.

## MANAGING CORPORATE STRATEGY THROUGH THE MULTIDIVISIONAL STRUCTURE

As Chapter 10 discusses, corporate-level strategies such as vertical integration or diversification can be used in many ways to strengthen a company's business model and improve its competitive position. However, important implementation problems also arise when a company enters new industries, often due to the increasing bureaucratic costs associated with managing a collection of business units that operate in different industries. Bureaucratic costs are especially high when a company seeks to gain the differentiation and low-cost advantages of transferring, sharing, or leveraging its distinctive competencies across its business units in different industries. For companies pursuing a multibusiness model based on related diversification, for example, the problems and costs of managing the handoffs or transfers between the value chain functions of its different business units to boost profitability rise sharply. The need to economize on these costs propels strategic managers to search for improved ways to implement the corporate-level strategies necessary to pursue a multibusiness model.

As a company begins to enter new industries and produce different kinds of products, such as cars, fast food, and computers, the structures described in Chapter 12, such as the functional and product structures, are not up to the task. These structures cannot provide the level of coordination between managers and functions necessary to implement a multibusiness model effectively. As a result, the control problems that give rise to bureaucratic costs, such as those related to measurement, customers, location, or strategy, escalate. Experiencing these problems is a sign that a company has outgrown its structure. Strategic managers need to invest more



resources to develop a more complex structure—one that allows it to implement its multibusiness model and strategies successfully. The answer for most large, complex companies is to move to a multidivisional structure, design a cross-industry control system, and fashion a corporate culture to reduce these problems and economize on bureaucratic costs.

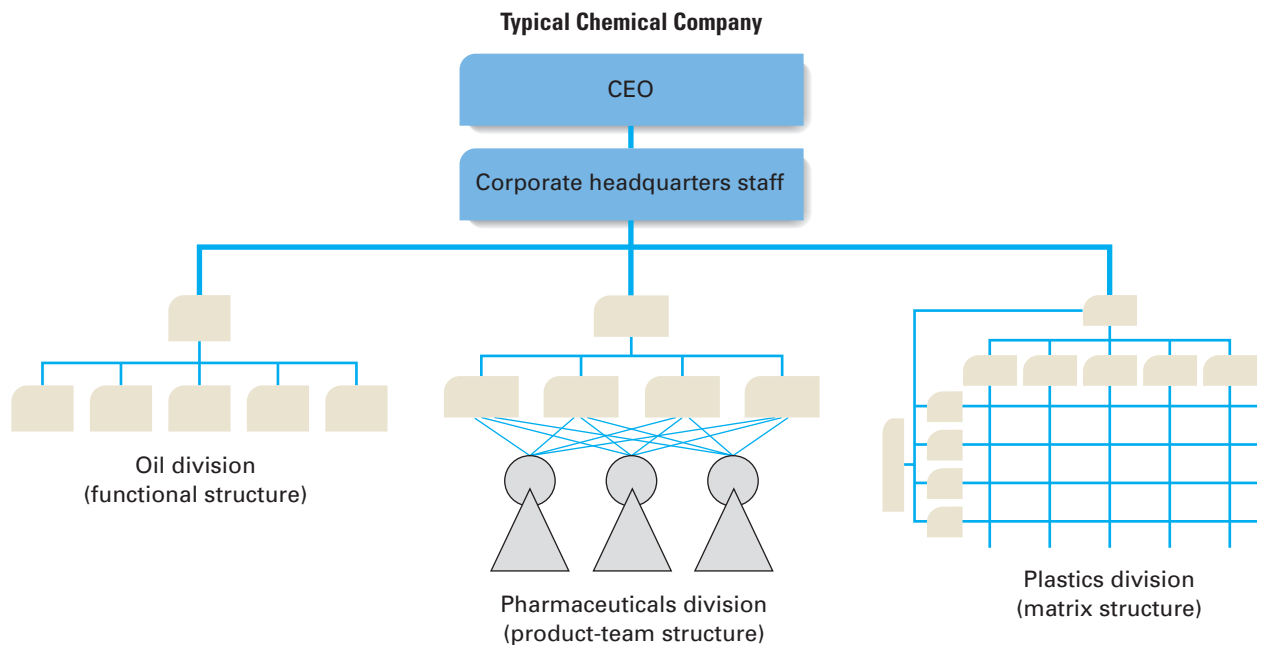
A multidivisional structure has two organizational design advantages over a functional or product structure that allow a company to grow and diversify in a way that reduces the coordination and control problems that are inevitable when it enters and competes in new industries. First, in each industry in which a company operates, strategic managers group all its different business operations in that industry into one division or subunit. Normally, each division contains a full set of the value chain functions it needs to pursue its industry business model and is called a *self-contained division*. For example, GE competes in more than 150 different industries, and in each industry, all of its divisions are self-contained, performing all the value creation functions necessary to give the division a competitive advantage.

Second, the office of *corporate headquarters staff* is created to monitor divisional activities and exercise financial control over each division.<sup>4</sup> This staff contains the corporate-level managers who oversee the activities of divisional managers. Hence, the organizational hierarchy is taller in a multidivisional structure than in a product or functional structure. The role of the new level of corporate management is to develop strategic control systems that lower a company's overall cost structure, including finding ways to economize on the costs of controlling the handoffs and transfers between divisions. The extra cost of these corporate managers is more than justified if their actions can lower the cost structure of the operating divisions or increase the divisions' ability to differentiate their product—both of which boost a company's ROIC.

In the multidivisional structure, the day-to-day operations of each division are the responsibility of divisional management; that is, divisional management has *operating responsibility*. The corporate headquarters, which includes top executives as well as their support staff, is responsible for overseeing the company's long-term multibusiness model and providing guidance for interdivisional projects. These executives have *strategic responsibility*. Such a combination of self-contained divisions with a centralized corporate management provides the extra coordination and control necessary to enter new industries successfully.

Figure 13.1 illustrates a typical multidivisional structure found in a large chemical company such as DuPont. Although this company might easily have 20 different divisions, only three—the oil, pharmaceuticals, and plastics divisions—are represented in this figure. Each division possesses the value chain functions it needs to pursue its own industry business model. Each division is treated by corporate managers as an independent profit center, and measures of profitability such as ROIC are used to monitor and evaluate each division's individual performance.<sup>5</sup> The use of this kind of output control makes it easier for corporate managers to identify high-performing and underperforming divisions and to take corrective action as necessary.

Because the division operates independently, the strategic or divisional managers in charge of each individual division can choose which organizational structure (for example, a product, matrix, or market structure), control systems, and culture to adopt to implement its business model and strategies most effectively. Figure 13.1 illustrates how this process works. It shows that managers of the oil division have chosen a functional structure to pursue its cost leadership strategy. The pharmaceuticals division has adopted a product-team structure to encourage the speedy

**Figure 13.1** Multidivisional Structure

development of new drugs. And managers of the plastics division implement a matrix structure that promotes cooperation between functions and speeds the innovation of improved plastic products that suit the changing needs of customers. These two divisions are pursuing differentiation based on a distinctive competence in innovation.

The CEO famous for employing the multidivisional structure to great advantage was Alfred Sloan, GM's first CEO, who implemented a multidivisional structure in 1921, noting that GM "needs to find a principle for coordination without losing the advantages of decentralization." Sloan placed each of GM's different car brands in a self-contained division so it possessed its own functions—sales, production, engineering, and finance. Each division was treated as a profit center and evaluated on its return on investment. Sloan was clear about the main advantage of decentralization: it made it much easier to evaluate the performance of each division. And, Sloan observed, it (1) "increases the morale of the organization by placing each operation on its own foundation...assuming its own responsibility and contributing its share to the final result"; (2) "develops statistics correctly reflecting...the true measure of efficiency"; and (3) "enables the corporation to direct the placing of additional capital where it will result in the greatest benefit to the corporation as a whole."<sup>6</sup>

Sloan recommended that exchanges or handoffs between divisions be set by a *transfer-pricing system* based on the cost of making a product plus some agreed-on rate of return. He recognized the risks that internal suppliers might become inefficient and raise the cost structure, and he recommended that GM should benchmark competitors to determine the fair price for a component. He established a centralized headquarters management staff to perform these calculations. Corporate management's primary role was to audit divisional performance and plan strategy for the



total organization. Divisional managers were to be responsible for all competitive product-related decisions.

### Advantages of a Multidivisional Structure

When managed effectively at both the corporate and the divisional levels, a multidivisional structure offers several strategic advantages. Together, they can raise corporate profitability to a new peak because they allow a company to more effectively implement its multibusiness model and strategies.

**Enhanced Corporate Financial Control** The profitability of different business divisions is clearly visible in the multidivisional structure.<sup>7</sup> Because each division is its own profit center, financial controls can be applied to each business on the basis of profitability criteria such as ROIC. Corporate managers establish performance goals for each division, monitor their performance on a regular basis, and intervene selectively if a division starts to underperform. They can then use this information to identify the divisions in which investment of the company's financial resources will yield the greatest long-term ROIC. As a result, they can allocate the company's funds among competing divisions in an optimal way, that is, a way that will maximize the profitability of the *whole* company. Essentially, managers at corporate headquarters act as "internal investors" who channel funds to high-performing divisions in which they will produce the most profits.

**Enhanced Strategic Control** The multidivisional structure makes divisional managers responsible for developing each division's business model and strategies; this allows corporate managers to focus on developing the multibusiness model, which is their main responsibility. The structure gives corporate managers the time they need to contemplate wider long-term strategic issues and develop a coordinated response to competitive changes, such as quickly changing industry boundaries. Teams of managers at corporate headquarters can also be created to collect and process crucial information that leads to improved functional performance at the divisional level. These managers also perform long-run strategic and scenario planning to find new ways to increase the performance of the entire company, such as evaluating which of the industries they compete in will likely be the most profitable in the future and vice versa. Then they can decide which industries they should expand into and which they should exit.

**Profitable Long-Run Growth** The division of responsibilities between corporate and divisional managers in the multidivisional structure allows a company to overcome organizational problems, such as communication problems and information overload. Divisional managers work to enhance their divisions' profitability; teams of managers at corporate headquarters devote their time to finding opportunities to expand or diversify its existing businesses so that the entire company enjoys profitable growth. Communication problems are also reduced because corporate managers use the same set of standardized accounting and financial output controls to evaluate all divisions. Also, from a behavior control perspective, corporate managers can implement a policy of management by exception, which means that they intervene only when problems arise.

**Stronger Pursuit of Internal Efficiency** As a single-business company grows, it often becomes difficult for top managers to accurately assess the profit contribution

of each functional activity because their activities are so interdependent. This means that it is often difficult for top managers to evaluate how well their company is performing relative to others in its industry—and to identify or pinpoint the specific source of the problem. As a result, inside one company, considerable degrees of organizational slack—that is, the unproductive use of functional resources—can go undetected. For example, the head of the finance function might employ a larger staff than is required for efficiency to reduce work pressures inside the department and to bring the manager higher status. In a multidivisional structure, however, corporate managers can compare the performance of one division against another in terms of its cost structure, sales, and the profit it generates. The corporate office is thus in a better position to identify the managerial inefficiencies that result in bureaucratic costs; divisional managers have no excuses for poor performance.

### Problems in Implementing a Multidivisional Structure

Although research suggests large companies that adopt multidivisional structures outperform those that retain functional structures, multidivisional structures have their disadvantages as well.<sup>8</sup> Good management can eliminate some of them, but others are inherent in the way the structure operates. Corporate managers have to continually pay attention to the way they operate to detect problems, such as the one Andrea Jung experienced at Avon described in the Opening Case.

**Establishing the Divisional-Corporate Authority Relationship** The authority relationship between corporate headquarters and the divisions must be correctly established. The multidivisional structure introduces a new level in the management hierarchy: the corporate level. The problem for corporate managers is to decide how much authority and control to delegate to divisional managers and how much authority to retain at corporate headquarters to give them the power to increase long-run profitability. Sloan encountered this problem when he implemented GM's multidivisional structure.<sup>9</sup> He found that when corporate managers retained too much power and authority, the managers of its business divisions lacked the autonomy required to change its business model to meet rapidly changing competitive conditions; the need to gain approval from corporate managers slowed down decision making. On the other hand, when too much authority is delegated to divisions, managers may start to pursue strategies that benefit their own divisions but add little to the whole company's profitability. The Opening Case describes how Avon recentralized control over its functional operations to United States corporate managers to prevent this problem.

The most important issue in managing a multidivisional structure is how much authority should be *centralized* at corporate headquarters and how much should be *decentralized* to the divisions. Corporate managers must consider how their company's multibusiness model and strategies will be affected by the way they make this decision now and in the future. There is no easy answer because every company is different. Also, as the environment changes or a company alters its multibusiness model, the optimal balance between centralization and decentralization of authority will change over time.

**Restrictive Financial Controls Lead to Short-Run Focus** Suppose corporate managers place too much emphasis on each division's *individual* profitability, for example, by establishing very high and stringent ROIC targets for each division.

Divisional managers may begin to distort the information they supply to corporate managers to hide declining divisional performance or start to pursue strategies that increase short-run profitability but reduce future profitability. For example, divisional managers may attempt to make the ROIC of their division look better by cutting investments in R&D, product development, or marketing—all of which increase ROIC in the short run. In the long run, however, cutting back on the investments and expenditures necessary to maintain the division's performance, particularly the crucial R&D investments that lead a stream of innovative products, will reduce its long-term profitability. Hence, corporate managers must carefully control their interactions with divisional managers to ensure that both the short- and long-term goals of the business are being met. In sum, the problem stems from the use of too restrictive financial controls; Chapter 11 discusses the “balanced scorecard” approach that helps solve it.

**Competition for Resources** The third problem of managing a multidivisional structure is that when the divisions compete among themselves for scarce resources, this rivalry can make it difficult or impossible to obtain the gains from transferring, sharing, or leveraging distinctive competencies across business units. For example, every year the funds available to corporate managers to allocate or distribute to the divisions is fixed, and, usually, the divisions that have obtained the highest ROIC receive proportionally more of these funds. In turn, because they have more money to invest in their business, this usually will raise their performance the next year so strong divisions grow ever stronger. This is what leads to competition for resources and reduces interdivisional coordination; there are many recorded instances in which one division manager tells another, “You want our new technology? Well you have to pay us \$2 billion to get it.” When divisions battle over transfer prices, the potential gains from pursuing a multibusiness model are lost.

**Transfer Pricing** As just noted, competition among divisions may lead to battles over **transfer pricing**, that is, conflicts over establishing the fair or “competitive” price of a resource or skill developed in one division that is to be transferred and sold to other divisions that require it. As Chapter 9 discusses, a major source of bureaucratic costs are the problems that arise from handoffs or transfers between divisions to obtain the benefits of the multibusiness models when pursuing a vertical integration or related diversification strategy. The problem of setting prices for resource transfers between divisions is a major source of these problems, because every supplying division has the incentive to set the highest possible transfer price for its products or resources to maximize its *own* profitability. The “purchasing” divisions realize the supplying divisions’ attempts to charge high prices will reduce their profitability; the result is competition between divisions that undermines cooperation and coordination. Such competition can completely destroy the corporate culture and turn a company into a battleground. If such battles go unresolved, the benefits of the multibusiness model will not be achieved. Hence, corporate managers must be sensitive to this problem and work hard with the divisions to design incentive and control systems to make the multidivisional structure work. Indeed, managing transfer pricing is one of corporate managers’ most important tasks.

**Duplication of Functional Resources** Because each division has its own set of value chain functions, functional resources are duplicated across divisions; thus, multidivisional structures are expensive to operate. R&D and marketing are

especially costly functional activities; to reduce their cost structure, some companies centralize most of the activities of these two functions at the corporate level in which they service the needs of all divisions. The expense involved in duplicating functional resources does not result in major problems if the differentiation advantages that result from the use of separate sets of specialist functions are substantial. Corporate managers must decide whether the duplication of functions is financially justified. And, they should always be on the lookout for ways to centralize or even outsource functional activities when this will reduce a company's cost structure and increase long-run profitability.

In sum, the advantages of divisional structures must be balanced against the problems of implementing them, but an observant, professional set of corporate (and divisional) managers who are sensitive to the issues involved can respond to and manage these problems. Indeed, advances in IT have made strategy implementation easier, as we discuss later in the chapter.

### Structure, Control, Culture, and Corporate-Level Strategy

Once corporate managers select a multidivisional structure, they must then make choices about what kind of integrating mechanisms and control systems to use to make the structure work efficiently. Such choices depend on whether a company chooses to pursue a multibusiness model based on a strategy of unrelated diversification, vertical integration, or related diversification.

As Chapter 9 discusses, many possible differentiation and cost advantages derive from vertical integration. A company can coordinate resource transfers between divisions operating in adjacent industries to reduce manufacturing costs and improve quality, for example.<sup>10</sup> This might mean locating a rolling mill next to a steel furnace to save the costs of reheating steel ingots, making it easier to control the quality of the final product.

The principal benefits from related diversification also derive from transferring, sharing, or leveraging functional competencies across divisions, such as sharing distribution and sales networks to increase differentiation or lower the overall cost structure. With both strategies, the benefits to the company result from some *exchange* of distinctive competencies among divisions. To secure these benefits, managers must coordinate the activities of the various divisions, so an organization's structure and control systems must be designed to manage the handoffs or transfers among divisions.

In the case of unrelated diversification, the multibusiness model is based on using general strategic management capabilities, for example, in corporate finance or organizational design. Corporate managers' ability to create a culture that supports entrepreneurial behavior that leads to rapid product development, or restructure an underperforming company and establish an effective set of financial controls, can result in major increases in profitability. With this strategy, however, there are *no* exchanges among divisions; each division operates separately and independently. The only exchanges that need to be coordinated are those between the divisions and corporate headquarters. Structure and control must therefore be designed to allow each division to operate independently, while at the same time making it easy for corporate managers to monitor divisional performance and intervene if necessary.

The choice of structure and control mechanisms depends on the degree to which a company using a multidivisional structure needs to control the handoffs and interactions among divisions. The more interdependent the divisions—that is, the more they

**Table 13.1** Corporate Strategy, Structure, and Control

Corporate Strategy	Appropriate Structure	Need for Integration	Type of Control		
			Financial Control	Behavior Control	Organizational Culture
Unrelated Diversification	Multidivisional	Low (no exchanges between divisions)	Great use (e.g., ROIC)	Some use (e.g., budgets)	Little use
Vertical Integration	Multidivisional	Medium (scheduling resource transfers)	Great use (e.g., ROIC, transfer pricing)	Great use (e.g., standardization, budgets)	Some use (e.g., shared norms and values)
Related Diversification	Multidivisional	High (achieving synergies between divisions by integrating roles)	Little use	Great use (e.g., rules, budgets)	Great use (e.g., norms, values, common language)

depend on each other for skills, resources, and competencies—the greater are the bureaucratic costs associated with obtaining the potential benefits from a particular corporate-level strategy.<sup>11</sup> Table 13.1 illustrates what forms of structure and control companies should adopt to economize on the bureaucratic costs associated with the three corporate strategies of unrelated diversification, vertical integration, and related diversification.<sup>12</sup> We examine these strategies in detail in the next sections.

**Unrelated Diversification** Because there are *no exchanges or linkages* among divisions, unrelated diversification is the easiest and cheapest strategy to manage; it is associated with the lowest level of bureaucratic costs. The main advantage of the structure and control system is that it allows corporate managers to evaluate divisional performance accurately. Thus, companies use multidivisional structures, and each division is evaluated by output controls such as ROIC. A company also uses an IT-based system of financial controls to allow corporate managers to obtain information quickly from the divisions and compare their performance on many dimensions. UTC, Tyco, Textron, and Dover are good examples of companies that use sophisticated financial controls to manage their structures and track divisional performance on a daily basis.

Divisions usually have considerable autonomy *unless* they fail to reach their ROIC goals, in which case corporate managers will intervene in the operations of a division to help solve problems. As problems arise, corporate managers step in and take corrective action, such as replacing managers or providing additional funding, depending on the reason for the problem. If they see no possibility of a turnaround, they may decide to divest the division. The multidivisional structure allows the unrelated company to operate its businesses as a portfolio of investments that can be bought and sold as business conditions change. Typically, managers in the various divisions do not know one another; they may not even know what other companies are in the corporate portfolio. Hence, the idea of a corporate-wide culture is meaningless.

The use of financial controls to manage a company means that no integration among divisions is necessary. This is why the bureaucratic costs of managing an unrelated company are low. The biggest problem facing corporate managers is to make capital allocations decisions between divisions to maximize the overall profitability of the portfolio and monitor divisional performance to ensure they are meeting ROIC targets.

Alco Standard, based in Valley Forge, Pennsylvania, demonstrates how to operate a successful strategy of unrelated diversification. Alco is one of the largest office supply companies in the United States, distributing office and paper supplies and materials through a nationwide network of wholly owned distribution companies. The policy of Alco's top management is that authority and control should be completely decentralized to the managers in each of the company's 50 divisions. Each division is left alone to make its own manufacturing or purchasing decisions, even though some potential benefits that could be obtained from corporate-wide purchasing or marketing are lost. Corporate managers pursue this nonintervention policy because they believe that the gains from allowing its managers to act as independent entrepreneurs exceed the potential cost savings that would result from coordinating divisional activities. It believes that a decentralized operating system allows a big company to act similar to a small company and avoids the problems that arise when companies become bureaucratic and hard to change.

**Vertical Integration** Vertical integration is a more expensive strategy to manage than unrelated diversification because *sequential resource flows* from one division to the next must be coordinated. Once again, the multidivisional structure economizes on the bureaucratic costs associated with achieving such coordination because it provides the centralized control necessary for a vertically integrated company to benefit from resource transfers. Corporate managers are responsible for devising financial output and behavior controls that solve the problems of transferring resources from one division to the next; for example, they solve transfer pricing problems. Also, rules and procedures are created that specify how resource exchanges are made to solve potential handoff problems; complex resource exchanges may lead to conflict among divisions; and corporate managers must try to prevent this.

The way to distribute authority between corporate and divisional managers must be considered carefully in vertically integrated companies. The involvement of corporate managers in operating issues at the divisional level runs the risk that divisional managers feel they have no autonomy, so their performance suffers. These companies must strike the right balance of centralized control at corporate headquarters and decentralized control at the divisional level if they are to implement this strategy successfully.

Because the interests of their divisions are at stake, divisional managers need to be involved in decisions concerning scheduling and resource transfers. For example, the plastics division in a chemical company has a vital interest in the activities of the oil division because the quality of the products it gets from the oil division determines the quality of its own products. Integrating mechanisms must be created between divisions that encourage their managers to freely exchange or transfer information and skills.<sup>13</sup> To facilitate communication among divisions, corporate managers create teams composed of both corporate and divisional managers, **integrating roles** whereby an experienced corporate manager assumes the responsibility for managing complex transfers between two or more divisions. The use of integrating roles to coordinate divisions is common in high-tech and chemical companies, for example.



Thus, a strategy of vertical integration is managed through a combination of corporate and divisional controls. As a result, the organizational structure and control systems used to economize on the bureaucratic costs of managing this strategy are more complex and difficult to implement than those used for unrelated diversification. However, as long as the benefits that derive from vertical integration are realized, the extra expense in implementing this strategy can be justified.

**Related Diversification** In the case of related diversification, the gains from pursuing this multibusiness model derive from the transfer, sharing, and leveraging of R&D knowledge, industry information, customer bases, and so on, across divisions. Also, with this structure, the high level of divisional resource sharing and the exchange of functional competencies makes it difficult for corporate managers to evaluate the performance of each individual division.<sup>14</sup> Thus, bureaucratic costs are substantial. The multidivisional structure helps to economize on these costs because it provides some of the extra coordination and control that is required. However, if a related company is to obtain the potential benefits from using its competencies efficiently and effectively, it has to adopt more complicated forms of integration and control at the divisional level to make the structure work.

First, output control is difficult to use because divisions share resources, so it is not easy to measure the performance of an individual division. Therefore, a company needs to develop a corporate culture that stresses cooperation among divisions and corporate rather than purely divisional goals. Second, corporate managers must establish sophisticated integrating devices to ensure coordination among divisions. Integrating roles and even integrating teams of corporate and divisional managers are essential because they provide the forum in which managers can meet, exchange information, and develop a common vision of corporate goals. An organization with a multidivisional structure must have the right mix of incentives and rewards for cooperation if it is to achieve gains from sharing skills and resources among divisions.<sup>15</sup> With unrelated diversification, divisions operate autonomously, and the company can quite easily reward managers on their division's individual performance. With related diversification, however, rewarding divisions is more difficult because they are engaged in so many shared activities, and corporate managers must be alert to the need to achieve equity in the rewards the different divisions receive. The goal is always to design a company's structure and control systems to maximize the benefits from pursuing a particular strategy while economizing on the bureaucratic costs of implementing it.

## The Role of Information Technology

The expanding use of IT is increasing the advantages and reducing the problems associated with implementing a multibusiness model effectively because it facilitates output control, behavior control, and integration between divisions and among divisions and corporate headquarters.

On the advantage side, IT provides a common software platform that can make it much less problematic for divisions to share information and knowledge and obtain the benefits from leveraging their competencies. IT facilitates output and financial control, making it easier for corporate headquarters to monitor divisional performance and decide when to intervene selectively. It also helps corporate managers better use their strategic and implementation skills because they can react more quickly given that they possess higher-quality, more timely information from the use of a sophisticated, cross-organizational IT infrastructure.

In a similar fashion, IT makes it easier to manage the problems that occur when implementing a multidivisional structure. Because it provides both corporate and divisional managers with more and better information, it makes it easier for corporate managers to decentralize control to divisional managers and yet react quickly, if the need arises. IT can also make it more difficult to distort information and hide bad news because divisional managers must provide standardized information that can be compared across divisions. Finally, IT eases the transfer pricing problem because divisional managers have access to detailed, up-to-date information about how much certain resources or skills would cost to buy in the external marketplace. Thus, a fair transfer price is easier to determine. The way in which SAP's enterprise resource planning (ERP) software helps to integrate the activities of divisions in a multidivisional structure is discussed in Strategy in Action 13.1.

## 13.1 STRATEGY IN ACTION

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### SAP's ERP System

SAP is the world's leading supplier of enterprise resources planning (ERP) software; it introduced the world's first ERP system in 1973. So great was the demand for its software that it had to train thousands of IT consultants from companies such as IBM, HP, Accenture, and Cap Gemini to install and customize it to meet the needs of companies around the globe. SAP's ERP system is popular because it manages functional activities at all stages of a company's value chain, as well as resource transfers among a company's different divisions.

First, SAP's software has modules specifically designed to manage each core functional activity. Each module contains the set of best practices that SAP's IT engineers have found works in building competencies in efficiency, quality, innovation, and responsiveness to customers. Each function inputs its data into its functional module in the way specified by SAP. For example, sales inputs all the information about customer needs required by SAP's sales module, and materials management inputs information about the product specifications it requires from suppliers into SAP's materials-management module. Each SAP module functions as an *expert system* that can reason through the information that functional managers put into it. It then provides managers with real-time feedback about the current state of vital functional operations and gives recommendations that allow managers to improve them. However, the magic of ERP does not stop there. SAP's ERP software connects across

functions inside each division. This means that managers in all functions of a division have access to other functions' expert systems; SAP's software is designed to alert managers when their functional operations are affected by changes taking place in another function. *Thus, SAP's ERP software allows managers throughout a division to better coordinate their activities*, which is a major source of competitive advantage.

Moreover, SAP software, running on corporate mainframe computers, takes the information from all the different expert systems in the divisions and creates a company-wide ERP system that provides corporate managers with an overview of the operations of all a company's divisions. In essence, SAP's ERP system creates a sophisticated corporate-level expert system that can reason through the huge volume of information being provided by all its divisions and functions. The ERP system can then recognize and diagnose common issues and problems and recommend organization-wide solutions, such as suggesting new ways to leverage, transfer, and share competencies and resources. Top managers, armed with the knowledge that their ERP software provides, can also use it to adjust their business model with the changing environment. The result, SAP claims, is that when a multidivisional company implements its corporate-wide ERP software, it can achieve productivity gains of 30% to 50%, which amounts to billions of dollars of savings for large multinational companies like Nestlé and Exxon.

## IMPLEMENTING STRATEGY ACROSS COUNTRIES

Global strategy can play a crucial role in strengthening the business model of both single-business and multibusiness companies. Indeed, few large companies that have expanded into new industries have not already expanded globally and replicated their business model in new countries to grow their profits. Companies can use four basic strategies as they begin to market their products and establish production facilities abroad:

1. A *localization strategy* is oriented toward local responsiveness, and a company decentralizes control to subsidiaries and divisions in each country in which it operates to produce and customize products to local markets.
2. An *international strategy* is based on R&D and marketing being centralized at home and all the other value creation functions being decentralized to national units.
3. A *global standardization strategy* is oriented toward cost reduction, with all the principal value creation functions centralized at the optimal global location.
4. A *transnational strategy* is focused so that it can achieve local responsiveness and cost reduction. Some functions are centralized; others are decentralized at the global location best suited to achieving these objectives.

The need to coordinate and integrate global value chain activities increases as a company moves from a localization to an international, to a global standardization, and then to a transnational strategy. To obtain the benefits of pursuing a transnational strategy, a company must transfer its distinctive competencies to the global location where it can create the most value and establish a global network to coordinate its divisions at home and abroad. The objective of such coordination is to obtain the benefits from transferring or leveraging competencies across a company's global business units. Thus, the bureaucratic costs associated with solving the communication and measurement problems that arise in managing handoffs or transfers across countries are much higher for companies pursuing a transnational strategy than it is for those pursuing the other strategies. The localization strategy does not require coordinating activities on a global level because value creation activities are handled locally, by country or world region. The international and global standardization strategies fit between the other two strategies although products have to be sold and marketed globally; hence, global product transfers must be managed, and there is less need to coordinate skill and resource transfers when using an international strategy than when using a transnational strategy.

The implication is that, as companies change from localization to international, global standardization, or transnational strategies, they require more complex structures, control systems, and cultures to coordinate the value creation activities associated with implementing those strategies. More complex structures economize on bureaucratic costs. In general, the choice of structure and control systems for managing a global business is a function of three factors:

1. The decision about how to distribute and allocate responsibility and authority between managers at home and abroad so that effective control over a company's global operations is maintained
2. The selection of the organizational structure that groups divisions both at home and abroad in a way that allows the best use of resources and serves the needs of foreign customers most effectively
3. The selection of the right kinds of integration and control mechanisms and organizational culture to make the overall global structure function effectively

**Table 13.2** Global Strategy/Structure Relationships

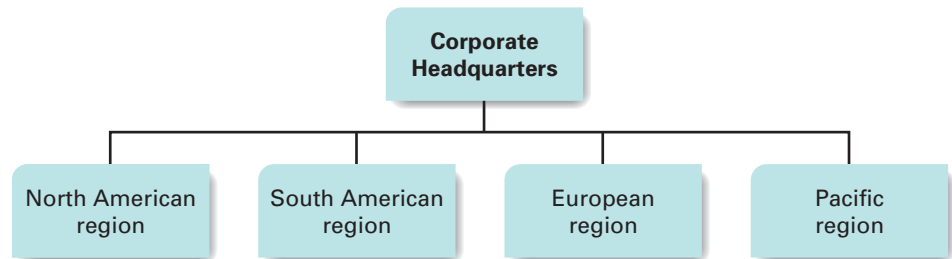
	Localization Strategy	International Strategy	Global Standardization Strategy	Transnational Strategy
	Need for Coordination			
	Low	Bureaucratic Costs		High
<b>Centralization of Authority</b>	Decentralized to national unit	Core competencies centralized; others decentralized to national units	Centralized at optimal global location	Simultaneously centralized and decentralized
<b>Horizontal Differentiation</b>	Global-area structure	Global-division structure	Global product-group structure	Global-matrix structure, matrix-in-the-mind
<b>Need for Complex Integrating Mechanisms</b>	Low	Medium	High	Very high
<b>Organizational Culture</b>	Not important	Quite important	Important	Very important

Table 13.2 summarizes the appropriate design choices for companies pursuing each of these strategies.

### Implementing a Localization Strategy

When a company pursues a localization strategy, it generally operates with a global-area structure (see Figure 13.2). When using this structure, a company duplicates all value creation activities and establishes overseas divisions in every country or world area in which it operates. Authority is decentralized to managers in each overseas division, and these managers devise the appropriate strategy for responding to the needs of the local environment. Managers at global headquarters use market and output controls such as ROIC, growth in market share, and operating costs to evaluate the performance of overseas divisions. On the basis of such global comparisons, they can make decisions about capital allocation and orchestrate the transfer of new knowledge among divisions.

A company that makes and sells the same products in many different countries often groups its overseas divisions into world regions to simplify the coordination of products across countries. Europe might be one region, the Pacific Rim another, and the Middle East a third. Grouping allows the same set of output and behavior controls to be applied across all divisions inside a region. Thus, global companies can reduce communications and transfer problems because information can be transmitted more easily across countries with broadly similar cultures. For example, consumers' preferences regarding product design and marketing are likely to be more similar among countries in one world region than among countries in different world regions.

**Figure 13.2** Global-Area Structure

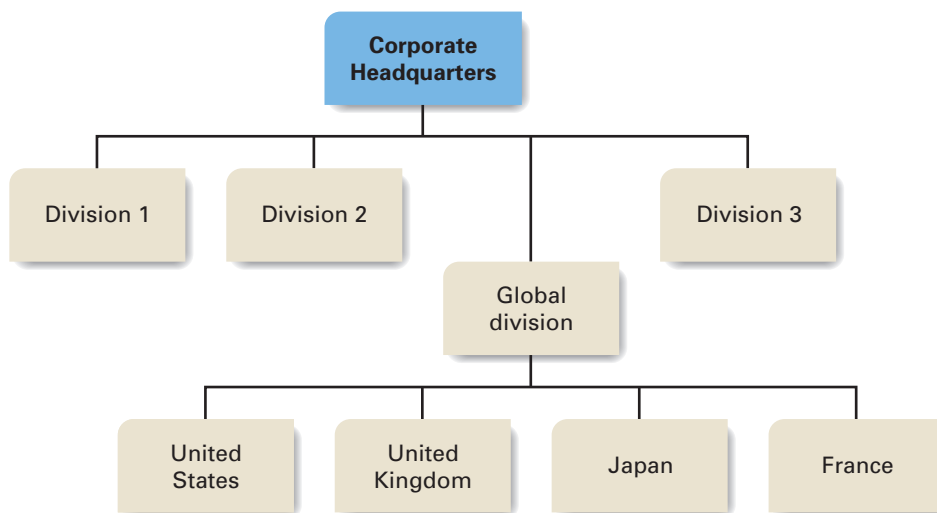
Because the overseas divisions themselves have little or no contact with others in different regions, no integrating mechanisms are needed. Nor does a global organizational culture develop because there are no transfers of skills or resources or transfer of managerial personnel among the various world regions. Historically, car companies such as GM and Ford used global-area structures to manage their overseas operations. Ford of Europe, for example, had little or no contact with its United States parent; capital was the principal resource exchanged.

One problem with a global-area structure and a localization strategy is that the duplication of specialist activities across countries raises a company's overall cost structure. Moreover, the company is not taking advantage of opportunities to transfer, share, or leverage its competencies and capabilities on a global basis; for example, it cannot apply the low-cost manufacturing expertise that it has developed in one world region to another. Thus, localization companies lose the many benefits of operating globally. As Chapter 8 discussed, the popularity of this strategic orientation has decreased.

### Implementing an International Strategy

A company pursuing an international strategy adopts a different route to global expansion. Normally, a company shifts to this strategy when it decides to sell domestically made products in markets abroad. Until the 1990s, for example, companies such as Mercedes-Benz and Jaguar made no attempt to produce in foreign markets; instead, they distributed and sold their domestically produced cars internationally. Such companies usually just add a *foreign sales organization* to their existing structure and continue to use the same control system. If a company is using a functional structure, this department has to coordinate manufacturing, sales, and R&D activities with the needs of the foreign market. Efforts at customization are minimal. In overseas countries, a company usually establishes a subsidiary to handle local sales and distribution. For example, the Mercedes-Benz overseas subsidiaries allocate dealerships; organize supplies of spare parts; and, of course, sell cars. A system of behavior controls is then established to keep the home office informed of changes in sales, spare parts requirements, and so on.

A company with many different products or businesses operating from a multidivisional structure has the challenging problem of coordinating the flow of different products across different countries. To manage these transfers, many companies create *global divisions*, which they add to their existing divisional structures (see Figure 13.3).<sup>16</sup> Global operations are managed as a separate divisional business,

**Figure 13.3** Global Division Structure

with managers given the authority and responsibility for coordinating domestic product divisions with overseas markets. The global division also monitors and controls the overseas subsidiaries that market the products and decides how much authority to delegate to managers in these countries.

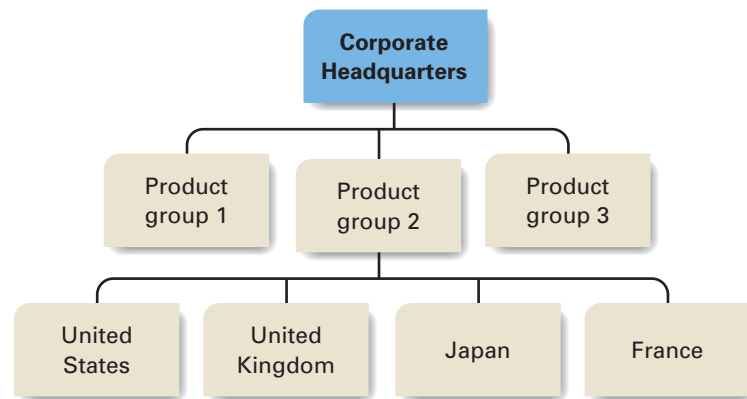
This arrangement of tasks and roles reduces the transaction of managing hand-offs across countries and world regions. However, managers abroad are essentially under the control of managers in the global division, and if domestic and overseas managers compete for control of strategy making, conflict and lack of cooperation may result. Companies such as IBM, Citibank, and DaimlerChrysler have experienced this problem. Very often, significant strategic control has been decentralized to overseas divisions. When cost pressures force corporate managers to reassess their strategy and they decide to intervene, such intervention frequently provokes resistance, much of it due to differences in culture—not just corporate but also country differences.

### Implementing a Global Standardization Strategy

When a company embarks on a global standardization strategy today, it locates its manufacturing and other value chain activities at the global location that will allow it to increase efficiency, quality, and innovation. In doing so, it has to solve the problems of coordinating and integrating its global value chain activities. It has to find a structure that lowers the bureaucratic costs associated with resource transfers between corporate headquarters and its overseas divisions and provides the centralized control that a global standardization strategy requires. The answer for many companies is a *global product-group structure* (see Figure 13.4).

In this structure, a product-group headquarters is created to coordinate the activities of a company's home and overseas operations. The managers at each product group's headquarters decide where to locate the different functions at the



**Figure 13.4** Global Product-Group Structure

optimal global location for performing that activity. For example, Phillips has one product group responsible for global R&D, manufacturing, marketing, and sales of its light bulbs; another for medical equipment; and so on. The headquarters of the medical division and its R&D is located in Bothell, Washington; manufacturing is done in Taiwan; and the products are sold by sales subsidiaries in each local market.

The product-group structure allows managers to decide how best to pursue a global standardization strategy, for example, to decide which value chain activities, such as manufacturing or product design, should be performed in which country to increase efficiency. Increasingly, American and Japanese companies are moving manufacturing to low-cost countries such as China but establishing product design centers in Europe or the United States to take advantage of foreign skills and capabilities and thus obtain the benefits from this strategy. The Running Case describes how Walmart has used its sophisticated global supply chain to allow it to establish product groups to pursue a global standardization strategy.

### Implementing a Transnational Strategy

The main failing of the global product-group structure is that, although it allows a company to achieve superior efficiency and quality, it is weak when it comes to responsiveness to customers because the focus is still on centralized control to reduce costs. Moreover, this structure makes it difficult for the different product divisions to trade information and knowledge and obtain the benefits from transferring, sharing, and leveraging their competencies. Sometimes the potential gains from sharing product, marketing, or R&D knowledge among product groups are high, but so too are the bureaucratic costs associated with achieving these gains. Is there a structure that can simultaneously economize on these costs and provide the coordination necessary to obtain these benefits?

In the 1990s, many companies implemented a *global-matrix structure* to simultaneously lower their global cost structures *and* differentiate their activities through superior innovation and responsiveness to customers globally.

## RUNNING CASE

### How Walmart Implements Global Expansion

Retailing giant Walmart has been aggressively expanding globally in recent years to boost its profitability. After moving into Mexico and Europe and establishing two global product groups in these regions, its managers turned their focus to Japan, where the supermarket business is extremely lucrative. They envisaged creating a highly profitable Japanese global product group that would benefit from the fact that, although Japanese customers pay some of the highest prices for food in the world, its supermarket chains are highly inefficient. Why?

Unlike efficient Japanese carmakers, which employ state-of-the-art IT materials-management systems to collect the detailed information needed to increase the quality and efficiency of their operations, Japan's retailers had lagged behind in adopting these systems. A major reason was that until the 1990s, Japan's Large Scale Retail Store Law allowed small Japanese retailers to block large supermarket chains from opening large, efficient new stores in their neighborhoods for 10 years or more. Although the Japanese government weakened the law so that local storeowners could delay a store opening for only 18 months, there was no history of low-cost competition in the Japanese retail market.

A second factor that led to low supermarket efficiency related to the way products such as groceries were distributed and sold in Japan. Traditionally, Japanese manufacturers sold their products only to wholesalers, with which they had developed long-term business relationships, not directly to retailers. Wholesalers add their own price markup and control distribution, making it much more difficult for supermarkets to compete on price and lowered competition. As a result, there were few incentives for Japanese retailers to invest in expensive materials-management systems to increase their efficiency.

In contrast, Walmart's focus on developing a sophisticated global supply chain to lower the costs of its purchasing, shipping, and sales activities has

made it the most efficient global discount retailer and grocer. In addition, Walmart's supply chain management eliminates the need for wholesalers because the company is such a huge, powerful buyer. So, Walmart managers thought that entering the Japanese supermarket industry might be very profitable indeed. They bought a significant stake in Seiyu Ltd., Japan's fourth-largest supermarket, to gain a foothold in the Japanese market. An opportunity to expand and strengthen its base arose when Japan's third-largest supermarket chain, Daiei, which had been losing money for years, was put up for sale.

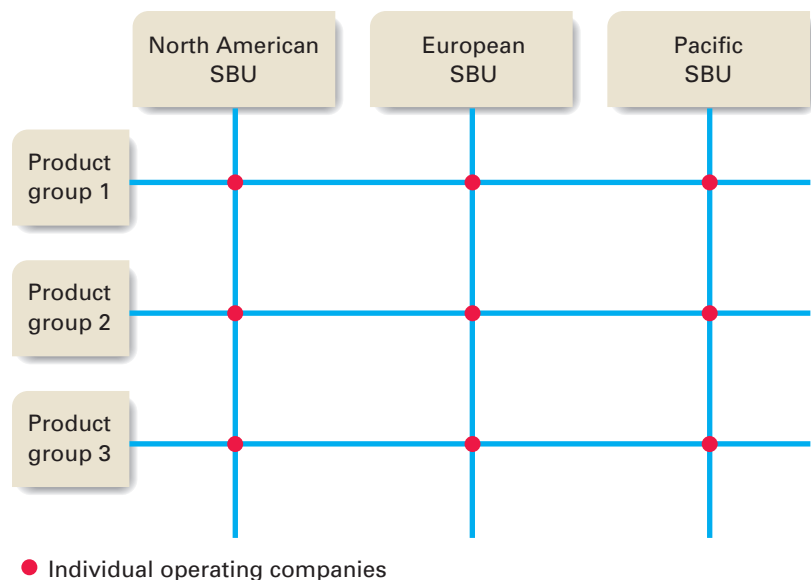
Walmart's Japanese strategy was to acquire Daiei and then combine it with its Seiyu operations to create a strong Japanese global product group. Its product group managers believed that if Walmart could leverage its IT-based global supply chain across an expanded chain of Japanese supermarkets, it would significantly increase Seiyu's and Daiei's efficiency and make the product group highly profitable. Also, as in the United States, they hoped that over time, the Japanese group's growing competitive advantage would either force other Japanese supermarket chains either to go out of business or sell out to Walmart so that it would eventually dominate the Japanese supermarket industry. To accomplish this, product group managers put into motion major plans to identify lower-priced groceries from abroad that would be attractive to Japanese customers and then use its IT system to purchase these groceries efficiently from producers around the world.

To Walmart's annoyance, Japan's Industrial Revitalization Corp., which had the power to decide which company could buy Daiei, decided it did not want Walmart to establish a powerful product group and become one of the largest retailers in Japan. It rejected Walmart's bid for Daiei; however, the world's largest retailer is still watching for other opportunities to expand its presence in the lucrative Japanese market.

Figure 13.5 shows such a structure that might be used by a company such as Ford, HP, SAP, or Nestlé. On the vertical axis, instead of functions, are the company's product *groups*. These groups provide specialist services such as R&D, product design, and marketing information to its overseas divisions, which are often grouped by world region. They might be the petroleum, plastics, pharmaceuticals, or fertilizer product groups. On the horizontal axis are the company's *overseas divisions* in the various countries or world regions in which it operates. Managers at the regional or country level control local operations. Through a system of output and behavior controls, they then report to managers in product-group headquarters in the United States and ultimately to the CEO. Managers for world regions or countries are also responsible for working with U.S. product-group managers to develop the control and reward systems that will promote transfer, sharing, or leveraging of competencies.

Implementing a matrix structure thus decentralizes control to overseas managers and provides them with considerable flexibility for managing local issues, but it can still give product-group and top corporate executives in the United States the centralized control they need to coordinate company activities on a global level. The matrix structure can allow knowledge and experience to be transferred among divisions in both product groups and geographic regions because it offers many opportunities for face-to-face contact between managers at home and abroad. The matrix also facilitates the transmission of a company's norms and values and, hence, the development of a global corporate culture. This is especially important for a company with far-flung global operations for which lines of communication are longer. Club Med, for instance, uses a matrix to standardize high-quality customer service across its global vacation villages. Nestlé's experience with the global-matrix structure is profiled in Strategy in Action 13.2.

**Figure 13.5** Global-Matrix Structure



## 13.2 STRATEGY IN ACTION

### Nestlé's Global Matrix Structure

Nestlé, based in Vevey, Switzerland, is the world's largest food company, with global sales in excess of \$70 billion in 2009. The company has been pursuing an ambitious program of global expansion by acquiring many famous companies, for example, Perrier, the French mineral water producer, and Rowntree, the British candy maker. In the United States, Nestlé bought Carnation, Stouffer Foods, Contadina, Ralston Purina, and Dreyer's Grand Ice Cream.

In the past, Nestlé pursued a localization strategy and managed its operating companies through a global-area structure. In each country, its individual divisions (such as its Carnation division) were responsible for managing business-level strategy. For example, they had the authority to make all product development, marketing, and manufacturing decisions. Nestlé's corporate managers at its Vevey headquarters made the vital acquisition, expansion, and corporate resource decisions, such as how best to invest its capital, and the size of the corporate staff had increased dramatically to manage its rapid global expansion.

In the 1990s, Nestlé realized it had major problems. Corporate managers had become remote from the divisional managers in its thousands of operating divisions. They did not understand the problems divisions faced, and because authority was centralized, Nestlé was often slow to respond to the fast-changing food products industry. Moreover, the way the company operated made it impossible to obtain the potential benefits from sharing and leveraging its distinctive competencies in food product development and marketing, both among divisions in a product group and among product groups and world regions. Because each product group operated separately, corporate executives could not integrate product-group activities around the world. To raise corporate performance, Nestlé's managers had to find a new way to organize its activities.

Its CEO at the time, Helmut Maucher, started restructuring Nestlé from the top down. He stripped away the power of corporate managers by decentralizing authority to the managers of seven global product groups that he created to oversee the company's major product lines (for example, coffee, milk, and candy). Each global

product group was to integrate the activities of all the operating divisions in its group to transfer and leverage distinctive competencies to increase profitability. After the change, managers in the candy product group, for instance, began orchestrating the marketing and sale of Rowntree candy products, such as After Eight Mints and Smarties throughout Europe and the United States, and sales climbed by 60%.

Maucher then grouped all divisions within a country or world region into one national or regional strategic business unit (SBU) and created a team of SBU managers to link, coordinate, and oversee their activities. When the different divisions started to share joint purchasing, marketing, and sales activities, major cost savings resulted. In the United States, the SBU management team reduced the number of sales offices nationwide from 115 to 22 and the number of suppliers of packaging materials from 43 to 3.

Finally, Maucher decided to use a matrix structure to integrate the activities of the seven global-product groups with the operations of Nestlé's country-based SBUs. The goal of this matrix structure is to allow the company to pursue a transnational strategy and obtain the benefits of differentiation from global learning and from cost reductions from higher cooperation among divisions inside each product group. For example, regional SBU managers spend considerable time in Vevey with product-group executives discussing ways to take advantage of transferring and sharing the resources of the company on a global basis and inside each product group.

To further increase integration, Nestlé signed a \$300 million contract with SAP to install and maintain a company-wide ERP system to integrate across *all* its global operations. Nestlé's top managers use their ERP system to provide them with the information they need to centralize control over its far-flung operations that they found the matrix structure did not provide by itself. Using the ERP system, for example, provides them with real-time information about the way Nestlé's global divisions are performing. They no longer need to rely solely on divisional managers for this information, so they can intervene on a global level as necessary.

## Ethical Dilemma

Unethical and illegal behavior is prevalent in global business. For example, while bribery is considered “acceptable” in some countries, multinational companies are often found guilty of allowing overseas executives to bribe government officials. Many countries, like the United States, have laws and severe penalties to discourage payouts on bribes. In addition to bribery, many United States companies have been accused of perpetuating unethical “sweatshop” conditions abroad and turning a blind eye on abusive behavior of contract manufacturers toward workers. As a manager, if asked to improve your company’s structure to prevent unethical and illegal behavior, what kind of control system could you use? In what ways could you develop a global organizational culture that reduces the likelihood of such behavior? What is the best way to decide on the balance between centralization and decentralization to reduce these problems?

Nestlé is not the only company to find the task of integrating and controlling a global-matrix structure a difficult task. Some, such as ABB, Motorola, and Ford have dismantled their matrix structures and moved to a simplified global product-group approach using IT to integrate across countries. If a matrix is chosen, however, other possible ways of making it work effectively include developing a strong global organizational culture to facilitate communication and coordination among country-based managers. For example, many companies transfer managers between their domestic and overseas operations, so they can implant their domestic culture in their new global division.

Toyota has made great efforts to understand how to manage car plants in overseas locations and how to transplant its culture into those plants. When it decided to manufacture cars in the United States, it first formed a joint venture with GM, and the companies combined their expertise in this venture, which was known as NUMMI. Toyota was responsible for implanting its knowledge of lean production in this plant; all the workers were cross-trained and taught how to monitor and benchmark their own performance and how to work on quality teams to improve it. Toyota then took all the learning from this venture and transferred it to its wholly owned car plants in Georgetown, Kentucky, where it manufactures cars with as good a reliability record as those made in its Japanese plants. Every Toyota plant is under the control of Japanese managers, however, and managers from Toyota’s Japanese headquarters monitor their performance and work to transfer and implant Toyota’s latest R&D innovations into its next car models.

## ENTRY MODE AND IMPLEMENTATION

As we discuss in Chapter 10, many organizations today are altering their business models and strategies and entering or leaving industries to find better ways to use their resources and capabilities to create value. This section focuses on the implementation issues that arise when companies use internal new venturing, joint ventures, and/or acquisitions to enter new industries.

### Internal New Venturing

Chapter 10 discusses how companies enter new industries by using internal new venturing to transfer and leverage their existing competencies to create the set of value chain activities necessary to compete effectively in a new industry. How can managers create a setting in which employees are encouraged to think about how to apply their functional competencies in new industries? In particular, how can structure, control, and culture be used to increase the success of the new-venturing process?

At the heart of this issue is that corporate managers must treat the internal new-venturing process as a form of entrepreneurship and the managers who are to pioneer and lead new ventures as **intrapreneurs**, that is, as inside or internal entrepreneurs. This means that organizational structure, control, and culture must be designed to encourage creativity and give new-venture managers real autonomy to develop and champion new products. At the same time, corporate managers want to make sure that their investment in a new market or industry will be profitable because commonalities exist between the new industry and its core industry so that the potential benefits of transferring or leveraging competencies will be obtained.<sup>17</sup> Apple, 3M,

and Google are examples of companies that carefully select the right mix of structure, control, and culture to create a work context that facilitates the new-venturing process and promotes product innovation. For example, 3M's goal is that at least 30% of its growth in sales each year should come from new products developed within the past five years. To meet this challenging goal, 3M designed a sophisticated control and incentive system that provides its employees with the freedom and motivation to experiment and take risks.

Another approach to internal new venturing is championed by managers who believe that the best way to encourage new-product development is to separate the new venture unit from the rest of the organization. To provide the new-venture's managers with the autonomy to experiment and take risks, a company establishes a **new-venture division**, that is, a separate and independent division to develop a new product. The reason for creating an autonomous unit is that if a new venture's managers work within a company's existing structure under the scrutiny of its corporate managers, they will not have the autonomy they need to pursue exciting new product ideas. In a separate unit in a new location, however, new venture managers will be able to act as if they were external entrepreneurs as they work to create a new product and develop a business model to bring it to market successfully.

The new-venture unit or division uses controls that reinforce its entrepreneurial spirit. Strict output controls are inappropriate because they may promote short-term thinking and inhibit risk taking. Instead, stock options are often used to create a culture for entrepreneurship. Another issue is how to deal with corporate managers. The upfront R&D costs of new venturing are high, and its success is uncertain. After spending millions of dollars, corporate managers often become concerned about how successful the new-venture division will be. As a result, they might attempt to introduce strict output controls, including restrictive budgets to make the managers of the new venture more accountable—but which at the same time harm its entrepreneurial culture.<sup>18</sup> Corporate managers may believe it is important to use output and behavior controls to limit the new venture manager's autonomy; otherwise, they might make costly mistakes and waste resources on frivolous ideas.

Recently, there have been some indications that 3M's internal approach may be superior to the use of external new-venture divisions. It appears that many new-venture divisions have failed to get successful new products to market. And even if they do, the new-venture division eventually begins to operate like any other divisions and the whole company's cost structure rises because of the duplication of value chain activities. Another issue is that scientists are often not the best people to develop successful business models because they lack formal training. Just as many medical doctors are earning MBAs today to understand the many strategic issues they must confront when they decide to become the managers of hospitals, so scientists need to be able to think strategically. If this skill is lacking in a new-venture division, the result is failure.

## Joint Ventures

Joint ventures are a second method used by large, established companies to maintain their momentum and grow their profits by entering new markets and industries.<sup>19</sup> A joint venture occurs when two companies agree to pool some combination of their resources and capabilities and establish a new business unit to develop a new product and a business model that will allow it bring the new product to market



successfully. These companies believe that through collaboration, by sharing their technology or marketing skills to develop an improved product for example, they will be able to create more value and profit in the new industry than if they decide to “go it alone.” Both companies transfer competent managers, who have a proven track record of success, to manage the new subunit that they both own. Sometimes they take an equal “50/50” ownership stake, but sometimes one company insists on having a 51% share or more, giving it the ability to buy out the other party at some point in the future should problems emerge. The way a joint venture is organized and controlled becomes an important issue in this context.

Allocating authority and responsibility is the first major implementation issue on which companies have to decide. Both companies need to be able to monitor the progress of the joint venture so that they can learn from its activities and benefit from their investment in it. Some companies insist on 51% ownership stakes because only then do they have the authority and control over the new ventures. Future problems could arise such as what to do if the new venture performs poorly or how to proceed if conflict develops between the parent companies over time—because one partner feels “cheated.” For example, what will happen in the future is unknown, and frequently one parent company benefits much more from the product innovations the new company develops; if the other company demands “compensation,” they come into conflict.<sup>20</sup> Also, as discussed in Chapter 8, a company also risks losing control of its core technology or competence when it enters into a strategic alliance. One parent company might come to believe this is taking place and so feels threatened by the other. A joint venture can also be dangerous not only because one parent might decide to take the new technology and then “go it alone” in the development process but also because its partner might be acquired by a competitor. For example, Compaq shared its proprietary server technology with a company in the computer storage industry to promote joint product development. Then, it watched helplessly as that company was acquired by Sun Microsystems, which consequently obtained Compaq’s technology.

The implementation issues are strongly dependent on whether the purpose of the joint venture is to share and develop technology, jointly distribute and market products and brands, or share access to customers. Sometimes companies can simply realize the joint benefits from collaboration without having to form a new company. For example, Nestlé and Coca-Cola announced a 10-year joint venture, to be called Beverage Partners Worldwide, through which Coca-Cola will distribute and sell Nestlé’s Nestea iced tea, Nescafé, and other brands throughout the globe.<sup>21</sup> Similarly, Starbucks’s Frappuccino is distributed by Pepsi. In this kind of joint venture, both companies can gain from sharing and pooling different competencies so that both realize value that would not otherwise be possible. In these cases, issues of ownership and control are less important.

Once the ownership issue has been settled, one company appoints the CEO who becomes responsible for creating a cohesive top management team out of the managers transferred from the parent companies. The job of the top management team is to develop a successful business model. These managers then need to choose an organizational structure, such as the functional or product team, that will make the best use of the resources and skills they receive from the parent companies. The need to create an effective organizational design that integrates people and functions is of paramount importance to ensure that the best use is made of limited resources. So is the need to build a new culture for their new company that unites managers who used to work in companies with different cultures.

Managing these implementation issues is difficult, expensive, and time-consuming, so it is not surprising that when a lot is at stake and the future uncertain, many companies decide they would be better off acquiring another company and integrating it into their operations. This is Microsoft's favored strategy when it decides to enter new industries in the computer sector. Usually, it takes a 51% stake in an emerging company, which gives it the right to buy out the company and integrate its technology into its existing software divisions should it prove to have some competency vital to Microsoft's future interests. First, however, Microsoft shares its resources and expertise with the new company to spur the development of its R&D competence. If the risks are lower, however, and it is easier to forecast the future, as in the venture between Coca-Cola and Nestlé, then to reduce bureaucratic costs, a strategic alliance, which does not require the creation of a new subunit, may be quite capable of managing the transfers of complementary resources and skills between companies.

## Mergers and Acquisitions

Mergers and acquisitions are the third method companies use to enter new industries or countries.<sup>22</sup> How to implement structure, control systems, and culture to manage a new acquisition is important because many acquisitions are unsuccessful. And, one of the main reasons acquisitions perform poorly is that many companies do not anticipate the difficulties associated with merging or integrating new companies into their existing operations.<sup>23</sup>

At the level of organizational structure, managers of both the acquiring and acquired companies have to confront the problem of how to establish new lines of authority and responsibility that will allow them to make the best use of both companies' competencies. The massive merger between HP and Compaq illustrates the issues. Before the merger, the top management teams of both companies spent thousands of hours analyzing the range of both companies' activities and performing a value chain analysis to determine how cost and differentiation advantages might be achieved. Based on this analysis, they merged all of both company's divisions into four main product groups.

Imagine the problems deciding who would control which group and which operating division and to whom these managers would report. To counter fears that infighting would prevent the benefits of the merger from being realized, the companies' CEOs were careful to announce in press releases that the process of merging divisions was going smoothly and that battles over responsibilities and control of resources were being resolved. One problem with a mishandled merger is that skilled managers who feel they have been demoted will leave the company, and if many leave, the loss of their skills may prevent the benefits of the merger from being realized. In 2009, after Cisco acquired the maker of the popular Flip camcorder, it announced that it was establishing a \$15 million fund to reward Flip executives who decide to stay with the company.

Once managers have established clear lines of authority, they must decide how to coordinate and streamline the operations of both merged companies to reduce costs and leverage and share competencies. For large companies like HP, the answer is to choose the multidivisional structure, but important control issues still have to be resolved. In general, the more similar or related are the acquired companies' products and markets, the easier it is to integrate their operations. If the acquiring company has an efficient control system, it can be adapted to the new company to

standardize the way its activities are monitored and measured. Or managers can work hard to combine the best elements of each company's control systems and cultures or introduce a new IT system to integrate their operations.

If managers make unrelated acquisitions, however, and then try to interfere with a company's strategy in an industry they know little about or apply inappropriate structure and controls to manage the new business, then major strategy implementation problems can arise. For example, if managers try to integrate unrelated companies with related ones in the search for some elusive benefits, apply the wrong kinds of controls at the divisional level, or interfere in business-level strategy, corporate performance can suffer as bureaucratic costs skyrocket. These mistakes explain why related acquisitions are sometimes more successful than unrelated ones.<sup>24</sup>

Even in the case of related diversification, the business processes of each company frequently are different, and their computer systems may be incompatible. The issue facing the merged company is how to use output and behavior controls to standardize business processes and reduce the cost of handing off and transferring resources. After Nestlé installed SAP's ERP software, for example, managers discovered that each of Nestlé's 150 different United States divisions was buying its own supply of vanilla from the same set of suppliers. However, the divisions were not sharing information about these purchases, and vanilla suppliers, dealing with each Nestlé division separately, tried to charge each division as much as they could, with the result that each division paid a different price for the same input!<sup>25</sup> Each division at Nestlé used a different code for its independent purchase, and managers at United States headquarters did not have the information to discover this until SAP's software provided it.

Finally, even when acquiring a company in a closely related industry, managers must realize that each company has a unique culture, norms, values, and a way of doing things. Such idiosyncrasies must be understood to integrate the operations of the merged company effectively. Indeed, such idiosyncrasies are likely to be especially important when companies from different countries merge. Over time, top managers can change the culture and alter the internal workings of the company, but this is a difficult implementation task.

In sum, corporate managers' capabilities in organizational design are vital in ensuring the success of a merger or acquisition. Their ability to integrate and connect divisions to leverage competencies ultimately determines how well the new merged company will perform.<sup>26</sup> The path to merger and acquisition is fraught with danger, which is why some companies claim that internal new venturing is the safest path and that it is best to grow organically from within. Yet with industry boundaries blurring and new global competitors emerging, companies often do not have the time or resources to go it alone. How to enter a new industry or country is a complex implementation issue that requires thorough strategic analysis.

## INFORMATION TECHNOLOGY, THE INTERNET, AND OUTSOURCING

The many ways in which advances in IT affect strategy implementation is an important issue today. Evidence that managerial capabilities in managing IT can be a source of competitive advantage is growing; companies that do not adopt

leading-edge information systems are likely to be at a competitive disadvantage. IT includes the many different varieties of computer software platforms and databases and the computer hardware on which they run, such as mainframes and servers. IT also encompasses a broad array of communication media and devices that link people, including voice mail, e-mail, voice conferencing, videoconferencing, the Internet, groupware and corporate intranets, cell phones, fax machines, personal digital assistants (PDAs), smartphones, and so on.<sup>27</sup>

## Information Technology and Strategy Implementation

At the level of organizational structure, control, and culture, advanced IT drastically increases the number of ways in which strategic managers can implement their strategies effectively. First, IT is an important factor that promotes the development of functional competencies and capabilities. Indeed, a company's IT capabilities are often a major source of competitive advantage because they are embedded in a company and are difficult to imitate. Walmart, for example, takes steps to legally protect its core competency in IT by blocking the movement of some of its key programmers to dot-coms like Amazon or Target. A company's ability to pursue a cost-leadership or differentiation business model depends on its possession of distinctive competencies in efficiency, quality, innovation, and customer responsiveness—and IT is a major facilitator of these sources of competitive advantage.<sup>28</sup>

Second, IT enables a company to transfer its knowledge and expertise across functional groups and integrate that knowledge into a function's operations, so it can deliver new and improved products to customers. The way in which Citibank implemented an organization-wide IT system to increase responsiveness to customers is instructive. After studying its business model, Citibank's managers found that the main customer complaint was the amount of time they had to wait for a response to some banking question, so they set out to solve this problem. Teams of managers examined the way Citibank's current IT system worked and then redesigned it to reduce the handoffs between people and functions necessary to provide customers with answers more quickly. Employees were then given extensive training in operating the new IT system. These changes resulted in significant time and cost savings, as well as an increase in the level of personalized service it is able to offer its clients, and these have changes have increased customer satisfaction and the number of customers.<sup>29</sup>

IT also has important effects on a company's ability to innovate and perform R&D. It improves the knowledge base that employees draw on when they engage in problem solving and decision making. IT also provides a mechanism to promote collaboration and information sharing both inside and across a company's functions and business units that speeds up product development. However, the availability of knowledge alone is not enough to promote innovation; organizational members' ability to use knowledge creatively is the key to promoting innovation and creating competitive advantage.<sup>30</sup> IT allows new ideas to be transmitted easily and quickly to the product team, function, or divisions that can use it to add value to products and boost profitability. The project-based work that is characteristic of matrix structures provides a vivid example of this process.

As a project progresses, the need for particular team members waxes and wanes. Some employees will be part of a project from beginning to end, but others only participate at key times when their expertise is required. IT provides managers with the real-time capability to monitor project progress and needs, to allocate each expert's time accordingly, and so increase the value each employee can add to a product.

Traditionally, product design has involved sequential processing across functions, with handoffs as each stage of the process is completed (see Chapter 4). Using advanced IT, this linear process has been replaced by parallel engineering that allows employees in different functions to work simultaneously and interact in real time to share information about design improvements, opportunities to reduce costs, and so on. This also promotes innovation.

IT has major effects on other aspects of a company's structure and control systems. The increasing use of IT has allowed managers to flatten the organizational hierarchy and reduce the number management levels to coordinate the work process. Because it provides managers with so much more useful, quality, and timely information, IT also permits greater decentralization of authority while simultaneously increasing integration within organizations. E-mail systems, the development of organization-wide corporate intranets, and, of course, ERP systems, have broken down the communication between functions and divisions. The result has been improved performance.<sup>31</sup> To facilitate the use of IT and make organizational structure work, however, a company must create a control and incentive structure to motivate people and subunits, as Strategy in Action 13.3 suggests.

Some companies are taking full advantage of IT's ability to help them integrate their activities to respond better to customer needs. These companies make the most cost-effective use of their employees' skills by using a virtual organizational structure. The **virtual organization** is composed of people who are linked by laptops, smartphones, computer-aided design (CAD) systems, and global video teleconferencing and who may rarely, if ever, see one another face-to-face. People join and leave a project team as their services are needed, much as in a matrix structure.

Accenture, the global management consulting company, is such a virtual organization. Its consultants connect through their laptops to its centralized **knowledge management system**, a company-specific information system that systematizes the knowledge of its employees and provides them with access to other employees who have the expertise to solve the problems that they encounter as they perform their jobs. The consultants pool their knowledge in a massive internal database that they can easily access externally through the Internet. The company's 40,000 consultants often work from their homes, traveling to meet the company's clients throughout the world and only rarely stopping at Accenture's branch offices to meet their superiors and colleagues. CEO George Shaheen says that the company's headquarters are wherever he happens to be at the time. (He spends 80% of his time traveling.)<sup>32</sup>

## Strategic Outsourcing and Network Structure

IT has also affected a company's ability to pursue strategic outsourcing to strengthen its business model. As Chapter 9 discusses, strategic outsourcing is increasing rapidly because companies recognize the many opportunities it offers to promote differentiation, reduce costs, and increase flexibility. Recall that outsourcing occurs as companies use short- and long-term contracts and strategic alliances to form relationships with other companies. IT increases the efficiency of these relationships. For example, it allows for the more efficient movement of raw materials and component parts between a company and its suppliers and distributors. It also promotes the transfer, sharing, and leveraging of competencies between companies that have formed a strategic alliance that can lead to design and engineering improvements that increase differentiation and lower costs.

## 13.3 STRATEGY IN ACTION

### Oracle's New Approach to Control

Oracle is the second-largest software provider after Microsoft. In the early 2000s, its cofounder and CEO Larry Ellison recognized that his company had developed a major problem. Its performance was slipping because it had not implemented the Internet-based software it had developed to allow companies to better control and make use of functional resources even though its customers were using its software to increase the performance of their functions. Ellison moved quickly to change Oracle's functional control systems so that they were Internet-based.

One of the main advantages of Internet-based control software is that it gives corporate managers the ability to monitor and evaluate a company's complex and widespread global operations. Corporate managers can easily compare the performance of different divisions spread around the world in real time and quickly identify problems and take corrective action. However, Ellison discovered that Oracle's financial and human resource information control systems were located in more than 70 independent data centers operating around the world. Consequently, it took days or weeks to track basic details, such as the size of the company's global workforce and changes in the global sales of its leading products, so that corrective action often came too late and many opportunities were being lost.

Recognizing the irony of the situation, Ellison ordered his managers to implement its Internet-based control systems as quickly as possible. His goal was to have all of Oracle's global sales, cost, profit, and human resource information and control systems consolidated in two locations and to make their services available to all its managers with one click of a mouse. In addition, he instructed managers to study which kinds of functional activities were still being handled by "real" people and wherever possible to develop Internet-based software that could substitute or improve on their efforts. For example, Oracle had 300 people responsible for monitoring and

managing its paper-based travel planning and expense-reporting systems. These tasks were automated into a software system and put online. Each employee is now responsible for filing his or her own reports that are processed by the software to ensure compliance with company procedures. The 300 people were then transferred into sales and consulting positions, and more than \$1 billion in cost savings a year resulted.

The use of Internet-based software control systems also allowed Oracle's functional managers to get closer to their customers and understand their changing needs, so they could sell them more of its products. Oracle's salespeople were taught how to use its new customer relationship management software, which requires they enter detailed information about customers' purchases, future plans, Web orders, and service requests into the system. As a result, corporate managers could track sales orders easily. If the system revealed problems such as lost sales or multiple service requests, they could move quickly to contact customers and find new ways to solve those problems.

So amazed was Ellison at the results of implementing Internet software systems that he radically rethought Oracle's control systems. Because of the advances in modern IT, especially ERP systems, he decided that Oracle's employees should perform only one of three tasks: building its products, servicing its products, or selling its products. All other activities should be automated by developing new information control systems, and it should be the manager's job to use control only to facilitate one of these three front-line activities. In addition, as we discussed in Chapter 8, Oracle has moved quickly in the 2000s to become a major player in the ERP market competing directly against SAP. A focus on effective strategy implementation can lead to major changes in a company's business model and strategies that boost its profitability.

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**Sources:** M. Moeller, "Oracle: Practicing What It Preaches," *Business Week* (August 16, 1999): 1–5; <http://www.oracle.com>. 2009.

As a consequence, there has been growing interest in electronic **business-to-business (B2B)** networks in which companies in adjacent industries, for example, carmakers and car component makers, use the same software platform to link to each other and negotiate over prices, quality specifications, and delivery terms. The purchasing companies list the quantity and specifications of the inputs they require and



invite bids from the thousands of component suppliers around the world. Because suppliers use the same software platform, electronic bidding, auctions, and transactions are conducted more efficiently between buyers and sellers around the world. The goal is to achieve joint gains for buyers and suppliers to help drive down costs and raise quality at the industry level. Strategy in Action 13.4, which describes the role of Li & Fung in managing the global supply chain for companies in Southeast Asia, illustrates how this process works.

To implement outsourcing effectively, strategic managers must decide what organizational arrangements to adopt. Increasingly, a **network structure**—the set of virtual strategic alliances an organization forms with suppliers, manufacturers, and distributors to produce and market a product—is becoming the structure of choice to implement outsourcing. An example of a network structure is the series of strategic alliances that Japanese carmakers such as Toyota and Honda have formed with their parts suppliers. All members of the network work together on a long-term basis

## 13.4 STRATEGY IN ACTION

### Li & Fung's Global Supply-Chain Management

Identifying the overseas suppliers that offer the lowest-priced and highest-quality products is an important but difficult task for strategic managers because the suppliers are located in thousands of cities in many countries around the world. To help them, global companies use the services of foreign intermediaries or brokers, located near these suppliers, to find the ones that best suit their purchasing needs. Li & Fung, run by brothers Victor and William Fung, is one of the brokers that have helped hundreds of global companies identify suitable foreign suppliers, especially suppliers in mainland China.

In the 2000s, managing global companies' supply chains became an even more complicated task because overseas suppliers were increasingly specializing in just one part of the task of producing a product in their search for ways to reduce costs. In the past, a company such as Target might have negotiated with a supplier to manufacture 1 million units of a shirt at a certain cost per unit. But with specialization, Target might find it can reduce the costs of making shirts even more by splitting the operations involved in producing the shirt and negotiating with different suppliers, often in different countries, to perform each separate operation. For example, to reduce the unit cost of a shirt, Target might first negotiate with a yarn manufacturer in Vietnam to make the yarn, ship the

yarn to a Chinese supplier to weave it into cloth, and ship the cloth to several different factories in Malaysia and the Philippines to cut the cloth and sew the pieces into shirts. Another company might take responsibility for packaging and shipping the shirts to wherever in the world they are required. Because a company like Target has thousands of different clothing products under production and these products change all the time, there are clearly enormous problems associated with managing a global supply chain to obtain the most potential cost savings.

This is the opportunity that Li & Fung capitalized on. Realizing that many global companies do not have the time or expertise to find such specialized low-price suppliers, they moved quickly to provide this service. Li & Fung employs 3,600 agents who travel across 37 countries to find new suppliers and inspect existing suppliers to find new ways to help their clients, global companies, get lower prices or higher-quality products. Global companies are happy to outsource their supply-chain management to Li & Fung because they realize significant cost savings. And although they pay a hefty fee to Li & Fung, they avoid the costs of employing their own agents. As the complexity of supply-chain management continues to increase, more and more companies like Li & Fung will be appearing.

to find new ways to reduce costs and increase car component quality. Moreover, developing a network structure allows an organization to avoid the high bureaucratic costs of operating a complex organizational structure. Finally, a network structure allows a company to form strategic alliances with foreign suppliers, which gives managers access to low-cost foreign sources of inputs. The way Nike uses a global network structure to produce and market its sports, casual, and dress shoes is instructive.

Nike, located in Beaverton, Oregon, is the largest and most profitable sports shoemaker in the world. The key to Nike's success is the network structure that Philip Knight, its founder and CEO, created to allow his company to design and market its shoes. Today, the most successful companies simultaneously pursue a low-cost and a differentiation strategy. Knight realized this early and created the network structure to allow his company to achieve this goal.

By far, the largest function at Nike's headquarters in Beaverton is the design function, which is staffed by talented designers who pioneer the innovations in sports shoe design that have made Nike so successful. Designers use computer-aided design (CAD) to innovate new shoe models, and all new-product information, including manufacturing instructions, is stored electronically. When the designers have done their work, they relay the blueprints for the new products via the Internet to its network of suppliers and manufacturers throughout Southeast Asia with which Nike has formed contracts and alliances. Instructions for the design of a new sole, for example, may be sent to a supplier in Taiwan, and instructions for the leather uppers may be sent to a supplier in Malaysia. These suppliers produce the shoe parts that are then sent for final assembly to a contract manufacturer in China. From China, a shipping company that has also partnered with Nike, will ship its shoes to wholesalers and distributors throughout the world. Of the 100 million pairs of shoes Nike makes each year, 99% are made in Southeast Asia.

There are three main advantages to this network structure for Nike (and other companies). First, Nike can lower its cost structure because wages in Southeast Asia are a fraction of what they are in the United States. Second, Nike can respond to changes in sports shoe fashion very quickly. Using its global IT system, it can, literally overnight, change the instructions it gives to each of its suppliers so that within a few weeks contract manufacturers abroad can produce the new models of shoes. Any alliance partners that fail to meet Nike's standards are replaced with new partners, so Nike has great control over its network structure. In fact, the company works closely with its suppliers to take advantage of any new developments in technology that can help it reduce costs and increase quality. Third, the ability to outsource all its manufacturing abroad allows Nike to keep its United States structure fluid and flexible. Nike uses a functional structure to organize its activities and decentralizes control of the design process to teams that are assigned to develop each of the new kinds of sports shoes for which Nike is known.

In conclusion, the implications of IT for strategy implementation are still evolving and will continue to do so as new software and hardware reshape a company's business model and its strategies. IT is changing the nature of value chain activities both inside and among organizations, affecting all four building blocks of competitive advantage. For the multibusiness company, as for the single-business company, the need to be alert to such changes to strengthen its position in its core business has become vital, and the success of companies like Nike, Toyota, and Walmart compared to the failure of others like GM and Kmart can be traced, in part, to their success in developing the IT capabilities that lead to sustained competitive advantage.

## SUMMARY OF CHAPTER

1. A company uses organizational design to combine structure, control systems, and culture in ways that allow it to implement its multibusiness model successfully.
2. As a company grows and diversifies, it adopts a multidivisional structure. Although this structure costs more to operate than a functional or product structure, it economizes on the bureaucratic costs associated with operating through a functional structure and enables a company to handle its value creation activities more effectively.
3. As companies change their corporate strategies over time, they must change their structures because different strategies are managed in different ways. In particular, the move from unrelated diversification to vertical integration to related diversification increases the bureaucratic costs associated with managing a multibusiness model. Each requires a different combination of structure, control, and culture to economize on those costs.
4. As a company moves from a localization to an international, global standardization, and transnational strategy, it also needs to switch to a more complex structure that allows it to coordinate increasingly complex resource transfers. Similarly, it needs to adopt a more complex integration and control system that facilitates resource sharing and the leveraging of competencies around the globe. When the gains are substantial, companies frequently adopt a global-matrix structure to share knowledge and expertise or implement their control systems and culture.
5. To encourage internal new venturing, companies must design internal venturing processes that give new-venture managers the autonomy they need to develop new products. Similarly, when establishing a joint venture with another company, managers need to carefully design the new unit's structure and control systems to maximize its chance of success.
6. The profitability of mergers and acquisitions depends on the structure and control systems that companies adopt to manage them and the way a company integrates them into its existing operating structure.
7. IT is having increasingly important effects on the way multibusiness companies implement their strategies. Not only does IT help improve the efficiency with which the multidivisional structure operates, it also allows for the better control of complex value chain activities. The growth of outsourcing has also been promoted by IT, and some companies have developed network structures to coordinate their global value chain activities.

## DISCUSSION QUESTIONS

1. When would a company decide to change from a functional to a multidivisional structure?
2. If a related company begins to buy unrelated businesses, in what ways should it change its structure or control mechanisms to manage the acquisitions?
3. What prompts a company to change from a global standardization to a transnational strategy, and what new implementation problems arise as it does so?
4. How would you design a structure and control system to encourage entrepreneurship in a large, established corporation?
5. What are the problems associated with implementing a strategy of related diversification through acquisitions?

## PRACTICING STRATEGIC MANAGEMENT

### Small-Group Exercise: Deciding on an Organizational Structure

This small-group exercise is a continuation of the small-group exercise in Chapter 12. Break into the same groups that you used in Chapter 12, reread the scenario in that chapter, and recall your group's debate about the appropriate organizational structure for your soft drink company. Because it is your intention to compete with Coca-Cola for market share worldwide, your strategy should also have a global dimension, and you must consider the best structure globally as well as domestically. Debate the pros and cons of the types of global structures and decide which is most appropriate and will best fit your domestic structure.

### Article File 13

Find an example of a company pursuing a multibusiness model that has changed its structure and control systems to manage its strategy better. What were the problems with the way it formerly implemented its strategy? What changes did it make to its structure and control systems? What effects does it expect these changes will have on performance?

### Strategic Management Project: Module 13

Take the information that you collected in the strategic management project from Chapter 12 on strategy implementation and link it to the

multibusiness model. You should collect information to determine if your company competes across industries or countries and also to see what role IT plays in allowing it to implement its business model. If your company *does* operate across countries or industries, answer the following questions:

1. Does your company use a multidivisional structure? Why or why not? What crucial implementation problems must your company manage to implement its strategy effectively? For example, what kind of integration mechanisms does it employ?
2. What are your company's corporate-level strategies? How do they affect the way it uses organizational structure, control, and culture?
3. What kind of international strategy does your company pursue? How does it control its global activities? What kind of structure does it use? Why?
4. Can you suggest ways of altering the company's structure or control systems to strengthen its business model? Would these changes increase or decrease bureaucratic costs?
5. Does your company have a particular entry mode that it has used to implement its strategy?
6. In what ways does your company use IT to coordinate its value chain activities?
7. Assess how well your company has implemented its multibusiness (or business) model.

## C L O S I N G C A S E

## Ford's CEO Designs a New Global Structure

Designing a global organization structure to operate efficiently across many countries is a critical issue for multinational companies, as Ford has discovered over time. Ford realized early in its history that a major opportunity to increase its profitability was to take its American car-manufacturing skills and apply them in countries abroad. Over time, it established car-manufacturing divisions in different countries in Europe, Asia, and Australia. Ford decentralized decision-making authority to each global division, which controlled its own activities and developed cars suited to the local market. The result was that each division came to operate independently from its United States parent company. Ford of Europe, for example, became the largest and most profitable carmaker in Europe.

Ford remained a highly profitable company until Japanese carmakers began to flood the world with their small, reliable, low-priced cars in the 1980s. As car buyers began to buy the Japanese imports in large numbers, Ford tried to draw on the skills of its European unit to help build smaller, more fuel-efficient cars for the United States market. But it had never before tried to get its United States and European design and manufacturing units to cooperate; this proved difficult to achieve because its decentralized global organizational structure did not encourage them to cooperate. In the 1990s, Ford embarked on a massive project to create a new global-matrix structure that would solve the decentralized task and authority problems that were preventing it from utilizing its resources effectively.

In the 2000 plan, Ford laid out a timetable of how all its global carmaking units would learn to cooperate using one set of global support functions, such as design, purchasing, and so on. Country managers continued to resist the changes, however, to preserve their country empires and forced Ford to redesign its proposed global structure again and again. By the mid-2000s, Ford's United States, European, and Asia/Pacific divisions were still operating as a collection of different autonomous "empires." Ford had failed to lower its cost structure or design and make a profitable "world car" that could be sold to customers around the globe.

Once again, Ford decided to restructure itself. It moved to a "world structure," in which one set of managers was given authority over the whole of a specific global operation such as manufacturing or car design. Then Ford began to design cars for the global market. Its new structure never worked to speed car design and production, even as it constantly changed global lines of authority and the locations in which it operated to increase profitability. Ford went through multiple reorganizations to try to meet the Japanese challenge, but nothing worked. Losing billions of dollars, Ford announced in 2006 a revamped "Way Forward" plan to turn around its United States and global operations, a plan that called for cutting 44,000 jobs; closing 16 plants; and freshening 70% of the company's Ford, Mercury, and Lincoln car lineup.

In October 2006, Ford also appointed a new president and CEO, Alan Mulally, an expert in organizational design, to help turn around its operations. Mulally, a former Boeing executive, had led that company's global reorganization effort. He began to work out how to change Ford's global structure to reduce costs and speed product development. In the structure Mulally inherited, Ford's American unit reported to the CEO, but its other global and functional operations reported to the next two most senior executives, Mark Fields, president of Ford's Americas operation, and Mark Schulz, president of international operations. Mulally decided that Ford's downsizing should be accompanied by a major reorganization of its hierarchy, and he decided to flatten Ford's structure and recentralize control. At the same time, however, he put the focus on teamwork and adopted a cross-functional approach to handling the enormous value chain challenges that still confronted the organization.

The position of president of international operations was eliminated, and Mark Fields continues to report to Mulally but so also do the heads of the other two world regions: Lewis Booth, head of Ford of Europe, and John Parker, head of Ford of Asia Pacific and Africa and Mazda. Two levels in the hierarchy are gone, and Mulally's new organizational design clearly defines each global executive's role

in the company's hierarchy. Ford can begin acting like one company instead of separate global units, each with their own interests.<sup>33</sup> In addition, the heads of its global value chain functions also now report directly to Mulally, not to Fields. These heads include Tony Brown, global head of purchasing; Nick Smither, head of IT; Richard Parry-Jones, chief technical officer; and Bennie Fowler, head of quality and advanced manufacturing engineering. Mulally's goal is to provide a centralized focus on using the company's global functional assets to better support its carmaking business units.

At the same time, Mulally also took a major restructuring step, announcing the creation of a new position, global product development chief, who is responsible for overseeing the development of Ford's entire global lines of vehicles. He appointed Derrick Kuzak, head of product development in the Americas, to head Ford's new global engineering design effort, and he also reports directly to Mulally. Kuzak oversees efforts to streamline product development and engineering systems around the world. As Mulally commented, "An integrated, global product development team supporting our automotive business units will enable us to make the best use of our global assets and capabilities and accelerate development of the new vehicles our customers prefer, and do so more efficiently."<sup>34</sup>

Mulally's goal was to force a cross-functional approach on all his top managers—one that he will

personally oversee—to standardize its global carmaking and allow functional units to continuously improve quality, productivity, and the speed at which new products can be introduced. But beyond streamlining and standardizing its approach, its new-product development group must also ensure that its new vehicles are customized to better meet the needs of regional customers. All Ford's executives now understand the company's very survival was at stake; they had to work together to accelerate efforts to reduce costs and catch up to more efficient competitors such as Toyota.

Despite the fact that in 2009 Ford was still losing billions of dollars as the 2008 recession continued, its new global organizational structure did seem to be working. Ford was in the best competitive position of any United States carmaker, and it had not needed to borrow billions of dollars from the United States government so that it could continue to operate. Only time will tell, but Mulally remains confident.<sup>35</sup>

### Case Discussion Questions

1. What kind of global strategy did Ford pursue at the beginning? What kind of global strategy does it pursue now?
2. In what main ways has Ford changed its global structure to allow it to coordinate the production and sale of its products more effectively around the world? In particular, what different forms of organizational structure has it adopted?



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# ANALYZING A CASE STUDY AND WRITING A CASE STUDY ANALYSIS

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## WHAT IS CASE STUDY ANALYSIS?

Case study analysis is an integral part of a course in strategic management. The purpose of a case study is to provide students with experience of the strategic management problems that actual organizations face. A case study presents an account of what happened to a business or industry over a number of years. It chronicles the events that managers had to deal with, such as changes in the competitive environment, and charts the managers' response, which usually involved changing the business- or corporate-level strategy. The cases in this book cover a wide range of issues and problems that managers have had to confront. Some cases are about finding the right business-level strategy to compete in changing conditions. Some are about companies that grew by acquisition, with little concern for the rationale behind their growth, and how growth by acquisition affected their future profitability. Each case is different because each organization is different. The underlying thread in all cases, however, is the use of strategic management techniques to solve business problems.

Cases prove valuable in a strategic management course for several reasons. First, cases provide you, the student, with experience of organizational problems that you probably have not had the opportunity to experience firsthand. In a relatively short period of time, you will have the chance to appreciate and analyze the problems faced by many different companies and to understand how managers tried to deal with them.

Second, cases illustrate the theory and content of strategic management. The meaning and implications of this information are made clearer when they are applied to case studies. The theory and concepts help reveal what is going on in the companies studied and allow you to evaluate the solutions that specific companies adopted to deal with their problems. Consequently, when you analyze cases, you will be like a detective who, with a set of conceptual tools, probes what happened and what or who was responsible and then marshals the evidence that provides the solution. Top managers enjoy the thrill of testing their problem-solving abilities in the real world. It is important to remember that no one knows what the right answer is. All that managers can do is to make the best guess. In fact, managers say repeatedly that they are happy if they are right only half the time in solving strategic problems. Strategic management is an uncertain game, and using cases to see how theory can be put into practice is one way of improving your skills of diagnostic investigation.

Third, case studies provide you with the opportunity to participate in class and to gain experience in presenting your ideas to others. Instructors may sometimes call on students as a group to identify what is going on in a case, and through classroom discussion the issues in and solutions to the case problem will reveal themselves. In such a situation, you will have to organize your views and conclusions so that you

can present them to the class. Your classmates may have analyzed the issues differently from you, and they will want you to argue your points before they will accept your conclusions, so be prepared for debate. This mode of discussion is an example of the dialectical approach to decision making. This is how decisions are made in the actual business world.

Instructors also may assign an individual, but more commonly a group, to analyze the case before the whole class. The individual or group probably will be responsible for a thirty- to forty-minute presentation of the case to the class. That presentation must cover the issues posed, the problems facing the company, and a series of recommendations for resolving the problems. The discussion then will be thrown open to the class, and you will have to defend your ideas. Through such discussions and presentations, you will experience how to convey your ideas effectively to others. Remember that a great deal of managers' time is spent in these kinds of situations: presenting their ideas and engaging in discussion with other managers who have their own views about what is going on. Thus, you will experience in the classroom the actual process of strategic management, and this will serve you well in your future career.

If you work in groups to analyze case studies, you also will learn about the group process involved in working as a team. When people work in groups, it is often difficult to schedule time and allocate responsibility for the case analysis. There are always group members who shirk their responsibilities and group members who are so sure of their own ideas that they try to dominate the group's analysis. Most of the strategic management takes place in groups, however, and it is best if you learn about these problems now.

## ANALYZING A CASE STUDY

The purpose of the case study is to let you apply the concepts of strategic management when you analyze the issues facing a specific company. To analyze a case study, therefore, you must examine closely the issues confronting the company. Most often you will need to read the case several times—once to grasp the overall picture of what is happening to the company and then several times more to discover and grasp the specific problems.

Generally, detailed analysis of a case study should include eight areas:

1. The history, development, and growth of the company over time
2. The identification of the company's internal strengths and weaknesses
3. The nature of the external environment surrounding the company
4. A SWOT analysis
5. The kind of corporate-level strategy that the company is pursuing
6. The nature of the company's business-level strategy
7. The company's structure and control systems and how they match its strategy
8. Recommendations

To analyze a case, you need to apply the concepts taught in this course to each of these areas. To help you further, we next offer a summary of the steps you can take to analyze the case material for each of the eight points we just noted:

1. *Analyze the company's history, development, and growth.* A convenient way to investigate how a company's past strategy and structure affect it in the present is to chart the critical incidents in its history—that is, the events that were

the most unusual or the most essential for its development into the company it is today. Some of the events have to do with its founding, its initial products, how it makes new-product market decisions, and how it developed and chose functional competencies to pursue. Its entry into new businesses and shifts in its main lines of business are also important milestones to consider.

2. *Identify the company's internal strengths and weaknesses.* Once the historical profile is completed, you can begin the SWOT analysis. Use all the incidents you have charted to develop an account of the company's strengths and weaknesses as they have emerged historically. Examine each of the value creation functions of the company, and identify the functions in which the company is currently strong and currently weak. Some companies might be weak in marketing; some might be strong in research and development. Make lists of these strengths and weaknesses. The SWOT Checklist (Table 1) gives examples of what might go in these lists.
3. *Analyze the external environment.* To identify environmental opportunities and threats, apply all the concepts on industry and macroenvironments to analyze the environment the company is confronting. Of particular importance at the industry level are Porter's five forces model and the stage of the life cycle model. Which factors in the macroenvironment will appear salient depends on the specific company being analyzed. Use each factor in turn (for instance, demographic factors) to see whether it is relevant for the company in question.

Having done this analysis, you will have generated both an analysis of the company's environment and a list of opportunities and threats. The SWOT Checklist table also lists some common environmental opportunities and threats that you may look for, but the list you generate will be specific to your company.

4. *Evaluate the SWOT analysis.* Having identified the company's external opportunities and threats as well as its internal strengths and weaknesses, consider what your findings mean. You need to balance strengths and weaknesses against opportunities and threats. Is the company in an overall strong competitive position? Can it continue to pursue its current business- or corporate-level strategy profitably? What can the company do to turn weaknesses into strengths and threats into opportunities? Can it develop new functional, business, or corporate strategies to accomplish this change? *Never merely generate the SWOT analysis and then put it aside.* Because it provides a succinct summary of the company's condition, a good SWOT analysis is the key to all the analyses that follow.
5. *Analyze corporate-level strategy.* To analyze corporate-level strategy, you first need to define the company's mission and goals. Sometimes the mission and goals are stated explicitly in the case; at other times, you will have to infer them from available information. The information you need to collect to find out the company's corporate strategy includes such factors as its lines of business and the nature of its subsidiaries and acquisitions. It is important to analyze the relationship among the company's businesses. Do they trade or exchange resources? Are there gains to be achieved from synergy? Alternatively, is the company just running a portfolio of investments? This analysis should enable you to define the corporate strategy that the company is pursuing (for example, related or unrelated diversification, or a combination of both) and to conclude whether the company operates in just one core business. Then, using your SWOT analysis, debate the merits of this strategy. Is it appropriate given the environment the company is in? Could a change in corporate strategy provide the company with new opportunities or transform a weakness into a strength? For example, should the company diversify from its core business into new businesses?

**Table 1** A SWOT Checklist

Potential Internal Strengths	Potential Internal Weaknesses
Many product lines?	Obsolete, narrow product lines?
Broad market coverage?	Rising manufacturing costs?
Manufacturing competence?	Decline in R&D innovations?
Good marketing skills?	Poor marketing plan?
Good materials management systems?	Poor material management systems?
R&D skills and leadership?	Loss of customer good will?
Information system competencies?	Inadequate human resources?
Human resource competencies?	Inadequate information systems?
Brand name reputation?	Loss of brand name capital?
Portfolio management skills?	Growth without direction?
Cost of differentiation advantage?	Bad portfolio management?
New-venture management expertise?	Loss of corporate direction?
Appropriate management style?	Infighting among divisions?
Appropriate organizational structure?	Loss of corporate control?
Appropriate control systems?	Inappropriate organizational structure and control systems?
Ability to manage strategic change?	High conflict and politics?
Well-developed corporate strategy?	Poor financial management?
Good financial management?	Others?
Others?	
Potential Environmental Opportunities	Potential Environmental Threats
Expand core business(es)?	Attacks on core business(es)?
Exploit new market segments?	Increases in domestic competition?
Widen product range?	Increase in foreign competition?
Extend cost or differentiation advantage?	Change in consumer tastes?
Diversify into new growth businesses?	Fall in barriers to entry?
Expand into foreign markets?	Rise in new or substitute products?
Apply R&D skills in new areas?	Increase in industry rivalry?
Enter new related businesses?	New forms of industry competition?
Vertically integrate forward?	Potential for takeover?
Vertically integrate backward?	Existence of corporate raiders?
Enlarge corporate portfolio?	Increase in regional competition?
Overcome barriers to entry?	Changes in demographic factors?
Reduce rivalry among competitors?	Changes in economic factors?
Make profitable new acquisitions?	Downturn in economy?
Apply brand name capital in new areas?	Rising labor costs?
Seek fast market growth?	Slower market growth?
Others?	Others?

Other issues should be considered as well. How and why has the company's strategy changed over time? What is the claimed rationale for any changes? Often, it is a good idea to analyze the company's businesses or products to assess its situation and identify which divisions contribute the most to or detract from its competitive advantage. It is also useful to explore how the company has built its portfolio over time. Did it acquire new businesses, or did it internally venture its own? All of these factors provide clues about the company and indicate ways of improving its future performance.

6. *Analyze business-level strategy.* Once you know the company's corporate-level strategy and have done the SWOT analysis, the next step is to identify the company's business-level strategy. If the company is a single-business company, its business-level strategy is identical to its corporate-level strategy. If the company is in many businesses, each business will have its own business-level strategy. You will need to identify the company's generic competitive strategy—differentiation, low-cost, or focus—and its investment strategy, given its relative competitive position and the stage of the life cycle. The company also may market different products using different business-level strategies. For example, it may offer a low-cost product range and a line of differentiated products. Be sure to give a full account of a company's business-level strategy to show how it competes.

Identifying the functional strategies that a company pursues to build competitive advantage through superior efficiency, quality, innovation, and customer responsiveness and to achieve its business-level strategy is very important. The SWOT analysis will have provided you with information on the company's functional competencies. You should investigate its production, marketing, or research and development strategy further to gain a picture of where the company is going. For example, pursuing a low-cost or a differentiation strategy successfully requires very different sets of competencies. Has the company developed the right ones? If it has, how can it exploit them further? Can it pursue both a low-cost and a differentiation strategy simultaneously?

The SWOT analysis is especially important at this point if the industry analysis, particularly Porter's model, has revealed threats to the company from the environment. Can the company deal with these threats? How should it change its business-level strategy to counter them? To evaluate the potential of a company's business-level strategy, you must first perform a thorough SWOT analysis that captures the essence of its problems.

Once you complete this analysis, you will have a full picture of the way the company is operating and be in a position to evaluate the potential of its strategy. Thus, you will be able to make recommendations concerning the pattern of its future actions. However, first you need to consider strategy implementation, or the way the company tries to achieve its strategy.

7. *Analyze structure and control systems.* The aim of this analysis is to identify what structure and control systems the company is using to implement its strategy and to evaluate whether that structure is the appropriate one for the company. Different corporate and business strategies require different structures. You need to determine the *degree of fit between the company's strategy and structure*. For example, does the company have the right level of vertical differentiation (e.g., does it have the appropriate number of levels in the hierarchy or decentralized control?) or horizontal differentiation (does it use a functional structure when it should be using a product structure?)? Similarly, is the company using the right integration or control systems to



manage its operations? Are managers being appropriately rewarded? Are the right rewards in place for encouraging cooperation among divisions? These are all issues to consider.

In some cases, there will be little information on these issues, whereas in others there will be a lot. In analyzing each case, you should gear the analysis toward its most salient issues. For example, organizational conflict, power, and politics will be important issues for some companies. Try to analyze why problems in these areas are occurring. Do they occur because of bad strategy formulation or because of bad strategy implementation?

Organizational change is an issue in many cases because the companies are attempting to alter their strategies or structures to solve strategic problems. Thus, as part of the analysis, you might suggest an action plan that the company in question could use to achieve its goals. For example, you might list in a logical sequence the steps the company would need to follow to alter its business-level strategy from differentiation to focus.

8. *Make recommendations.* The quality of your recommendations is a direct result of the thoroughness with which you prepared the case analysis. Recommendations are directed at solving whatever strategic problem the company is facing and increasing its future profitability. Your recommendations should be in line with your analysis; that is, they should follow logically from the previous discussion. For example, your recommendation generally will center on the specific ways of changing functional, business, and corporate strategies and organizational structure and control to improve business performance. The set of recommendations will be specific to each case, and so it is difficult to discuss these recommendations here. Such recommendations might include an increase in spending on specific research and development projects, the divesting of certain businesses, a change from a strategy of unrelated to related diversification, an increase in the level of integration among divisions by using task forces and teams, or a move to a different kind of structure to implement a new business-level strategy. Make sure your recommendations are mutually consistent and written in the form of an action plan. The plan might contain a timetable that sequences the actions for changing the company's strategy and a description of how changes at the corporate level will necessitate changes at the business level and subsequently at the functional level.

After following all these stages, you will have performed a thorough analysis of the case and will be in a position to join in class discussion or present your ideas to the class, depending on the format used by your professor. Remember that you must tailor your analysis to suit the specific issue discussed in your case. In some cases, you might completely omit one of the steps in the analysis because it is not relevant to the situation you are considering. You must be sensitive to the needs of the case and not apply the framework we have discussed in this section blindly. The framework is meant only as a guide, not as an outline.

## WRITING A CASE STUDY ANALYSIS

Often, as part of your course requirements, you will need to present a written case analysis. This may be an individual or a group report. Whatever the situation, there are certain guidelines to follow in writing a case analysis that will improve the

evaluation your work will receive from your instructor. Before we discuss these guidelines and before you use them, make sure that they do not conflict with any directions your instructor has given you.

The structure of your written report is critical. Generally, if you follow the steps for analysis discussed in the previous section, *you already will have a good structure for your written discussion*. All reports begin with an *introduction* to the case. In it, outline briefly what the company does, how it developed historically, what problems it is experiencing, and how you are going to approach the issues in the case write-up. Do this sequentially by writing, for example, “First, we discuss the environment of Company X. . . . Third, we discuss Company X’s business-level strategy. . . . Last, we provide recommendations for turning around Company X’s business.”

In the second part of the case write-up, the *strategic analysis* section, do the SWOT analysis, analyze and discuss the nature and problems of the company’s business-level and corporate strategies, and then analyze its structure and control systems. Make sure you use plenty of headings and subheadings to structure your analysis. For example, have separate sections on any important conceptual tool you use. Thus, you might have a section on Porter’s five forces model as part of your analysis of the environment. You might offer a separate section on portfolio techniques when analyzing a company’s corporate strategy. Tailor the sections and subsections to the specific issues of importance in the case.

In the third part of the case write-up, present your *solutions and recommendations*. Be comprehensive, and make sure they are in line with the previous analysis so that the recommendations fit together and move logically from one to the next. The recommendations section is very revealing because your instructor will have a good idea of how much work you put into the case from the quality of your recommendations.

Following this framework will provide a good structure for most written reports, though it must be shaped to fit the individual case being considered. Some cases are about excellent companies experiencing no problems. In such instances, it is hard to write recommendations. Instead, you can focus on analyzing why the company is doing so well, using that analysis to structure the discussion. Following are some minor suggestions that can help make a good analysis even better:

1. Do not repeat in summary form large pieces of factual information from the case. The instructor has read the case and knows what is going on. Rather, use the information in the case to illustrate your statements, defend your arguments, or make salient points. Beyond the brief introduction to the company, you must avoid being *descriptive*; instead, you must be *analytical*.
2. Make sure the sections and subsections of your discussion flow logically and smoothly from one to the next. That is, try to build on what has gone before so that the analysis of the case study moves toward a climax. This is particularly important for group analysis, because there is a tendency for people in a group to split up the work and say, “I’ll do the beginning, you take the middle, and I’ll do the end.” The result is a choppy, stilted analysis; the parts do not flow from one to the next, and it is obvious to the instructor that no real group work has been done.
3. Avoid grammatical and spelling errors. They make your work look sloppy.
4. In some instances, cases dealing with well-known companies end in 1998 or 1999 because no later information was available when the case was written. If possible, do a search for more information on what has happened to the company in subsequent years.

Many libraries now have comprehensive web-based electronic data search facilities that offer such sources as *ABI/Inform*, *The Wall Street Journal Index*, the *F&S Index*, and the *Nexis-Lexis* databases. These enable you to identify any article that has been written in the business press on the company of your choice within the past few years. A number of nonelectronic data sources are also useful. For example, *F&S Predicasts* publishes an annual list of articles relating to major companies that appeared in the national and international business press. *S&P Industry Surveys* is a great source for basic industry data, and *Value Line Ratings and Reports* can contain good summaries of a firm's financial position and future prospects. You will also want to collect full financial information on the company. Again, this can be accessed from web-based electronic databases such as the *Edgar* database, which archives all forms that publicly quoted companies have to file with the Securities and Exchange Commission (SEC; e.g., 10-K filings can be accessed from the SEC's *Edgar* database). Most SEC forms for public companies can now be accessed from Internet-based financial sites, such as Yahoo's finance site (<http://finance.yahoo.com/>).

5. Sometimes instructors hand out questions for each case to help you in your analysis. Use these as a guide for writing the case analysis. They often illuminate the important issues that have to be covered in the discussion.

If you follow the guidelines in this section, you should be able to write a thorough and effective evaluation.

## THE ROLE OF FINANCIAL ANALYSIS IN CASE STUDY ANALYSIS

An important aspect of analyzing a case study and writing a case study analysis is the role and use of financial information. A careful analysis of the company's financial condition immensely improves a case write-up. After all, financial data represent the concrete results of the company's strategy and structure. Although analyzing financial statements can be quite complex, a general idea of a company's financial position can be determined through the use of ratio analysis. Financial performance ratios can be calculated from the balance sheet and income statement. These ratios can be classified into five subgroups: profit ratios, liquidity ratios, activity ratios, leverage ratios, and shareholder-return ratios. These ratios should be compared with the industry average or the company's prior years of performance. It should be noted, however, that deviation from the average is not necessarily bad; it simply warrants further investigation. For example, young companies will have purchased assets at a different price and will likely have a different capital structure than older companies do. In addition to ratio analysis, a company's cash flow position is of critical importance and should be assessed. Cash flow shows how much actual cash a company possesses.

### Profit Ratios

Profit ratios measure the efficiency with which the company uses its resources. The more efficient the company, the greater is its profitability. It is useful to compare a company's profitability against that of its major competitors in its industry to determine whether the company is operating more or less efficiently than its rivals. In

addition, the change in a company's profit ratios over time tells whether its performance is improving or declining.

A number of different profit ratios can be used, and each of them measures a different aspect of a company's performance. Here, we look at the most commonly used profit ratios.

**Return on Invested Capital** This ratio measures the profit earned on the capital invested in the company. It is defined as follows:

$$\text{Return on invested capital (ROIC)} = \frac{\text{Net profit}}{\text{Invested capital}}$$

Net profit is calculated by subtracting the total costs of operating the company away from its total revenues (total revenues – total costs). Total costs are the (1) costs of goods sold, (2) sales, general, and administrative expenses, (3) R&D expenses, and (4) other expenses. Net profit can be calculated before or after taxes, although many financial analysts prefer the before-tax figure. Invested capital is the amount that is invested in the operations of a company—that is, in property, plant, equipment, inventories, and other assets. Invested capital comes from two main sources: interest-bearing debt and shareholders' equity. Interest-bearing debt is money the company borrows from banks and from those who purchase its bonds. Shareholders' equity is the money raised from selling shares to the public, *plus* earnings that have been retained by the company in prior years and are available to fund current investments. ROIC measures the effectiveness with which a company is using the capital funds that it has available for investment. As such, it is recognized to be an excellent measure of the value a company is creating.<sup>1</sup> Remember that a company's ROIC can be decomposed into its constituent parts.

**Return on Total Assets (ROA)** This ratio measures the profit earned on the employment of assets. It is defined as follows:

$$\text{Return on total assets} = \frac{\text{Net profit}}{\text{Total assets}}$$

**Return on Stockholders' Equity (ROE)** This ratio measures the percentage of profit earned on common stockholders' investment in the company. It is defined as follows:

$$\text{Return on stockholders equity} = \frac{\text{Net profit}}{\text{Stockholders equity}}$$

If a company has no debt, this will be the same as ROIC.

## Liquidity Ratios

A company's liquidity is a measure of its ability to meet short-term obligations. An asset is deemed liquid if it can be readily converted into cash. Liquid assets are current assets such as cash, marketable securities, accounts receivable, and so on. Two liquidity ratios are commonly used.

<sup>1</sup>Tom Copeland, Tim Koller, and Jack Murrin, *Valuation: Measuring and Managing the Value of Companies* (New York: Wiley, 1996).

**Current Ratio** The current ratio measures the extent to which the claims of short-term creditors are covered by assets that can be quickly converted into cash. Most companies should have a ratio of at least 1, because failure to meet these commitments can lead to bankruptcy. The ratio is defined as follows:

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

**Quick Ratio** The quick ratio measures a company's ability to pay off the claims of short-term creditors without relying on selling its inventories. This is a valuable measure since in practice the sale of inventories is often difficult. It is defined as follows:

$$\text{Quick ratio} = \frac{\text{Current assets} - \text{inventory}}{\text{Current liabilities}}$$

## Activity Ratios

Activity ratios indicate how effectively a company is managing its assets. Two ratios are particularly useful.

**Inventory Turnover** This measures the number of times inventory is turned over. It is useful in determining whether a firm is carrying excess stock in inventory. It is defined as follows:

$$\text{Inventory turnover} = \frac{\text{Cost of goods sold}}{\text{Inventory}}$$

Cost of goods sold is a better measure of turnover than sales because it is the cost of the inventory items. Inventory is taken at the balance sheet date. Some companies choose to compute an average inventory, beginning inventory, and ending inventory, but for simplicity, use the inventory at the balance sheet date.

**Days Sales Outstanding (DSO) or Average Collection Period** This ratio is the average time a company has to wait to receive its cash after making a sale. It measures how effective the company's credit, billing, and collection procedures are. It is defined as follows:

$$\text{DSO} = \frac{\text{Accounts receivable}}{\text{Total sales}/360}$$

Accounts receivable is divided by average daily sales. The use of 360 is the standard number of days for most financial analysis.

## Leverage Ratios

A company is said to be highly leveraged if it uses more debt than equity, including stock and retained earnings. The balance between debt and equity is called the *capital structure*. The optimal capital structure is determined by the individual company. Debt has a lower cost because creditors take less risk; they know they will get their interest and principal. However, debt can be risky to the firm because if enough profit is not made to cover the interest and principal payments, bankruptcy can result. Three leverage ratios are commonly used.

**Debt-to-Assets Ratio** The debt-to-assets ratio is the most direct measure of the extent to which borrowed funds have been used to finance a company's investments. It is defined as follows:

$$\text{Debt-to-assets ratio} = \frac{\text{Total debt}}{\text{Total assets}}$$

Total debt is the sum of a company's current liabilities and its long-term debt, and total assets are the sum of fixed assets and current assets.

**Debt-to-Equity Ratio** The debt-to-equity ratio indicates the balance between debt and equity in a company's capital structure. This is perhaps the most widely used measure of a company's leverage. It is defined as follows:

$$\text{Debt-to-equity ratio} = \frac{\text{Total debt}}{\text{Total equity}}$$

**Times-Covered Ratio** The times-covered ratio measures the extent to which a company's gross profit covers its annual interest payments. If this ratio declines to less than 1, the company is unable to meet its interest costs and is technically insolvent. The ratio is defined as follows:

$$\text{Times-covered ratio} = \frac{\text{Profit before interest and tax}}{\text{Total interest charges}}$$

## Shareholder-Return Ratios

Shareholder-return ratios measure the return that shareholders earn from holding stock in the company. Given the goal of maximizing stockholders' wealth, providing shareholders with an adequate rate of return is a primary objective of most companies. As with profit ratios, it can be helpful to compare a company's shareholder returns against those of similar companies as a yardstick for determining how well the company is satisfying the demands of this particularly important group of organizational constituents. Four ratios are commonly used.

**Total Shareholder Returns** Total shareholder returns measure the returns earned by time  $t + 1$  on an investment in a company's stock made at time  $t$ . (Time  $t$  is the time at which the initial investment is made.) Total shareholder returns include both dividend payments and appreciation in the value of the stock (adjusted for stock splits) and are defined as follows:

$$\text{Total shareholder returns} = \frac{\text{Stock price } (t + 1) - \text{stock price } (t) + \text{sum of annual dividends per share}}{\text{Stock price } (t)}$$

If a shareholder invests \$2 at time  $t$  and at time  $t + 1$  the share is worth \$3, while the sum of annual dividends for the period  $t$  to  $t + 1$  has amounted to \$0.20, total shareholder returns are equal to  $(3 - 2 + 0.2)/2 = 0.6$ , which is a 60 percent return on an initial investment of \$2 made at time  $t$ .

**Price-Earnings Ratio** The price-earnings ratio measures the amount investors are willing to pay per dollar of profit. It is defined as follows:

$$\text{Price-earnings ratio} = \frac{\text{Market price per share}}{\text{Earnings per share}}$$

**Market-to-Book Value** Market-to-book value measures a company's expected future growth prospects. It is defined as follows:

$$\text{Market-to-book value} = \frac{\text{Market price per share}}{\text{Earnings per share}}$$



**Dividend Yield** The dividend yield measures the return to shareholders received in the form of dividends. It is defined as follows:

$$\text{Dividend yield} = \frac{\text{Dividend per share}}{\text{Market price per share}}$$

Market price per share can be calculated for the first of the year, in which case the dividend yield refers to the return on an investment made at the beginning of the year. Alternatively, the average share price over the year may be used. A company must decide how much of its profits to pay to stockholders and how much to reinvest in the company. Companies with strong growth prospects should have a lower dividend payout ratio than mature companies. The rationale is that shareholders can invest the money elsewhere if the company is not growing. The optimal ratio depends on the individual firm, but the key decider is whether the company can produce better returns than the investor can earn elsewhere.

## Cash Flow

Cash flow position is cash received minus cash distributed. The net cash flow can be taken from a company's statement of cash flows. Cash flow is important for what it reveals about a company's financing needs. A strong positive cash flow enables a company to fund future investments without having to borrow money from bankers or investors. This is desirable because the company avoids paying out interest or dividends. A weak or negative cash flow means that a company has to turn to external sources to fund future investments. Generally, companies in strong-growth industries often find themselves in a poor cash flow position (because their investment needs are substantial), whereas successful companies based in mature industries generally find themselves in a strong cash flow position.

A company's internally generated cash flow is calculated by adding back its depreciation provision to profits after interest, taxes, and dividend payments. If this figure is insufficient to cover proposed new investments, the company has little choice but to borrow funds to make up the shortfall or to curtail investments. If this figure exceeds proposed new investments, the company can use the excess to build up its liquidity (that is, through investments in financial assets) or repay existing loans ahead of schedule.

## CONCLUSION

When evaluating a case, it is important to be *systematic*. Analyze the case in a logical fashion, beginning with the identification of operating and financial strengths and weaknesses and environmental opportunities and threats. Move on to assess the value of a company's current strategies only when you are fully conversant with the SWOT analysis of the company. Ask yourself whether the company's current strategies make sense given its SWOT analysis. If they do not, what changes need to be made? What are your recommendations? Above all, link any strategic recommendations you may make to the SWOT analysis. State explicitly how the strategies you identify take advantage of the company's strengths to exploit environmental opportunities, how they rectify the company's weaknesses, and how they counter environmental threats. Also, do not forget to outline what needs to be done to implement your recommendations.

# NOTES

## Chapter 1

<sup>1</sup>"How Big Can It Grow?" *The Economist*, April 17, 2004, 74–78; "Trial by Check-out," *The Economist*, June 26, 2004, 74–76; Walmart Form 10-K, 200; Information at Walmart's Web site (<http://www.walmartstores.com>); Robert Slater, *The Wal-Mart Triumph* (New York: Portfolio Trade Books, 2004); "The bulldozer from Bentonville Slows; Wal-Mart," *The Economist*, February 17, 2007, 70.

<sup>2</sup>There are several different ratios for measuring profitability, such as return on invested capital, return on assets, and return on equity. Although these different measures are highly correlated with each other, finance theorists argue that the return on invested capital is the most accurate measure of profitability. See T. Copeland, T. Koller, and J. Murrin, *Valuation: Measuring and Managing the Value of Companies* (New York: Wiley, 1996).

<sup>3</sup>Trying to estimate the relative importance of industry effects and firm strategy on firm profitability has been one of the most important areas of research in the strategy literature during the past decade. See Y. E. Spanos and S. Lioukas, "An Examination of the Causal Logic of Rent Generation," *Strategic Management* 22, no. 10 (October 2001): 907–934; and R. P. Rumelt, "How Much Does Industry Matter?" *Strategic Management* 12 (1991): 167–185. See also A. J. Mauri and M. P. Michaels, "Firm and Industry Effects within Strategic Management: An Empirical Examination," *Strategic Management* 19 (1998): 211–219.

<sup>4</sup>This view is known as agency theory. See M. C. Jensen and W. H. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure," *Journal of Financial Economics* 3 (1976): 305–360; and E. F. Fama, "Agency Problems and the Theory of the Firm," *Journal of Political Economy* 88 (1980): 375–390.

<sup>5</sup>K. R. Andrews, *The Concept of Corporate Strategy* (Homewood, Ill.: Dow Jones Irwin, 1971); H. I. Ansoff, *Corporate Strategy* (New York: McGraw-Hill, 1965); C. W. Hofer and D. Schendel, *Strategy*

*Formulation: Analytical Concepts* (St. Paul, Minn.: West, 1978). See also P. J. Brews and M. R. Hunt, "Learning to Plan and Planning to Learn," *Strategic Management* 20 (1999): 889–913; and R. W. Grant, "Planning in a Turbulent Environment," *Strategic Management* 24 (2003): 491–517.

<sup>6</sup><http://www.w.kodak.com/US/en/corp/careers/why/valuesmission.jhtml>.

<sup>7</sup>These three questions were first proposed by P. F. Drucker, *Management: Tasks, Responsibilities, Practices* (New York: Harper & Row, 1974), 74–94.

<sup>8</sup>D. F. Abell, *Defining the Business: The Starting Point of Strategic Planning* (Englewood Cliffs, N.J.: Prentice-Hall, 1980).

<sup>9</sup>P. A. Kidwell and P. E. Ceruzzi, *Landmarks in Digital Computing* (Washington, D.C.: Smithsonian Institution, 1994).

<sup>10</sup>J. C. Collins and J. I. Porras, "Building Your Company's Vision," *Harvard Business Review* (September–October 1996): 65–77.

<sup>11</sup><http://www.nucor.com/>.

<sup>12</sup>See J. P. Kotter and J. L. Heskett, *Corporate Culture and Performance* (New York: Free Press, 1992). For similar work, see Collins and Porras, "Building Your Company's Vision."

<sup>13</sup>E. Freeman, *Strategic Management: A Stakeholder Approach* (Boston: Pitman Press, 1984).

<sup>14</sup>M. D. Richards, *Setting Strategic Goals and Objectives* (St. Paul, Minn.: West, 1986).

<sup>15</sup>E. A. Locke, G. P. Latham, and M. Erez, "The Determinants of Goal Commitment," *Academy of Management Review* 13 (1988): 23–39.

<sup>16</sup>R. E. Hoskisson, M. A. Hitt, and C. W. L. Hill, "Managerial Incentives and Investment in R&D in Large Multiproduct Firms," *Organization Science* 3 (1993): 325–341.

<sup>17</sup>Andrews, *Concept of Corporate Strategy*; Ansoff, *Corporate Strategy*; Hofer and Schendel, *Strategy Formulation*.

<sup>18</sup>For details, see R. A. Burgelman, "Intraorganizational Ecology of Strategy Making and Organizational Adaptation: Theory and Field Research," *Organization Science* 2 (1991): 239–262; H. Mintzberg, "Patterns in Strategy Formulation," *Management Science* 24 (1978): 934–948; S. L. Hart, "An Integrative Framework for Strategy Making Processes," *Academy of Management Review* 17 (1992): 327–351; G. Hamel, "Strategy as Revolution," *Harvard Business Review* 74 (July–August 1996): 69–83; and R. W. Grant, "Planning in a Turbulent Environment," *Strategic Management Journal* 24 (2003): 491–517. See also G. Gavetti, D. Levinthal, and J. W. Rivkin, "Strategy Making in Novel and Complex Worlds: The Power of Analogy," *Strategic Management Journal* 26 (2005): 691–712.

<sup>19</sup>This is the premise of those who advocate that complexity and chaos theory should be applied to strategic management. See S. Brown and K. M. Eisenhardt, "The Art of Continuous Change: Linking Complexity Theory and Time Based Evolution in Relentlessly Shifting Organizations," *Administrative Science Quarterly* 29 (1997): 1–34; and R. Stacey and D. Parker, *Chaos, Management and Economics* (London: Institute for Economic Affairs, 1994). See also H. Courtney, J. Kirkland, and P. Viguier, "Strategy under Uncertainty," *Harvard Business Review* 75 (November–December 1997): 66–79.

<sup>20</sup>Hart, "Integrative Framework"; Hamel, "Strategy as Revolution."

<sup>21</sup>See Burgelman, "Intraorganizational Ecology;" and Mintzberg, "Patterns in Strategy Formulation."

<sup>22</sup>R. A. Burgelman and A. S. Grove, "Strategic Dissonance," *California Management Review* (Winter 1996): 8–28.

<sup>23</sup>C. W. L. Hill and F. T. Rothaermel, "The Performance of Incumbent Firms in the Face of Radical Technological Innovation," *Academy of Management Review* 28 (2003): 257–274.

<sup>24</sup>This story was related to the author by George Rathmann, who at one time was head of 3M's research activities.

<sup>25</sup>R. T. Pascale, "Perspectives on Strategy: The Real Story behind Honda's Success," *California Management Review* 26 (1984): 47–72.

<sup>26</sup>This viewpoint is strongly emphasized by Burgelman and Grove, "Strategic Dissonance."

<sup>27</sup>C. C. Miller and L. B. Cardinal, "Strategic Planning and Firm Performance: A Synthesis of More Than Two Decades of Research," *Academy of Management Journal* 37 (1994): 1649–1665. See also P. R. Rogers, A. Miller, and W. Q. Judge, "Using Information Processing Theory to Understand Planning/Performance Relationships in the Context of Strategy," *Strategic Management* 20 (1999): 567–577.

<sup>28</sup>P. J. Brews and M. R. Hunt, "Learning to Plan and Planning to Learn," *Strategic Management Journal* 20 (1999): 889–913.

<sup>29</sup>P. Cornelius, A. Van de Putte, and M. Romani, "Three Decades of Scenario Planning at Shell," *California Management Review* 48 (2005): 92–110.

<sup>30</sup>H. Courtney, J. Kirkland, and P. Viguier, "Strategy Under Uncertainty," *Harvard Business Review* 75 (November–December 1997): 66–79.

<sup>31</sup>P. J. H. Schoemaker, "Multiple Scenario Development: Its Conceptual and Behavioral Foundation," *Strategic Management Journal* 14 (1993): 193–213.

<sup>32</sup>P. Schoemaker, P. J. H. van der Heijden, and A. J. M. Cornelius, "Integrating Scenarios into Strategic Planning at Royal Dutch Shell," *Planning Review* 20, no. 3 (1992): 41–47; I. Wylie, "There Is No Alternative to . . ." *Fast Company* (July 2002): 106–111.

<sup>33</sup>"The Next Big Surprise: Scenario Planning," *The Economist*, October 13, 2001, 71.

<sup>34</sup>See C. R. Schwenk, "Cognitive Simplification Processes in Strategic Decision Making," *Strategic Management* 5 (1984): 111–128; and K. M. Eisenhardt and M. Zbaracki, "Strategic Decision Making," *Strategic Management* 13 (Special Issue, 1992): 17–37.

<sup>35</sup>H. Simon, *Administrative Behavior* (New York: McGraw-Hill, 1957).

<sup>36</sup>The original statement of this phenomenon was made by A. Tversky and D. Kahneman, "Judgment under Uncertainty: Heuristics and Biases," *Science* 185 (1974): 1124–1131. See also D. Lovallo and D. Kahneman, "Delusions of Success: How Optimism Undermines Executives' Decisions," *Harvard Business Review* 81 (July 2003): 56–67; and J. S. Hammond, R. L. Keeny, and H. Raiffa, "The Hidden Traps in Decision Making," *Harvard Business Review* 76 (September–October 1998): 25–34.

<sup>37</sup>Schwenk, *Cognitive Simplification Processes*, 111–128.

<sup>38</sup>B. M. Staw, "The Escalation of Commitment to a Course of Action," *Academy of Management Review* 6 (1981): 577–587.

<sup>39</sup>R. Roll, "The Hubris Hypotheses of Corporate Takeovers," *Journal of Business* 59 (1986): 197–216.

<sup>40</sup>See R. O. Mason, "A Dialectic Approach to Strategic Planning," *Management Science* 13 (1969): 403–414; R. A. Cosier and J. C. Aplin, "A Critical View of Dialectic Inquiry in Strategic Planning," *Strategic Management* 1 (1980): 343–356; and I. I. Mintzoff and R. O. Mason, "Structuring III—Structured Policy Issues: Further Explorations in a Methodology for Messy Problems," *Strategic Management* 1 (1980): 331–342.

<sup>41</sup>Mason, *A Dialectic Approach*, 403–414.

<sup>42</sup>Lovallo and Kahneman, "Delusions of Success."

<sup>43</sup>For a summary of research on strategic leadership, see D. C. Hambrick, "Putting Top Managers Back into the Picture," *Strategic Management* 10 (Special Issue, 1989): 5–15. See also D. Goldman, "What Makes a Leader?" *Harvard Business Review* (November–December 1998): 92–105; H. Mintzberg, "Covert Leadership," *Harvard Business Review* (November–December 1998): 140–148; and R. S. Tedlow, "What Titans Can Teach Us," *Harvard Business Review* (December 2001): 70–79.

<sup>44</sup>N. M. Tichy and D. O. Ulrich, "The Leadership Challenge: A Call for the Transformational Leader," *Sloan Management Review* (Fall 1984): 59–68; F. Westley and H. Mintzberg, "Visionary Leadership and Strategic Management," *Strategic Management* 10 (Special Issue, 1989): 17–32.

<sup>45</sup>Comments were made by Jim Donald at a presentation to University of Washington MBA students.

<sup>46</sup>B. McConnell and J. Huba, *Creating Customer Evangelists* (Chicago: Dearborn Trade Publishing, 2003).

<sup>47</sup>E. Wrapp, "Good Managers Don't Make Policy Decisions," *Harvard Business Review* (September–October 1967): 91–99.

<sup>48</sup>J. Pfeffer, *Managing with Power* (Boston: Harvard Business School Press, 1992).

<sup>49</sup>D. Goldman, "What Makes a Leader?" *Harvard Business Review* (November–December 1998): 92–105.

<sup>50</sup>C. Y. Baldwin, "Fundamental Enterprise Valuation: Return on Invested Capital," *Harvard Business School Note* 9-801-125, July 3, 2004; T. Copeland et al., *Valuation: Measuring and Managing the Value of Companies* (New York: Wiley, 2000).

## Chapter 2

<sup>1</sup>S. James, "Lofty Steel Prices Could Keep Climbing," *Herald Tribune*, May 19, 2008; "A Changed Game," *The Economist*, July 15, 2006, 61–62; M. Gene, U.S. Steel Is on a Roll, *Business Week*, June 30, 2008, 20.

<sup>2</sup>M. E. Porter, *Competitive Strategy* (New York: Free Press, 1980).

<sup>3</sup>J. E. Bain, *Barriers to New Competition* (Cambridge, Mass.: Harvard University Press, 1956). For a review of the modern literature on barriers to entry, see R. J. Gilbert, "Mobility Barriers and the Value of Incumbency," in R. Schmalensee and R. D. Willig (eds.), *Handbook of Industrial Organization*, vol. 1 (Amsterdam: North-Holland, 1989). See also R. P. McAfee, H. M. Mialon, and M. A. Williams, "What Is a Barrier to Entry?" *American Economic Review* 94 (May 2004): 461–468.

<sup>4</sup>A detailed discussion of switching costs and lock in can be found in C. Shapiro and H. R. Varian, *Information Rules: A Strategic Guide to the Network Economy* (Boston: Harvard Business School Press, 1999).

<sup>5</sup>Most of this information on barriers to entry can be found in the industrial organization economics literature. See especially the following works: Bain, *Barriers to New Competition*; M. Mann, "Seller Concentration, Barriers to Entry and Rates of Return in 30 Industries," *Review of*

*Economics and Statistics* 48 (1966): 296–307; W. S. Comanor and T. A. Wilson, “Advertising, Market Structure and Performance,” *Review of Economics and Statistics* 49 (1967): 423–440; Gilbert, “Mobility Barriers”; and K. Cool, L.-H. Roller, and B. Leleux, “The Relative Impact of Actual and Potential Rivalry on Firm Profitability in the Pharmaceutical Industry,” *Strategic Management Journal* 20 (1999): 1–14.

<sup>6</sup>For a discussion of tacit agreements, see T. C. Schelling, *The Strategy of Conflict* (Cambridge, Mass.: Harvard University Press, 1960).

<sup>7</sup>M. Busse, “Firm Financial Condition and Airline Price Wars,” *Rand Journal of Economics* 33 (2002): 298–318.

<sup>8</sup>For a review, see F. Karakaya, “Market Exit and Barriers to Exit: Theory and Practice,” *Psychology and Marketing* 17 (2000): 651–668.

<sup>9</sup>P. Ghemawat, *Commitment: The Dynamics of Strategy* (Boston: Harvard Business School Press, 1991).

<sup>10</sup>A. S. Grove, *Only the Paranoid Survive* (New York: Doubleday, 1996).

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<sup>25</sup>Note that Figure 3.9 is a simplification and ignores some other important items that enter the calculation, such as depreciation/sales (a determinant of ROS) and other assets/sales (a determinant of capital turnover).

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## Chapter 5

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## Chapter 6

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<sup>23</sup>The next section draws heavily on Marvin B. Lieberman, "Strategies for Capacity Expansion," *Sloan Management Review* 8 (1987): 19–27; and Porter, *Competitive Strategy*, 324–338.

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<sup>3</sup>J. M. Utterback, *Mastering the Dynamics of Innovation* (Boston: Harvard Business School Press, 1994); C. Shapiro and H. R. Varian, *Information Rules: A Strategic Guide to the Network Economy* (Boston: Harvard Business School Press, 1999).

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<sup>14</sup>E. Mansfield, M. Schwartz, and S. Wagner, "Imitation Costs and Patents: An Empirical Study," *Economic Journal* 91 (1981): 907–918.

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## Chapter 10

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