STRATEGIC MANAGEMENT

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Points to be addressed

- What is strategy?
- Porter’s perspective
- Resource-based view
- Integration of both concepts

What is strategy?

What is strategy?

- Means by which individuals or organizations achieve their goals
  - not detailed actions
  - plans, policies, principles that unify and guide specific actions
- For a company, the essence of strategy is to make choices about:
  - Where to compete?
  - How to compete?

Coca-Cola: **where** does it compete?

- Industry: Soft Drinks
  - branded carbonated drinks - Coca-Cola, Sprite, Fanta
  - other drinks - Juices Minute Maid, Hi-C, Fiver Alive, Dasani Water
- Geographically: 200 countries
  - 27% of US sales
  - 27% in the following four markets - Mexico, Brazil, Japan and China
- Activities:
  - product development, brand management, and concentrate production
  - local bottling and distribution franchises
  - Holds stocks in more than half of the largest bottlers

Coca-Cola: **how** does it compete?

- Differentiation Strategy
  - brand image through intensive advertising and promotion
  - market leadership through mass marketing and close relationships with major bottlers in each country

Strategy and technology

- In technology-based industries, competition is mainly about technology.
  - Established industries - pharmaceutical, chemical, telecommunications, electronics
  - Emerging Industries - Alternative Energy, Biotechnology, Nanotechnology
- In many other industries, less technology-intensive, technological developments are important sources of competitive advantage.
  - Food, household products, financial services, ...
  - How can a company use technology to establish and exploit a competitive advantage, that is, to compete?

Porter’s perspective

Michael Porter

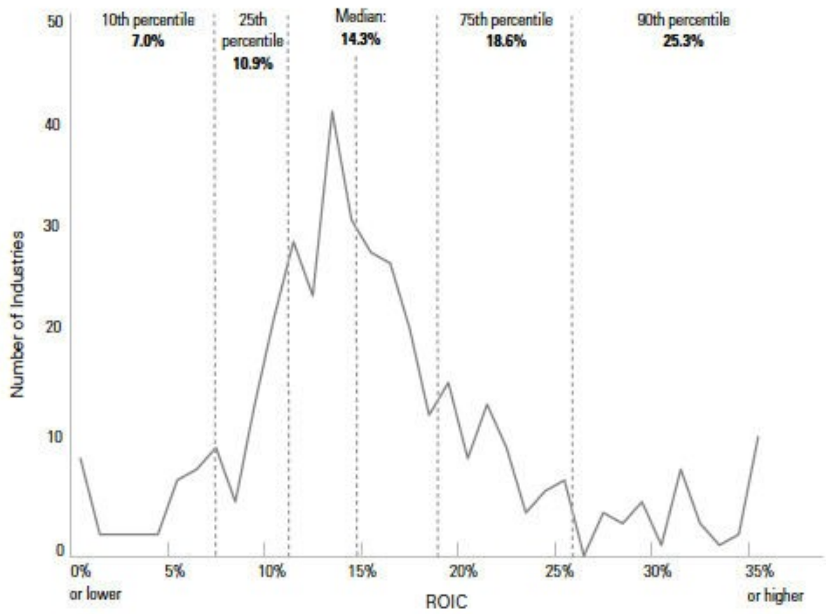
- He created the area of contemporary strategy, and is considered in several opinion studies to be the most influential thinker in management and competitiveness worldwide.
- His foundational book, Competitive Strategy: Techniques for Analyzing Industries and Competitors, dates from 1980.
- Professor at Harvard University, Harvard Business School.
- Basic training in aerospace and mechanical engineering at Princeton.

The success of a company

- According to Porter, the success of a company is a function of:
  - Industry attractiveness
- Factors affecting industry profitability, forces that erode an industry's long-term profitability
  - Competitive positioning
- Achieve a sustainable competitive advantage through differentiation or cost.

Industry attractiveness

Average Return on Invested Capital in U.S. Industries, 1992–2006

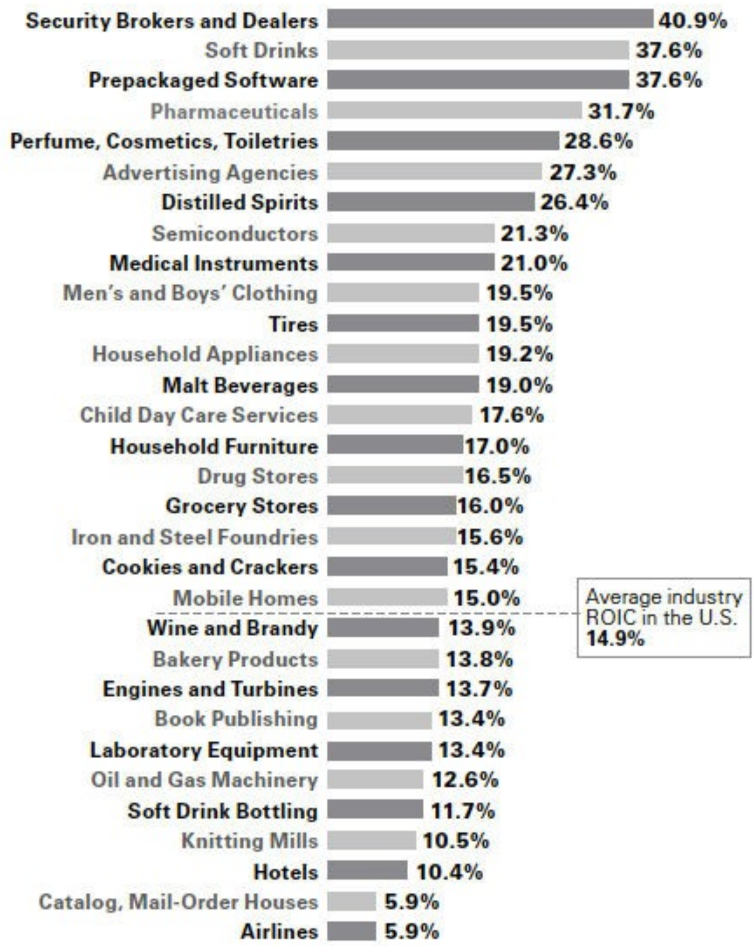


Return on invested capital (ROIC) is the appropriate measure of profitability for strategy formulation, not to mention for equity investors. Return on sales or the growth rate of profits fail to account for the capital required to compete in the industry. Here, we utilize earnings before interest and taxes divided by average invested capital less excess cash as the measure of ROIC. This measure controls for idiosyncratic differences in capital structure and tax rates across companies and industries.

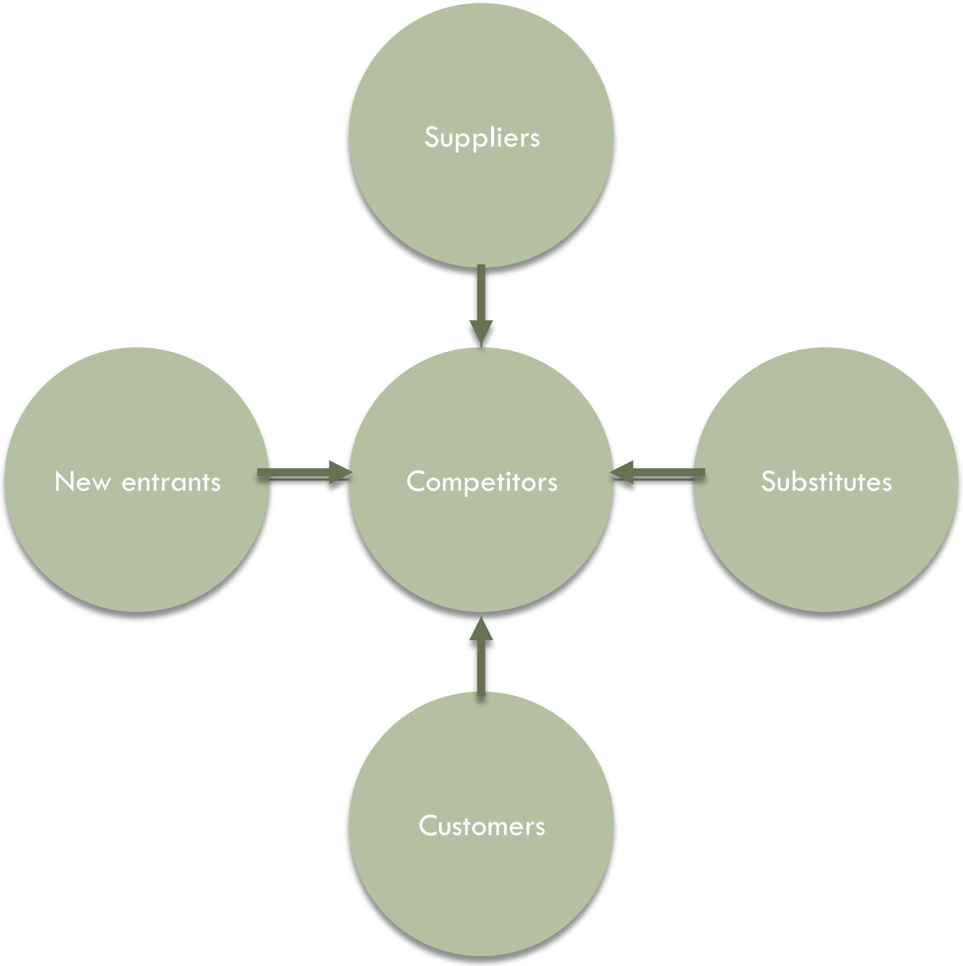
Source: Standard & Poor's, Compustat, and author's calculations

Profitability of Selected U.S. Industries

Average ROIC, 1992–2006



Industry attractiveness



- Porter's Five Forces
  - Horizontal competition
    - Degree of rivalry between established competitors
    - Threat of new competitors
    - Substitute threat
  - Vertical competition
    - Suppliers' bargaining power
    - Customers' bargaining power

Competitors

- Industry rivalry is high if:
  - there are many competitors of similar size and power;
  - industry has weak growth;
  - the product has reduced switching costs or is undifferentiated;
  - there are high fixed costs;
  - there are strong barriers to exit;
  - excess capacity exists.
  - Substitute threats are strong if:
  - there is a propensity for the buyer to replace it;
  - substitute price / performance compromise is an alternative

New entrants

- High economies of scale
- High Product Differentiation / Brand Capital
- High Capital Requirements
- High switching costs
- High cost of access to distribution channels
- Absolute Advantages:
  - Experience, technology, IPRs, skills, competencies…
  - Independent of scale
  - Advantage of the first in the market?
- High Expected Retaliation
  - Association effect between competitors against new entries
- Legal and government barriers

Replacement products (substitutes)

Threat of replacement products is high when

- Nearby substitutes available
- Low replacement switching costs (which may not be in the same industry)
- High performance value of substitutes
- High profitability of substitute producers

Suppliers

Suppliers are powerful if:

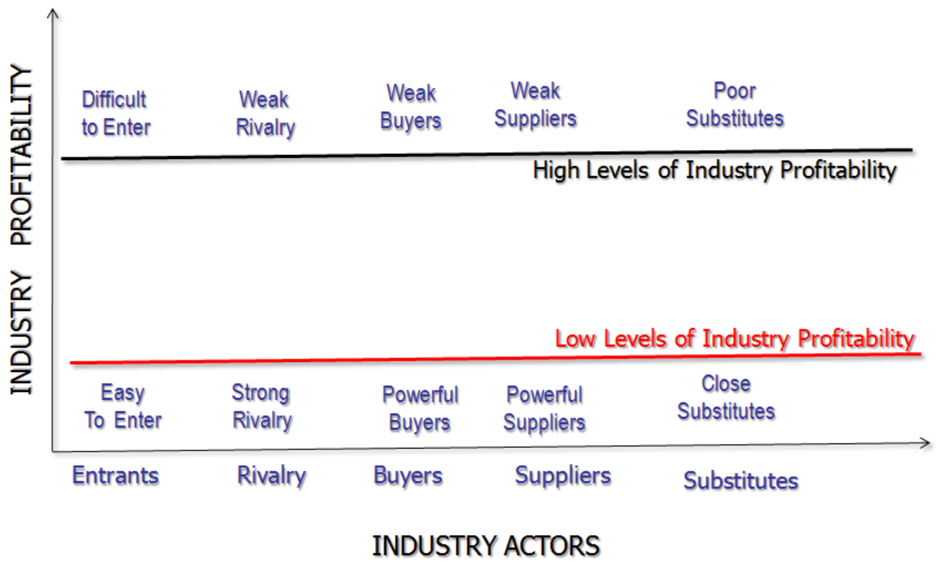
- Few companies dominate the supplier industry
- Few substitutes for supplier's products
- Buyer is not a major customer for supplier
- The supplier is important from a particular point of view (price / quality) from the buyer's point of view.
- Supplier is highly differentiated
- The supplier is able to induce high switching costs.
- High threat of direct vendor integration
- Low threat of backward integration by buyer
- Rivalry between competing companies

Customers

Buyer groups are powerful if:

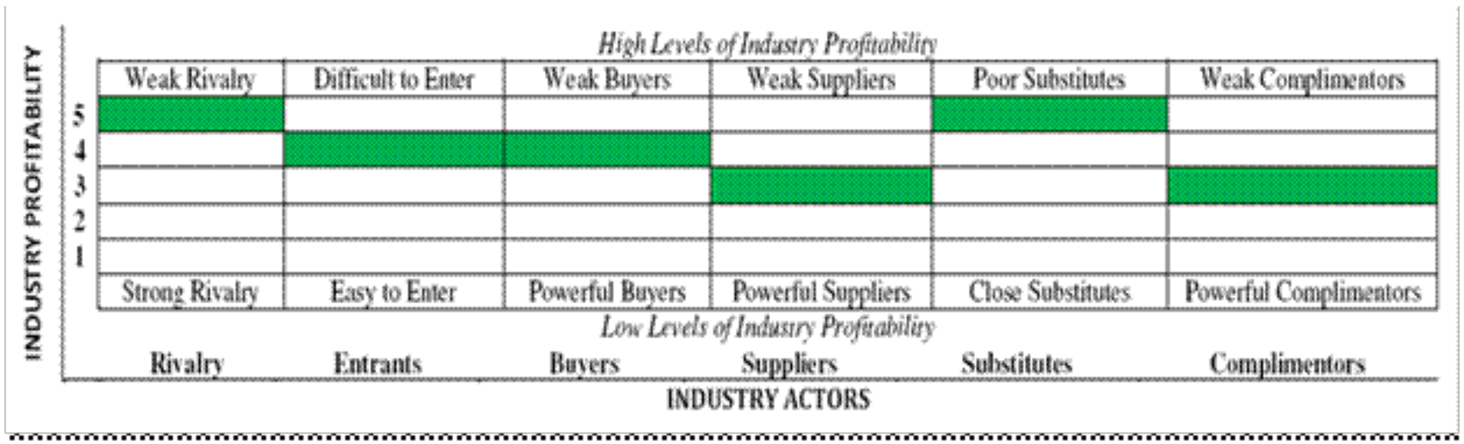
- Buyer concentration is high
- Buyer’s purchases represent a significant fraction of supplier sales
- Products are undifferentiated
- Exchange costs are low
- Are buyers' profits low?
  - FMCG Distribution
- Buyer presents a credible threat of backward integration

Industry analysis



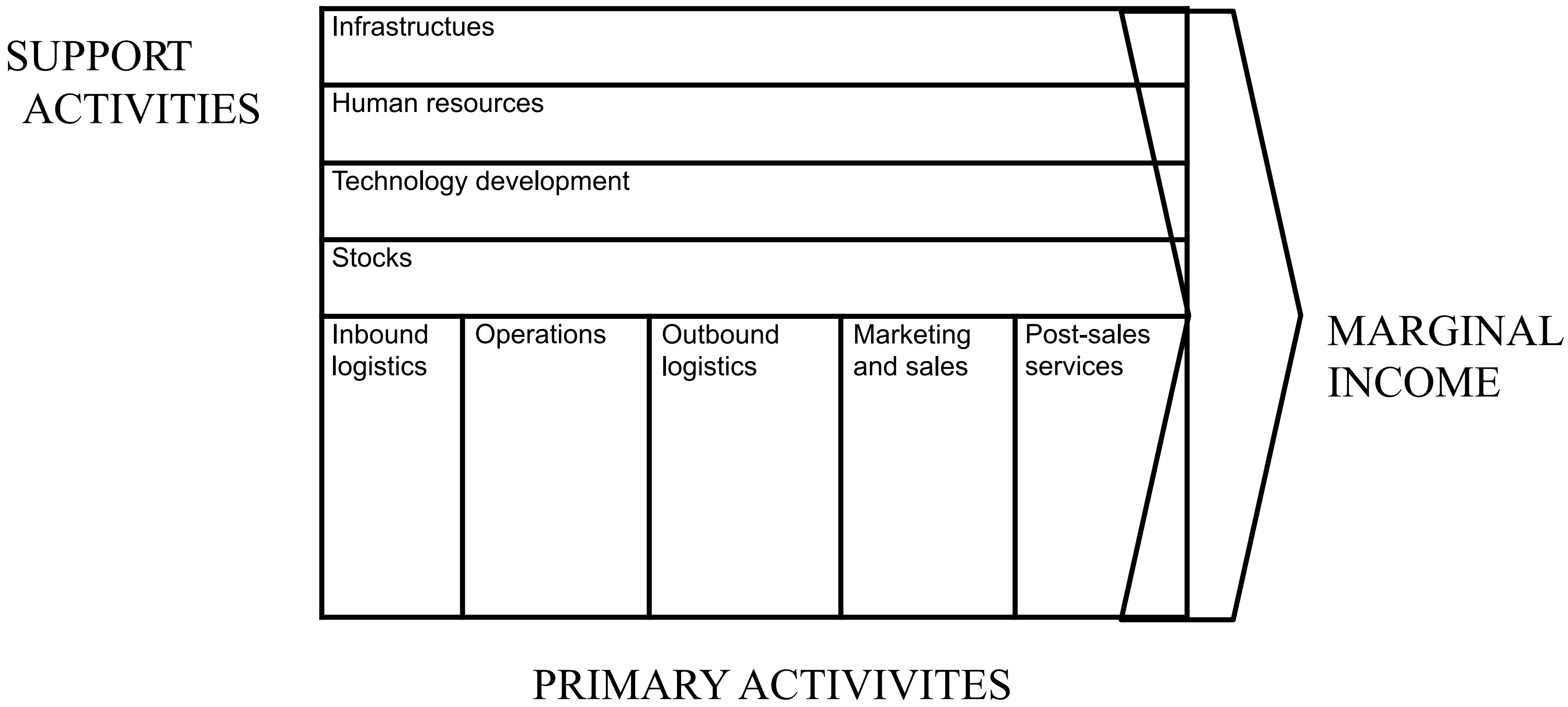
In theory…

…in practice



Competitive positioning

Porter's value chain



Lowcost or differentiation through unique activities

Support activities

- Infrastructure
  - General management, planning, finance, accounting, legal support, state relations
- Human Resources
  - Recruitment, training, development and remuneration
- Technological development
  - R&D, technological aspects of processes, equipment and products
- Stocks
  - Acquisition of inbound materials for the enterprise value chain

Primary activities

- Inbound Logistics
  - Receipt, storage and distribution of entries
- Operations
  - Transformation of final product entries
- Outbound Logistics
  - Collection, storage and distribution of product or service to customers
- Marketing and sales
  - Purchase of goods and services by end consumers and purchase induction activities
- Post-sales service
  - Provision of services designed to increase or maintain the value of the product.

Technology in the value chain

Inbound logistics

- Transportation
- Material handling
- Storage
- Communication systems
- Testing
- Information systems

Operações

- Product
- Materials
- Tools
- Material handling
- Packaging
- Maintenance
- Testing
- Information systems

Outbound logistics

- Transportation
- Material handling
- Packaging
- Communication systems
- Information systems

Marketing and sales

- Media
- Audio and video recording
- Communication systems
- Information systems

Post-sales services

- Diagnostics and testing
- Communication systems
- Information systems

Competitive positioning

- Low cost
  - Cost structure efficiency should allow prices below the average competitor, which in the long run should put you out of business
- Differentiation
  - The alternative is to offer unique product attributes that customers value and are willing to pay a premium for.

Low cost advantage

1. Break down the value chain into various activities
2. Characterize the weight of each activity in the total cost.
3. Identify cost factors for each activity
   - Capital-intensive - investment costs, production volume, downtime
   - Labor-intensive activities - wages, pace of work, defective
4. Determine the relative efficiency with which each activity is performed
   - Compare with competitors costs
5. Recognize cost dependencies between activities
   - Example: Complex Designs Lead to High Service Costs
6. Identify cost reduction opportunities
   - How to increase volume if economies of scale are important?
   - If wages are high, is it possible to reduce them directly or by relocating production?
   - If a certain activity cannot be done efficiently in the company, can it be subcontracted?

Differentiation advantage

1. Design a value chain for the business and customers
   - It may be helpful to consider not only the immediate but also the most downstream customers
2. Identify differentiating factors of competitors in each activity
   - Infrastructure - information system that enables rapid responses
   - Human Resources - Training that enables excellence in customer service
   - Technology - Unique Product Features, Fast Product Development
   - Inbound Logistics - Quality of Components and Materials
   - Operations - no defects, diversity of offer
   - Outbound Logistics - Fast Delivery, Efficient Order Processing
   - Marketing and Sales - Brand Building and Reputation
   - Service - Customer Support, Customer Credit, Spare Part Availability

Differentiation advantage

3. Select the most promising differentiation factors
   - Some differentiating factors may involve interactions between various activities.
     - Example: Product reliability requires monitoring of supplier deliveries, high skills and motivation of production personnel, and quality control and product testing.
   - Consider the sustainability of differentiation
     - More feasible if based on company-specific resources, or skills that evolve the complex coordination of a large number of resources.
4. Identify competitors differentiation factors in each activity
   - To create customer value, the customer must be able to reduce their costs or improve their differentiation.
     - Logic: If delivering components in a just-in-time philosophy costs the supplier over 1000 Euros per month but saves the customer 6000 Euros per month in stock costs, then the supplier must achieve a price that exceeds the cost of differentiation.
     - Example: Procter & Gamble organizes its distribution around rapid response technologies, reducing distribution time and increasing delivery reliability. This enables retailers to reduce inventory costs while increasing the reliability of their deliveries to final consumers.

Resource-based view

Resources

- Tangible resources
- Intangible assets
- Human resources
- Organizational capabilities

Tangible resources

- Easier to identify and evaluate
- Often the only resources present in the balance sheet
- Examples: real estate, manufacturing equipment, raw materials
- They may be essential, but will rarely be a source of competitive advantage because of their standard character.

Intangible assets

- Often have more value than tangible resources
- In general, invisible on balance
  - one of the main reasons for the divergence between book value and market value of companies
- Examples: reputation, brand reputation, culture, technological knowledge, patents, trademarks, accumulated learning and experience
- They often play an important role in the competitive advantage (or disadvantage) and value of the company

Human resources

- Employee Expertise and Effort
- Evidently absent from balance sheet
- Identifying and assessing a company's human resources is complex and difficult:
  - What set of skills, knowledge, attitudes and values lead to the best performance in each professional category?
  - Social and emotional skills and values are increasingly recognized as important, resulting in particular in their ability to harmonize efforts and integrate skills.

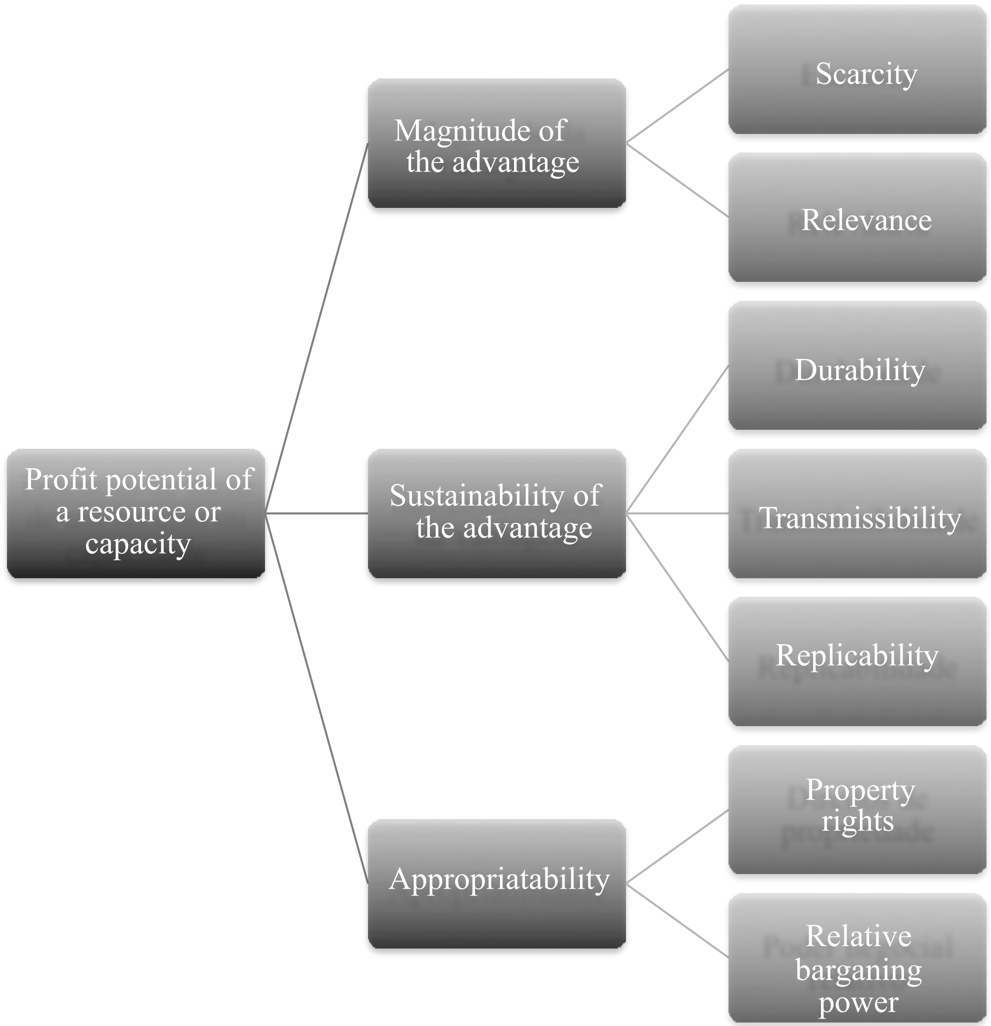
Organizational capabilities

- These are complex combinations of assets, people, and processes that organizations use to turn inputs into outputs.
- Descriptive capabilities of efficiency and effectiveness
- Examples:
  - A surgeon is virtually useless without a radiologist, an anesthetist, nurses, surgical instruments, imaging equipment, and a variety of other resources.
  - Low cost structure, high quality production, fast product development

Resources – some examples

Tangible resources	Intangible resources	Human resources	Organizational capabilities
"Via Verde" - Brisa	Nike's brand image	Red Sox's baseball team	Dell's customer's service
Cash reserves at Modelo Continente	Dell's reputation	MIT's faculty	Inbound logistics at Wal-Mart
Energy power lines from REN	George Clooney vs John Malkovich for Nespresso	Boston Philharmonic's musicians	Sony's product development process
Vineyards from Herdade do Esporão (Finagra)	Steve Jobs as Apple's CEO	NY Times' journalists	Coca-Cola's global distribution coordination

Elements of Competitive Advantage



Magnitude of the advantage

- Scarcity
  - A widely available resource may be essential to compete, but it is not a sufficient basis for competitive advantage.
  - In oil exploration, new technologies such as 3-D seismic analysis are critical to reducing costs, but are widely available.
- Relevance
  - Resources or capabilities must be relevant to market success factors
  - With retail banking moving into vending machines and home banking, branch networks are becoming less and less relevant for customer service.

Sustentability of the advantage

- Durability
  - The life of proprietary equipment or technologies has been shortened by the increasing pace of technological evolution.
  - Brands, on the other hand, may show remarkable resilience over time.
- Transmissibility
  - It results from the specificity of the company, or a loss of value with the transfer.
  - Sources of immobility: geography, imperfect information, resource complementarity, complexity and volume of capabilities
- Replicability
  - Capacity complexity and volume makes replication difficult
  - Resources and capacities accumulated over a long time can only be replicated at very high costs.

Appropriability

- Property Rights
  - Ownership of resources is not always clearly defined.
  - Where capabilities depend on employees' (non-company-owned) skills and efforts, there is a tension between employees and shareholders for ownership
- Relative bargaining power
  - If an employee's individual contribution is clearly identifiable, if they are mobile, and if their skills are equally valuable to other companies, then they are in a strong position to appropriate most of their contribution to the added value created by the company.

Integration of both concepts

Success formula (1)

- Porter - Strategy is war!
  - Select a business in an attractive industry where excellence can be achieved.
  - An attractive industry is one where one can achieve as monopolistic a position as possible.
  - Sustainable advantage is achieved by being better than competitors, if not all, at least in those activities that are most crucial to the competition.

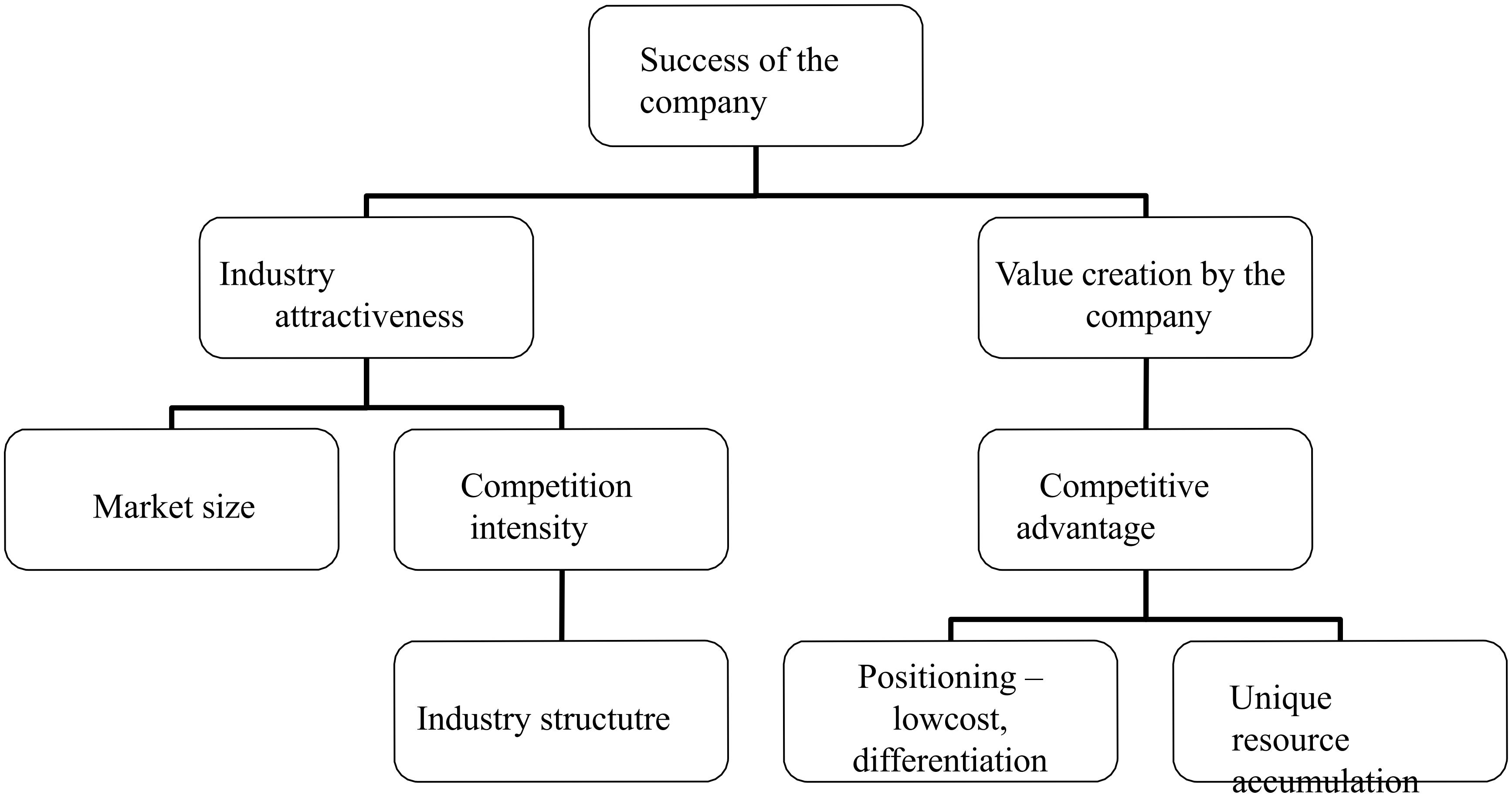
Success formula (2)

- Resources - Strategy is real estate!
  - Develop rare, non-tradable resources and capabilities that underlie the core competencies of the company.
  - Making the resulting advantages sustainable by avoiding imitation and substitution by competitors.
  - Take ownership of economic results by preventing the margin from being squeezed from the outside and avoiding internal waste.
  - Ensure that the implementation process is done so that the costs do not outweigh the benefits.

Comparison

	Porter	Resources
Strategy focus	Industry / Business	Company
Advantage types	Low cost or differentiation	Resources, capacities, core skills and competencies
Basic unit for the advantage	Activities	Core products, strategic architecture
Formula	War	Real estate

Integration



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