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2024 RELEASE

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Crafting & Executing STRATEGY

THE QUEST FOR COMPETITIVE ADVANTAGE

Mc Graw Hill

Concepts and Cases

CRAFTING AND EXECUTING STRATEGY

The Quest for Competitive Advantage

Concepts and Cases | 2024 RELEASE

Arthur A. Thompson
The University of Alabama

Margaret A. Peteraf
Dartmouth College

John E. Gamble
Texas A&M University–Corpus Christi

A.J. Strickland III
The University of Alabama

Mc Graw Hill

CRAFTING & EXECUTING STRATEGY: THE QUEST FOR COMPETITIVE ADVANTAGE, CONCEPTS AND CASES

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To our families and spouses

About the Authors

Courtesy of Arthur A. Thompson, Jr.

Arthur A. Thompson, Jr., (now retired) was John R. Miller Professor of Business Administration, on the faculty of the University of Alabama's College of Commerce and Business Administration for 24 years. He earned his BS and PhD degrees in economics from the University of Tennessee and spent three years on the business school faculty at Virginia Tech before joining the University of Alabama faculty. In 1974 and again in 1982, Dr. Thompson spent semester-long sabbaticals as a visiting scholar at the Harvard Business School.

His areas of specialization are business strategy, competition and market analysis, and the economics of business enterprises. In addition to publishing over 30 articles in some 25 different professional and trade publications, he has authored or co-authored five textbooks and six computer-based simulation exercises. His textbooks and strategy simulations have been used at well over 1,000 college and university campuses worldwide. Dr. Thompson now spends much of his time preparing new editions of his three strategy textbooks and helping operate a business simulation enterprise of which he is a major partner and president.

Dr. Thompson and his wife of 62 years have two married daughters, two grandchildren, and a male Havanese named Jalen.

Courtesy of Margaret A. Peteraf

Margaret A. Peteraf is the Leon E. Williams Professor of Management Emerita at the Tuck School of Business at Dartmouth College. She is an internationally recognized scholar of strategic management and has earned myriad honors and prizes for her scholarly contributions. Twice, she was awarded the Strategic Management Society Best Paper Prize recognizing the deep influence of her work on the field of Strategic Management. She was also a co-recipient of the first Academy of Management's STR Distinguished Scholarship Award (which has been characterized as the "Nobel Prize" of Strategic Management) for her work on the resource-based view of the firm. Professor Peteraf is a fellow of the Strategic Management Society and the Academy of Management. She served previously as a member of the Board of Governors of both the Society and the Academy of Management and as Chair of the Business Policy and Strategy Division of the Academy. She has also served on numerous editorial boards, including that of the *Strategic Management Journal,* the *Academy of Management Review,* and *Organization Science.* She has taught in Executive Education programs in various programs around the world and has won teaching awards at the MBA and Executive level.

Professor Peteraf earned her PhD, MA, and MPhil at Yale University and held previous faculty appointments at Northwestern University's Kellogg Graduate School of Management and at the University of Minnesota's Carlson School of Management.

John E. Gamble is the Mary & Jeff Bell Endowed Distinguished Professor and former Dean of the College of Business at Texas A&M University–Corpus Christi. His teaching and research have focused on strategic management and entrepreneurship at the undergraduate and graduate levels. He has conducted courses in strategic management in Germany since 2001, which have been sponsored by the University of Applied Sciences in Worms.

Courtesy of Leah Godfredson, Ever After Photography

Dr. Gamble's research has been published in various scholarly journals and he is the author or co-author of more than 75 case studies published in an assortment of strategic management and strategic marketing texts. He has done consulting on industry and market analysis for clients in a diverse mix of industries.

Professor Gamble received his PhD, MA, and BS degrees from The University of Alabama and was a faculty member in the Mitchell College of Business at the University of South Alabama before his appointment to the faculty at Texas A&M University–Corpus Christi.

Dr. A. J. (Lonnie) Strickland is the Thomas R. Miller Professor of Strategic Management at the Culverhouse School of Business at The University of Alabama. He is a native of north Georgia, and attended the University of Georgia, where he received a BS degree in math and physics; Georgia Institute of Technology, where he received an MS in industrial management; and Georgia State University, where he received his PhD in business administration.

Courtesy of Dr. A. J. (Lonnie) Strickland

Lonnie's experience in consulting and executive development is in the strategic management arena, with a concentration in industry and competitive analysis. He has developed strategic planning systems for numerous firms all over the world. He served as Director of Marketing and Strategy at BellSouth, has taken two companies to the New York Stock Exchange, is one of the founders and directors of American Equity Investment Life Holding (AEL), and serves on numerous boards of directors. He is a very popular speaker in the area of strategic management.

Lonnie and his wife, Kitty, have been married for over 50 years. They have two children and two grandchildren. Each summer, Lonnie and his wife live on their private game reserve in South Africa where they enjoy taking their friends on safaris.

Preface

By offering the most engaging, clearly articulated, and conceptually sound text on strategic management, *Crafting and Executing Strategy* has been able to maintain its position as the leading textbook in strategic management for over 40 years. With this latest edition, we build on this strong foundation, maintaining the attributes of the book that have long made it the most teachable text on the market, while updating the content, sharpening its presentation, and providing enlightening new illustrations, examples, and business cases.

The distinguishing mark of the 2024 Release is its enriched and enlivened presentation of the material in each of the 12 chapters, providing an as up-to-date and engrossing discussion of the core concepts and analytical tools as you will find anywhere. As with each of our new editions, there is an accompanying lineup of exciting new cases that bring the content to life and are sure to provoke interesting classroom discussions, deepening students' understanding of the material in the process.

While this 2024 Release retains the 12-chapter structure of the prior edition, every chapter—indeed every paragraph and every line—has been reexamined, refined, and refreshed. New content has been added to keep the material in line with the latest developments in the theory and practice of strategic management. In other areas, coverage has been trimmed to keep the book at a more manageable size. Scores of new examples have been added, along with many new Illustration Capsules, to enrich understanding of the content and to provide students with a ringside view of strategy in action. The result is a text that cuts straight to the chase in terms of what students really need to know and gives instructors a leg up on teaching that material effectively. The chapter content remains, as always, solidly mainstream and balanced, mirroring *both* the penetrating insight of academic thought and the pragmatism of real-world strategic management.

A standout feature of this text has always been the tight linkage between the content of the chapters and the cases. The lineup of cases that accompany the 2024 Release is outstanding in this respect—a truly appealing mix of strategically relevant and thoughtfully crafted cases, certain to engage students and sharpen their skills in applying the concepts and tools of strategic analysis. Most involve high-profile companies that the students will immediately recognize and relate to; all are framed around key strategic issues and serve to add depth and context to the topical content of the chapters. We are confident you will be impressed with how well these cases work in the classroom and the amount of student interest they will spark.

For some years now, growing numbers of strategy instructors at business schools worldwide have been transitioning from a purely text-case course structure to a more robust and energizing text-case-simulation course structure. Incorporating a competition-based strategy simulation has the strong appeal of providing class members with *an immediate and engaging opportunity to apply the concepts and analytical tools covered in the chapters and to become personally involved in crafting and executing a strategy for a virtual company that they have been assigned to manage and that competes head-to-head with companies run by other class members.* Two widely used and pedagogically effective online strategy simulations, *The Business Strategy Game* and *GLO-BUS,* are optional companions for this text. Both simulations were created by Arthur Thompson, one of the text authors, and, like the cases, are closely linked to the content of each chapter in the text. The Exercises for Simulation Participants, found at the end of each chapter and integrated into the Connect package for the text, provide clear guidance to class members in applying the concepts and analytical tools covered in the chapters to the issues and decisions that they have to wrestle with in managing their simulation company.

Through our experiences as business school faculty members, we fully understand the assessment demands on faculty teaching strategic management and business policy courses. In many institutions, capstone courses have emerged as the logical home for assessing student achievement of program learning objectives. To assist instructors in assessing student achievement of these objectives, in line with AACSB requirements, the 2024 Release includes a set of Assurance of Learning Exercises at the end of each chapter that links to the specific learning objectives appearing at the beginning of each chapter and highlighted throughout the text. An important instructional feature of the 2024 Release is its more closely *integrated* linkage of selected chapter-end Assurance of Learning Exercises and cases to Connect™. Your students will be able to use Connect to (1) complete Assurance of Learning Exercises appearing at the end of each of the 12 chapters, (2) complete Exercises for Simulation Participants, (3) complete assignable application-based activities (mini-simulations), (4) complete chapter-end quizzes, and (5) complete case tutorials based upon the suggested assignment questions for all 27 cases in this edition. All of the Connect exercises are automatically graded, thereby enabling you to easily assess the learning that has occurred.

In addition, both of the companion strategy simulations have a built-in Learning Assurance Report that quantifies how well each member of your class performed on nine skills/learning measures *versus tens of thousands of other students worldwide* who completed the simulation in the past 12 months. We believe the chapter-end Assurance of Learning Exercises, the online and automatically graded Connect™ exercises, and the Learning Assurance Report generated at the conclusion of *The Business Strategy Game* and *GLO-BUS* simulations provide you with easy-to-use, empirical measures of student learning in your course. All can be used in conjunction with other instructor-developed or school-developed scoring rubrics and assessment tools to comprehensively evaluate course or program learning outcomes and measure compliance with AACSB accreditation standards.

Taken together, the various components of the 2024 Release package and the supporting set of instructor resources provide you with enormous course design flexibility and a powerful kit of teaching/learning tools. We've done our very best to ensure that the elements constituting the 2024 Release will work well for you in the classroom, help you economize on the time needed to be well prepared for each class, and cause students to conclude that your course is one of the very best they have ever taken—from the standpoint of both enjoyment and learning.

DIFFERENTIATING FEATURES OF THE 2024 RELEASE

Nine standout features strongly differentiate this text and the accompanying instructional package from others in the field:

1. *We provide the clearest discussion of business models to be found anywhere.* By introducing this often-misunderstood concept right in the first chapter, defining it precisely, and providing clear examples, we give students a leg up on grasping this important concept. Follow-on discussions in the next eight chapters drive the concept home. Illustration capsules and cases show how a new business model can enable a company to compete successfully even against well-established rivals. In some cases, a new business model can even be the agent for disrupting an existing industry.
2. *Our integrated coverage of the two most popular perspectives on strategic management—positioning theory and resource-based theory—is unsurpassed by any other leading strategy text.* Principles and concepts from both the positioning perspective and the resource-based perspective are prominently and comprehensively integrated into our coverage of crafting both single-business and multibusiness strategies. By highlighting the relationship between a firm's resources and capabilities to the activities it conducts along its value chain, we show explicitly how these two perspectives relate to one another. Moreover, in Chapters 3 through 8, it is emphasized repeatedly that a company's strategy must be matched *not only* to its external market circumstances *but also* to its internal resources and organizational capabilities.
3. *With this new edition, we provide the clearest, easiest to understand presentation of the value-price-cost framework.* In recent years, this framework has become an essential aid to teaching students how companies create economic value in the course of conducting business. We show how this simple framework informs the concept of the business model as well as the all-important concept of competitive advantage. In Chapter 5, we add further clarity by showing in pictorial fashion how the value-price-cost framework relates to the different sources of competitive advantage that underlie the five generic strategies.
4. *Our coverage of cooperative strategies and the role that interorganizational activity can play in the pursuit of competitive advantage is similarly distinguished.* The topics of the value net, ecosystems, strategic alliances, licensing, joint ventures, and other types of collaborative relationships are featured prominently in a number of chapters and are integrated into other material throughout the text. We show how strategies of this nature can contribute to the success of single-business companies as well as multibusiness enterprises, whether with respect to firms operating in domestic markets or those operating in the international realm.
5. *The attention we give to international strategies, in all their dimensions, make this textbook an indispensable aid to understanding strategy formulation and execution in an increasingly connected, global world.* Our treatment of this topic as one of the most critical elements of the *scope* of a company's activities brings home to students the connection between the topic of international strategy with other topics concerning firm scope, such as multibusiness (or corporate) strategy, outsourcing, insourcing, and vertical integration.
6. *With a standalone chapter devoted to these topics, our coverage of business ethics, social responsibility, and sustainability goes well beyond that offered by any other leading strategy text.* Chapter 9, "Ethics, Corporate Social Responsibility, Environmental

Sustainability, and Strategy," fulfills the important functions of alerting students to the role and importance of ethical and socially responsible decision making and the value of sustainable business practices. Moreover, discussions of the roles of values and ethics are integrated into portions of other chapters, beginning with the first chapter, to further reinforce why and how considerations relating to ethics, values, social responsibility, and sustainability should figure prominently into the managerial task of crafting and executing company strategies. This material thereby fulfills the accreditation requirement of the AACSB International that business ethics be visibly and thoroughly embedded in the core curriculum.

7. *Long known as an important differentiator of this text, the case collection in the 2024 Release is truly unrivaled* from the standpoints of student appeal, teachability, and suitability for drilling students in the use of the concepts and analytical treatments in Chapters 1 through 12. The 27 cases included in this edition are the very latest, the best, and the most on target that we could find. The ample information about the cases in the Instructor's Manual makes it effortless to select a set of cases each term that will capture the interest of students from start to finish.
8. *The text is now optimized for hybrid and online delivery through robust assignment and assessment content integrated into Connect*™. The *Connect* package for the 2024 Release allows instructors to assign auto-graded quizzes and select chapter-end Assurance of Learning Exercises to assess class members' understanding of chapter concepts. The package also includes application-based activities (mini-simulations) and open-ended and auto-graded Exercises for Simulation Participants. In addition, our texts have pioneered the extension of *Connec*t to case analyses. The auto-graded case exercises for the cases in this edition are robust and extensive and will better enable students to make meaningful contributions to class discussions. The auto-graded *Connect* case exercises may also be used as graded assignments in the course.
9. *Two cutting-edge and widely used strategy simulations—The Business Strategy Game and GLO-BUS—are optional companions to the 2024 Release.* These give you an unmatched capability to employ a text-case-simulation model of course delivery.

WHAT IS NEW IN THE 2024 RELEASE?

CHAPTER 1

- New introduction on the radical transformation of business in the past decade
- New Illustration Capsules: Amazon's Strategy; Turo, Zipcars, and Enterprise: Three Contrasting Business Models

CHAPTER 2

- New content in the section "Linking the Vision and Mission with Company Values" on Samsung's five core values
- New content in the section "Developing a Company Mission Statement" on Singapore Airlines
- New Illustration Capsule: IKEA's Vision, Mission and Core Values
- Updated Illustration Capsules: Examples of Strategic Visions (General Motors); Examples of Company Objectives (YUM! Brands, Lululemon)

CHAPTER 3

- New content on The Six Components of the Macro-Environment
- New strategic group map example (Food Delivery Services)
- New Illustration Capsule: Macro-Environmental Changes Resulting from the COVID-19 Pandemic

CHAPTER 4

- New content on The Concept of a Company Value Chain
- New content on Improving Internally Performed Value Chain Analysis
- Updated Illustration Capsules: The Value Chain for Everlane; Benchmarking in the Solar Industry

CHAPTER 5

- New discussion of competitive strategy
- New example of intangible attributes (Tesla)

CHAPTER 6

- New content on Timing a Company's Strategic Moves
- New examples of Horizontal Merger and Acquisition Strategies (Coca-Cola, Airbnb)
- New content on Why M&As Fail to Produce Anticipated Results
- New discussion on nearsourcing
- New content on the business ecosystem

CHAPTER 7

- New coverage of multinational enterprises

CHAPTER 8

- New content on and new example of a Nine-Cell Industry Attractiveness-Competitive Strength Matrix
- Updated Illustration Capsules: Examples of Companies Pursuing Related AND Unrelated Diversification Strategies; The Kraft-Heinz Merger; Restructuring Strategically at VF Corporation

CHAPTER 9

- New content on The School of Ethical Relativism in the areas of underage labor and bribes and kickbacks
- New content on Diversity, Equity, and Inclusion (DEI)
- New content on Environmental, Social, and Governance (ESG)
- New content on corporate sustainability
- New Illustration Capsule: Ethical Violations at Cryptocurrency Exchange FTX
- Updated Illustration Capsules: Warby Parker; Unilever

CHAPTER 10

- New content in Recruiting, Training, and Retaining Capable Employees (Southwest Airlines example, best practices for staffing)
- New content on ecosystems

- New Illustration Capsule: Diversity and Inclusion at the Top Levels of Management
- Updated Illustration Capsules: Management Development at Deloitte Touche Tomatsu Limited; Zara's Strategy Execution Capabilities; Which Value Chain Activities Does Apple Outsource and Why?

CHAPTER 11

- New content on Six Sigma programs
- Updated Illustration Capsules: Charleston Area Medical Center's Six Sigma Program; How Wegman's Rewards and Motivates Employees

CHAPTER 12

- New content on Unhealthy Cultures that Impede Good Strategy Execution
- Updated Illustration Capsules: Puma's High-Performance Culture; Driving Cultural Change at Goldman Sachs

THE CASE COLLECTION

The 27-case lineup in this 2024 Release is flush with interesting companies and valuable lessons for students in the art and science of crafting and executing strategy. There's a good blend of cases from a length perspective—about two-thirds of the cases are under 15 pages yet offer plenty for students to chew on; and the remainder are detail-rich cases that call for more sweeping analysis.

At least 25 of the 27 cases involve companies, products, people, or activities that students will have heard of, know about from personal experience, or can easily identify with. The lineup includes at least 20 cases that will deepen student understanding of the special demands of competing in industry environments where product life cycles are short and competitive maneuvering among rivals is quite active. Twenty-three of the cases involve situations in which company resources and competitive capabilities play as large a role in the strategy-making, strategy executing scheme of things as industry and competitive conditions do. Scattered throughout the lineup are 20 cases concerning non-U.S. companies, globally competitive industries, and/or cross-cultural situations. These cases, in conjunction with the globalized content of the text chapters, provide abundant material for linking the study of strategic management tightly to the ongoing globalization of the world economy. You'll also find 8 cases dealing with the strategic problems of family-owned or relatively small entrepreneurial businesses and 24 cases involving public companies and situations where students can do further research on the Internet.

The "Guide to Case Analysis" follows the last case. It contains sections on what a case is, why cases are a standard part of courses in strategy, preparing a case for class discussion, doing a written case analysis, doing an oral presentation, and using financial ratio analysis to assess a company's financial condition. We suggest having students read this guide before the first class discussion of a case.

A number of cases have accompanying videos from various sources which are listed in Section 3 of the Instructor's Manual, in a separate Video Library within the Instructor's Resources, and in the Teaching Note for each case.

THE TWO STRATEGY SIMULATION SUPPLEMENTS: *THE BUSINESS STRATEGY GAME* AND *GLO-BUS*

The Business Strategy Game and *GLO-BUS: Developing Winning Competitive Strategies*—two competition-based strategy simulations that are delivered online and that feature automated processing and grading of performance—are being marketed by the publisher as companion supplements for use with the 2024 Release (and other texts in the field).

- *The Business Strategy Game* is the world's most popular strategy simulation, having been used by nearly 3,600 different instructors for courses involving over 1 million students at 1,375 university campuses in 77 countries. It features global competition in the athletic footwear industry, a product/market setting familiar to students everywhere and one whose managerial challenges are easily grasped. A freshly updated and much-enhanced version of *The Business Strategy Game* was introduced in August 2018.
- *GLO-BUS,* a newer and somewhat simpler strategy simulation first introduced in 2004 and freshly revamped in 2016 to center on competition in two exciting product categories—wearable miniature action cameras and unmanned camera-equipped drones suitable for multiple commercial purposes, has been used by 2,100 different instructors for courses involving nearly 450,000 students at 800+ university campuses in 53 countries. In 2023, this latest version of *GLO-BUS* was used in 1,230 classes for courses with enrollment of nearly 27,500 students on 240 campuses.

  Arthur A. Thompson, a senior author of this text and the lead co-author of both The Business Strategy Game and *GLO-BUS,* designed both simulations to provide instructors with an appealing and proven means of:

- Getting class members personally engaged in thinking strategically and applying the chapter content.
- Giving students valuable practice in synthesizing a variety of functional and operating decisions into an overall strategy and competitive approach that produces good financial and strategic results in a globally competitive marketplace.

How the Strategy Simulations Work

In both *The Business Strategy Game (BSG)* and *GLO-BUS,* class members are divided into teams of one to five persons and assigned to run a company that competes head-to-head against companies run by other class members.

- In *BSG,* team members run athletic footwear companies that produce and market both branded and private-label footwear in a global market arena with four distinct geographic regions—Europe-Africa, North America, Asia-Pacific, and Latin America.
- In *GLO-BUS,* team members operate companies that design, assemble, and market professional quality action-capture video cameras and unmanned camera-equipped copter drones in a global market arena that also consists of four distinct geographic regions—Europe-Africa, North America, Asia-Pacific, and Latin America.

In both simulations, each management team is called upon to craft a strategy for their company and make decisions relating to production capacity, plant operations, workforce compensation, pricing and marketing, social responsibility/citizenship, and finance.

Company co-managers are held accountable for their decision making. Each company's performance is scored on the basis of earnings per share, return-on-equity investment, stock price, credit rating, and image rating. Rankings of company performance, along with a wealth of industry and company statistics, are available to company co-managers after each decision round to use in making strategy adjustments and operating decisions for the next competitive round. You can be certain that the market environment, strategic issues, and operating challenges that company co-managers must contend with are *very tightly linked* to what your class members will be reading about in the text chapters. The circumstances that co-managers face in running their simulation company embrace the very concepts, analytical tools, and strategy options they encounter in the text chapters (this is something you can quickly confirm by skimming through some of the Exercises for Simulation Participants that appear at the end of each chapter).

We suggest that you schedule one or two practice rounds and anywhere from six to 10 regular (scored) decision rounds (more rounds are better than fewer rounds). Each decision round represents a year of company operations and will entail roughly two hours of time for company co-managers to complete. In traditional 13-week, semester-long courses, there is merit in scheduling one decision round per week. In courses that run five to 10 weeks, it is wise to schedule two decision rounds per week for the last several weeks of the term (sample course schedules are provided for courses of varying length and varying numbers of class meetings).

When the instructor-specified deadline for a decision round arrives, the simulation server automatically accesses the saved decision entries of each company, determines the competitiveness and buyer appeal of each company's product offering relative to the other companies being run by students in your class, and then awards sales and market shares to the competing companies, geographic region by geographic region. The unit sales volumes awarded to each company *are totally governed by*

- How its prices compare against the prices of rival brands.
- How its product quality compares against the quality of rival brands.
- How its product line breadth and selection compare.
- How its advertising effort compares.
- And so on, for each of the remaining competitive factors that determine unit sales and market shares.

The competitiveness and overall buyer appeal of each company's product offering *in comparison to the product offerings of rival companies* is all-decisive—this algorithmic feature is what makes *BSG* and *GLO-BUS* "competition-based" strategy simulations. Once each company's sales and market shares are awarded based on the competitiveness and buyer appeal of its respective overall product offering vis-à-vis those of rival companies, the various company and industry reports detailing the outcomes of the decision round are then generated. Company co-managers can access the results of the decision round 15 to 20 minutes after the decision deadline. Rest assured that both simulations were meticulously designed to be instructor-friendly. You'll be pleasantly surprised—and we think quite pleased—at how little time it takes to gear up for and to administer an automated online simulation like *The Business Strategy Game* or *GLO-BUS.*

Special Note: ***Both simulations work especially well for online classes or in distance-learning situations where students are not on-campus*. This is because *team members***

running the same company who are logged-in simultaneously on different computers at different locations can easily have an online meeting by using two tremendously valuable built-in capabilities:

They can click a button to work collaboratively in viewing reports and making decision entries. When in "Collaboration Mode," each team member sees the same screen at the same time as all other team members who are logged-in and have joined Collaboration Mode. If one team member chooses to view a particular decision screen, that same screen appears on the monitors for all team members engaged in collaboration. Each team member controls their own color-coded mouse pointer (with their first-name appearing in a color-coded box linked to their mouse pointer) and can make a decision entry or move the mouse to point to particular on-screen items.

They can click a second button to talk to one another (using the built-in real-time VOIP audio chat feature). Chat capability among team members working in Collaboration Mode enables team members to debate and discuss the merits of alternative decision entries and strategies. In effect, they can have an online meeting to conveniently and effectively collaborate in running their simulation company (as opposed to meeting face-to-face and gathering around a single computer).

Moreover, instructors have capability to use their own computers to join any company's online meeting. They can not only talk online to the managers of a company but also utilize the Collaboration feature that enables all attendees to view the same screen. When in Collaboration Mode instructors have their own red-colored mouse pointer linked to a red box labeled Instructor. This instructor-friendly feature curtails having to schedule meetings with team members in your office should something arise that requires your participation.

Even if you are teaching an in-person class rather than an online course, you will find that a big majority of class members will opt to take advantage of the built-in collaboration and voice chat features because the members of many company teams will like the convenience of having an online meeting to prepare their decision entries as opposed to having face-to-face meetings and gathering around a single computer either in the computer lab or at some other location of their choosing.

The Compelling Case for Incorporating Use of a Strategy Simulation

There are *three exceptionally important benefits* associated with using a competition-based simulation in strategy courses taken by seniors and MBA students:

- *A three-pronged text-case-simulation course model delivers significantly more teaching-learning power than the traditional text-case model.* Using *both* cases and a strategy simulation to drill students in thinking strategically and applying what they read in the text chapters is a stronger, more effective means of helping them connect theory with practice and develop better business judgment. What cases do that a simulation cannot is give class members broad exposure to a variety of companies and industry situations and insight into the kinds of strategy-related problems managers face. But what a competition-based strategy simulation does far better than case analysis is thrust class members squarely into *an active, hands-on managerial role* where they are totally responsible for assessing market conditions, determining how to respond to the actions of competitors, forging a long-term direction and strategy for their company, and making all kinds of operating decisions. Because they are held fully accountable for their decisions and their company's performance, *co-managers are strongly motivated* to dig deeply into company operations, probe for ways to be more cost-efficient and competitive, and ferret out strategic moves and decisions calculated to boost company performance. *Consequently, incorporating both case assignments and a strategy simulation to develop the skills of class members in thinking strategically and applying the concepts and tools of strategic analysis turns out to be more pedagogically powerful than relying solely on case assignments—there's stronger retention of the lessons learned and better achievement of course learning objectives.*

To provide you with quantitative evidence of the learning that occurs with using *The Business Strategy Game* or *GLO-BUS,* there is a built-in Learning Assurance Report showing how well each class member performs on nine skills/learning measures versus tens of thousands of students worldwide who have completed the simulation in the past 12 months.

- *The competitive nature of a strategy simulation arouses positive energy and steps up the whole tempo of the course by a notch or two.* Nothing sparks class excitement quicker or better than the concerted efforts on the part of class members at each decision round to achieve a high industry ranking and avoid the perilous consequences of being outcompeted by other class members. Students really enjoy taking on the role of a manager, running their own company, crafting strategies, making all kinds of operating decisions, trying to outcompete rival companies, and getting immediate feedback on the resulting company performance. Lots of back-and-forth chatter occurs when the results of the latest simulation round become available and co-managers renew their quest for strategic moves and actions that will strengthen company performance. Co-managers become *emotionally invested* in running their company and figuring out what strategic moves to make to boost their company's performance. Interest levels climb. All this stimulates learning and causes students to see the practical relevance of the subject matter and the benefits of taking your course.

  As soon as your students start to say, "Wow! Not only is this fun but I am learning a lot," *which they will,* you have won the battle of engaging students in the subject matter and moved the value of taking your course to a much higher plateau in the business school curriculum. This translates into *a livelier, richer learning experience from a student perspective and better instructor-course evaluations.*
- *Use of a fully automated online simulation reduces the time instructors spend on course preparation, course administration, and grading.* Since the simulation exercise involves a 20- to 30-hour workload for student teams (roughly two hours per decision round times 10 to 12 rounds, plus optional assignments), simulation adopters often compensate by trimming the number of assigned cases from, say, 10 to 12 to perhaps 4 to 6. This significantly reduces the time instructors spend reading cases, studying teaching notes, and otherwise getting ready to lead class discussion of a case or grade oral team presentations. Course preparation time is further cut because you can use several class days to have students bring their laptops to class or meet in a computer lab to work on upcoming decision rounds or a three-year strategic plan (in lieu of lecturing on a chapter or covering an additional assigned case). Not only does use of a simulation permit assigning fewer cases, but it also permits you to eliminate at least one assignment that entails considerable grading on your part. Grading one less written case or essay exam or other written assignment saves enormous time. With *BSG* and *GLO-BUS,* grading is effortless and takes only minutes; once you enter percentage weights for each assignment in

your online grade book, a suggested overall grade is calculated for you. You'll be pleasantly surprised—and quite pleased—at how little time it takes to gear up for and administer *The Business Strategy Game* or *GLO-BUS.*

In sum, incorporating use of a strategy simulation turns out to be *a win–win proposition for both students and instructors.* Moreover, a very convincing argument can be made that a competition-based strategy simulation is *the single most effective teaching/learning tool that instructors can employ to teach the discipline of business and competitive strategy, to make learning more enjoyable, and to promote better achievement of course learning objectives.*

A Bird's-Eye View of *The Business Strategy Game*

The setting for *The Business Strategy Game (BSG)* is the global athletic footwear industry (there can be little doubt in today's world that a globally competitive strategy simulation is *vastly superior* to a simulation with a domestic-only setting). Global market demand for footwear grows at the rate of seven to nine percent annually for the first five years and five to seven percent annually for the second five years. However, market growth rates vary by geographic region—North America, Latin America, Europe-Africa, and Asia-Pacific.

Companies begin the simulation producing branded and private-label footwear in two plants, one in North America and one in Asia. They have the option to establish production facilities in Latin America and Europe-Africa. Company co-managers exercise control over production costs on the basis of the styling and quality they opt to manufacture, plant location (wages and incentive compensation vary from region to region), the use of best practices and Six Sigma programs to reduce the production of defective footwear and to boost worker productivity, and compensation practices.

All newly produced footwear is shipped in bulk containers to one of four geographic distribution centers. All sales in a geographic region are made from footwear inventories in that region's distribution center. Costs at the four regional distribution centers are a function of inventory storage costs, packing and shipping fees, import tariffs paid on incoming pairs shipped from foreign plants, and exchange rate impacts. At the start of the simulation, import tariffs average $4 per pair in North America, $6 in Europe-Africa, $8 per pair in Latin America, and $10 in the Asia-Pacific region. Instructors have the option to alter tariffs as the game progresses.

Companies market their brand of athletic footwear to footwear retailers worldwide and to individuals buying online at the company's website. Each company's sales and market share in the branded footwear segments hinge on its competitiveness on 13 factors: attractive pricing, footwear styling and quality, product line breadth, advertising, use of mail-in rebates, appeal of celebrities endorsing a company's brand, success in convincing footwear retailers to carry its brand, number of weeks it takes to fill retailer orders, effectiveness of a company's online sales effort at its website, and brand reputation. Sales of private-label footwear hinge solely on being the low-price bidder.

All told, company co-managers make as many as 57 types of decisions each period that cut across production operations (up to 11 decisions per plant, with a maximum of four plants), the addition of facility space, equipment, and production improvement options (up to eight decisions per plant), worker compensation and training (up to six decisions per plant), shipping and distribution center operations (five decisions per geographic region), pricing and marketing (up to nine decisions in four geographic regions), bids to sign celebrities (two decision entries per bid), financing of company operations (up to eight decisions), and corporate social responsibility and environmental sustainability (up to eight decisions). Plus, there are 10 entries for each region pertaining to assumptions about the upcoming-year actions and competitive efforts of rival companies that factor directly into the forecasts of a company's unit sales, revenues, and market share in each of the four geographic regions.

Each time company co-managers make a decision entry, an assortment of on-screen calculations instantly shows the projected effects on unit sales, revenues, market shares, unit costs, profit, earnings per share, ROE, and other operating statistics. The on-screen calculations help team members evaluate the relative merits of one decision entry versus another and put together a promising strategy.

Companies can employ any of the five generic competitive strategy options in selling branded footwear—low-cost leadership, differentiation, best-cost provider, focused low cost, and focused differentiation. They can pursue essentially the same strategy worldwide or craft slightly or very different strategies for the Europe-Africa, Asia-Pacific, Latin America, and North America markets. They can strive for competitive advantage based on more advertising, a wider selection of models, more appealing styling/quality, bigger rebates, and so on.

Any well-conceived, well-executed competitive approach is capable of succeeding, provided it is not overpowered by the strategies of competitors or defeated by the presence of too many copycat strategies that dilute its effectiveness. The challenge for each company's management team is to craft and execute a competitive strategy that produces good performance on five measures: earnings per share, return on equity investment, stock price appreciation, credit rating, and brand image.

All activity for *The Business Strategy Game* takes place at **www.bsg-online.com**.

A Bird's-Eye View of *GLO-BUS*

In *GLO-BUS,* class members run companies that are in a neck-and-neck race for global market leadership in two product categories: (1) wearable video cameras smaller than a teacup that deliver stunning video quality and have powerful photo capture capabilities (comparable to those designed and marketed by global industry leader GoPro and numerous others) and (2) sophisticated camera-equipped copter drones that incorporate a company designed and assembled action-capture camera and that are sold to commercial enterprises for prices in the \$850 to 2,000+ range. Global market demand for action cameras grows at the rate of six to eight percent annually for the first five years and four to six percent annually for the second five years. Global market demand for commercial drones grows briskly at rates averaging 18 percent for the first two years, then gradually slows over eight years to a rate of four to six percent.

Companies assemble action cameras and drones of varying designs and performance capabilities at a Taiwan facility and ship finished goods directly to buyers in North America, Asia-Pacific, Europe-Africa, and Latin America. Both products are assembled usually within two weeks of being received and are then shipped to buyers no later than two to three days after assembly. Companies maintain no finished goods inventories and all parts and components are delivered by suppliers on a just-in-time basis (which eliminates the need to track inventories and simplifies the accounting for plant operations and costs).

Company co-managers determine the quality and performance features of the cameras and drones being assembled. They impact production costs by raising/lowering specifications for parts/components and expenditures for product R&D, adjusting work force compensation, spending more/less on worker training and productivity improvement, lengthening/shortening warranties offered (which affects warranty costs), and how cost-efficiently they manage assembly operations. They have options to manage/control selling and certain other costs as well.

In each decision round, company co-managers make some 50 types of decisions relating to the design and performance of the company's two products (21 decisions, 10 for cameras and 11 for drones), assembly operations and workforce compensation (up to eight decision entries for each product), pricing and marketing (seven decisions for cameras and five for drones), corporate social responsibility and citizenship (up to six decisions), and the financing of company operations (up to eight decisions). In addition, there are 10 entries for cameras and seven entries for drones involving assumptions about the competitive actions of rivals; these entries help company co-managers to make more accurate forecasts of their company's unit sales (so they have a good idea of how many cameras and drones will need to be assembled each year to fill customer orders). Each time co-managers make a decision entry, an assortment of on-screen calculations instantly shows the projected effects on unit sales, revenues, market shares, total profit, earnings per share, ROE, costs, and other operating outcomes. All of these on-screen calculations help co-managers evaluate the relative merits of one decision entry versus another. Company managers can try out as many different decision combinations as they wish in stitching the separate decision entries into a cohesive whole that is projected to produce good company performance.

Competition in action cameras revolves around 11 factors that determine each company's unit sales/market share:

1. How each company's average wholesale price to retailers compares against the all-company average wholesale prices being charged in each geographic region.
2. How each company's camera performance and quality compares against industry-wide camera performance/quality.
3. How the number of week-long sales promotion campaigns a company has in each region compares against the regional average number of weekly promotions.
4. How the size of each company's discounts off the regular wholesale prices during sales promotion campaigns compares against the regional average promotional discount.
5. How each company's annual advertising expenditures compare against regional average advertising expenditures.
6. How the number of models in each company's camera line compares against the industry-wide average number of models.
7. The number of retailers stocking and merchandising a company's brand in each region.
8. Annual expenditures to support the merchandising efforts of retailers stocking a company's brand in each region.
9. The amount by which a company's expenditures for ongoing improvement and updating of its company's website in a region is above/below the all-company regional average expenditure.
10. How the length of each company's camera warranties compare against the warranty periods of rival companies.
11. How well a company's brand image/reputation compares against the brand images/reputations of rival companies.

Competition among rival makers of commercial copter drones is more narrowly focused on just nine sales-determining factors:

1. How a company's average retail price for drones at the company's website in each region compares against the all-company regional average website price.
2. How each company's drone performance and quality compares against the all-company average drone performance/quality.
3. How the number of models in each company's drone line compares against the industry-wide average number of models.
4. How each company's annual expenditures to recruit/support third-party online electronics retailers in merchandising its brand of drones in each region compares against the regional average.
5. The amount by which a company's price discount to third-party online retailers is above/below the regional average discounted price.
6. How well a company's expenditures for search engine advertising in a region compares against the regional average.
7. How well a company's expenditures for ongoing improvement and updating of its website in a region compares against the regional average.
8. How the length of each company's drone warranties in a region compares against the regional average warranty period.
9. How well a company's brand image/reputation compares against the brand images/reputations of rival companies.

Each company typically seeks to enhance its performance and build competitive advantage via its own custom-tailored competitive strategy based on more attractive pricing, greater advertising, a wider selection of models, more appealing performance/quality, longer warranties, a better image/reputation, and so on. The greater the differences in the overall competitiveness of the product offerings of rival companies, the bigger the differences in their resulting sales volumes and market shares. Conversely, the smaller the overall competitive differences in the product offerings of rival companies, the smaller the differences in sales volumes and market shares. This algorithmic approach is what makes *GLO-BUS* a "competition-based" strategy simulation and accounts for why *the sales and market share outcomes for each decision round are always unique to the particular strategies and decision combinations employed by the competing companies.*

As with *BSG, all the various generic competitive strategy options*—low-cost leadership, differentiation, best-cost provider, focused low-cost, and focused differentiation—*are viable choices for pursuing competitive advantage and good company performance.* A company can have a strategy aimed at being the clear market leader in either action cameras or drones or both. It can focus its competitive efforts on one or two or three geographic regions or strive to build strong market positions in all four geographic regions. It can pursue essentially the same strategy worldwide or craft customized strategies for the Europe-Africa, Asia-Pacific, Latin America, and North America markets. Just as with *The Business Strategy Game, most any well-conceived, well-executed competitive approach is capable of succeeding, provided it is not overpowered by the strategies of competitors or defeated by the presence of too many copycat strategies that dilute its effectiveness.*

The challenge for each company's management team is to craft and execute a competitive strategy that produces good performance on five measures: earnings per share, return on equity investment, stock price appreciation, credit rating, and brand image.

All activity for *GLO-BUS* occurs at **www.glo-bus.com**.

Special Note: The time required of company co-managers to complete each decision round in *GLO-BUS* is typically about 15 to 30 minutes less than for *The Business Strategy Game* because

1. there are only 8 market segments (vs. 12 in *BSG*),
2. co-managers have only one assembly site to operate (vs. potentially as many as four plants in *BSG,* one in each geographic region), and
3. newly assembled cameras and drones are shipped directly to buyers, eliminating the need to manage finished goods inventories and operate distribution centers.

Administration and Operating Features of the Two Simulations

The Internet delivery and user-friendly designs of both *BSG* and *GLO-BUS* make them incredibly easy to administer, even for first-time users. And the menus and controls are so similar that you can readily switch between the two simulations or use one in your undergraduate class and the other in a graduate class. If you have not yet used either of the two simulations, you may find the following of particular interest:

- *Each simulation has a 15-minute video tour that introduces students to the simulation, takes them through the website, and helps them to a successful start. For instructors, there are two 15-minute video tours that introduce each of the simulation websites—one of the student site and one of the instructor site; these will help you in previewing what the simulation involves for students and the many features and options available to instructors in conducting the simulation and monitoring the results.*
- *Instructors who are considering use of either simulation can attend any of the 30 or so author-conducted webinars/demos scheduled throughout each year—these run 60 to 75 minutes, allow ample time for Q&A, and provide essentially all of the "training" you need. Our Instructor Support team is always readily available to assist you throughout the term, should you have questions or need assistance of any kind.*
- *In the course of running their company (making decision entries and viewing reports), class members have one-click access to* two- to five-minute video tutorials *for* each *decision screen and each page of* each *report.*

  In addition, they have one-click access to "Help" sections containing detailed explanations of (a) the information on each decision entry screen and all relevant cause-effect relationships, (b) the information on each page of the Industry Reports, and (c) the numbers presented in the Company Reports. The Help pages for each decision entry screen also contain tips and suggestions for making wise decision entries. The video tutorials and full-blown Help page discussions allow company co-managers to figure things out for themselves, thereby relieving instructors of having to answer questions about "how things work."
- *It is quick and easy to set up either simulation for your course.* Setting up the simulation for your course is done online and takes about 30 minutes the first time you do it and about 15 to 20 minutes thereafter. There is on-screen guidance for each step of the straightforward/easy-to-understand Course Setup Procedure. Should you encounter any issues or have questions, you can easily call Tech Support for hands-on assistance in completing the Course Setup procedure, getting answers to questions, or resolving any problems you are having.

- *Sample course outlines for integrating* BSG *or* GLO-BUS *into your strategy course are provided* for semester-long courses, 10-week or quarter-long courses, and 5-week courses; each course outline consists of suggested activities and assignments for each and every class meeting. These provide useful guidance on incorporating use of the simulation and preparing a syllabus in your course.
- *There's also a three-page, author-prepared document titled "Instructor Best Practices for Successfully Using the Simulation" written especially for first-time users. Plus* there is a 37-page Instructor's Manual that provides comprehensive explanations and guidance, and the author team for the two simulations is always available via e-mail or telephone to provide whatever assistance you need.
- *An online Instructor Center serves as your hub for conducting all administrative activities and monitoring the results of the company decisions.* The Instructor Center is the screen you are sent to when you enter your user name and password to log in. *Every function and feature that you need for using the simulation in your course is on the Instructor Center page or accessible from it. Online grade books provide you with scores indicating each company's and each participant's performance on each phase of the simulation.* Once you enter percentage weights to put on each performance measure, overall scores are automatically calculated (which you can scale or not as you see fit). No other administrative actions on your part are required beyond that of moving participants to a different team (should the need arise), keeping tabs on the outcomes of the decision rounds and how well the companies are doing (to whatever extent desired), and using the automatically calculated numerical averages in the online grade book to determine the overall grades to assign class members on the entire simulation exercise.
- Both participants and instructors conduct all activities online (at **www.bsg-online.com** for *The Business Strategy Game* and at **www.glo-bus.com** for *GLO-BUS*). *All materials are delivered digitally to class members and instructors.*

  Students gain full access to everything needed during the course of the simulation, including the Participant's Guide, immediately upon registering—students can read the Participant's Guide and other accompanying content on their monitors or make print outs, as they prefer.

  Likewise, instructors gain full access to all menus and materials on the website immediately upon creating an Instructor Account at the website home page.
- *As indicated earlier, both simulations offer integrated text chat, audio chat, and collaboration features for team members (students) who are logged on simultaneously to facilitate online team meetings and collaboration among company co-managers.*
- *The audio and collaboration features make the simulations highly suitable for use in distance-learning or online courses* (and are currently being used in many such courses).
- *The date/time deadlines for each decision round and other related assignments are set and totally controlled by the instructor (and can be changed at any time for any reason).* Decision rounds can be scheduled once per week, twice per week, daily, or even twice daily, depending on how you want to conduct the exercise.
- *The management teams for each company can range from one to five co-managers, and the number of companies competing head-to-head in a single market group or "industry" can range from 4 to 12.* If you have a large class and need more than 12 companies, the Course Setup procedure makes it simple to create two or more

industries for your class. In a small class, there can be no fewer than four company teams—two-person teams will work just fine. (For classes with fewer than eight students, please call us at 205-722-9149 or e-mail instructor support to discuss how best to proceed.)

The decision entries that co-managers make are saved directly to the simulation server when a student-user clicks the Save button. When a decision round deadline passes, the decision entries of all companies are then "processed" automatically. *Complete results are available to company co-managers and the instructor 15–20 minutes after the decision deadline. Participants and instructors are immediately notified via e-mail as soon as the decision outcomes are ready.*

- Company co-managers learn the details of "what happened" in a seven-page Industry Report, a Competitive Intelligence report for each geographic region, and a set of Company Reports (consisting of assorted sales, cost, and operating statistics and a set of financial statements—income statement, balance sheet, and cash flow statement).
- *A "scoreboard of company performance" incorporates two performance measures:* (1) how well each company meets "investor expectations" on earnings per share, return on shareholders' equity (ROE), stock price appreciation, credit rating, and image rating and (2) how well each company stacks up against the "best-in-industry performer" on each of these same five measures.
- You have *the option to assign two "open-book" multiple-choice tests of 20 questions.* Quiz 1 covers the contents of the Participant's Guide. Quiz 2 measures understanding of key aspects of company operations and student command of ways to improve company performance. The self-scoring quizzes are taken online by each student individually, with scores reported instantaneously to participants and recorded in your online grade book. *Requiring completion of both quizzes is very highly recommended.*
- There is *a built-in three-year strategic plan feature* that entails having each company's management team (1) articulate a strategic vision for their company (in a few sentences), (2) set performance targets for EPS, ROE, stock price appreciation, credit rating, and image rating for each of the next three years, (3) state the competitive strategy the company will pursue, (4) cite data showing that the chosen strategy either is currently on track or requires further managerial actions, and (5) develop a projected income statement for each of the next three years based upon expected unit sales, revenues, costs, and profits. *Each company's strategic plan is automatically graded on a scale of 1 to 100,* with points being earned for meeting or beating the performance targets that were established. The scores are recorded in your online grade book. *Assigning completion of three-year strategic plans is entirely optional—you can have company managers complete no plan, one plan, or two plans.*
- *At the conclusion of the simulation, you can choose to have each company management team prepare a slide presentation reviewing their company's performance and strategy.* A Company Presentation link in each co-manager's Corporate Lobby provides explicit slide-by-slide suggestions of what to cover in a presentation to either the class, the instructor, or an "outside" board of directors.
- There is *a comprehensive 12-question peer evaluation form* that co-managers can complete midway through the exercise and/or at the end of the exercise to help you gauge the caliber of effort each co-manager has put into the exercise. *Peer evaluations*

are automatically scored on a scale of 1 to 100, and the scores are recorded in your online grade book.

- *There is an Activity Log that provides an informative summary of each co-manager's use of various parts of the website—the* frequency and length of log-ons, how many times decision entries were saved to the server each decision round, and how many times each set of reports was viewed each decision round. The combined information from the peer evaluations and the Activity Log provide good evidence about whether a co-manager was a strong or weak contributor.
- *An end-of-simulation Learning Assurance Report (LAR) provides you with solid empirical data concerning how well your students performed versus students playing the simulation at all schools/campuses worldwide over the past 12 months.* The report measures nine areas of student proficiency, business know-how, and decision-making skill, and provides potent benchmark evidence valid for gauging the extent to which your school's academic curriculum is delivering the desired degree of student learning as concerns accreditation standards. The LAR is useful in two very important respects.
    - It provides you with a clear overview of how well your students rank relative to students at other schools worldwide who have gone through this same competition-based simulation exercise over the past 12 months.
    - Because the report provides highly credible evidence regarding the caliber of business proficiency and decision-making prowess of your students, it can be used to help assess whether your school's academic curriculum in business is providing students with the desired degree of business understanding and decision-making acumen.

      Professors, department chairs, and deans at many business schools worldwide are engaged in developing ongoing evidence of whether their academic programs meet the Assurance of Learning Standards now being applied by the Association to Advance Collegiate Schools of Business (AACSB); a prime goal of this Learning Assurance Report is to contribute significantly to this effort.
- There is *a weekly ranking of the best-performing companies* worldwide posted on the homepage—all co-managers and instructors whose companies appear in the rankings are automatically notified by e-mail. You can browse through the latest rankings by clicking on the Global Top Performers icon on the left-center of the homepage.
- *At the conclusion of the simulation, the co-managers of the overall best-performing company in your class are automatically e-mailed an "Industry Champion" certificate suitable for framing.* This certificate serves to document an award or achievement that each co-manager of a champion company can put on their résumé.
- *The co-managers of each industry-winning company playing the two simulations across the world are invited to participate in the "Best Strategy Invitational."* The BSIs for *GLO-BUS* and *The Business Strategy Game* are held three times each year—in late April/early May, in August, and in late November/early December. Those teams that accept the invitation to participate are divided into industries of 11 to 12 companies and compete for a period of 10 decision rounds for "Global Industry Championships." All participants who complete the competition receive frameable certificates, and the industry winners get a "Grand Champion" certificate. Receipt of these certificates also merits a line on a student's résumé.

For more details on either simulation, please consult Section 2 of the Instructor's Manual accompanying this text or register as an instructor at the simulation websites (**www.bsg-online.com** and **www.glo-bus.com**) to obtain immediate access to all aspects of the simulations, including video tours of the websites, participant guides, and instructor guides. You should also consider signing up for one of the webinars that the simulation authors conduct several times each month (sometimes several times weekly) to demonstrate how the software works, walk you through the various features and menu options, and answer any questions.

Comprehensive support, question-answering, and problem-solving is provided to all adopters of the two simulations by the simulation author teams—just use the Instructor Support button on the bottom left of the Instructor Center screen to send an e-mail or call us at 205-722-9149. If there are multiple instructors at your school who teach the course, we will be happy to set up a special webinar for you and your colleagues, give you a guided tour of the website, and answer whatever questions you may have about how one of the simulations might work in one of your courses. We think you'll be quite impressed with the cutting-edge capabilities that have been programmed into *The Business Strategy Game* and *GLO-BUS,* the simplicity with which both simulations can be administered, and their exceptionally tight connection to the text chapters, core concepts, and standard analytical tools.

RESOURCES AND SUPPORT MATERIALS FOR THE 2024 RELEASE

For Students

Key Points Summaries At the end of each chapter is a synopsis of the core concepts, analytical tools, and other key points discussed in the chapter. These chapter-end synopses, along with the core concept definitions and margin notes scattered throughout each chapter, help students focus on basic strategy principles, digest the messages of each chapter, and prepare for tests.

Two Sets of Chapter-End Exercises Each chapter concludes with two sets of exercises. The *Assurance of Learning Exercises* can be used as the basis for class discussion, oral presentation assignment, short written reports, and substitutes for case assignments. The *Exercises for Simulation Participants* are designed expressly for use in class which incorporate the use of a simulation. The questions in both sets of exercises (along with the Illustration Capsules that qualify as "mini-cases") can be used as catalysts for experiential learning and to promote student-to-student and student-to-faculty engagement.

Connect™ The 2024 Release takes full advantage of Connect™, a personalized teaching and learning tool. The Connect™ package for this edition includes several robust and valuable features that simplify the task of assigning and grading:

- Autograded chapter quizzes consisting of 20 multiple-choice questions that students can take to measure their grasp of the material presented in each of the 12 chapters.

- A variety of interactive exercises for the 12 chapters that drill students in the use and application of the concepts and tools of strategic analysis.
- Whiteboard Videos: These brief, contemporary, and engaging videos offer dynamic, student-centered introductions, illustrations, and animations that guide students through challenging concepts with assignable assessment questions.
- A variety of cases, found in most chapters, provide an opportunity for students to delve further into the topical content and read about real-life products and companies. Accompanied by assignable, thought-provoking questions that check students' ability to apply the course material to these scenarios, these case analyses help students foster their critical thinking abilities and develop their workplace-readiness skills.
- Interactive versions of Assurance of Learning Exercises for each chapter that drill students in the use and application of the concepts and tools of strategic analysis. There is both an auto-graded and open-ended short-answer interactive exercise for each of the 12 chapters.
- Exercises for Simulation Participants require students to apply concepts presented in all 12 chapters to business simulation participation in both auto-graded and open-ended assignment questions.

The Connect package also includes fully auto-graded interactive application exercises for each of the 27 cases in this edition. The exercises require students to work through tutorials based upon the analysis set forth in the assignment questions for the case; these exercises have multiple components such as resource and capability analysis, financial ratio analysis, identification of a company's strategy, or analysis of the five competitive forces. The content of these case exercises is tailored to match the circumstances presented in each case, calling upon students to do whatever strategic thinking and strategic analysis is called for to arrive at pragmatic, analysis-based action recommendations for improving company performance.

All of the Connect exercises are automatically graded (with the exception of a few exercise components that entail student entry of essay answers), thereby simplifying the task of evaluating each class member's performance and monitoring the learning outcomes. The progress-tracking function built into the Connect system enables you to:

- View scored work immediately and track individual or group performance with assignment and grade reports.
- Access an instant view of student or class performance relative to learning objectives.
- Collect data and generate reports required by many accreditation organizations, such as AACSB International.

SmartBook® SmartBook is the first and only adaptive reading experience designed to change the way students read and learn. It creates a personalized reading experience by highlighting the most impactful concepts a student needs to learn at that moment in time. As a student engages with SmartBook, the reading experience continuously adapts by highlighting content based on what the student knows and doesn't know. This ensures that the focus is on the content he or she needs to learn, while simultaneously promoting long-term retention of material. Use SmartBook's real-time reports to quickly identify the concepts that require more attention from individual students or the entire class. The end result? Students are more engaged with course content, can better prioritize their time, and come to class ready to participate.

FOR INSTRUCTORS

Connect Instructor Resources

Connect's Instructor Resources include an Instructor's Manual, Test Bank, PowerPoint slides, Case Support, and other materials. Contact your local representative to discuss pairing your Learning Management Systems with these valuable resources.

Instructor's Manual

The accompanying IM contains:

- A section on instructor resources, chapter features, and an overview of the cases.
- A section on using a strategy simulation in your course, what is involved, the compelling benefits, and how to proceed. Using one of the two companion simulations is a powerful and constructive way of emotionally connecting students to the subject matter of the course. The author team knows of no more effective way to arouse the competitive energy of students and prepare them for the challenges of real-world business decision making than to have them match strategic wits with classmates in running a company in head-to-head competition for global market leadership.
- A section on organizing your course, deciding what the workload should be, and settling on specific assignments.
- Sample syllabi and course outlines.
- A set of lecture notes on each chapter.
- Answers to the chapter-end Assurance of Learning Exercises.
- A comprehensive case teaching note for each of the 27 cases. These teaching notes are filled with suggestions for using the case effectively, have very thorough, analysis-based answers to the suggested assignment questions for the case, links to videos that accompany the case, and contain an epilogue detailing any important developments since the case was written.

A Comprehensive Test Bank and Test Builder Software

There is a 600+ question Test Bank, consisting of both multiple-choice questions and short-answer/essay questions. All of the Test Bank questions are also accessible via Test Builder.

Available within Connect, Test Builder is a cloud-based tool that enables instructors to format tests that can be printed or administered within an LMS. Test Builder offers a modern, streamlined interface for easy content configuration that matches course needs, without requiring a download.

Test Builder allows you to:

- Access all Test Bank content from this title.
- Easily pinpoint the most relevant content through robust filtering options.
- Manipulate the order of questions or scramble questions and/or answers.
- Pin questions to a specific location within a test.

- Determine your preferred treatment of algorithmic questions.
- Choose the layout and spacing.
- Add instructions and configure default settings.

Test Builder provides a secure interface for better protection of content and allows for just-in-time updates to flow directly into assessments.

PowerPoint Slides

To facilitate delivery preparation of your lectures and to serve as chapter outlines, you'll have access to approximately 350 colorful and professional-looking slides displaying core concepts, analytical procedures, key points, and all the figures in the text chapters.

The Business Strategy Game and *GLO-BUS* Online Simulations

Using one of the two companion simulations is a powerful and constructive way of emotionally connecting students to the subject matter of the course. We know of no more effective way to arouse the competitive energy of students and prepare them for the challenges of real-world business decision making than to have them match strategic wits with classmates in running a company in head-to-head competition for global market leadership.

OLC-Aligned Courses

Implementing High-Quality Instruction and Assessment through Preconfigured Courseware

In consultation with the Online Learning Consortium (OLC) and our certified Faculty Consultants, McGraw Hill has created pre-configured courseware using OLC's quality scorecard to align with best practices in online course delivery. This turnkey courseware contains a combination of formative assessments, summative assessments, homework, and application activities, and can easily be customized to meet an individual instructor's needs and desired course outcomes. For more information, visit **https://www.mheducation.com/highered/olc**.

Remote Proctoring & Browser-Locking Capabilities

Remote proctoring and browser-locking capabilities, hosted by Proctorio within Connect, provide control of the assessment environment by enabling security options and verifying the identity of the student.

Seamlessly integrated within Connect, these services allow instructors to control the assessment experience by verifying identification, restricting browser activity, and monitoring student actions.

Instant and detailed reporting gives instructors an at-a-glance view of potential academic integrity concerns, thereby avoiding personal bias and supporting evidence-based claims.

Reflecting the Diverse World Around Us

McGraw Hill believes in unlocking the potential of every learner at every stage of life. To accomplish that, we are dedicated to creating products that reflect, and are accessible to, all the diverse, global customers we serve. Within McGraw Hill, we foster a culture of belonging, and we work with partners who share our commitment to equity, inclusion, and diversity in all forms. In McGraw Hill Higher Education, this includes, but is not limited to, the following:

- Refreshing and implementing inclusive content guidelines around topics including generalizations and stereotypes, gender, abilities/disabilities, race/ethnicity, sexual orientation, diversity of names, and age.
- Enhancing best practices in assessment creation to eliminate cultural, cognitive, and affective bias.
- Maintaining and continually updating a robust photo library of diverse images that reflect our student populations.
- Including more diverse voices in the development and review of our content.
- Strengthening art guidelines to improve accessibility by ensuring meaningful text and images are distinguishable and perceivable by users with limited color vision and moderately low vision.

Create

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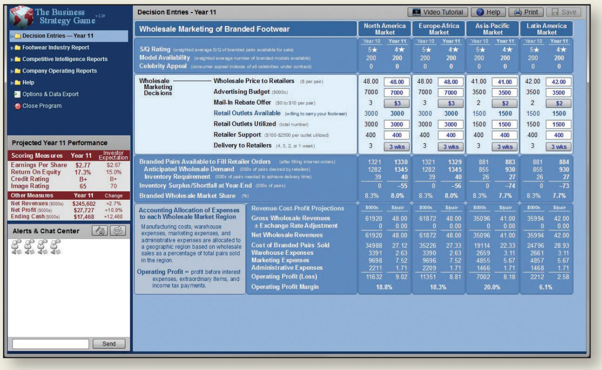
Arthur A. Thompson

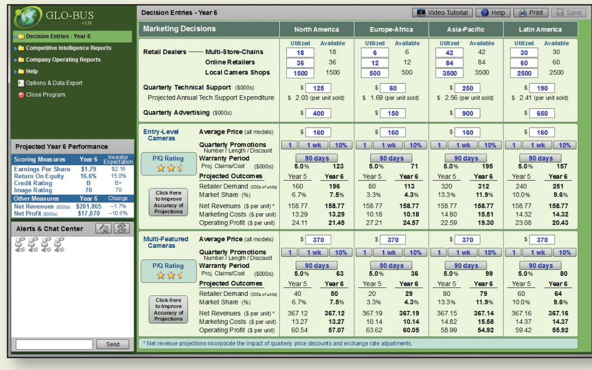
Margaret A. Peteraf

John E. Gamble

A. J. Strickland

The Business Strategy Game or *GLO-BUS* Simulation Exercises





The Business Strategy Game **or** ***GLO-BUS*** **Simulation Exercises**
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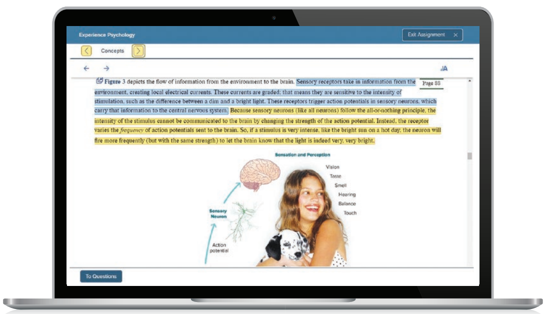

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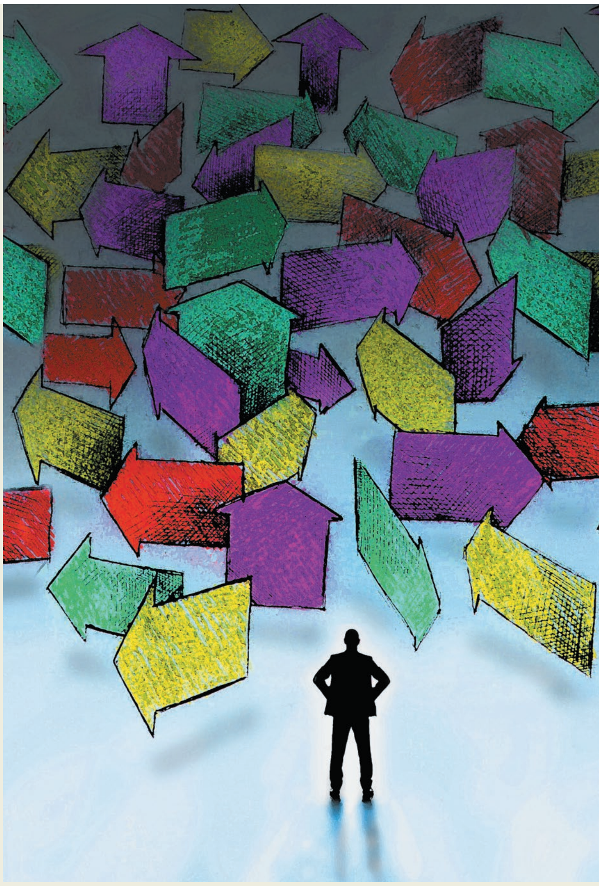
PART 1

Concepts and Techniques for Crafting and Executing Strategy

chapter 1

What Is Strategy and Why Is It Important?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Learning Objectives

After reading this chapter, you should be able to

LO 1-1 Understand what is meant by a company's *strategy* and why it needs to differ from competitors' strategies.

LO 1-2 Grasp the concept of a *sustainable competitive advantage*.

LO 1-3 Explain how the five most basic strategic approaches can set a company apart from its rivals.

LO 1-4 Understand why a company's strategy tends to evolve.

LO 1-5 Identify what constitutes a viable business model.

LO 1-6 List the three tests of a winning strategy.

The best strategies are born from specialized insight and deliver unique value.

Amanda Wagner—*President and CEO of Immunitas Therapeutics*

Strategy is about stretching limited resources to fit ambitious aspirations.

C. K. Prahalad—*Co-founder of The Next Practices Group, a global management consultancy*

The business model is a cornerstone for senior managers.

Raffi Amit—*Professor and consultant*

The world of business has undergone a radical transformation over the last decade. New technologies have led to the rise of new industries and business models, such as renewable energy and the sharing economy, as well as the increasing use of data analytics and artificial intelligence. Consumer behavior has changed with the accelerated usage of social media, e-commerce, and digital marketing. Consumer and investor concerns about climate change and the social impact of business activities have increased the importance of environmental sustainability, social responsibility, and corporate governance. In response to the increasing global tensions, companies have had to rework their supply chains, reduce their reliance on practices such as offshoring, and bring production nearer to home. The COVID-19 pandemic also had a profound impact on business, causing widespread economic disruption and forcing companies to adapt to new ways of operating.

Clearly, the need for excellent strategic management has never been greater. But despite the vast changes in business conditions and practices, the principles of strategic management have remained largely the same. And for good reason! The principles, concepts, and frameworks of strategic management continue to be relevant in these challenging and changing times. Moreover, they really work!

Strategy has always been of paramount importance in business and remains so. As stated by *The Economist,* a leading business publication, "Leadership and hard work are all very well and luck is mighty useful, but it is strategy that makes or breaks a firm."[1] Luck and circumstance can explain why some companies are blessed with initial, short-lived success. But only a well-crafted, well-executed, constantly evolving strategy can explain why an elite set of companies somehow manage to rise to the top and stay there, year after year, pleasing their customers, shareholders, and other stakeholders alike in the process. Companies such as Apple, Disney, Starbucks, Alphabet (parent company of Google), Merck, General Motors, and Adobe Systems come to mind—but long-lived success is not just the province of U.S. companies. Diverse kinds of companies, both large and small, from many different countries have been able to sustain strong performance records, including Denmark's Lego Group, South Korea's Samsung, the United Kingdom's HSBC (in banking), Dubai's Emirates Airlines, Switzerland's Rolex, China Mobile (in telecommunications), and India's Tata Steel.

In this opening chapter, we define the concept of strategy and describe its many facets. We introduce you to the concept of competitive advantage and explore the tight linkage between a company's strategy and its quest for competitive advantage. We will also explain why company strategies are partly proactive and partly reactive, why they evolve over time, and the relationship between a company's strategy and its business model. We conclude the chapter with a discussion of what sets a winning strategy apart from others and why that strategy should also pass the test of moral scrutiny. By the end of this chapter, you will have a clear idea of why the tasks of crafting and executing strategy are core management functions and why excellent execution of an excellent strategy is the most reliable recipe for turning a company into a standout performer over the long term.

WHAT DO WE MEAN BY *STRATEGY?*

CORE CONCEPT

A company's **strategy** is the set of coordinated actions that its managers take in order to outperform the company's competitors and achieve superior profitability.

A company's **strategy** is the set of coordinated actions that its managers take in order to outperform the company's competitors and achieve superior profitability. The objective of a well-crafted strategy is not merely temporary competitive success and profits in the short run, but rather the sort of lasting success that can support growth and secure the company's future over the long term. Achieving this entails making a managerial commitment to a coherent array of well-considered choices about how to compete.[2] These include

- *How* to position the company in the marketplace.
- *How* to attract customers.
- *How* to compete against rivals.
- *How* to achieve the company's performance targets.
- *How* to capitalize on opportunities to grow the business.
- *How* to respond to changing economic and market conditions.

LO 1-1

Understand what is meant by a company's *strategy* and why it needs to differ from competitors' strategies.

In most industries, companies have considerable freedom in choosing the *hows* of strategy.[3] Some companies strive to achieve lower costs than rivals, while others aim for product superiority or more personalized customer service dimensions that rivals cannot match. Some companies opt for wide product lines, while others concentrate their energies on a narrow product lineup. Some deliberately confine their operations to local or regional markets; others opt to compete nationally, internationally (several countries), or globally (all or most of the major country markets worldwide). Choices of how best to compete against rivals have to be made in light of the firm's resources and capabilities and in light of the competitive approaches rival companies are employing.

Strategy Is about Competing Differently

Mimicking the strategies of successful industry rivals—with either copycat product offerings or maneuvers to stake out the same market position—rarely works. Rather, every company's strategy needs to have some distinctive element that draws in customers and provides a competitive edge. Strategy, at its essence, is about competing differently—doing what rival firms *don't* do or what rival firms *can't* do.[4] This does not mean that the key elements of a company's strategy have to be 100 percent different, but rather that they must differ in at least *some important respects.* A strategy stands a better chance of succeeding when it is predicated on actions, business approaches, and competitive moves aimed at (1) appealing to buyers in ways that *set a company apart from its rivals* and (2) staking out a market position that is not crowded with strong competitors.

Strategy is about competing differently from rivals—doing what competitors don't do or, even better, doing what they can't do!

A company's strategy provides direction and guidance, in terms of not only what the company *should* do but also what it *should not* do. Knowing what not to do can be as important as knowing what to do, strategically. At best, making the wrong strategic moves will prove a distraction and a waste of company resources. At worst, it can bring about unintended long-term consequences that put the company's very survival at risk.

Figure 1.1 illustrates the broad types of actions and approaches that often characterize a company's strategy in a particular business or industry. For a more concrete example, see Illustration Capsule 1.1 describing the elements of Amazon's successful strategy.

FIGURE 1.1 Identifying a Company's Strategy—What to Look For

Strategy and the Quest for Competitive Advantage

LO 1-2

Grasp the concept of a *sustainable competitive advantage.*

The heart and soul of any strategy are the actions in the marketplace that managers take to gain a competitive advantage over rivals. A company has a **competitive advantage** whenever it has some type of edge over rivals in attracting buyers and coping with competitive forces. A competitive advantage is essential for realizing greater marketplace success and higher profitability over the long term.

There are many routes to competitive advantage, but they all involve one of two basic mechanisms. Either they provide the customer with a product or service that the customer values more highly than others (higher perceived value), or they produce their product or service more efficiently (lower costs). Delivering superior value or delivering value more efficiently—whatever form it takes—nearly always requires performing value chain activities differently than rivals and building capabilities that are not readily matched. For example, it is evident that Apple, Inc. has gained a competitive advantage over its rivals in the technological device industry through its efforts to create "must-have," exciting new products, that are beautifully designed, technologically advanced, easy to use, and sold in appealing stores that offer a fun experience, knowledgeable staff, and excellent service. By differentiating itself in this manner from its competitors Apple has been able to charge prices for its products that are well above those of its rivals and far exceed the low cost of its inputs. Its expansion policies have allowed the company to make it easy for customers to find an Apple store in almost any high-quality mall or urban shopping district, further enhancing the brand and cementing customer loyalty. A creative *distinctive* strategy such as that used by Apple is a company's most reliable ticket for developing a competitive advantage over its rivals. If a strategy is not distinctive, then there can be no competitive advantage, since no firm would be meeting customer needs better or operating more efficiently than any other.

CORE CONCEPT

A company achieves a **competitive advantage** when it provides buyers with superior value compared to rival sellers or offers the same value at a lower cost to the firm. The advantage is **sustainable** if it persists despite the best efforts of competitors to match or surpass this advantage.

If a company's competitive edge holds promise for being *sustainable* (as opposed to just temporary), then so much the better for both the strategy and the company's future profitability. What makes a competitive advantage **sustainable** (or durable), as opposed to temporary, are elements of the strategy that give buyers lasting reasons to prefer a company's products or services over those of competitors—*reasons that competitors are unable to nullify, duplicate, or overcome despite their best efforts.* In the case of Apple, the company's unparalleled name recognition, its reputation for technically superior, beautifully designed, "must-have" products, and the accessibility of the appealing, consumer-friendly stores with knowledgeable staff, make it difficult for competitors to weaken or overcome Apple's competitive advantage. Not only has Apple's strategy provided the company with a sustainable competitive advantage, but it has made Apple, Inc. one of the most admired companies on the planet.

Five of the most frequently used and dependable strategic approaches to setting a company apart from rivals, building strong customer loyalty, and gaining a competitive advantage are

• LO 1-3

Explain how the five most basic strategic approaches can set a company apart from rivals.

1. *A low-cost provider strategy*—achieving a cost-based advantage over rivals. Walmart and Southwest Airlines earned strong market positions because of the low-cost advantages they achieved over their rivals. Low-cost provider strategies can produce a durable competitive edge when rivals find it hard to match the low-cost leader's approach to driving costs out of the business.
2. *A broad differentiation strategy*—seeking to differentiate the company's product or service from that of rivals in ways that will appeal to a broad spectrum of buyers. Successful adopters of differentiation strategies include Apple (innovative products), Johnson & Johnson in baby products (product reliability), Rolex (luxury and prestige), and BMW (engineering design and performance). One way to sustain this type of competitive advantage is to be sufficiently innovative to thwart the efforts of clever rivals to copy or closely imitate the product offering.

ILLUSTRATION CAPSULE 1.1

Amazon's Strategy: Achieving Advantage by Competing Differently

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Amazon was launched in 1995 by Jeff Bezos as an online retailer of books. Bezos chose to offer value to customers in a way that involved competing differently than established book retailers such as Barnes & Noble, Waldenbooks, Borders, and Books-A-Million. At the time of Amazon's launch, its established rivals relied on brick-and-mortar locations with extensive inventories to attract customers. For example, Barnes & Noble and Waldenbooks both operated approximately 1,300 store locations in the early-1990s.

Amazon's online retailing approach was keyed to an emerging market segment that was not crowded with strong rivals, and its business model utilized a very different cost structure than traditional book sellers. Amazon's cost was much lower than that of rivals as it did not have the vast fixed and variable costs associated with building, leasing, and operating physical locations. In addition to offering book sales exclusively through its website, Amazon stocked only about 2,000 book titles. The company offered 2.5 million book titles on its website by 1996, but the vast majority of its orders were fulfilled by third-party partners that would ship books to customers placing orders at **Amazon.com**.

Amazon began to build its own network of warehouses in 1997 to accelerate and control deliveries to customers, which allowed it to expand into new product categories such as electronics, housewares, toys, and other frequently purchased consumer goods. Amazon's key differentiating features evolved to focus on an exhaustive product line, prompt delivery, superior customer service—all of which required actions to build best-in-world IT and logistics capabilities. Amazon's approach to achieving advantage bore little resemblance to the moves and approaches of its rivals who were primarily focused on merchandising and inventory management for brick-and-mortar stores. By the mid-2000s, Amazon had commercialized its highly refined IT and cloud application capabilities with the launch of Amazon Web Services (AWS). AWS offered these services to business and governmental customers needing reliable cloud services. Also, Amazon had launched an Order Fulfillment Network division by the mid-2000s to provide order fulfillment services to nearly any type of merchant.

Key elements of Amazon's distinctive strategy include

- *Online Retailing.* Amazon boasted the largest selection of merchandise available through an online retailer. The company held inventory purchased for resale and sold products offered by third-party sellers. The company recorded gross revenue from items sold from its inventory as product sales and recognized its net share of revenue of items sold by third-party sellers as service sales. The company intended to maintain its advantage in online retailing by expanding product selection across numerous product categories and providing prompt delivery and hassle-free returns.
- *International online retailing sales.* Amazon's international sales increased 22 percent from 2020 to 2021, as revenues from both inventory purchased for resale and sales by third-party sellers grew. The company's strategy to drive increases in international unit sales includes efforts to reduce prices for international customers, including low-price shipping offers. The company is working to improve fulfillment network efficiency and supply chain shortcomings to further reduce prices in international markets.
- *Fulfillment by Amazon.* In the early 2000s, it took Amazon an average of 18 hours to process an order and have it placed on a truck for delivery. The company had reduced order-processing time to two hours by 2022. This service was made available to third-party merchants and supported with a network of 253 fulfillment centers, 110 sortation centers, and 467 delivery stations in North America, with an additional 157 fulfillment centers, 58 sortation centers, and 588 delivery stations across the globe. Amazon's delivery network also included more than 260,000 drivers worldwide, and an air cargo fleet with more than 100 aircraft. By 2022, Amazon had invested more than $100 billion in its order fulfillment network. Outsourcing fulfillment to Amazon could save vendors up to 72 percent on shipping costs relative to two-day shipping offered by FedEx or UPS.

(*Continued*)

- *Amazon Web Services.* Amazon understood how web hosting and cloud services could become a differentiated service since cloud computing needs varied greatly among various types of customers. Examples of distinctive differences in providing value to customers were related to server configurations optimized for storage, memory, high-performance computing, graphics rendering, machine learning, and a host of differing networking capabilities. Amazon's investment in AWS included the development of its own Graviton microprocessor series, which provided up to 40 percent better price performance than the comparable latest generation x86 processors. Also, the company's AWS cloud services utilized an iterative innovation process to provide customers with more functionality that is available through other cloud hosting services.
- *Devices.* Amazon had sold hundreds of millions of Alexa-enabled devices for use in homes, offices, cars, and third-party manufacturer devices. Alexa allowed users to listen to music, watch videos, control lighting and home automation, and provide useful information such as customized news, weather forecasts or current traffic information. In 2023, Amazon was developing several other personal assistance devices, including new models of Kindle, FireTV, Alexa/Echo, Ring, Blink, or Astro home robots.
- *Amazon Prime Video and Prime Music.* In 2011, Amazon began including over 5,000 streaming movies and television programs as a part of the Amazon Prime subscription. The company expanded its lineup of programming to include Amazon Original movies and series such as Reacher, Jack Ryan, Outer Range, and Night Sky. The company also expanded its sports programming with Thursday Night Football in 2022. Prime Music allowed Amazon Prime members to stream millions of songs.

3. *A focused low-cost strategy*—concentrating on a narrow buyer segment (or market niche) and outcompeting rivals by having lower costs and thus being able to serve niche members at a lower price. Private-label manufacturers of food, health and beauty products, and nutritional supplements use their low-cost advantage to offer supermarket buyers lower prices than those demanded by producers of branded products. IKEA's emphasis on modular furniture, ready for assembly, makes it a focused low-cost player in the furniture market.
4. *A focused differentiation strategy*—concentrating on a narrow buyer segment (or market niche) and outcompeting rivals by offering buyers customized attributes that meet their specialized needs and tastes better than rivals' products. Lululemon, for example, specializes in high-quality yoga clothing and the like, attracting a devoted set of buyers in the process. Tesla, Inc., with its electric cars, LinkedIn specializing in the business and employment aspects of social networking, and Goya Foods in Hispanic specialty food products provide some other examples of this strategy.
5. *A best-cost provider strategy*—giving customers more value for the money by satisfying their expectations on key quality features, performance, and/or service attributes while beating their price expectations. This approach is a hybrid strategy that blends elements of low-cost provider and differentiation strategies; the aim is to have lower costs than rivals while simultaneously offering better differentiating attributes. Target is an example of a company that is known for its hip product design (a reputation it built by featuring limited edition lines by designers such as Rodarte, Victoria Beckham, and Jason Wu), as well as a more appealing shopping ambience for discount store shoppers. Its dual focus on low costs as well as differentiation shows how a best-cost provider strategy can offer customers great value for the money.

Winning a *sustainable* competitive edge over rivals with any of the preceding five strategies generally hinges as much on building competitively valuable expertise and capabilities that rivals cannot readily match as it does on having a distinctive product offering. Clever rivals can nearly always copy the attributes of a popular product or service, but for rivals to match the experience, know-how, and specialized capabilities that a company has developed and perfected over a long period of time is substantially harder to do and takes much longer. The success of Swatch in watches, for example, was driven by impressive design, marketing, and engineering capabilities, while Apple has demonstrated outstanding product innovation capabilities in digital music players, smartphones, and e-readers. Hyundai has become the world's fastest-growing automaker as a result of its advanced manufacturing processes and unparalleled quality control systems. Capabilities such as these have been hard for competitors to imitate or best.

Why a Company's Strategy Evolves over Time

LO 1.4

Understand why a company's strategy tends to evolve.

The appeal of a strategy that yields a sustainable competitive advantage is that it offers the potential for a more enduring edge than a temporary advantage over rivals. But sustainability is a relative term, with some advantages lasting longer than others. And regardless of how sustainable a competitive advantage may appear to be at a given point in time, conditions change. Even a substantial competitive advantage over rivals may crumble in the face of drastic shifts in market conditions or disruptive innovations. Therefore, managers of every company must be willing and ready to modify the strategy in response to changing market conditions, advancing technology, unexpected moves by competitors, shifting buyer needs, emerging market opportunities, and new ideas for improving the strategy. Most of the time, a company's strategy evolves incrementally as management fine-tunes various pieces of the strategy and adjusts the strategy in response to unfolding events.[5] However, on occasion, major strategy shifts are called for, such as when the strategy is clearly failing or when industry conditions change in dramatic ways. Industry environments characterized by high-velocity change require companies to repeatedly adapt their strategies.[6] For example, companies in industries with rapid-fire advances in technology like 3-D printing, shale fracking, and genetic engineering often find it essential to adjust key elements of their strategies several times a year. When the technological change is drastic enough to "disrupt" the entire industry, displacing market leaders and altering market boundaries, companies may find it necessary to "reinvent" entirely their approach to providing value to their customers.

Changing circumstances and ongoing management efforts to improve the strategy cause a company's strategy to evolve over time—a condition that makes the task of crafting strategy a *work in progress,* not a one-time event.

Regardless of whether a company's strategy changes gradually or swiftly, the important point is that the task of crafting strategy is not a one-time event but always a work in progress. Adapting to new conditions and constantly evaluating what is working well enough to continue and what needs to be improved are normal parts of the strategy-making process, resulting in an *evolving strategy.*[7]

A company's strategy is shaped partly by management analysis and choice and partly by the necessity of adapting and learning by doing.

A Company's Strategy Is Partly Proactive and Partly Reactive

The evolving nature of a company's strategy means that the typical company strategy is a blend of (1) *proactive,* planned initiatives to improve the company's financial performance and secure a competitive edge and (2) *reactive* responses to unanticipated developments and fresh market conditions. The biggest portion of a company's current strategy flows from previously initiated actions that have proven themselves in the marketplace and newly launched initiatives aimed at edging out rivals and boosting financial performance. This part of management's action plan for running the company is its **deliberate strategy,** consisting of proactive strategy elements that are both planned and realized as planned (while other planned strategy elements may not work out and are abandoned in consequence)—see Figure 1.2.[8]

CORE CONCEPT

A company's **deliberate strategy** consists of *proactive* strategy elements that are planned; its **emergent strategy** consists of *reactive* strategy elements that emerge as changing conditions warrant.

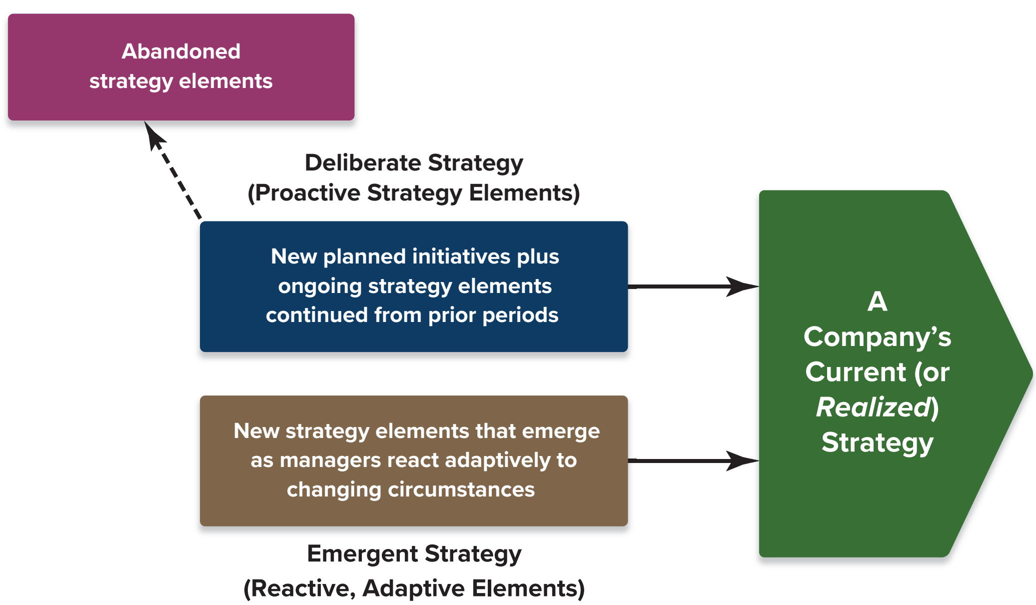
A strategy cannot be considered ethical just because it involves actions that are legal. To meet the standard of being ethical, a strategy must entail actions and behavior that can pass moral scrutiny in the sense of *not being* deceitful, unfair or harmful to others, disreputable, or unreasonably damaging to the environment.

But managers must always be willing to supplement or modify the proactive strategy elements with as-needed reactions to unanticipated conditions. Inevitably, there will be occasions when market and competitive conditions take an unexpected turn that calls for some kind of strategic reaction. Hence, *a portion of a company's strategy is always developed on the fly,* coming as a response to fresh strategic maneuvers on the part of rival firms, unexpected shifts in customer requirements, fast-changing technological developments, newly appearing market opportunities, a changing political or economic climate, or other unanticipated happenings in the surrounding environment. These adaptive strategy adjustments make up the firm's **emergent strategy.** A company's strategy *in toto* (its **realized strategy**) thus tends to be a *combination* of proactive and reactive elements, with certain strategy elements being *abandoned* because they have become obsolete or ineffective. A company's realized strategy can be observed in the pattern of its actions over time, which is a far better indicator than any of its strategic plans on paper or any public pronouncements about its strategy.

Strategy and Ethics: Passing the Test of Moral Scrutiny

In choosing among strategic alternatives, company managers are well advised to embrace actions that can pass the test of moral scrutiny. Just keeping a company's strategic actions within the bounds of what is legal does not mean the strategy is ethical. Ethical and moral standards are not fully governed by what is legal. Rather, they involve issues of "right" versus "wrong" and duty—what one should do. A strategy is ethical only if it does not entail actions that cross the moral line from "can do" to "should not do." For example, a company's strategy *definitely* crosses into the "should not do" zone and

FIGURE 1.2 A Company's Strategy Is a Blend of Proactive Initiatives and Reactive Adjustments



cannot pass moral scrutiny if it entails actions and behaviors that are deceitful, unfair or harmful to others, disreputable, or unreasonably damaging to the environment. A company's strategic actions cross over into the "should not do" zone and are likely to be deemed unethical when (1) they reflect badly on the company or (2) they adversely impact the legitimate interests and well-being of shareholders, customers, employees, suppliers, the communities where it operates, and society at large or (3) they provoke public outcries about inappropriate or "irresponsible" actions, behavior, or outcomes.

Admittedly, it is not always easy to categorize a given strategic behavior as ethical or unethical. Many strategic actions fall in a gray zone and can be deemed ethical or unethical depending on how high one sets the bar for what qualifies as ethical behavior. For example, is it ethical for advertisers of alcoholic products to place ads in media having an audience of as much as 50 percent underage viewers? Is it ethical for companies to employ undocumented workers who may have been brought to the United States as children? Is it ethical for Nike, Under Armour, and other makers of athletic wear to pay a university athletic department large sums of money as an "inducement" for the university's athletic teams to use their brand of products? Is it ethical for pharmaceutical manufacturers to charge higher prices for life-saving drugs in some countries than they charge in others? Is it ethical for a company to ignore the damage done to the environment by its operations in a particular country, even though they are in compliance with current environmental regulations in that country?

Senior executives with strong ethical convictions are generally proactive in linking strategic action and ethics; they forbid the pursuit of ethically questionable business opportunities and insist that all aspects of company strategy are in accord with high ethical standards. They make it clear that all company personnel are expected to act with integrity, and they put organizational checks and balances into place to monitor behavior, enforce ethical codes of conduct, and provide guidance to employees regarding any gray areas. Their commitment to ethical business conduct is genuine, not hypocritical lip service.

The reputational and financial damage that unethical strategies and behavior can do is substantial. When a company is put in the public spotlight because certain personnel are alleged to have engaged in misdeeds, unethical behavior, fraudulent accounting, or criminal behavior, its revenues and stock price are usually hammered hard. Many customers and suppliers shy away from doing business with a company that engages in sleazy practices or turns a blind eye to its employees' illegal or unethical behavior. Repulsed by unethical strategies or behavior, wary customers take their business elsewhere and wary suppliers tread carefully. Moreover, employees with character and integrity do not want to work for a company whose strategies are shady or whose executives lack character and integrity. Consequently, solid business reasons exist for companies to shun the use of unethical strategy elements. Besides, immoral or unethical actions are just plain wrong.

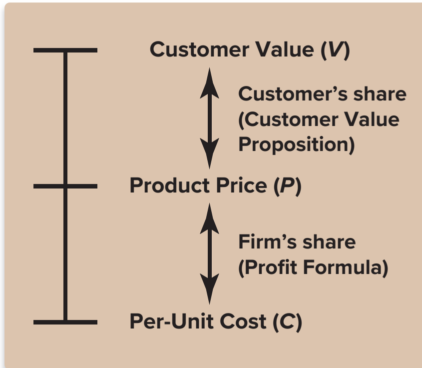
A COMPANY'S STRATEGY AND ITS BUSINESS MODEL

LO 1-5

Identify what constitutes a viable business model.

At the core of every sound strategy is the company's **business model.** A business model is management's blueprint for delivering a valuable product or service to customers in a manner that will generate revenues sufficient to cover costs and yield an attractive profit.[9] The two elements of a company's business model are (1) its *customer value proposition* and (2) its *profit formula.* The customer value proposition lays out the company's approach to satisfying buyer wants and needs at a price customers will consider

FIGURE 1.3 The Business Model and the Value-Price-Cost Framework



CORE CONCEPT

A company's **business model** sets forth the logic for how its strategy will create value for customers and at the same time generate revenues sufficient to cover costs and realize a profit.

a good value. The profit formula describes the company's approach to determining a cost structure that will allow for acceptable profits, given the pricing tied to its customer value proposition. Figure 1.3 illustrates the elements of the business model in terms of what is known as the *value-price-cost framework*.[10] As the framework indicates, the customer value proposition can be expressed as $V - P$, which is essentially the customers' perception of how much value they are getting for the money. The profit formula, on a per-unit basis, can be expressed as $P - C$. Plainly, from a customer perspective, the greater the value delivered (V) and the lower the price (P), the more attractive is the company's value proposition. On the other hand, the lower the costs (C), given the customer value proposition ($V - P$), the greater the ability of the business model to be a moneymaker. Thus, the profit formula reveals how efficiently a company can meet customer wants and needs and deliver on the value proposition. The nitty-gritty issue surrounding a company's business model is whether it can execute its customer value proposition profitably. Just because company managers have crafted a strategy for competing and running the business does not automatically mean that the strategy will lead to profitability—it may or it may not.

Cable television providers utilize a business model keyed to delivering news and entertainment that viewers will find valuable, in the hopes of securing sufficient revenues from subscriptions and advertising to cover operating expenses and allow for profits. Aircraft engine manufacturer Rolls-Royce employs an innovative "power-by-the-hour" business model that charges airlines leasing fees for engine use, maintenance, and repairs based on actual hours flown. The company retains ownership of the engines and is able to minimize engine maintenance costs through the use of sophisticated sensors that optimize maintenance and repair schedules. Gillette's business model in razor blades involves selling a "master product"—the razor—at an attractively low price and then making money on repeat purchases of razor blades that can be produced cheaply and sold at high-profit margins. Printer manufacturers like Hewlett-Packard, Canon, and Epson pursue much the same business model as Gillette—selling printers at a low (virtually break-even) price and making large profit margins on the repeat purchases of ink cartridges and other printer supplies. McDonald's invented the business model for fast food—providing value to customers in the form of economical quick-service meals at clean, convenient locations. Its profit formula involves such elements as standardized cost-efficient store design, stringent specifications for ingredients, detailed operating procedures for each unit, sizable investment in human resources and training, and heavy reliance on advertising and in-store promotions to drive volume. Note that companies may evolve by changing their business model, as a means of adapting to changing conditions. Illustration Capsule 1.2 describes three contrasting business models in the car rental market.

WHAT MAKES A STRATEGY A WINNER?

Three tests can be applied to determine whether a strategy is a *winning strategy:*

LO 1-6

List the three tests of a winning strategy.

1. ***The Fit Test:*** *How well does the strategy fit the company's situation?* To qualify as a winner, a strategy has to be well matched to industry and competitive conditions, a company's best market opportunities, and other pertinent aspects of the business environment in which the company operates. No strategy can work well unless it exhibits good *external fit* with respect to prevailing market conditions. At the same time, a winning strategy must be tailored to the company's resources and competitive capabilities and be supported by a complementary set of functional activities (i.e., activities in the realms of supply chain management, operations, sales and marketing, and so on). That is, it must also exhibit *internal fit* and be compatible with a company's ability to execute the strategy in a competent manner. Unless a strategy exhibits good fit with both the external and internal aspects of a company's overall situation, it is likely to be an underperformer and fall short of producing winning results. Winning strategies also exhibit *dynamic fit* in the sense that they evolve over time in a manner that maintains close and effective alignment with the company's situation even as external and internal conditions change.[11]

To pass the *fit test,* a strategy must exhibit fit along three dimensions: (1) external, (2) internal, and (3) dynamic.

2. ***The Competitive Advantage Test:*** *Is the strategy helping the company achieve a competitive advantage? Is the competitive advantage likely to be sustainable?* Strategies that fail to achieve a competitive advantage over rivals are unlikely to produce superior performance. And unless the competitive advantage is sustainable, superior performance is unlikely to last for more than a brief period of time. Winning strategies enable a company to achieve a competitive advantage over key rivals that is long-lasting. The bigger and more durable the competitive advantage, the more powerful it is.

A **winning strategy** must pass three tests:
1. The fit test
2. The competitive advantage test
3. The performance test

3. ***The Performance Test:*** *Is the strategy producing superior company performance?* The mark of a winning strategy is strong company performance. Two kinds of performance indicators tell the most about the caliber of a company's strategy: (1) competitive strength and market standing and (2) profitability and financial strength. Above-average financial performance or gains in market share, competitive position, or profitability are signs of a winning strategy.

Strategies—either existing or proposed—that come up short on one or more of the preceding tests are plainly less desirable than strategies passing all three tests with flying colors. New initiatives that don't seem to match the company's internal and external situations should be scrapped before they come to fruition, while existing strategies must be scrutinized on a regular basis to ensure they have good fit, offer a competitive advantage, and are contributing to above-average performance or performance improvements. Failure to pass one or more of the three tests should prompt managers to make immediate changes in an existing strategy.

ILLUSTRATION CAPSULE 1.2

Turo, Zipcar, and Enterprise Rent-A-Car: Three Contrasting Business Models

Mikbiz/Shutterstock

	Turo	Zipcar	Enterprise Rent-A-Car
Customer value proposition	– Turo is the world's largest car sharing marketplace. – Account holders (Guests) undergo an approval process and are allowed to book a car or truck from third-party hosts in 7,500+ cities in the United States, Canada, and the United Kingdom. – Turo customers can request delivery of the vehicle by the host to travel hubs like airports, train stations, and hotels, or to custom delivery locations. – Car owners are allowed to rent their personal vehicles or vehicles acquired specifically for Turo rentals as a host. – Turo hosts earn on average $10,516 in annual income per vehicle made available for rental.	• Zipcar is a subsidiary of the Avis Budget Group. – Zipcar provides on-demand access to cars by the minute, hour or day in approximately 500 cities and 500 universities. • Zipcar is a round-trip car-sharing network that allows members to access cars on demand by the hour or day. – Zipcar offers members over 60 different makes and models, including hybrids, SUVs, luxury cars, and cargo vans. – The Zipcar mobile app allows members to find the closest car, reserve, unlock and lock it, and report its state.	• Provides car and truck rentals to travelers, auto repair customers, and customers needing local transportation through a network of over 8,500 airport and neighborhood locations worldwide in more than 90 countries. – Fleet of 1.85 million cars and trucks are rented on a daily basis with longer term rentals available. – Enterprise also offers fleet management services for companies of all sizes and a CarShare program that allows companies to rent vehicles on an hourly rate for employees with transportation needs shorter than one day.
Profit Formula	Revenue generation: – Turo trip charges began at $32/day (provided to host) and included a trip fee (dedicated to Turo) ranging from 2.5% to 100% of the daily rental rate. – Additional fees could be charged for additional distance, late return, cleaning, cancellations by the guest or host, and no show fees.	Revenue generation: – Monthly subscription fees of $9/month or $90/year plus driving costs starting at $10/hour.	Revenue generation: – Corporate and consumer rental rates for cars and trucks needed on a daily basis. Hourly rates for businesses needing cars and trucks for less than one day.

	Turo	Zipcar	Enterprise Rent-A-Car
	Cost structure: – Fixed costs associated with developing software for computers, tablets, and smartphones	Cost structure: – The Zipcar subsidiary provided Avis Budget Group with greater capacity utilization of its rental fleet. – Lease expense on dedicated parking spaces for rental fleet.	Cost structure: – Fixed costs associated with acquiring a fleet of 1.85 million cars and trucks. – Leases on airport and neighborhood locations.
	– Fixed and variable costs related to operating data centers, advertising, reservation systems, overhead and support activities	– Fixed and variable costs related to advertising, reservation systems, vehicle maintenance, compensation of employees, corporate overhead and support activities.	– Fixed and variable costs related to advertising, reservation systems, vehicle maintenance, compensation of employees at 8,500+ locations, corporate overhead and support activities.
	Profit margin: – Profitability dependent on generating sufficient trip fees and other fees to cover costs and provide attractive profits	Profit margin: – Profitability dependent on generating sufficient membership fees and hourly rental revenues to cover costs and provide attractive profits	Profit margin: – Profitability dependent on generating sufficient rental revenues to cover costs and provide attractive profits.

WHY CRAFTING AND EXECUTING STRATEGY ARE IMPORTANT TASKS

Crafting and executing strategy are top-priority managerial tasks for two big reasons. First, a clear and reasoned strategy is management's prescription for doing business, its road map to competitive advantage, its game plan for pleasing customers, and its formula for improving performance. High-performing enterprises are nearly always the product of astute, creative, and proactive strategy making. Companies don't get to the top of the industry rankings or stay there with flawed strategies, copycat strategies, or timid attempts to try to do better. Only a handful of companies can boast of hitting home runs in the marketplace due to lucky breaks or the good fortune of having stumbled into the right market at the right time with the right product. Even if this is the case, success will not be lasting unless the companies subsequently craft a strategy that capitalizes on their luck, builds on what is working, and discards the rest. So there can be little argument that the process of crafting a company's strategy matters—and matters a lot.

Second, even the best-conceived strategies will result in performance shortfalls if they are not executed proficiently. The processes of crafting and executing strategies must go hand in hand if a company is to be successful in the long term. The chief executive officer of one successful company put it well when they said

> In the main, our competitors are acquainted with the same fundamental concepts and techniques and approaches that we follow, and they are as free to pursue them as we are. More often than not, the difference between their level of success and ours lies in the relative thoroughness and self-discipline with which we and they develop and execute our strategies for the future.

Good Strategy + Good Strategy Execution = Good Management

Crafting and executing strategy are thus core management tasks. Among all the things managers do, nothing affects a company's ultimate success or failure more fundamentally than how well its management team charts the company's direction, develops competitively effective strategic moves, and pursues what needs to be done internally to produce good day-in, day-out strategy execution and operating excellence. Indeed, *good strategy and good strategy execution are the most telling and trustworthy signs of good management.* The rationale for using the twin standards of good strategy making and good strategy execution to determine whether a company is well managed is therefore compelling: *The better conceived a company's strategy and the more competently it is executed, the more likely the company will be a standout performer in the marketplace.* In stark contrast, a company that lacks clear-cut direction, has a flawed strategy, or can't execute its strategy competently is a company whose financial performance is probably suffering, whose business is at long-term risk, and whose management is sorely lacking.

THE ROAD AHEAD

> How well a company performs is directly attributable to the caliber of its strategy and the proficiency with which the strategy is executed.

Throughout the chapters to come and in Part 2 of this text, the spotlight is on the foremost question in running a business enterprise: *What must managers do, and do well, to make a company successful in the marketplace?* The answer that emerges is that doing a good job of managing inherently requires good strategic thinking and good management of the strategy-making, strategy-executing process.

The mission of this book is to provide a solid overview of what every business student and aspiring manager needs to know about crafting and executing strategy. We will explore what good strategic thinking entails, describe the core concepts and tools of strategic analysis, and examine the ins and outs of crafting and executing strategy. The accompanying cases will help build your skills in both diagnosing how well the strategy-making, strategy-executing task is being performed and prescribing actions for how the strategy in question or its execution can be improved. The strategic management course that you are enrolled in may also include a strategy simulation exercise in which you will run a company in head-to-head competition with companies run by your classmates. Your mastery of the strategic management concepts presented in the following chapters will put you in a strong position to craft a winning strategy for your company and figure out how to execute it in a cost-effective and profitable manner. As you progress through the chapters of the text and the activities assigned during the term, we hope to convince you that first-rate capabilities in crafting and executing strategy are essential to good management.

As you tackle the content and accompanying activities of this book, ponder the following observation by the essayist and poet Ralph Waldo Emerson: "Commerce is a game of skill which many people play, but which few play well." If your efforts help you become a savvy player and better equip you to succeed in business, the time and energy you spend here will indeed prove worthwhile.

KEY POINTS

1. A company's strategy is the set of coordinated actions that its managers take in order to outperform its competitors and achieve superior profitability.
2. The success of a company's strategy depends upon *competing differently* from rivals and gaining a competitive advantage over them.
3. A company achieves a *competitive advantage* when it provides buyers with superior value compared to rival sellers or produces its products or services more efficiently. The advantage is *sustainable* if it persists despite the best efforts of competitors to match or surpass this advantage.
4. A company's strategy typically evolves over time, emerging from a blend of (1) proactive deliberate actions on the part of company managers to improve the strategy and (2) reactive emergent responses to unanticipated developments and fresh market conditions.
5. A company's business model sets forth the logic for how its strategy will create value for customers and at the same time generate revenues sufficient to cover costs and realize a profit. Thus, it contains two crucial elements: (1) the *customer value proposition*—a plan for satisfying customer wants and needs at a price customers will consider good value, and (2) the *profit formula*—a plan for a cost structure that will enable the company to deliver the customer value proposition profitably. These elements are illustrated by the value-price-cost framework.
6. A winning strategy will pass three tests: (1) *fit* (external, internal, and dynamic consistency), (2) *competitive advantage* (durable competitive advantage), and (3) *performance* (outstanding financial and market performance).
7. Ethical strategies must entail actions and behavior that can pass the test of moral scrutiny in the sense of *not being* deceitful, unfair or harmful to others, disreputable, or unreasonably damaging to the environment.
8. Crafting and executing strategy are core management functions. How well a company performs and the degree of market success it enjoys are directly attributable to the caliber of its strategy and the proficiency with which the strategy is executed.

ASSURANCE OF LEARNING EXERCISES

1. Based on your experiences and/or knowledge of **Amazon.com** does Amazon's strategy (as described in Illustration Capsule 1.1) seem to set it apart from rivals? Does the strategy seem to be keyed to a cost-based advantage, differentiating features, serving the unique needs of a niche, or some combination of these? What is there about Amazon's strategy that can lead to sustainable competitive advantage?

   Mc Graw Hill connect **LO 1-1, LO 1-2, LO 1-3**
2. Elements of Amazon's strategy have evolved in meaningful ways since the company's founding in 1994. After reviewing the company's history on Internet sites

   LO 1-4, LO 1-6

such as Wikipedia and Encyclopedia Britannica prepare a one- to two-page report that discusses how its strategy has evolved. Your report should also assess how well Amazon's strategy passes the three tests of a winning strategy.

connect LO 1-5

3. Go to **investor.siriusxm.com** and check whether Sirius XM's recent financial reports indicate that its business model is working. Are its subscription fees increasing or declining? Are its revenue stream advertising and equipment sales growing or declining? Does its cost structure allow for acceptable profit margins?

connect

EXERCISES FOR SIMULATION PARTICIPANTS

Three basic questions must be answered by managers of organizations of all sizes as they begin the process of crafting strategy:

- What is our present situation?
- Where do we want to go from here?
- How are we going to get there?

After you have read the Participant's Guide or Player's Manual for the strategy simulation exercise that you will participate in during this academic term, you and your co-managers should come up with brief one- or two-paragraph answers to these three questions *prior to* entering your first set of decisions. While your answer to the first of the six questions can be developed from your reading of the manual, the remaining questions will require a collaborative discussion among the members of your company's management team about how you intend to manage the company you have been assigned to run.

LO 1-1

1. Your company's strategy in the business simulation for this course should include choices about what types of issues?

LO 1-6

2. What is your company's current situation? A substantive answer to this question should cover the following issues:
   - Does your company appear to be in sound financial condition?
   - What problems does your company have that need to be addressed?

LO 1-3

3. Why will your company matter to customers? A complete answer to this question should say something about each of the following:
   - How will you create customer value?
   - What will be distinctive about the company's products or services?
   - How will capabilities and resources be deployed to deliver customer value?

LO 1-5

4. What are the primary elements of your company's business model?
   - Describe your customer value proposition.
   - Discuss the profit formula tied to your business model.
   - What level of revenues is required for your company's business model to become a moneymaker?

LO 1-6

5. How will you build and sustain competitive advantage?
   - Which of the basic strategic and competitive approaches discussed in this chapter do you think makes the most sense to pursue?
   - What kind of competitive advantage over rivals will you try to achieve?

- How do you envision that your strategy might evolve as you react to the competitive moves of rival firms?
- Does your strategy have the ability to pass the three tests of a winning strategy? Explain.

6. Why will strategy execution be important to your company's success? **LO 1-1, 1-2, 1-6**

ENDNOTES

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chapter 2

Charting a Company's Direction

Its Vision, Mission, Objectives, and Strategy

Learning Objectives

After reading this chapter, you should be able to

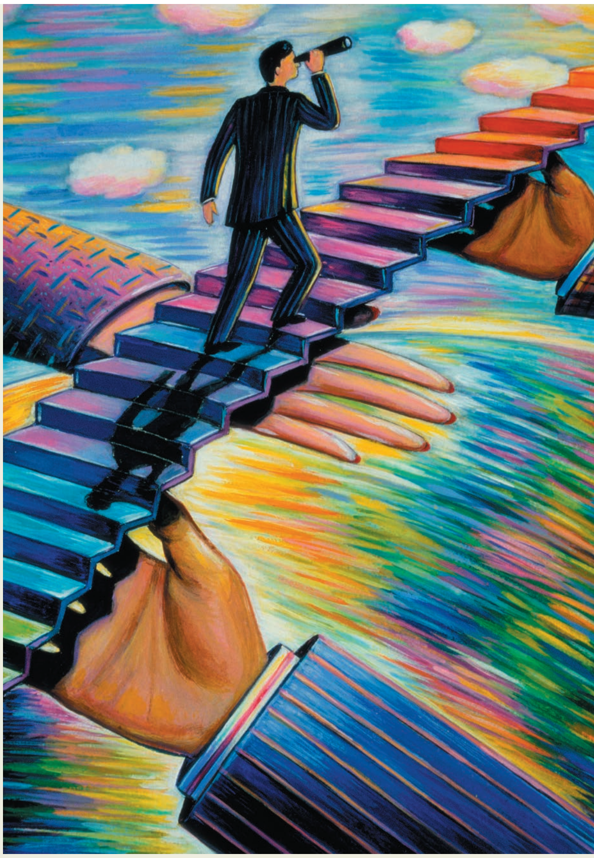
LO 2-1 Understand why it is critical for managers to have a clear strategic vision of where the company needs to head.

LO 2-2 Explain the importance of setting both strategic and financial objectives.

LO 2-3 Explain why the strategic initiatives taken at various organizational levels must be tightly coordinated.

LO 2-4 Recognize what a company must do to achieve operating excellence and to execute its strategy proficiently.

LO 2-5 Comprehend the role and responsibility of a company's board of directors in overseeing the strategic management process.



Pamela Hamilton/Getty Images

Before you plan how to get to where you want to go, you must first know why you are going and where you are going. The why is connected to the company's mission, while the where is all about its vision.

Ella L. J. Bell Smith—*Professor and consultant*

A mission and vision give a company its True North, and a strategy enables the firm to get there.

Constance Helfat—*Professor and thought leader*

Boards have a critical role in the overarching strategy of a firm.

Karen Schnatterly—*Professor and Thought Leader*

Crafting and executing strategy are the heart and soul of managing a business enterprise. But exactly what is involved in developing a strategy and executing it proficiently? What goes into charting a company's strategic course and long-term direction? Is any analysis required? Does a company need a strategic plan? What are the various components of the strategy-making, strategy-executing process and to what extent are company personnel—aside from senior management—involved in the process?

This chapter presents an overview of the ins and outs of crafting and executing company strategies. The focus is on management's direction-setting responsibilities—charting a strategic course, setting performance targets, and choosing a strategy capable of producing the desired outcomes. We explain why strategy-making is a task for a company's entire management team and which kinds of strategic decisions tend to be made at which levels of management. The chapter concludes with a look at the roles and responsibilities of a company's board of directors and how good corporate governance protects shareholder interests and promotes good management.

WHAT DOES THE STRATEGY-MAKING, STRATEGY-EXECUTING PROCESS ENTAIL?

Crafting and executing a company's strategy is an ongoing process that consists of five interrelated stages:

1. *Developing a strategic vision* that charts the company's long-term direction, a *mission statement* that describes the company's purpose, and a set of *core values* to guide the pursuit of the vision and mission.
2. *Setting objectives* for measuring the company's performance and tracking its progress in moving in the intended long-term direction.
3. *Crafting a strategy* for advancing the company along the path management has charted and achieving its performance objectives.
4. *Executing the chosen strategy* efficiently and effectively.
5. *Monitoring developments, evaluating performance, and initiating corrective adjustments* in the company's vision and mission statement, objectives, strategy, or approach to strategy execution in light of actual experience, changing conditions, new ideas, and new opportunities.

CORE CONCEPT

A **strategic inflection point** is the point at which the extent of industry change requires management to consider changing the company's strategic vision.

Figure 2.1 displays this five-stage process, which we examine next in some detail. The first three stages of the strategic management process involve making a strategic plan. A **strategic plan** maps out where a company is headed, establishes strategic and financial targets, and outlines the basic business model, competitive moves, and approaches to be used in achieving the desired business results.[1] We explain this more fully at the conclusion of our discussion of stage 3, later in this chapter.

The five-stage process model illustrates the need for management to evaluate a number of external and internal factors in deciding upon a strategic direction, appropriate objectives, and approaches to crafting and executing strategy (see Table 2.1). Management's decisions that are made in the strategic management process must be shaped by the prevailing economic conditions and competitive environment and the company's own internal resources and competitive capabilities. These strategy-shaping conditions will be the focus of Chapters 3 and 4.

The model shown in Figure 2.1 also illustrates the need for management to evaluate the company's performance on an ongoing basis. Any indication that the company is failing to achieve its objectives calls for corrective adjustments in one of the first four stages of the process. The company's implementation efforts might have fallen short, and new tactics must be devised to fully exploit the potential of the company's strategy. If management determines that the company's execution efforts are sufficient, it should challenge the assumptions underlying the company's business model and strategy and then make alterations to better fit competitive conditions and the company's internal capabilities. If the company's strategic approach to competition is rated as sound, then perhaps management set overly ambitious targets for the company's performance.

The evaluation stage of the strategic management process shown in Figure 2.1 also allows for a change in the company's vision, but this should be necessary only when it becomes evident to management that the industry has changed in a significant way that renders the vision obsolete. Such occasions can be referred to as strategic inflection points. When a company reaches a strategic inflection point, management has tough decisions to make about the company's direction because abandoning

FIGURE 2.1 The Strategy-Making, Strategy-Executing Process

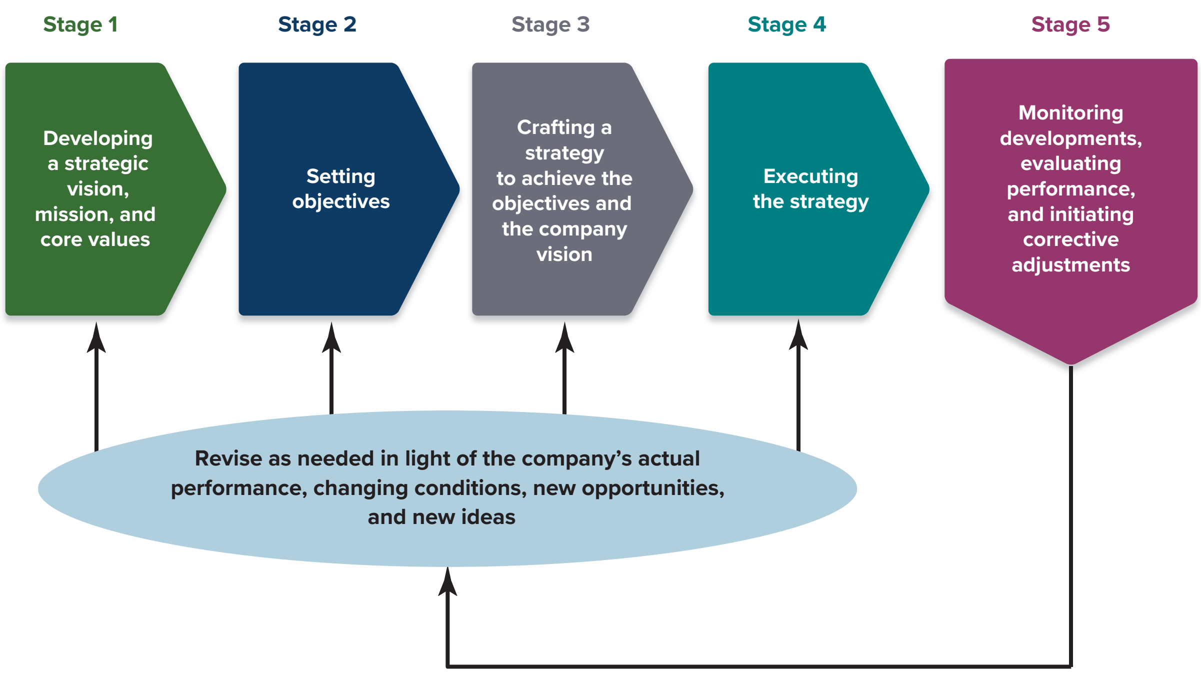


TABLE 2.1 Factors Shaping Decisions in the Strategy-Making, Strategy-Execution Process

External Considerations • Does sticking with the company's present strategic course present attractive opportunities for growth and profitability? • What kind of competitive forces are industry members facing, and are they acting to enhance or weaken the company's prospects for growth and profitability? • What factors are driving industry change, and what impact on the company's prospects will they have? • How are industry rivals positioned, and what strategic moves are they likely to make next? • What are the key factors of future competitive success, and does the industry offer good prospects for attractive profits for companies possessing those capabilities?
Internal Considerations • Does the company have an appealing customer value proposition? • What are the company's competitively important resources and capabilities, and are they potent enough to produce a sustainable competitive advantage? • Does the company have sufficient business and competitive strength to seize market opportunities and nullify external threats? • Are the company's costs competitive with those of key rivals? • Is the company competitively stronger or weaker than key rivals?

an established course carries considerable risk. However, responding to unfolding changes in the marketplace in a timely fashion lessens a company's chances of becoming trapped in a stagnant or declining business or letting attractive new growth opportunities slip away.

STAGE 1: DEVELOPING A STRATEGIC VISION, MISSION STATEMENT, AND SET OF CORE VALUES

LO 2-1

Understand why it is critical for managers to have a clear strategic vision of where the company needs to head.

Very early in the strategy-making process, a company's senior managers must wrestle with the issue of what directional path the company should take. Can the company's prospects be improved by changing its product offerings, or the markets in which it participates, or the customers it aims to serve? Deciding to commit the company to one path versus another pushes managers to draw some carefully reasoned conclusions about whether the company's present strategic course offers attractive opportunities for growth and profitability or whether changes of one kind or another in the company's strategy and long-term direction are needed.

Developing a Strategic Vision

CORE CONCEPT

A **strategic vision** describes management's aspirations for the company's future and the course and direction charted to achieve them.

Top management's views about the company's long-term direction and what product–market–customer business mix seems optimal for the road ahead constitute a **strategic vision** for the company. A strategic vision delineates management's aspirations for the company's future, providing a panoramic view of "where we are going" and a convincing rationale for why this makes good business sense. A strategic vision thus points an organization in a particular direction, charts a strategic path for it to follow, builds commitment to the future course of action, and molds organizational identity. A clearly articulated strategic vision communicates management's aspirations to stakeholders (customers, employees, stockholders, suppliers, etc.) and helps steer the energies of company personnel in a common direction. The vision of Google's cofounders Larry Page and Sergey Brin "to organize the world's information and make it universally accessible and useful" provides a good example. In serving as the company's guiding light, it has captured the imagination of stakeholders and the public at large, served as the basis for crafting the company's strategic actions, and aided internal efforts to mobilize and direct the company's resources.

Well-conceived visions are *distinctive* and *specific* to a particular organization; they avoid generic, feel-good statements like "We will become a global leader and the first choice of customers in every market we serve."[2] Likewise, a strategic vision proclaiming management's quest "to be the most innovative" or "to be recognized as the best company in the industry" offers scant guidance about a company's long-term direction or the kind of company that management is striving to build.

An effectively communicated vision is a valuable management tool for enlisting the commitment of company personnel to actions that move the company in the intended long-term direction.

A surprising number of the vision statements found on company websites and in annual reports are vague and unrevealing, saying very little about the company's future direction. Some could apply to almost any company in any industry. Many read like a public relations statement—high-sounding words that someone came up with because it is fashionable for companies to have an official vision statement.[3] An example is Hilton Hotel's vision "to fill the earth with light and the warmth of hospitality," which simply borders on the incredulous. The real purpose of a vision statement is to serve as a management tool for giving the organization a sense of direction.

For a strategic vision to function as a valuable management tool, it must convey what top executives want the business to look like and provide managers at all organizational levels with a reference point in making strategic decisions and preparing the company for the future. It must say something definitive about how the company's leaders intend to position the company beyond where it is today. Table 2.2 provides some dos and don'ts in composing an effectively worded vision statement. Illustration Capsule 2.1 provides a critique of the strategic visions of several prominent companies.

TABLE 2.2 Wording a Vision Statement—the Dos and Don'ts

The Dos	The Don'ts
Be graphic. Paint a clear picture of where the company is headed and the market position(s) the company is striving to stake out.	**Don't be vague or incomplete.** Never skimp on specifics about where the company is headed or how the company intends to prepare for the future.
Be forward-looking and directional. Describe the strategic course that will help the company prepare for the future.	**Don't dwell on the present.** A vision is not about what a company once did or does now; it's about "where we are going."
Keep it focused. Focus on providing managers with guidance in making decisions and allocating resources.	**Don't use overly broad language.** Avoid all-inclusive language that gives the company license to pursue any opportunity.
Have some wiggle room. Language that allows some flexibility allows the directional course to be adjusted as market, customer, and technology circumstances change.	**Don't state the vision in bland or uninspiring terms.** The best vision statements have the power to motivate company personnel and inspire shareholder confidence about the company's future.
Be sure the journey is feasible. The path and direction should be within the realm of what the company can accomplish; over time, a company should be able to demonstrate measurable progress in achieving the vision.	**Don't be generic.** A vision statement that could apply to companies in any of several industries (or to any of several companies in the same industry) is not specific enough to provide any guidance.
Indicate why the directional path makes good business sense. The directional path should be in the long-term interests of stakeholders (especially shareholders, employees, and suppliers).	**Don't rely on superlatives.** Visions that claim the company's strategic course is the "best" or "most successful" usually lack specifics about the path the company is taking to get there.
Make it memorable. A well-stated vision is short, easily communicated, and memorable. Ideally, it should be reducible to a few choice lines or a one-phrase slogan.	**Don't run on and on.** A vision statement that is not concise and to the point will tend to lose its audience.

Sources: John P. Kotter, *Leading Change* (Boston: Harvard Business School Press, 1996); Hugh Davidson, *The Committed Enterprise* (Oxford: Butterworth Heinemann, 2002); Michel Robert, *Strategy Pure and Simple II* (New York: McGraw-Hill, 1992).

ILLUSTRATION CAPSULE 2.1

Examples of Strategic Visions—How Well Do They Measure Up?

TonyV3112/Shutterstock

Vision Statement	Effective Elements	Shortcomings
Nike NIKE, Inc. fosters a culture of invention. We create products, services and experiences for today's athlete* while solving problems for the next generation. *If you have a body, you are an athlete.	• Forward-looking • Flexible	• Vague • Not focused
Whole Foods Whole Foods Market is a dynamic leader in the quality food business. We are a mission-driven company that aims to set the standards of excellence for food retailers. We are building a business in which high standards permeate all aspects of our company. Quality is a state of mind at Whole Foods Market. Our motto—Whole Foods, Whole People, Whole Planet—emphasizes that our vision reaches far beyond just being a food retailer. Our success in fulfilling our vision is measured by customer satisfaction, team member happiness and excellence, return on capital investment, improvement in the state of the environment and local and larger community support. Our ability to instill a clear sense of interdependence among our various stakeholders (the people who are interested and benefit from the success of our company) is contingent upon our efforts to communicate more often, more openly, and more compassionately. Better communication equals better understanding and more trust.	• Forward-looking • Graphic • Focused • Makes good business sense	• Long • Not memorable
General Motors Our goal is to deliver world-class customer experiences at every touchpoint and do so on a foundation of trust and transparency.	• Desirable • Flexible	• Too broad • Vague • Unfocused
Keurig Dr. Pepper A leading producer and distributor of hot and cold beverages to satisfy every consumer need, anytime and anywhere.	• Easy to communicate • Focused	• Not distinctive • Not forward-looking

Source: Company documents and websites

Communicating the Strategic Vision

A strategic vision offers little value to the organization unless it's effectively communicated down the line to lower-level managers and employees. A vision cannot provide direction for middle managers or inspire and energize employees unless everyone in the company is familiar with it and can observe senior management's commitment to the vision. It is particularly important for executives to provide a compelling rationale for a dramatically *new* strategic vision and company direction. When company personnel don't understand or accept the need for redirecting organizational efforts, they are prone to resist change. Hence, explaining the basis for the new direction, addressing employee concerns head-on, calming fears, lifting spirits, and providing updates and progress reports as events unfold all become part of the task in mobilizing support for the vision and winning commitment to needed actions.

Winning the support of organization members for the vision nearly always requires putting "where we are going and why" in writing, distributing the statement organizationwide, and having top executives personally explain the vision and its rationale to as many people as feasible. Ideally, executives should present their vision for the company in a manner that reaches out and grabs people. An engaging and convincing strategic vision has enormous motivational value—for the same reason that a stonemason is more inspired by the opportunity to build a great cathedral for the ages than a house. Thus, executive ability to paint a convincing and inspiring picture of a company's journey to a future destination is an important element of effective strategic leadership.

Expressing the Essence of the Vision in a Slogan The task of effectively conveying the vision to company personnel is assisted when management can capture the vision of where to head in a catchy or easily remembered slogan. A number of organizations have summed up their vision in a brief phrase. Instagram's vision is "Capture and share the world's moments," while Charles Schwab's is simply "Helping investors help themselves." Habitat for Humanity's aspirational vision is "A world where everyone has a decent place to live." While Greenpeace's envisioned future is to "halt environmental abuse and promote environmental solutions." Even Scotland Yard has a catchy vision, which is to "make London the safest major city in the world." Creating a short slogan to illuminate an organization's direction and using it repeatedly as a reminder of "where we are headed and why" helps rally organization members to maintain their focus and hurdle whatever obstacles lie in the company's path.

Why a Sound, Well-Communicated Strategic Vision Matters A well-thought-out, forcefully communicated strategic vision pays off in several respects: (1) It crystallizes senior executives' own views about the firm's long-term direction; (2) it reduces the risk of rudderless decision making; (3) it is a tool for winning the support of organization members to help make the vision a reality; (4) it provides a beacon for lower-level managers in setting departmental objectives and crafting departmental strategies that are in sync with the company's overall strategy; and (5) it helps an organization prepare for the future. When top executives are able to demonstrate significant progress in achieving these five benefits, the first step in organizational direction setting has been successfully completed.

Developing a Company Mission Statement

The distinction between a strategic vision and a mission statement is fairly clear-cut: A strategic vision portrays a company's aspirations for its *future* ("where we are going"), whereas a company's **mission statement** describes the purpose of its *present* business ("who we are, what we do, and why we are here").

The defining characteristic of a strategic vision is that it lays out the company's *future strategic course*—"the direction we are headed and the shape of our business in the future." It is aspirational. In contrast, a **mission statement** describes the enterprise's *present purpose*—"who we are, what we do, and why we are here." It is purely descriptive. Ideally, a company mission statement (1) identifies the company's products and/or services, (2) specifies the buyer needs that the company seeks to satisfy and the customer groups or markets that it serves, and (3) gives the company its own identity. The mission statements found in company annual reports or posted on company websites are typically quite brief; some do a better job than others of conveying what the enterprise's current business operations and purpose are all about.

Consider, for example, the mission statement of Singapore Airlines, which is consistently rated among the world's best airlines in terms of passenger safety and comfort:

> Singapore Airlines is a global company dedicated to providing air transportation services of the highest quality and to maximizing returns for the benefit of its shareholders and employees.

Note that Singapore Airlines' mission statement does a good job of conveying "who we are, what we do, and why we are here," but it provides no sense of "where we are headed." This is as it should be, since a company's vision statement speaks to the future.

Another example of a well-stated mission statement with ample specifics about what the organization does is that of St. Jude Children's Research Hospital: "to advance cures, and means of prevention, for pediatric catastrophic diseases through research and treatment. Consistent with the vision of our founder Danny Thomas, no child is denied treatment based on race, religion or a family's ability to pay." An example of a not-so-revealing mission statement is that of Microsoft: "To empower every person and every organization on the planet to achieve more." It says nothing about the company's activities or business makeup and could apply to many companies in many different industries. A person unfamiliar with Microsoft could not even discern from its mission statement that it is an a provider of computer software and services without reading between the lines. Coca-Cola, which markets more than 200 beverage brands in over 200 countries, also has an uninformative mission statement: "to refresh the world; to inspire moments of optimism and happiness; to create value and make a difference." A mission statement that provides scant indication of "who we are and what we do" has no apparent value.

To be well worded, a company mission statement must employ language specific enough to distinguish its business makeup and purpose from those of other enterprises and give the company its own identity.

All too often, companies couch their mission in terms of making a profit, like Dean Foods with its mission "To maximize long-term stockholder value." This, too, is flawed. Profit is more correctly an *objective* and a *result* of what a company does. Moreover, earning a profit is the obvious intent of every commercial enterprise. Companies such as Gap, Inc., Edward Jones, BMW, Shell Oil, The Boston Consulting Group, Citigroup, and DreamWorks Pictures, are all striving to earn a profit for shareholders; but plainly the fundamentals of their businesses are substantially different when it comes to "who we are and what we do." It is management's answer to "make a profit doing what and for whom?" that reveals the substance of a company's true mission and business purpose.

Linking the Vision and Mission with Company Values

CORE CONCEPT

A company's **values** are the beliefs, traits, and behavioral norms that company personnel are expected to display in conducting the company's business and pursuing its strategic vision and mission.

Companies commonly develop a set of values to guide the actions and behavior of company personnel in conducting the company's business and pursuing its strategic vision and mission. By **values** (or **core values,** as they are often called) we mean certain designated beliefs, traits, and behavioral norms that management has determined should guide the pursuit of its vision and mission. Values relate to such things as fair treatment, honor and integrity, ethical behavior, innovativeness, teamwork, a passion for top-notch quality or superior customer service, social responsibility, and community citizenship.

Most companies articulate four to eight core values that company personnel are expected to display and that are supposed to be mirrored in how the company conducts its business. Build-A-Bear Workshop, with its cuddly Teddy bears and stuffed animals, credits six core values with creating its highly acclaimed working environment: (1) Reach, (2) Learn, (3) Di-bear-sity, (4) Colla-bear-ate, (5) Give, and (6) Cele-bear-ate.

At Samsung, five core values are linked to its philosophy of devoting its talent and technology to create superior products and services that contribute to a better global society: (1) giving people opportunities to reach their full potential, (2) developing the best products and services on the market, (3) embracing change, (4) operating in an ethical way, and (5) dedication to social and environmental responsibility. Guardian Life's values of (1) We do the right thing, (2) People count, and (3) We hold ourselves to very high standards, are reflected not only in how it serves its 29 million insurance customers but are also evident across its business operations. The company's move to improve its information technology capabilities after Hurricane Sandy prepared it to protect the health of employees with a quick move to remote and hybrid working arrangements required by the COVID-19 pandemic. Also, the company's values have driven its commitment to diversity, equity, and inclusion in terms of hiring practices, compensation, and promotions. In 2023, 51 percent of Guardian's were women and 41 percent were members of underrepresented groups. The company's board of directors had received national recognition for its diverse makeup.

Do companies practice what they preach when it comes to their professed values? Sometimes no, sometimes yes—it runs the gamut. At one extreme are companies with window-dressing values; the values are given lip service by top executives but have little discernible impact on either how company personnel behave or how the company operates. Such companies have value statements because they are in vogue and make the company look good. The limitation of these value statements becomes apparent whenever corporate misdeeds come to light. Prime examples include Volkswagen, with its emissions scandal, and Uber, facing multiple allegations of misbehavior and a criminal probe of illegal operations. At the other extreme are companies whose executives are committed to grounding company operations on sound values and principled ways of doing business. Executives at these companies deliberately seek to ingrain the designated core values into the corporate culture—the core values thus become an integral part of the company's DNA and what makes the company tick. At such values-driven companies, executives "walk the talk" and company personnel are held accountable for embodying the stated values in their behavior.

At companies where the stated values are real rather than cosmetic, managers connect values to the pursuit of the strategic vision and mission in one of two ways. In companies with long-standing values that are deeply entrenched in the corporate culture, senior managers are careful to craft a vision, mission, strategy, and set of operating practices that match established values; moreover, they repeatedly emphasize how the value-based behavioral norms contribute to the company's business success. If the company changes to a different vision or strategy, executives make a point of explaining how and why the core values continue to be relevant. Few companies with sincere commitment to established core values ever undertake strategic moves that conflict with ingrained values. In new companies, top management has to consider what values and business conduct should characterize the company and then draft a value statement that is circulated among managers and employees for discussion and possible modification. A final value statement that incorporates the desired behaviors and that connects to the vision and mission is then officially adopted. Some companies combine their vision, mission, and values into a single statement or document, circulate it to all organization members, and in many instances post the vision, mission, and value statement on the company's website. Illustration Capsule 2.2 describes how the success of IKEA has been largely driven by the nature of its mission, linked to its vision and core values.

STAGE 2: SETTING OBJECTIVES

LO 2-2

Explain the importance of setting both strategic and financial objectives.

The managerial purpose of setting **objectives** is to convert the vision and mission into specific performance targets. Objectives reflect management's aspirations for company performance in light of the industry's prevailing economic and competitive conditions and the company's internal capabilities. Well-stated objectives must be *specific,* as well as *quantifiable* or *measurable.* As Bill Hewlett, cofounder of Hewlett-Packard, shrewdly observed, "You cannot manage what you cannot measure. . . . And what gets measured gets done."[4] Concrete, measurable objectives are managerially valuable for three reasons: (1) they focus organizational attention and align actions throughout the organization, (2) they serve as *yardsticks* for tracking a company's performance and progress, and (3) they motivate employees to expend greater effort and perform at a high level. For company objectives to serve their purpose well, they must also meet three other criteria: they must contain a deadline for achievement and they must be challenging, yet achievable.

CORE CONCEPT

Objectives are an organization's performance targets—the specific results management wants to achieve.

Well-chosen **objectives** are:

- specific
- measurable
- time-limited
- challenging
- achievable

Setting Stretch Objectives

The experiences of countless companies teach that one of the best ways to promote outstanding company performance is for managers to set performance targets high enough to *stretch an organization to perform at its full potential and deliver the best possible results.* Challenging company personnel to go all out and deliver "stretch" gains in performance pushes an enterprise to be more inventive, to exhibit more urgency in improving both its financial performance and its business position, and to be more intentional and focused in its actions. At Google (now Alphabet) and Amazon, for example, stretch goals have spurred the development of drones—Amazon's for delivery and Google's for both delivery and high-speed Internet delivery from the skies. Employing stretch goals can help create an exciting work environment and attract the best people. In many cases, stretch objectives spur exceptional

ILLUSTRATION CAPSULE 2.2 IKEA's Vision, Mission, and Core Values

IKEA is a multinational furniture retail company known for the affordability, Scandinavian design, and utility of its products. Since its founding in Sweden in 1943, the company's vision, mission, and core values have guided its actions and shaped its corporate culture.

IKEA's vision is to "**create a better everyday life for the many people**", which includes its employees and suppliers, as well as its customers. The company's quest to create a better life for people also extends to social responsibility and addressing broad external challenges such as climate change, unsustainable consumption, and inequality. IKEA's commitment to climate change focuses on its climate footprint, which comes from the materials used in its products.

IKEA's mission is to "**offer a wide range of well-designed, functional home furnishing products at prices so low that as many people as possible will be able to afford them.**" This mission is reflected in the company's focus on producing high-quality products at affordable prices, as well as its commitment to making good design accessible to everyone.

The company prides itself on its eight core values, which begin with "*Togetherness*", its commitment to teamwork and collaboration. "*Cost-consciousness*", "*Caring for people and* planet", and "*Simplicity*" speak to its focus on affordability, sustainability, and efficiency, while "*Renew and improve*" along with "*Different with a meaning*" reflect its entrepreneurial spirit and willingness to learn from mistakes and innovate. The last two core values, "*Give and take responsibility*" and "*Lead by example*" express what they value in their leaders.

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Overall, IKEA is a company that is driven by a deep commitment to improving the everyday lives of its customers and other stakeholders, while also being mindful of its impact on the environment and society. These values are what set IKEA apart from its competitors and make it a beloved brand all over the world, with revenues of $48.6 billion by 2022.

Developed with Dr. Diana Garza, *University of the Incarnate Word.*

Sources: Company website and IKEA Sustainability Strategy — People & Planet Positive — © Inter IKEA Systems B.V. 2022.

performance and help build a firewall against contentment with modest gains in organizational performance.

There is a difference, however, between stretch goals that are clearly reachable with enough effort, and those that are well beyond the organization's current capabilities, regardless of the level of effort. **Extreme stretch goals**, involving radical expectations, fail more often than not. And failure to meet such goals can kill motivation, erode employee confidence, and damage both worker and company performance. CEO Marissa Mayer's inability to return Yahoo to greatness is a case in point.

Extreme stretch goals can work as envisioned under certain circumstances. High profile success stories at companies such as SpaceX, and **Alibaba.com** provide evidence. Walmart and IKEA are among the companies who have set extreme stretch goals for reducing their carbon footprints. However, radical objectives that are not achieved can erode employee confidence and ultimately damage company performance. **Stretch objectives** are most likely to produce desired results when the company is building upon strong recent performance and when ample resources are available to support growth aspirations.[5]

CORE CONCEPT

Stretch objectives set performance targets high enough to *stretch* an organization to perform at its full potential and deliver the best possible results. **Extreme stretch goals** are warranted only under certain conditions.

CORE CONCEPT

Financial objectives communicate management's goals for financial performance. **Strategic objectives** lay out target outcomes concerning a company's market standing, competitive position, and future business prospects.

What Kinds of Objectives to Set

Two distinct types of performance targets are required: those relating to financial performance and those relating to strategic performance. **Financial objectives** communicate management's goals for financial performance. **Strategic objectives** are goals concerning a company's marketing standing and competitive position. A company's set of financial and strategic objectives should include both near-term and longer-term performance targets. Short-term (quarterly or annual) objectives focus attention on delivering performance improvements in the current period and satisfy shareholder expectations for near-term progress. Longer-term targets (three to five years off) force managers to consider what to do *now* to put the company in position to perform better later. Long-term objectives are critical for achieving optimal long-term performance and stand as a barrier to a nearsighted management philosophy and an undue focus on short-term results. When trade-offs have to be made between achieving long-term objectives and achieving short-term objectives, long-term objectives should take precedence (unless the achievement of one or more short-term performance targets has unique importance). Examples of commonly used financial and strategic objectives are listed in Table 2.3. Illustration Capsule 2.3 provides selected financial and strategic objectives of three prominent companies.

The Need for a Balanced Approach to Objective Setting

The importance of setting and attaining financial objectives is obvious. Without adequate profitability and financial strength, a company's long-term health and ultimate survival are jeopardized. Furthermore, subpar earnings and a weak balance sheet alarm shareholders and creditors and put the jobs of senior executives at risk.

TABLE 2.3 Common Financial and Strategic Objectives

Financial Objectives	Strategic Objectives
• An *x* percent increase in annual revenues • Annual increases in after-tax profits of *x* percent • Annual increases in earnings per share of *x* percent • Annual dividend increases of *x* percent • Profit margins of *x* percent • An *x* percent return on capital employed (ROCE) or return on shareholders' equity (ROE) investment • Increased shareholder value in the form of an upward-trending stock price • Bond and credit ratings of *x* • Internal cash flows of *x* dollars to fund new capital investment	• Winning an *x* percent market share • Achieving lower overall costs than rivals • Overtaking key competitors on product performance, quality, or customer service • Deriving *x* percent of revenues from the sale of new products introduced within the past five years • Having broader or deeper technological capabilities than rivals • Having a wider product line than rivals • Having a better-known or more powerful brand name than rivals • Having stronger national or global sales and distribution capabilities than rivals • Consistently getting new or improved products to market ahead of rivals

ILLUSTRATION CAPSULE 2.3 Examples of Company Objectives

YUM! Brands (KFC, Pizza Hut, Taco Bell)

Achieve same store sales growth of 2–3 percent annually; increase net new units by 3–4 percent annually; achieve system sales growth of mid to high single-digit annually; achieve EPS growth in low double-digits annually; add 1,250 net new KFC units annually; 90 percent of net new Pizza Hut units will be small format assets; double telepizza footprint in Latin America by 2,500 net new units by 2038; maintain capital structure of approximately 5.0x EBITDA consolidated net leverage.

LULULEMON ATHLETICA, INC.

Optimize and strategically grow square footage in North America; explore new concepts such as pop-up stores to take advantage of seasonality build a robust digital ecosystem with key investments in customer relationship management, analytics, and capabilities to elevate guest experience across all touch points; continue to expand the brand globally through international expansion, with plans to increase the number of stores in China from 95 to 220 by 2026; increase revenue $12.5 billion by 2026; double its digital revenue as well as quadruple its international business; expand store square footage by 5 percent annually, which includes new store openings and optimizations.

Eric Broder Van Dyke/Shutterstock

GENERAL MILLS

Generate low single-digit organic net sales growth and high single-digit growth in earnings per share. Deliver double-digit returns to shareholders over the long term. To drive future growth, focus on Consumer First strategy to gain a deep understanding of consumer needs and respond quickly to give them what they want; more specifically: (1) grow cereal globally with a strong line-up of new products, including new flavors of iconic Cheerios; (2) innovate in fast growing segments of the yogurt category to improve performance and expand the yogurt platform into new cities in China; (3) expand distribution and advertising for high-performing brands, such as Häagen-Dazs and Old El Paso; (4) build a more agile organization by streamlining support functions, allowing for more fluid use of resources and idea sharing around the world; (5) enhancing e-commerce know-how to capture more growth in this emerging channel; and (6) investing in strategic revenue management tools to optimize promotions, prices, and mix of products to drive sales growth.

Note: Developed with Kathleen T. Durante.

Sources: Information posted on company websites; **www.retaildive.com/news/what-lululemon-is-prioritizing-in-the-years-ahead**.

In consequence, companies often focus most of their attention on financial outcomes. However, good financial performance, by itself, is not enough. Of equal or greater importance is a company's strategic performance—outcomes that indicate whether a company's market position and competitiveness are deteriorating, holding steady, or improving. *A stronger market standing and greater competitive vitality—especially when accompanied by competitive advantage—is what enables a company to improve its financial performance.*

Moreover, financial performance measures are really *lagging indicators* that reflect the results of past decisions and organizational activities.[6] But a company's past or

CORE CONCEPT

The **balanced scorecard** is a widely used method for combining the use of both strategic and financial objectives, tracking their achievement, and giving management a more complete and balanced view of how well an organization is performing.

current financial performance is not a reliable indicator of its future prospects—poor financial performers often turn things around and do better, while good financial performers can fall upon hard times. The best and most reliable *leading indicators* of a company's future financial performance and business prospects are strategic outcomes that indicate whether the company's competitiveness and market position are stronger or weaker. The accomplishment of strategic objectives signals that the company is well positioned to sustain or improve its performance. For instance, if a company is achieving ambitious strategic objectives such that its competitive strength and market position are on the rise, then there's reason to expect that its *future* financial performance will be better than its current or past performance. If a company is losing ground to competitors and its market position is slipping—outcomes that reflect weak strategic performance—then its ability to maintain its present profitability is highly suspect.

Consequently, it is important to use a performance measurement system that strikes a *balance* between financial and strategic objectives.[7] The most widely used framework of this sort is known as the **balanced scorecard.**[8] This is a method for linking financial performance objectives to specific strategic objectives that derive from a company's business model. It maps out the key objectives of a company, with performance indicators, along four dimensions:

CORE CONCEPT

The four dimensions of a **Balanced Scorecard:**

1. Financial
2. Customer
3. Internal Process
4. Organizational (formerly called Growth and Learning)

1. Financial: listing financial objectives
2. Customer: objectives relating to customers and the market
3. Internal process: objectives relating to productivity and quality
4. Organizational: objectives concerning human capital, culture, infrastructure, and innovation

Done well, this can provide a company's employees with clear guidelines about how their jobs are linked to the overall objectives of the organization, so they can contribute most productively and collaboratively to the achievement of these goals. The balanced scorecard methodology continues to be ranked as one of the most popular management tools.[9] Over 50 percent of companies in the United States, Europe, and Asia report using a balanced scorecard approach to measuring strategic and financial performance.[10] Organizations that have adopted the balanced scorecard approach include 7-Eleven, Ann Taylor Stores, Allianz Italy, Wells Fargo Bank, Ford Motor Company, Verizon, ExxonMobil, Pfizer, DuPont, Royal Canadian Mounted Police, U.S. Army Medical Command, and over 30 colleges and universities.[11] Despite its popularity, the balanced scorecard is not without limitations. Importantly, it may not capture some of the most important priorities of a particular organization, such as resource acquisition or partnering with other organizations. Further, as with most strategy tools, its value depends on implementation and follow through as much as on substance.

Setting Objectives for Every Organizational Level

Objective setting should not stop with top management's establishing companywide performance targets. Company objectives need to be broken down into performance targets for each of the organization's separate businesses, product lines, functional departments, and individual work units. Employees within various functional areas and operating levels will be guided much better by specific objectives relating directly to their departmental activities than broad organizational-level goals. Objective setting is thus a *top-down process* that must extend to the lowest organizational levels. This means that each organizational unit must take care to set performance targets that support—rather than conflict with or negate—the achievement of companywide strategic and financial objectives.

The ideal situation is a team effort in which each organizational unit strives to produce results that contribute to the achievement of the company's performance targets and strategic vision. Such consistency signals that organizational units know their strategic role and are on board in helping the company move down the chosen strategic path and produce the desired results.

STAGE 3: CRAFTING A STRATEGY

LO 2-3

Explain why the strategic initiatives taken at various organizational levels must be tightly coordinated.

As indicated in Chapter 1, the task of stitching a strategy together entails addressing a series of "hows": *how* to attract and please customers, *how* to compete against rivals, *how* to position the company in the marketplace, *how* to respond to changing market conditions, *how* to capitalize on attractive opportunities to grow the business, and *how* to achieve strategic and financial objectives. Choosing among the alternatives available in a way that coheres into a viable business model requires an understanding of the basic principles of strategic management. Fast-changing business environments demand astute entrepreneurship searching for opportunities to do new things or to do existing things in new or better ways.

In choosing among opportunities and addressing the hows of strategy, strategists must embrace the risks of uncertainty and the discomfort that naturally accompanies such risks. Bold strategies involve making difficult choices and placing bets on the future. Good strategic planning is not about eliminating risks, but about increasing the odds of success.

This places a premium on astute entrepreneurship searching for opportunities to do new things or to do existing things in new or better ways.[12] The faster a company's business environment is changing, the more critical it becomes for its managers to be good entrepreneurs in diagnosing the direction and force of the changes underway and in responding with timely adjustments in strategy. Strategy makers have to pay attention to early warnings of future change and be willing to experiment with dare-to-be-different ways to establish a market position in that future. When obstacles appear unexpectedly in a company's path, it is up to management to adapt rapidly and innovatively. *Masterful strategies come from doing things differently from competitors where it counts—out-innovating them, being more efficient, being more imaginative, adapting faster—rather than running with the herd.* Good strategy making is therefore inseparable from good business entrepreneurship. One cannot exist without the other.

Strategy Making Involves Managers at All Organizational Levels

A company's senior executives obviously have lead strategy-making roles and responsibilities. The chief executive officer (CEO), as captain of the ship, carries the mantles of chief direction setter, chief objective setter, chief strategy maker, and chief strategy implementer for the total enterprise. Ultimate responsibility for *leading* the strategy-making, strategy-executing process rests with the CEO. And the CEO is always fully accountable for the results the strategy produces, whether good or bad. In some enterprises, the CEO or owner functions as chief architect of the strategy, personally deciding what the key elements of the company's strategy will be, although they may seek the advice of key subordinates and board members. A CEO-centered approach to strategy development is characteristic of small owner-managed companies and some large corporations that were founded by the present CEO or that have a CEO with strong strategic leadership skills. Mary Barra at General Motors, Mark Zuckerberg at Meta (formerly Facebook), Howard Schultz at Starbucks, Jeff Bezos at Amazon, Jack Ma of Alibaba, Warren Buffett at Berkshire Hathaway, and Marillyn Hewson at Lockheed Martin are examples of high-profile corporate CEOs who have wielded a heavy hand in shaping their company's strategy.

In most companies, crafting and executing strategy is a *collaborative team effort* in which every manager has a role for the area they head; it is rarely something that only high-level managers do.

In most corporations, however, strategy is the product of more than just the CEO's handiwork. Typically, other senior executives—business unit heads, the chief financial officer, and vice presidents for production, marketing, and other functional departments—have influential strategy-making roles and help fashion the chief strategy components. Normally, a company's chief financial officer is in charge of devising and implementing an appropriate financial strategy; the production vice president takes the lead in developing the company's production strategy; the marketing vice president orchestrates sales and marketing strategy; a brand manager is in charge of the strategy for a particular brand in the company's product lineup; and so on. Moreover, the strategy-making efforts of top managers are complemented by advice and counsel from the company's board of directors; normally, all major strategic decisions are submitted to the board of directors for review, discussion, perhaps modification, and official approval.

But strategy making is by no means solely a *top* management function, the exclusive province of owner-entrepreneurs, CEOs, high-ranking executives, and board members. The more a company's operations cut across different products, industries, and geographic areas, the more that headquarters executives have little option but to delegate considerable strategy-making authority to down-the-line managers in charge of particular subsidiaries, divisions, product lines, geographic sales offices, distribution centers, and plants. On-the-scene managers who oversee specific operating units can be reliably counted on to have more detailed command of the strategic issues for the particular operating unit under their supervision since they have more intimate knowledge of the prevailing market and competitive conditions, customer requirements and expectations, and all the other relevant aspects affecting the several strategic options available. Managers with day-to-day familiarity of, and authority over, a specific operating unit thus have a big edge over headquarters executives in making wise strategic choices for their unit. The result is that, in most of today's companies, crafting and executing strategy is a *collaborative team effort* in which *every company manager plays a strategy-making role*—ranging from minor to major—for the area they head.

The larger and more diverse the operations of an enterprise, the more points of strategic initiative it has and the more levels of management that have a significant strategy-making role.

Take, for example, a company like Berkshire Hathaway, a $276 billion global corporation with over 370,000 employees, and businesses that include insurance, apparel, jewelry, railroads, home furnishings, machinery, electrical power, and natural gas distribution. While top-level headquarters executives may well be personally involved in shaping Berkshire Hathaway's *overall* strategy and fashioning *important* strategic moves, they simply cannot know enough about the situation in every organizational unit to direct every strategic move made in the company's worldwide organization. Rather, it takes involvement on the part of the whole management team—top executives, business group heads, the heads of specific business units and product categories, and key managers in plants, sales offices, and distribution centers—to craft the thousands of strategic initiatives that end up composing the whole of Berkshire Hathaway's strategy.

A Company's Strategy-Making Hierarchy

In diversified companies like GE, where multiple and sometimes strikingly different businesses have to be managed, crafting a full-fledged strategy involves four distinct types of strategic actions and initiatives. Each of these involves different facets of the company's overall strategy and calls for the participation of different types of managers, as shown in Figure 2.2.

As shown in Figure 2.2, **corporate strategy** is orchestrated by the CEO and other senior executives and establishes an overall strategy for managing a *set of businesses* in a diversified, multibusiness company. Corporate strategy concerns how to improve the combined performance of the set of businesses the company has diversified into by capturing cross-business synergies and turning them into competitive advantage. It addresses the questions of what businesses to hold or divest, which new markets to enter, and how to best enter new markets (by acquisition, creation of a strategic alliance, or through internal development, for example). Corporate strategy and business diversification are the subjects of Chapter 8, in which they are discussed in detail.

CORE CONCEPT

Corporate strategy establishes an overall game plan for managing a *set of businesses* in a diversified, multibusiness company.

Business strategy is primarily concerned with strengthening the company's market position and building competitive advantage in a *single-business company* or in a *single business unit* of a diversified multibusiness corporation.

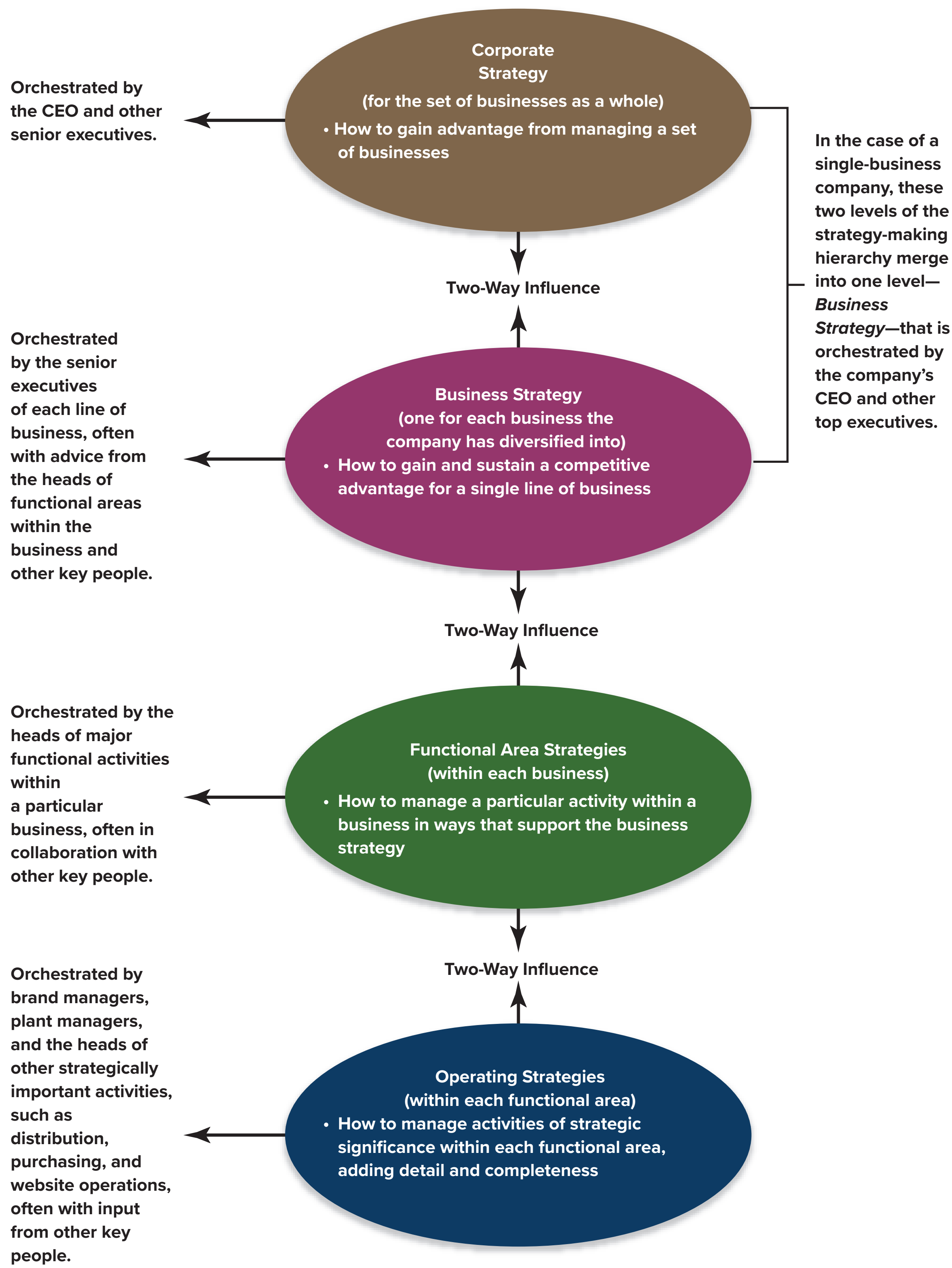
Business strategy is concerned with strengthening the market position, building competitive advantage, and improving the performance of a single line of business. Business strategy is primarily the responsibility of business unit heads, although corporate-level executives may well exert strong influence; in diversified companies it is not unusual for corporate officers to insist that business-level objectives and strategy conform to corporate-level objectives and strategy themes. The business head has at least two other strategy-related roles: (1) seeing that lower-level strategies are well conceived, consistent, and adequately matched to the overall business strategy; and (2) keeping corporate-level officers (and sometimes the board of directors) informed of emerging strategic issues.

Functional-area strategies concern the approaches employed in managing particular functions within a business—like research and development (R&D), production, procurement of inputs, sales and marketing, distribution, customer service, and finance. A company's marketing strategy, for example, represents the managerial game plan for running the sales and marketing part of the business. A company's product development strategy represents the game plan for keeping the company's product lineup in tune with what buyers are looking for.

Functional strategies flesh out the details of a company's business strategy. Lead responsibility for functional strategies within a business is normally delegated to the heads of the respective functions, with the general manager of the business having final approval. Since the different functional-level strategies must be compatible with the overall business strategy and with one another to have beneficial impact, there are times when the general business manager exerts strong influence on the content of the functional strategies.

Operating strategies concern the relatively narrow approaches for managing key operating units (e.g., plants, distribution centers, purchasing centers) and specific operating activities with strategic significance (e.g., quality control, materials purchasing, brand management, Internet sales). A plant manager needs a strategy for accomplishing the plant's objectives, carrying out the plant's part of the company's overall manufacturing game plan, and dealing with any strategy-related problems that exist at the plant. A company's advertising manager needs a strategy for getting maximum audience exposure and sales impact from the ad budget. Operating strategies, while of limited scope, add further detail and completeness to functional strategies and to

FIGURE 2.2 A Company's Strategy-Making Hierarchy



the overall business strategy. Lead responsibility for operating strategies is usually delegated to frontline managers, subject to the review and approval of higher-ranking managers.

A company's strategy is at full power only when its many pieces are united.

Even though operating strategy is at the bottom of the strategy-making hierarchy, its importance should not be downplayed. A major plant that fails in its strategy to achieve production volume, unit cost, and quality targets can damage the company's reputation for quality products and undercut the achievement of company sales and profit objectives. Frontline managers are thus an important part of an organization's strategy-making team. One cannot reliably judge the strategic importance of a given action simply by the strategy level or location within the managerial hierarchy where it is initiated.

In single-business companies, the uppermost level of the strategy-making hierarchy is the business strategy, so a single-business company has three levels of strategy: business strategy, functional-area strategies, and operating strategies. Proprietorships, partnerships, and owner-managed enterprises may have only one or two strategy-making levels since it takes only a few key people to craft and oversee the firm's strategy. The larger and more diverse the operations of an enterprise, the more points of strategic initiative it has and the more levels of management that have a significant strategy-making role.

Uniting the Strategy-Making Hierarchy

The components of a company's strategy up and down the strategy hierarchy should be cohesive and mutually reinforcing, fitting together like a jigsaw puzzle. *Anything less than a unified collection of strategies weakens the overall strategy and is likely to impair company performance.*[13] It is the responsibility of top executives to achieve this unity by clearly communicating the company's vision, mission, objectives, and major strategy components to down-the-line managers and key personnel. Midlevel and frontline managers cannot craft unified strategic moves without first understanding the company's long-term direction and knowing the major components of the corporate and/or business strategies that their strategy-making efforts are supposed to support and enhance. Thus, as a general rule, strategy making must start at the top of the organization, then proceed downward from the corporate level to the business level, and then from the business level to the associated functional and operating levels. Once strategies up and down the hierarchy have been created, lower-level strategies must be scrutinized for consistency with and support of higher-level strategies. Any strategy conflicts must be addressed and resolved, either by modifying the lower-level strategies with conflicting elements or by adapting the higher-level strategy to accommodate what may be more appealing strategy ideas and initiatives bubbling up from below.

A Strategic Vision + Mission + Objectives + Strategy = A Strategic Plan

CORE CONCEPT

A company's **strategic plan** lays out its direction, business model, competitive strategy, and performance targets for some specified period of time.

Developing a strategic vision and mission, setting objectives, and crafting a strategy are basic direction-setting tasks. They map out where a company is headed, delineate its strategic and financial targets, articulate the basic business model, and outline the competitive moves and operating approaches to be used in achieving the desired business results. Together, these elements constitute a **strategic plan** for coping with industry conditions, competing against rivals, meeting objectives, and making progress along the chosen strategic course.[14] Typically, a strategic plan includes a commitment to allocate resources to carrying out the plan and specifies a time period for achieving goals.

In companies that do regular strategy reviews and develop explicit strategic plans, the strategic plan usually ends up as a written document that is circulated to most managers. Near-term performance targets are the part of the strategic plan most often communicated to employees more generally and spelled out explicitly. A number of companies summarize key elements of their strategic plans in the company's annual report to shareholders, in postings on their websites, or in statements provided to the business media; others, perhaps for reasons of competitive sensitivity, make only vague, general statements about their strategic plans.[15] In small, privately owned companies it is rare for strategic plans to exist in written form. Small-company strategic plans tend to reside in the thinking and directives of owner-executives; aspects of the plan are revealed in conversations with company personnel about where to head, what to accomplish, and how to proceed.

STAGE 4: EXECUTING THE STRATEGY

LO 2-4

Recognize what a company must do to achieve operating excellence and to execute its strategy proficiently.

Managing the implementation of a strategy is easily the most demanding and time-consuming part of the strategic management process. Converting strategic plans into actions and results tests a manager's ability to direct organizational change, motivate company personnel, build and strengthen competitive capabilities, create and nurture a strategy-supportive work climate, and meet or beat performance targets. Initiatives to put the strategy in place and execute it proficiently must be launched and managed on many organizational fronts.

Management's action agenda for executing the chosen strategy emerges from assessing what the company will have to do to achieve the financial and strategic performance targets. Each company manager has to think through the answer to the question "What needs to be done in my area to execute my piece of the strategic plan, and what actions should I take to get the process under way?" How much internal change is needed depends on how much of the strategy is new, how far internal practices and competencies deviate from what the strategy requires, and how well the present work culture supports good strategy execution. Depending on the amount of internal change involved, full implementation and proficient execution of the company strategy (or important new pieces thereof) can take several months to several years.

In most situations, managing the strategy execution process includes the following principal aspects:

- Creating a strategy-supporting structure.
- Staffing the organization to obtain needed skills and expertise.
- Developing and strengthening strategy-supporting resources and capabilities.
- Allocating ample resources to the activities critical to strategic success.
- Ensuring that policies and procedures facilitate effective strategy execution.

- Organizing the work effort along the lines of best practice.
- Installing information and operating systems that enable company personnel to perform essential activities.
- Motivating people and tying rewards directly to the achievement of performance objectives.
- Creating a company culture conducive to successful strategy execution.
- Exerting the internal leadership needed to propel implementation forward.

Good strategy execution requires diligent pursuit of operating excellence. It is a job for a company's whole management team. Success hinges on the skills and cooperation of operating managers who can push for needed changes in their organizational units and consistently deliver good results. Management's handling of the strategy implementation process can be considered successful if things go smoothly enough that the company meets or beats its strategic and financial performance targets and shows good progress in achieving management's strategic vision. In Chapters 10, 11, and 12, we discuss the various aspects of the strategy implementation process more fully.

STAGE 5: EVALUATING PERFORMANCE AND INITIATING CORRECTIVE ADJUSTMENTS

The fifth component of the strategy management process—monitoring new external developments, evaluating the company's progress, and making corrective adjustments—is the trigger point for deciding whether to continue or change the company's vision and mission, objectives, strategy, business model, and/or strategy execution methods.[16] As long as the company's strategy continues to pass the three tests of a winning strategy discussed in Chapter 1 (good fit, competitive advantage, strong performance), company executives may decide to stay the course. Simply fine-tuning the strategic plan and continuing with efforts to improve strategy execution are sufficient.

But whenever a company encounters disruptive changes in its environment, questions need to be raised about the appropriateness of its direction and strategy. If a company experiences a downturn in its market position or persistent shortfalls in performance, then company managers are obligated to ferret out the causes—do they relate to poor strategy, poor strategy execution, or both?—and take timely corrective action. A company's direction, objectives, business model, and strategy have to be revisited anytime external or internal conditions warrant.

Likewise, managers are obligated to assess which of the company's operating methods and approaches to strategy execution merit continuation and which need improvement. Proficient strategy execution is always the product of much organizational learning. It is achieved unevenly—coming quickly in some areas and proving troublesome in others. Consequently, top-notch strategy execution entails vigilantly searching for ways to improve and then making corrective adjustments whenever and wherever it is useful to do so.

A company's vision, mission, objectives, strategy, and approach to strategy execution are never final; reviewing whether and when to make revisions is an ongoing process.

CORPORATE GOVERNANCE: THE ROLE OF THE BOARD OF DIRECTORS IN THE STRATEGY-CRAFTING, STRATEGY-EXECUTING PROCESS

LO 2-5

Comprehend the role and responsibility of a company's board of directors in overseeing the strategic management process.

Although senior managers have the *lead responsibility* for crafting and executing a company's strategy, it is the duty of a company's board of directors to exercise strong oversight and see that management performs the various tasks involved in each of the five stages of the strategy-making, strategy-executing process in a manner that best serves the interests of shareholders and other stakeholders, including the company's customers, employees, and the communities in which the company operates.[17] A company's board of directors has four important obligations to fulfill:

1. *Oversee the company's financial accounting and financial reporting practices.* While top executives, particularly the company's CEO and CFO (chief financial officer), are primarily responsible for seeing that the company's financial statements fairly and accurately report the results of the company's operations, board members have a *legal obligation* to warrant the accuracy of the company's financial reports and protect shareholders. It is their job to ensure that generally accepted accounting principles (GAAP) are used properly in preparing the company's financial statements and that proper financial controls are in place to prevent fraud and misuse of funds. Virtually all boards of directors have an audit committee, always composed entirely of *outside directors* (*inside directors* hold management positions in the company and either directly or indirectly report to the CEO). The members of the audit committee have the lead responsibility for overseeing the decisions of the company's financial officers and consulting with both internal and external auditors to ensure accurate financial reporting and adequate financial controls.
2. *Critically appraise the company's direction, strategy, and business approaches.* Board members are also expected to guide management in choosing a strategic direction and to make independent judgments about the validity and wisdom of management's proposed strategic actions. This aspect of their duties takes on heightened importance when the company's strategy is failing or is plagued with faulty execution, and certainly when there is a precipitous collapse in profitability. But under more normal circumstances, many boards have found that meeting agendas become consumed by compliance matters with little time left to discuss matters of strategic importance. The board of directors and management at Philips Electronics hold annual two- to three-day retreats devoted exclusively to evaluating the company's long-term direction and various strategic proposals. The company's exit from the semiconductor business and its increased focus on medical technology and home health care resulted from management-board discussions during such retreats.[18]
3. *Evaluate the caliber of senior executives' strategic leadership skills.* The board is always responsible for determining whether the current CEO is doing a good job of strategic leadership (as a basis for awarding salary increases and bonuses and deciding on retention or removal).[19] Boards must also exercise due diligence in evaluating the strategic leadership skills of other senior executives in line to succeed the CEO. When the incumbent CEO steps down or leaves for a position elsewhere, the board must elect a successor, either going with an insider or deciding that an outsider is needed to perhaps radically change the company's strategic course. Often, the outside directors on a board visit company facilities and talk with company personnel

personally to evaluate whether the strategy is on track, how well the strategy is being executed, and how well issues and problems are being addressed by various managers. For example, independent board members at GE visit operating executives at each major business unit once a year to assess the company's talent pool and stay abreast of emerging strategic and operating issues affecting the company's divisions. Home Depot board members visit a store once per quarter to determine the health of the company's operations.[20]

4. *Institute a compensation plan for top executives that rewards them for actions and results that serve stakeholder interests, and most especially those of shareholders.* A basic principle of corporate governance is that the owners of a corporation (the shareholders) delegate operating authority and managerial control to top management in return for compensation. In their role as *agents* of shareholders, top executives have a clear and unequivocal duty to make decisions and operate the company in accord with shareholder interests. (This does not mean disregarding the interests of other stakeholders—employees, suppliers, the communities in which the company operates, and society at large.) Most boards of directors have a compensation committee, composed entirely of directors from *outside* the company, to develop a salary and incentive compensation plan that rewards senior executives for boosting the company's *long-term* performance on behalf of shareholders. The compensation committee's recommendations are presented to the full board for approval. But during the past 10 years, many boards of directors have done a poor job of ensuring that executive salary increases, bonuses, and stock option awards are tied tightly to performance measures that are truly in the long-term interests of shareholders. Rather, compensation packages at many companies have increasingly rewarded executives for short-term performance improvements—most notably, for achieving quarterly and annual earnings targets and boosting the stock price by specified percentages. This has had the perverse effect of causing company managers to become preoccupied with actions to improve a company's near-term performance, often motivating them to take unwise business risks to boost short-term earnings by amounts sufficient to qualify for multimillion-dollar compensation packages (that many see as obscenely large). The focus on short-term performance has proved damaging to long-term company performance and shareholder interests—witness the huge loss of shareholder wealth that occurred at many financial institutions during the banking crisis of 2008–2009 because of executive risk-taking in subprime loans, credit default swaps, and collateralized mortgage securities. As a consequence, the need to overhaul and reform executive compensation has become a hot topic in both public circles and corporate boardrooms. Illustration Capsule 2.4 discusses how weak governance at Volkswagen contributed to the 2015 emissions cheating scandal, which cost the company billions of dollars and the trust of its stakeholders.

CORE CONCEPT

A company's **stakeholders** include its stockholders, employees, suppliers, the communities in which the company operates, and society at large.

Every corporation should have a strong independent board of directors that (1) is well informed about the company's performance, (2) guides and judges the CEO and other top executives, (3) has the courage to curb management actions the board believes are inappropriate or unduly risky, (4) certifies to shareholders that the CEO is doing what the board expects, (5) provides insight and advice to management, and (6) is intensely involved in debating the pros and cons of key decisions and actions.[21] Boards of directors that lack the backbone to challenge a strong-willed or "imperial" CEO or that rubber-stamp almost anything the CEO recommends without probing inquiry and debate abdicate their fiduciary duty to represent and protect shareholder interests.

Effective corporate governance requires the board of directors to oversee the company's strategic direction, evaluate its senior executives, handle executive compensation, and oversee financial reporting practices.

ILLUSTRATION CAPSULE 2.4 Corporate Governance Failures at Volkswagen

In 2015, Volkswagen admitted to installing "defeat devices" on at least 11 million vehicles with diesel engines. These devices enabled the cars to pass emission tests, even though the engines actually emitted pollutants up to 40 times above what is allowed in the United States. Current estimates are that it will cost the company at least €7 billion to cover the cost of repairs and lawsuits. Although management must have been involved in approving the use of cheating devices, the Volkswagen supervisory board has been unwilling to accept any responsibility. Some board members even questioned whether it was the board's responsibility to be aware of such problems, stating "matters of technical expertise were not for us" and "the scandal had nothing, not one iota, to do with the advisory board." Yet governing boards do have a responsibility to be well informed, to provide oversight, and to become involved in key decisions and actions. So what caused this corporate governance failure? Why is this the third time in the past 20 years that Volkswagen has been embroiled in scandal?

The key feature of Volkswagen's board that appears to have led to these issues is a lack of independent directors. However, before explaining this in more detail it is important to understand the German governance model. German corporations operate two-tier governance structures, with a management board, and a separate supervisory board that does not contain any current executives. In addition, German law requires large companies to have at least 50 percent supervisory board representation from workers. This structure is meant to provide more oversight by independent board members and greater involvement by a wider set of stakeholders.

In Volkswagen's case, these objectives have been effectively circumvented. Although Volkswagen's supervisory board does not include any current management, the chairmanship appears to be a revolving door of former senior executives. Ferdinand Piëch, the chair during the scandal, was CEO for 9 years prior to becoming chair in 2002. Martin Winterkorn, the recently ousted CEO, was expected to become

Vytautas Kielaitis/Shutterstock

supervisory board chair prior to the scandal. The company continues to elevate management to the supervisory board even though they have presided over past scandals. Hans Dieter Poetsch, the newly appointed chair, was part of the management team that did not inform the supervisory board of the EPA investigation for two weeks.

VW also has a unique ownership structure where a single family, Porsche, controls more than 50 percent of voting shares. Piëch, a family member and chair until 2015, forced out CEOs and installed unqualified family members on the board, such as his former nanny and current wife. He also pushed out independent-minded board members, such as Gerhard Cromme, author of Germany's corporate governance code. The company has lost numerous independent directors over the past 10 years, leaving it with only one non-shareholder, non-labor representative. Although Piëch has now been removed, it is unclear that Volkswagen's board has solved the underlying problem. In 2022, the General Court of the European Commission upheld fines of nearly €1 billion for price-fixing and emissions rules violations by its Scania commercial truck division. Shareholders have seen billions of dollars wiped away and the Volkswagen brand tarnished. As long as the board continues to lack independent directors, change will likely be slow.

Note: Developed with Jacob M. Crandall.

Source: https://www.bloomberg.com/news/articles/2022-02-02/vw-s-scania-loses-fight-over-994-million-eu-antitrust-fine#xj4y7vzkg

KEY POINTS

The strategic management process consists of five interrelated and integrated stages:

1. *Developing a strategic vision* of the company's future, a *mission statement* that defines the company's current purpose, and a set of *core values* to guide the pursuit of the vision and mission. This stage of strategy making provides direction for the company, motivates and inspires company personnel, aligns and guides actions throughout the organization, and communicates to stakeholders management's aspirations for the company's future.
2. *Setting objectives* to convert the vision and mission into performance targets that can be used as yardsticks for measuring the company's performance. Objectives need to spell out *how much* of *what kind* of performance *by when.* Two broad types of objectives are required: *financial objectives* and *strategic objectives.* A *balanced scorecard* approach for measuring company performance entails setting both financial objectives and strategic objectives. *Stretch objectives* can spur exceptional performance and help build a firewall against complacency and mediocre performance. Extreme stretch objectives, however, are only warranted in limited circumstances.
3. *Crafting a strategy* to achieve the objectives and move the company along the strategic course that management has charted. A single business enterprise has three levels of strategy—business strategy for the company as a whole, functional-area strategies (e.g., marketing, R&D, logistics), and operating strategies (for key operating units, such as manufacturing plants). In diversified, multibusiness companies, the strategy-making task involves four distinct types or levels of strategy: corporate strategy for the company as a whole, business strategy (one for each business the company has diversified into), functional-area strategies within each business, and operating strategies. Thus, strategy making is an inclusive collaborative activity involving not only senior company executives but also the heads of major business divisions, functional-area managers, and operating managers on the frontlines.
4. *Executing the chosen strategy* and converting the strategic plan into action. Management's agenda for executing the chosen strategy emerges from assessing what the company will have to do to achieve the targeted financial and strategic performance. Management's handling of the strategy implementation process can be considered successful if things go smoothly enough that the company meets or beats its strategic and financial performance targets and shows good progress in achieving management's strategic vision.
5. *Monitoring developments, evaluating performance, and initiating corrective adjustments* in light of actual experience, changing conditions, new ideas, and new opportunities. This stage of the strategy management process is the trigger point for deciding whether to continue or change the company's vision and mission, objectives, business model strategy, and/or strategy execution methods.

The sum of a company's strategic vision, mission, objectives, and strategy constitutes a *strategic plan* for coping with industry conditions, outcompeting rivals, meeting objectives, and making progress toward aspirational goals.

Boards of directors have a duty to shareholders as well as other stakeholders to play a vigilant role in overseeing management's handling of a company's strategy-making, strategy-executing process. This entails four important obligations: (1) Ensure that the company issues accurate financial reports and has adequate financial controls;

(2) critically appraise the company's direction, strategy, and strategy execution; (3) evaluate the caliber of senior executives' strategic leadership skills; and (4) institute a compensation plan for top executives that rewards them for actions and results that serve stakeholder interests, most especially those of shareholders.

ASSURANCE OF LEARNING EXERCISES

connect
LO 2-1

1. Using the information in Table 2.2, critique the adequacy and merit of the following vision statements, listing effective elements and shortcomings. Rank the vision statements from best to worst once you complete your evaluation.

VISION STATEMENT	Effective Elements	Shortcomings
American Express		
• We work hard every day to make American Express the world's most respected service brand.		
Hilton Hotels Corporation		
Our vision is to be the first choice of the world's travelers. Hilton intends to build on the rich heritage and strength of our brands by • Consistently delighting our customers • Investing in our team members • Delivering innovative products and services • Continuously improving performance • Increasing shareholder value • Creating a culture of pride • Strengthening the loyalty of our constituents		
MasterCard		
• A world beyond cash.		
BASF		
We are "The Chemical Company" successfully operating in all major markets. • Our customers view BASF as their partner of choice. • Our innovative products, intelligent solutions and services make us the most competent worldwide supplier in the chemical industry. • We generate a high return on assets. • We strive for sustainable development. • We welcome change as an opportunity. • We, the employees of BASF, together ensure our success.		

Sources: Company websites and annual reports.

LO 2-2

2. Go to the company investor relations websites for Starbucks (**investor.starbucks.com**), Pfizer (**www.pfizer.com/investors**), and Salesforce (**investor.salesforce.com**) to find examples of strategic and financial objectives. List four

objectives for each company and indicate which of these are strategic and which are financial.

3. Go to the investor relations website for Walmart (**http://stock.walmart.com**) and review past presentations Walmart has made during various investor conferences by clicking on the Events option in the navigation bar. Prepare a one- to two-page report that outlines what Walmart has said to investors about its approach to strategy execution. Specifically, what has management discussed concerning staffing, resource allocation, policies and procedures, information and operating systems, continuous improvement, rewards and incentives, corporate culture, and internal leadership at the company? **LO 2-4**

4. Based on the information provided in Illustration Capsule 2.4, describe the ways in which Volkswagen did not fulfill the requirements of effective corporate governance. In what ways did the board of directors sidestep its obligations to protect shareholder interests? How could Volkswagen better select its board of directors to avoid mistakes such as the emissions scandal? Mc Graw Hill connect **LO 2-5**

EXERCISES FOR SIMULATION PARTICIPANTS

Mc Graw Hill connect

1. Which of the five stages of the strategy formulation, strategy execution process apply to your company in the simulation? **LO 2-5**
2. Meet with your co-managers and prepare a strategic vision statement for your company. It should be at least one sentence long and no longer than a brief paragraph. When you are finished, check to see if your vision statement meets the conditions for an effectively worded strategic vision set forth in Table 2.2. If not, then revise it accordingly. What would be a good slogan that captures the essence of your strategic vision and that could be used to help communicate the vision to company personnel, shareholders, and other stakeholders? **LO 2-1**
3. What are your company's financial objectives? What are your company's strategic objectives? **LO 2-2**
4. What are the three to four key elements of your company's strategy? **LO 2-3**
5. The strategy execution process for your company in the business simulation includes which principle aspects? **LO 2-4**

ENDNOTES

[1] Gordon Shaw, Robert Brown, and Philip Bromiley, "Strategic Stories: How 3M Is Rewriting Business Planning," *Harvard Business Review* 76, no. 3 (May–June 1998); David J. Collis and Michael G. Rukstad, "Can You Say What Your Strategy Is?" *Harvard Business Review* 86, no. 4 (April 2008), pp. 82–90.

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chapter 3

Evaluating a Company's External Environment

Learning Objectives

After reading this chapter, you should be able to

LO 3-1 Recognize the factors in a company's broad macro-environment that may have strategic significance.

LO 3-2 Recognize the factors that cause competition in an industry to be fierce, more or less normal, or relatively weak.

LO 3-3 Map the market positions of key groups of industry rivals.

LO 3-4 Determine whether an industry's outlook presents a company with sufficiently attractive opportunities for growth and profitability.

Fanatic Studio/Getty Images

No matter what it takes, the goal of *strategy* is to beat the competition.

Kenichi Ohmae—*Consultant and author*

Companies that solely focus on competition will die. Those that focus on value creation will thrive.

Edward de Bono—*Consultant and author*

It's critical for companies to adapt their strategies to an evolving external environment.

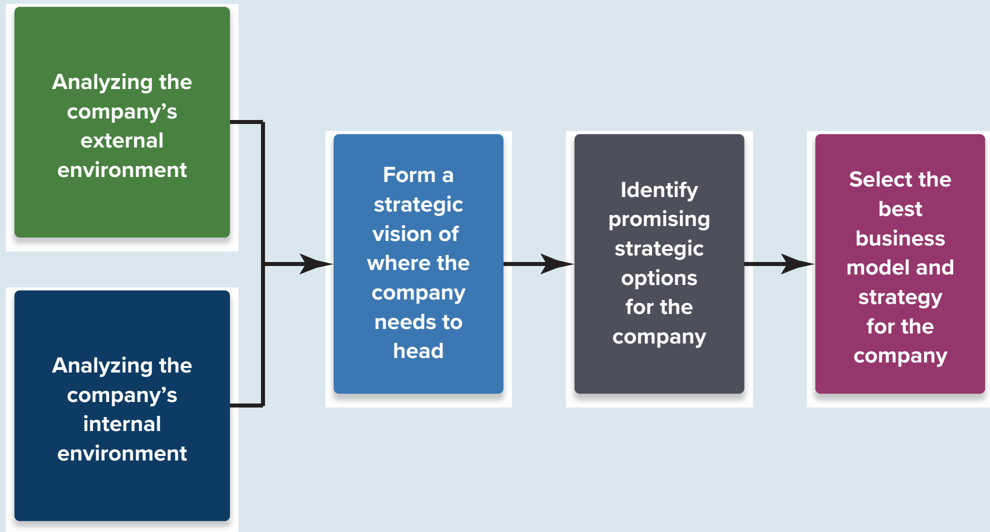
Amanda Wagner—*CEO of Immunitas Therapeutics*

In Chapter 2, we learned that the strategy formulation, strategy execution process begins with an appraisal of the company's present situation. Two facets of a company's situation are especially pertinent: (1) its external environment—most notably, the competitive conditions of the industry in which the company operates; and (2) its internal environment—particularly the company's resources and organizational capabilities.

Insightful diagnosis of a company's external and internal environments is a prerequisite for managers to succeed in crafting a strategy that is an excellent *fit* with the company's situation—the first test of a winning strategy. As depicted in Figure 3.1, strategic thinking begins with an appraisal of the company's external and internal environments (as a basis for deciding on a long-term direction and developing a strategic vision). It then moves toward an evaluation of the most promising alternative business models and strategies and finally culminates in choosing a specific strategy.

This chapter presents the concepts and analytic tools for zeroing in on those aspects of a company's external environment that should be considered in making strategic choices. Attention centers on the broad environmental context, the specific market arena in which a company operates, the drivers of change, the positions and likely actions of rival companies, and key success factors. In Chapter 4, we explore the methods of evaluating a company's internal circumstances and competitive capabilities.

FIGURE 3.1 From Analyzing the Company's Situation to Choosing a Strategy



ASSESSING THE COMPANY'S INDUSTRY AND COMPETITIVE ENVIRONMENT

Thinking strategically about a company's industry and competitive environment entails using some well-validated concepts and analytical tools to get clear answers to seven questions:

1. Do macro-environmental factors and industry characteristics offer sellers opportunities for growth and attractive profits?
2. What kinds of competitive forces are industry members facing, and how strong is each force?
3. What forces are driving industry change, and what impact will these changes have on competitive intensity and industry profitability?
4. What market positions do industry rivals occupy—who is strongly positioned and who is not?
5. What strategic moves are rivals likely to make next?
6. What are the key factors of competitive success?
7. Does the industry outlook offer good prospects for profitability?

Analysis-based answers to these questions are prerequisites for a strategy offering good fit with the external situation. The remainder of this chapter is devoted to describing the methods of obtaining solid answers to these seven questions.

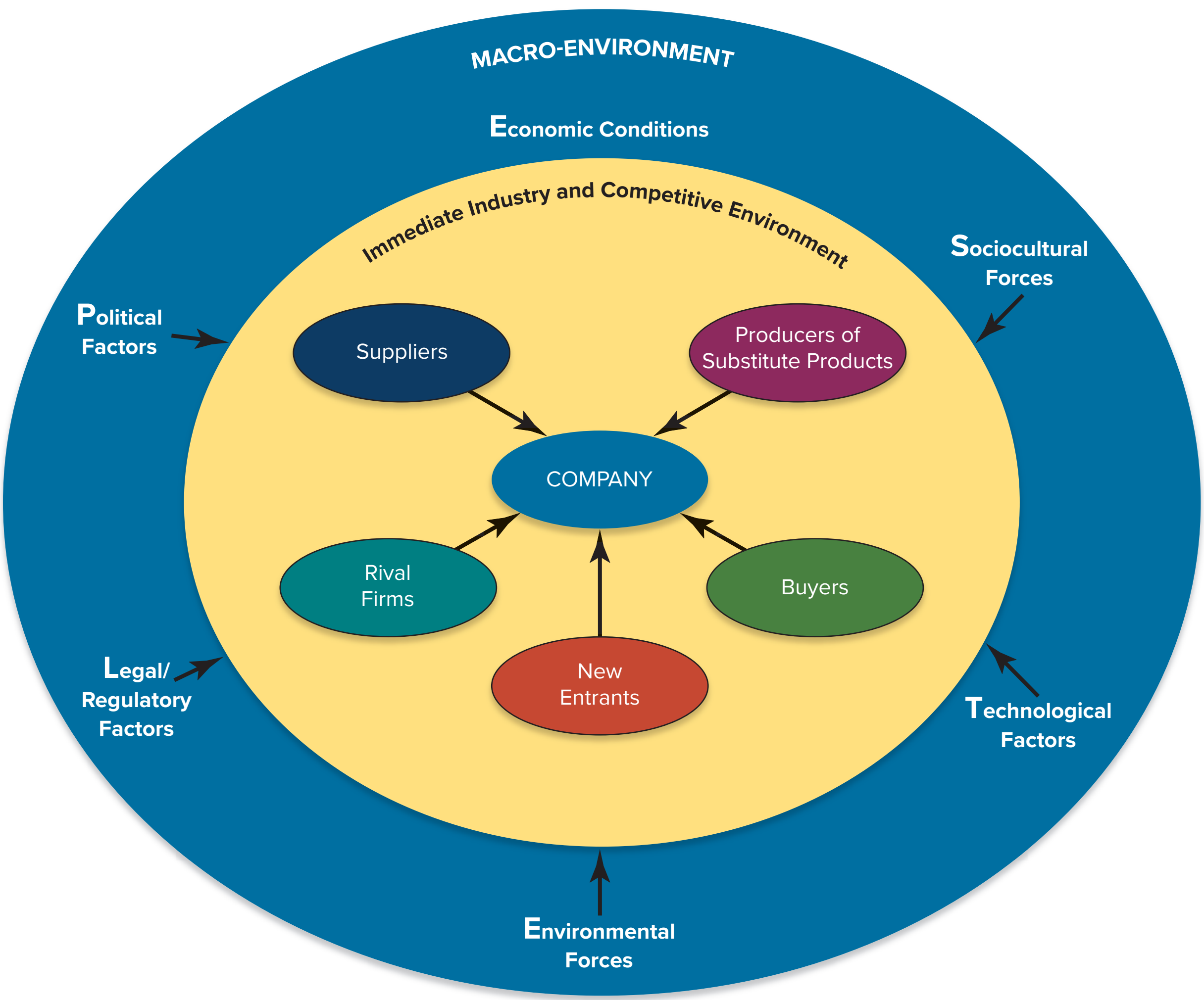
ANALYZING THE COMPANY'S MACRO-ENVIRONMENT

LO 3-1

Recognize the factors in a -company's broad macro-environment that may have strategic significance.

A company's external environment includes the immediate industry and competitive environment and a broader "macro-environment" (see Figure 3.2). This macro-environment comprises six principal components: political factors; economic conditions in the firm's general environment (local, country, regional, worldwide); sociocultural forces; technological factors; environmental factors (concerning the natural environment); and legal/regulatory conditions. Each of these components has the potential to affect the firm's more immediate industry and competitive environment, although some are likely to have a more important effect than others. An analysis of the impact of these factors is often referred to as **PESTEL analysis,** an acronym that serves as a reminder of the six components involved (Political, Economic, Sociocultural, Technological, Environmental, Legal/regulatory).

FIGURE 3.2 The Components of a Company's Macro-Environment



Since macro-economic factors affect different industries in different ways and to different degrees, it is important for managers to determine which of these represent the most *strategically relevant factors* outside the firm's industry boundaries. By *strategically relevant,* we mean important enough to have a bearing on the decisions the company ultimately makes about its long-term direction, objectives, strategy, and business model. The impact of the outer-ring factors depicted in Figure 3.2 on a company's choice of strategy can range from big to small. Those factors that are likely to have a bigger impact deserve the closest attention. But even factors that have a low impact on the company's business situation merit a watchful eye since their level of impact may change.

CORE CONCEPT

The **macro-environment** encompasses the broad environmental context in which a company's industry is situated.

For example, when stringent new federal banking regulations are announced, banks must rapidly adapt their strategies and lending practices to be in compliance. Cigarette producers must adapt to new antismoking ordinances, the decisions of governments to impose higher cigarette taxes, the growing cultural stigma attached to smoking and newly emerging e-cigarette technology. The homebuilding industry is affected by such macro-influences as trends in household incomes and buying power, rules and regulations that make it easier or harder for homebuyers to obtain mortgages, changes in mortgage interest rates, shifting preferences of families for renting versus owning a home, and shifts in buyer preferences for homes of various sizes, styles, and price ranges. Companies in the food processing, restaurant, sports, and fitness industries have to pay special attention to changes in lifestyles, eating habits, leisure-time preferences, and attitudes toward nutrition and fitness in fashioning their strategies. Table 3.1 provides a brief description of the components of the macro-environment and some examples of the industries or business situations that they might affect.

CORE CONCEPT

PESTEL analysis can be used to assess the strategic relevance of the six principal components of the macro-environment: **P**olitical, **E**conomic, **S**ocial, **T**echnological, **E**nvironmental, and **L**egal/Regulatory forces.

TABLE 3.1 The Six Components of the Macro-Environment

Component	Description
Political factors	These factors include political policies and processes, including the extent to which a government intervenes in the economy. They include such matters as tax policy, fiscal policy, tariffs, the political climate, and the strength of institutions such as the federal banking system. Some political factors, such as bailouts, are industry-specific. Others, such as energy policy, affect certain types of industries (energy producers and heavy users of energy) more than others.
Economic conditions	Economic conditions include the general economic climate and specific factors such as interest rates, exchange rates, the inflation rate, the unemployment rate, the rate of economic growth, trade deficits or surpluses, savings rates, and per-capita domestic product. Some industries, such as construction, are particularly vulnerable to economic downturns but are positively affected by factors such as low interest rates. Others, such as discount retailing, benefit when general economic conditions weaken, as consumers become more price-conscious.
Sociocultural forces	Sociocultural forces include the societal values, attitudes, cultural influences, and lifestyles that impact demand for particular goods and services, as well as demographic factors such as the population size, growth rate, and age distribution. Sociocultural forces vary by locale and change over time. An example is the trend toward healthier lifestyles, which can shift spending toward exercise equipment and health clubs and away from alcohol and snack foods. The demographic effect of people living longer is having a huge impact on the health care, nursing homes, travel, hospitality, and entertainment industries.

(continued)

TABLE 3.1 *(continued)*

Component	Description
Technological factors	Technological factors include the pace of technological change and technical developments that have the potential for wide-ranging effects on society, such as genetic engineering, nanotechnology, and solar energy technology. They include institutions involved in creating new knowledge and controlling the use of technology, such as R&D consortia, university-sponsored technology incubators, patent and copyright laws, and government control over the Internet. Technological change can encourage the birth of new industries, such as drones, virtual reality technology, and connected wearable devices. They can disrupt others, as cloud computing, 3-D printing, and big data solution have done, and they can render other industries obsolete (film cameras, music CDs).
Environmental forces	These include ecological and environmental forces such as weather, climate, climate change, and associated factors like flooding, fire, and water shortages. These factors can directly impact industries such as insurance, farming, energy production, and tourism. They may have an indirect but substantial effect on other industries such as transportation and utilities. The relevance of environmental considerations stems from the fact that some industries contribute more significantly than others to air and water pollution or to the depletion of irreplaceable natural resources, or to inefficient energy/resource usage, or are closely associated with other types of environmentally damaging activities (unsustainable agricultural practices, the creation of waste products that are not recyclable or biodegradable). Growing numbers of companies worldwide, in response to stricter environmental regulations and also to mounting public concerns about the environment, are implementing actions to operate in a more environmentally and ecologically responsible manner.
Legal and regulatory factors	These factors include the regulations and laws with which companies must comply, such as consumer laws, labor laws, antitrust laws, and occupational health and safety regulation. Some factors, such as financial services regulation, are industry-specific. Others affect certain types of industries more than others. For example, minimum wage legislation largely impacts low-wage industries (such as nursing homes and fast food restaurants) that employ substantial numbers of relatively unskilled workers. Companies in coal-mining, meat-packing, and steel-making, where many jobs are hazardous or carry high risk of injury, are much more impacted by occupational safety regulations than are companies in industries such as retailing or software programming.

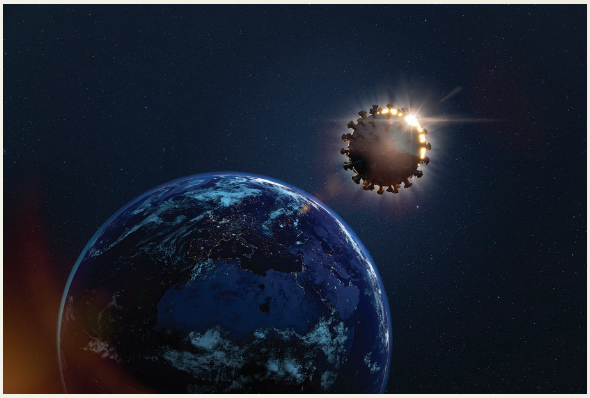
As the events surrounding the coronavirus pandemic of 2020 made abundantly clear, there is a class of macro-level external factors that is not included as part of PESTEL analysis. This is the set of factors that occurs more irregularly and unpredictably, unlike the categories within PESTEL that can be expected to affect firms in an ongoing and more foreseeable manner. This additional set of factors can be thought of as **societal shocks** to the macro-environment; they include terrorism (whether by domestic or foreign agents), civil war, foreign invasion or occupation, and epidemics and pandemics. Societal shocks such as these also affect different industries and companies to varying degrees, but they are much harder for companies to anticipate and prepare for since they often begin with little warning. Those companies that possess organizational agility and *dynamics capabilities*, as discussed in the next chapter, are invariably in the best position to weather such shocks. Illustration Capsule 3.1 illustrates how a societal in the form of the coronavirus pandemic of 2020 affected industries, businesses, geographies, and countries worldwide.

ILLUSTRATION CAPSULE 3.1 Macro-Environmental Changes Resulting from the COVID-19 Pandemic

The COVID-19 pandemic created devastating effects on the lives of people throughout the world and the global economy. As of January 2023, nearly 675 million COVID-19 Coronavirus cases had been recorded worldwide and more than 6.7 million deaths across the world had been linked to COVID-19. The pandemic also impacted employment and company performance in most economic sectors.

Emerging markets were impacted as international investment dried up, tourism collapsed, and demand for commodities fell. Developed markets and wealthy nations were not immune from dire consequences, although different sectors and industries were affected to varying degrees. In the United States, the hospitality and transportation industries were hard hit, along with retail, oil and gas, live sports, and other forms of entertainment. Small businesses and low-margin industries, with little ability to weather a significant downturn, were particularly vulnerable. Some industries, such as health care, online retail, and delivery services found themselves facing demand in excess of their capabilities, especially in light of supply chain breakdowns. The United Nations reported that the COVID-19 pandemic pushed global unemployment to over 200 million by 2022.

While global employment has begun to recover rapidly and the number of new cases and hospitalizations have declined significantly, the COVID-19 pandemic has produced lasting changes to the macro-environment. The economies of many countries have been impacted with high rates of inflation, interest rate hikes, and overall sluggish demand in products and services. Also, technology has become more prominent in the workplace with almost every type of employer embracing videoconferencing, remote working arrangements, and online selling. For example, online shopping was growing in popularity prior to 2020, but COVID-19 shifted the purchasing preferences of a large percentage of consumers to online retailing and home delivery for types of products ranging from apparel to groceries. The convenience-driven preference of consumers for online shopping is reflected in the preference of many employees for remote working. By mid-2023, many companies had permanently shifted some types of jobs to 100 percent remote. Other companies were struggling on how best to motivate employees to return to company offices.



Viaframe/Corbis/Getty Images

The companies that have thrived in the post-pandemic macro-environment have tended to possess strong organizational agility skills related to the management of resources and personnel and to their relationships with customers and supply chain partners.

Sources: COVID-19 Coronavirus Pandemic: Cases, Deaths, and Recovered," *Worldometer,* COVID Live - Coronavirus Statistics - Worldometer (worldometers.info), accessed January 30, 2023; "COVID crisis to push global unemployment over 200 million mark in 2022," *United Nations News,* COVID crisis to push global unemployment over 200 million mark in 2022. UN News, access January 30, 2023.

As company managers scan the external environment, they must be alert for potentially important outer-ring developments (whether in the form of societal shocks or among the components of PESTEL analysis), assess their impact and influence, and adapt the company's direction and strategy as needed. However, the factors in a company's environment having the *greatest* strategy-shaping impact typically pertain to the company's immediate industry and competitive environment. Consequently, it is on a company's industry and competitive environment (depicted in the center of Figure 3.2) that we concentrate the bulk of our attention in this chapter.

ASSESSING THE COMPANY'S INDUSTRY AND COMPETITIVE ENVIRONMENT

LO 3-2

Recognize the factors that cause competition in an industry to be fierce, more or less normal, or relatively weak.

After gaining an understanding of the industry's general economic characteristics, attention should be focused on the competitive dynamics of the industry. This entails using some well-validated concepts and analytic tools. These include the five forces framework, the value net, driving forces, strategic groups, competitor analysis, and key success factors. Proper use of these analytic tools can provide managers with the understanding needed to craft a strategy that fits the company's situation within their industry environment. The remainder of this chapter is devoted to describing how managers can use these tools to inform and improve their strategic choices.

The Five Forces Framework

The character and strength of the competitive forces operating in an industry are never the same from one industry to another. The most powerful and widely used tool for diagnosing the principal competitive pressures in a market is the *five forces framework*.[1] This framework, depicted in Figure 3.3, holds that competitive pressures on companies within an industry come from five sources. These include (1) competition from *rival sellers,* (2) competition from *potential new entrants* to the industry, (3) competition from producers of *substitute products,* (4) *supplier* bargaining power, and (5) *customer* bargaining power.

Using the five forces model to determine the nature and strength of competitive pressures in a given industry involves three steps:

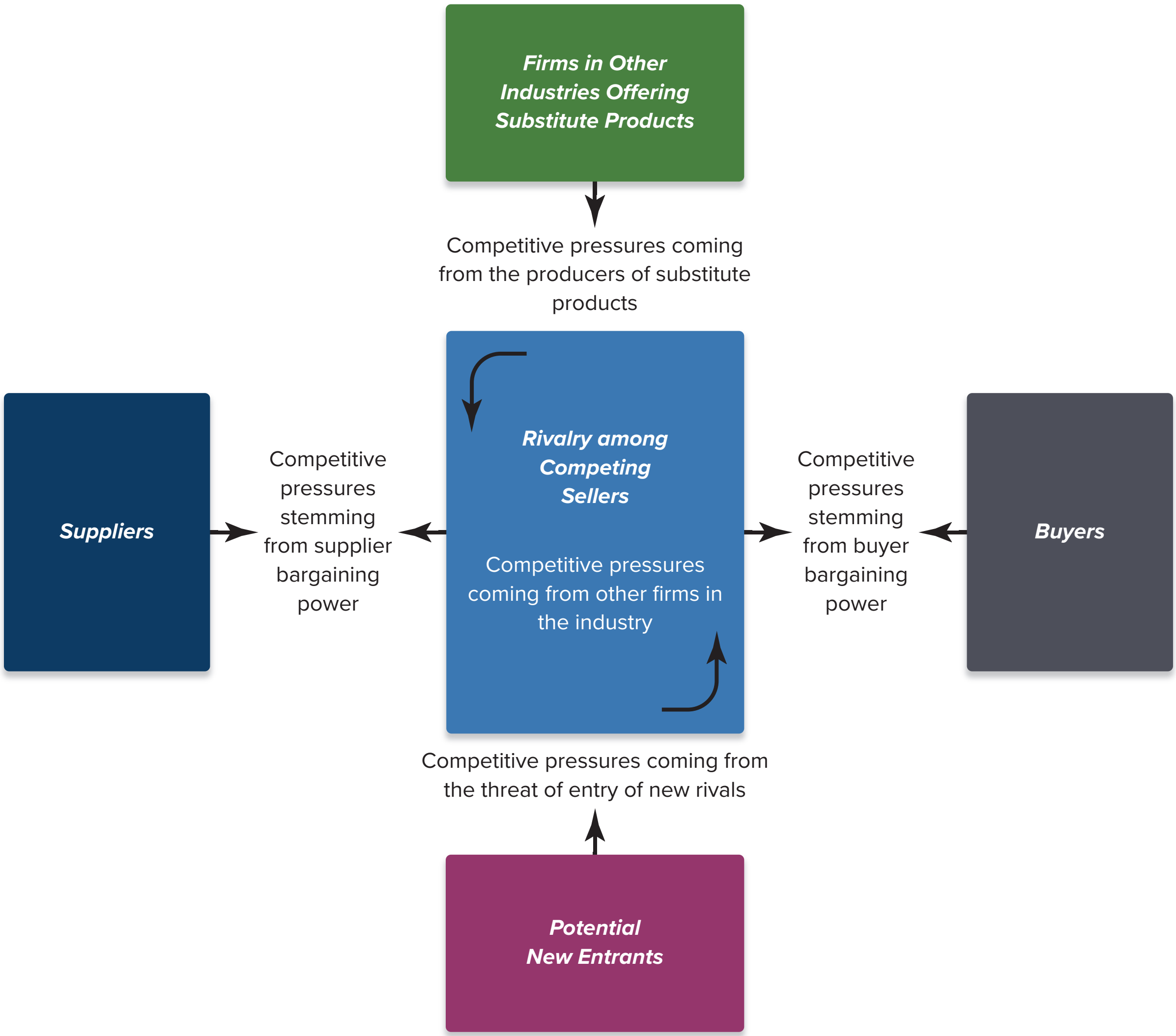
- *Step 1:* For each of the five forces, identify the different parties involved, along with the specific factors that bring about competitive pressures.
- *Step 2:* Evaluate how strong the pressures stemming from each of the five forces are (strong, moderate, or weak).
- *Step 3:* Determine whether the five forces, overall, are supportive of high industry profitability.

Competitive Pressures Created by the Rivalry among Competing Sellers

The strongest of the five competitive forces is often the rivalry for buyer patronage among competing sellers of a product or service. The intensity of rivalry among competing sellers within an industry depends on a number of identifiable factors. Figure 3.4 summarizes these factors, identifying those that intensify or weaken rivalry among direct competitors in an industry. A brief explanation of why these factors affect the degree of rivalry is in order:

- *Rivalry increases when buyer demand is growing slowly or declining.* Rapidly expanding buyer demand produces enough new business for all industry members to grow without having to draw customers away from rival enterprises. But in markets where buyer demand is slow-growing or shrinking, companies eager to gain more business are likely to engage in aggressive price discounting, sales promotions, and other tactics to increase their sales volumes at the expense of rivals, sometimes to the point of igniting a fierce battle for market share.

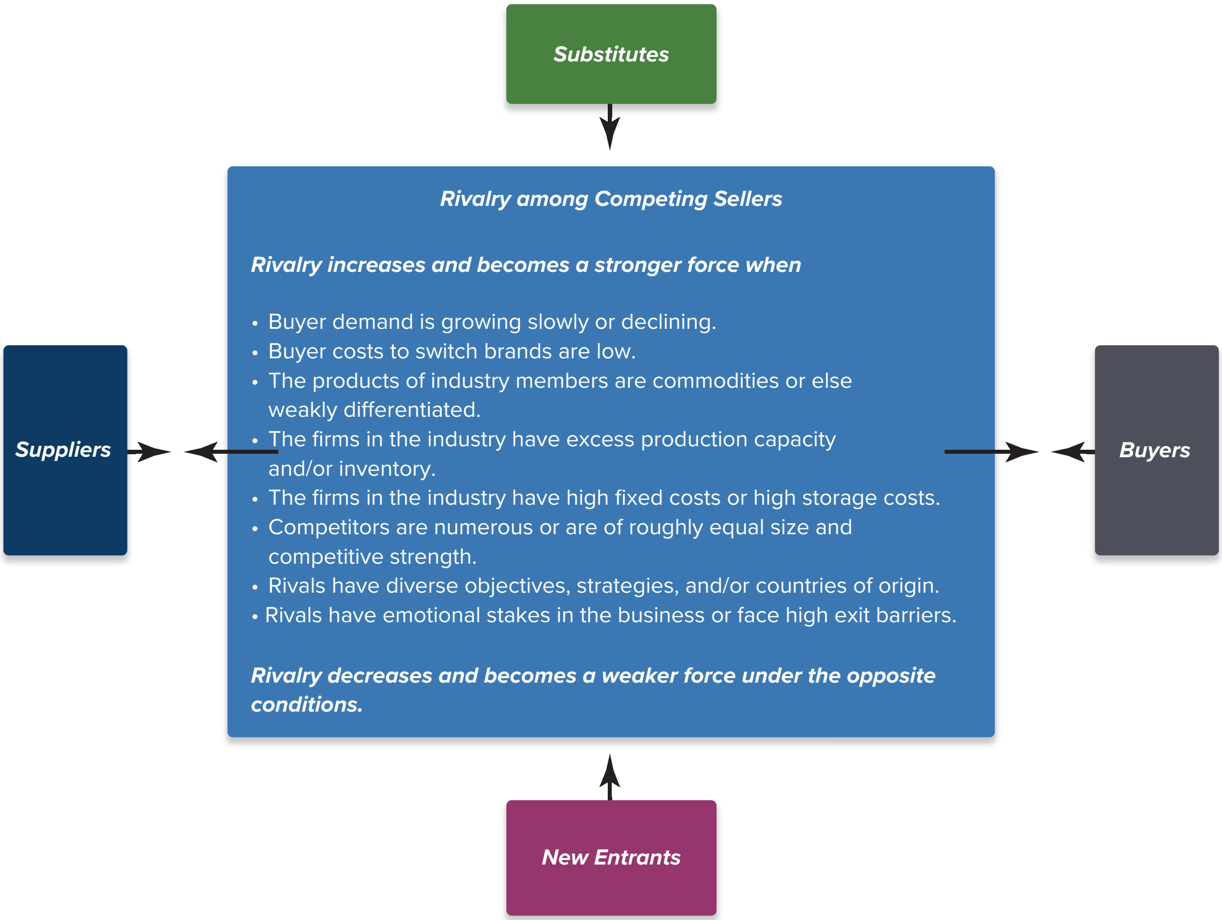
FIGURE 3.3 The Five Forces Model of Competition: A Key Analytic Tool



Sources: Adapted from M. E. Porter, "How Competitive Forces Shape Strategy," *Harvard Business Review* 57, no. 2 (1979), pp. 137–145; M. E. Porter, "The Five Competitive Forces That Shape Strategy," *Harvard Business Review* 86, no. 1 (2008), pp. 80–86.

- *Rivalry increases as it becomes less costly for buyers to switch brands.* The less costly (or easier) it is for buyers to switch their purchases from one seller to another, the easier it is for sellers to steal customers away from rivals. When the cost of switching brands is higher, buyers are less prone to brand switching and sellers have protection from rivalrous moves. Switching costs include not only monetary costs but also the time, inconvenience, and psychological costs involved in switching brands. For example, retailers may not switch to the brands of rival manufacturers because they are hesitant to sever long-standing supplier relationships or incur the additional expense of retraining employees, accessing technical support, or testing the

FIGURE 3.4 Factors Affecting the Strength of Rivalry



quality and reliability of the new brand. Consumers may not switch brands because they become emotionally attached to a particular brand (e.g. if you identify with the Harley motorcycle brand and lifestyle).

- *Rivalry increases as the products of rival sellers become less strongly differentiated.* When the offerings of rivals are identical or weakly differentiated, buyers have less reason to be brand-loyal—a condition that makes it easier for rivals to convince buyers to switch to their offerings. Moreover, when the products of different sellers are virtually identical, shoppers will choose on the basis of price, which can result in fierce price competition among sellers. On the other hand, strongly differentiated product offerings among rivals breed high brand loyalty on the part of buyers who view the attributes of certain brands as more appealing or better suited to their needs.
- *Rivalry is more intense when industry members have too much inventory or significant amounts of idle production capacity, especially if the industry's product*

entails high fixed costs or high storage costs. Whenever a market has excess supply (overproduction relative to demand), rivalry intensifies as sellers cut prices in a desperate effort to cope with the unsold inventory. A similar effect occurs when a product is perishable or seasonal, since firms often engage in aggressive price cutting to ensure that everything is sold. Likewise, whenever fixed costs account for a large fraction of total cost so that unit costs are significantly lower at full capacity, firms come under significant pressure to cut prices whenever they are operating below full capacity. Unused capacity imposes a significant cost-increasing penalty because there are fewer units over which to spread fixed costs. The pressure of high fixed or high storage costs can push rival firms into offering price concessions, special discounts, and rebates and employing other volume-boosting competitive tactics.

- *Rivalry intensifies as the number of competitors increases and they become more equal in size and capability.* When there are many competitors in a market, companies eager to increase their meager market share often engage in price-cutting activities to drive sales, leading to intense rivalry. When there are only a few competitors, companies are more wary of how their rivals may react to their attempts to take market share away from them. Fear of retaliation and a descent into a damaging price war leads to restrained competitive moves. Moreover, when rivals are of comparable size and competitive strength, they can usually compete on a fairly equal footing—an evenly matched contest tends to be fiercer than a contest in which one or more industry members have commanding market shares and substantially greater resources than their much smaller rivals.
- *Rivalry becomes more intense as the diversity of competitors increases in terms of long-term directions, objectives, strategies, and countries of origin.* A diverse group of sellers often contains one or more mavericks willing to try novel or rule-breaking market approaches, thus generating a more volatile and less predictable competitive environment. Globally competitive markets are often more rivalrous, especially when aggressors have lower costs and are intent on gaining a strong foothold in new country markets.
- *Rivalry is stronger when high exit barriers keep unprofitable firms from leaving the industry.* In industries where the assets cannot easily be sold or transferred to other uses, where workers are entitled to job protection, or where owners are committed to remaining in business for personal reasons, failing firms tend to hold on longer than they might otherwise—even when they are bleeding red ink. Deep price discounting typically ensues, in a desperate effort to cover costs and remain in business. This sort of rivalry can destabilize an otherwise attractive industry.

The previous factors, taken as whole, determine whether the rivalry in an industry is relatively strong, moderate, or weak. When rivalry is *strong,* the battle for market share is generally so vigorous that the profit margins of most industry members are squeezed to bare-bones levels. When rivalry is *moderate,* a more normal state, the maneuvering among industry members, while lively and healthy, still allows most industry members to earn acceptable profits. When rivalry is *weak,* most companies in the industry are relatively well satisfied with their sales growth and market shares and rarely undertake offensives to steal customers away from one another. Weak rivalry means that there is no downward pressure on industry profitability due to this particular competitive force.

The Choice of Competitive Weapons

Competitive battles among rival sellers can assume many forms that extend well beyond lively price competition. For example, competitors may resort to such marketing tactics as special sales promotions, heavy advertising, rebates, or low-interest-rate financing to drum up additional sales. Rivals may race one another to differentiate their products by offering better performance features or higher quality or improved customer service or a wider product selection. They may also compete through the rapid introduction of next-generation products, the frequent introduction of new or improved products, and efforts to build stronger dealer networks, establish positions in foreign markets, or otherwise expand distribution capabilities and market presence. Table 3.2 displays the competitive weapons that firms often employ in battling rivals, along with their primary effects with respect to price (P), cost (C), and value (V)—the elements of an effective business model and the value-price-cost framework, discussed in Chapter 1.

Competitive Pressures Associated with the Threat of New Entrants

New entrants into an industry threaten the position of rival firms since they will compete fiercely for market share, add to the number of industry rivals, and add to the industry's production capacity in the process. But even the *threat* of new entry puts added competitive pressure on current industry members and thus functions as an important competitive force. This is because credible threat of entry often prompts industry members to lower their prices and initiate defensive actions in an attempt to deter new entrants. Just how serious the threat of entry is in a particular market

TABLE 3.2 Common "Weapons" for Competing with Rivals

Types of Competitive Weapons	Primary Effects
Discounting prices, holding clearance sales	Lowers price (*P*), increases total sales volume and market share, lowers profits if price cuts are not offset by large increases in sales volume
Offering coupons, advertising items on sale	Increases sales volume and total revenues, lowers price (*P*), increases unit costs (*C*), may lower profit margins per unit sold ($P - C$)
Advertising product or service characteristics, using ads to enhance a company's image	Boosts buyer demand, increases product differentiation and perceived value (*V*), increases total sales volume and market share, but may increase unit costs (*C*) and lower profit margins per unit sold
Innovating to improve product performance and quality	Increases product differentiation and value (*V*), boosts buyer demand, boosts total sales volume, likely to increase unit costs (*C*)
Introducing new or improved features, increasing the number of styles to provide greater product selection	Increases product differentiation and value (*V*), strengthens buyer demand, boosts total sales volume and market share, likely to increase unit costs (*C*)
Increasing customization of product or service	Increases product differentiation and value (*V*), increases buyer switching costs, boosts total sales volume, often increases unit costs (*C*)
Building a bigger, better dealer network	Broadens access to buyers, boosts total sales volume and market share, may increase unit costs (*C*)
Improving warranties, offering low-interest financing	Increases product differentiation and value (*V*), increases unit costs (*C*), increases buyer switching costs, boosts total sales volume and market share

depends on (1) whether entry barriers are high or low, and (2) the expected reaction of existing industry members to the entry of newcomers.

Whether Entry Barriers Are High or Low The strength of the threat of entry is governed to a large degree by the height of the industry's entry barriers. High barriers reduce the threat of potential entry, whereas low barriers enable easier entry. Entry barriers are high under the following conditions:[2]

- *There are sizable economies of scale in production, distribution, advertising, or other activities.* When incumbent companies enjoy cost advantages associated with large-scale operations, outsiders must either enter on a large scale (a costly and perhaps risky move) or accept a cost disadvantage and consequently lower profitability.
- *Incumbents have other hard to replicate cost advantages over new entrants.* Aside from enjoying economies of scale, industry incumbents can have cost advantages that stem from the possession of patents or proprietary technology, exclusive partnerships with the best and cheapest suppliers, favorable locations, and low fixed costs (because they have older facilities that have been mostly depreciated). Learning-based cost savings can also accrue from experience in performing certain activities such as manufacturing or new product development or inventory management. The extent of such savings can be measured with learning/experience curves. The steeper the learning/experience curve, the bigger the cost advantage of the company with the largest *cumulative* production volume. The microprocessor industry provides an excellent example of this:

  > *Manufacturing unit costs for microprocessors tend to decline about 20 percent each time cumulative production volume doubles. With a 20 percent experience curve effect, if the first 1 million chips cost $100 each, once production volume reaches 2 million, the unit cost would fall to $80 (80 percent of $100), and by a production volume of 4 million, the unit cost would be $64 (80 percent of $80).*[3]

- *Customers have strong brand preferences and high degrees of loyalty to seller.* The stronger the attachment of buyers to established brands, the harder it is for a newcomer to break into the marketplace. In such cases, a new entrant must have the financial resources to spend enough on advertising and sales promotion to overcome customer loyalties and build its own clientele. Establishing brand recognition and building customer loyalty can be a slow and costly process. In addition, if it is difficult or costly for a customer to switch to a new brand, a new entrant may have to offer a discounted price or otherwise persuade buyers that its brand is worth the switching costs. Such barriers discourage new entry because they act to boost financial requirements and lower expected profit margins for new entrants.
- *Patents and other forms of intellectual property protection are in place.* In a number of industries, entry is prevented due to the existence of intellectual property protection laws that remain in place for a given number of years. Often, companies have a "wall of patents" in place to prevent other companies from entering with a "me too" strategy that replicates a key piece of technology.
- *There are strong "network effects" in customer demand.* In industries where buyers are more attracted to a product when there are many other users of the product, there are said to be "network effects," since demand is higher the larger the network of users. Video game systems are an example because users prefer to have the same systems as their friends so that they can play together on systems they all know and can share games. When incumbents have a large existing base of users,

new entrants with otherwise comparable products face a serious disadvantage in attracting buyers.

- *Capital requirements are high.* The larger the total dollar investment needed to enter the market successfully, the more limited the pool of potential entrants. The most obvious capital requirements for new entrants relate to manufacturing facilities and equipment, introductory advertising and sales promotion campaigns, working capital to finance inventories and customer credit, and sufficient cash to cover startup costs.
- *There are difficulties in building a network of distributors/dealers or in securing adequate space on retailers' shelves.* A potential entrant can face numerous distribution-channel challenges. Wholesale distributors may be reluctant to take on a product that lacks buyer recognition. Retailers must be recruited and convinced to give a new brand ample display space and an adequate trial period. When existing sellers have strong, well-functioning distributor–dealer networks, a newcomer has an uphill struggle in squeezing its way into existing distribution channels. Potential entrants sometimes have to "buy" their way into wholesale or retail channels by cutting their prices to provide dealers and distributors with higher markups and profit margins or by giving them big advertising and promotional allowances. As a consequence, a potential entrant's own profits may be squeezed unless and until its product gains enough consumer acceptance that distributors and retailers are willing to carry it.
- *There are restrictive regulatory policies.* Regulated industries like cable TV, telecommunications, electric and gas utilities, radio and television broadcasting, liquor retailing, nuclear power, and railroads entail government-controlled entry. Government agencies can also limit or even bar entry by requiring licenses and permits, such as the medallion required to drive a taxicab in New York City. Government-mandated safety regulations and environmental pollution standards also create entry barriers because they raise entry costs. Recently enacted banking regulations in many countries have made entry particularly difficult for small new bank startups—complying with all the new regulations along with the rigors of competing against existing banks requires very deep pockets.
- *There are restrictive trade policies.* In international markets, host governments commonly limit foreign entry and must approve all foreign investment applications. National governments commonly use tariffs and trade restrictions (antidumping rules, local content requirements, quotas, etc.) to raise entry barriers for foreign firms and protect domestic producers from outside competition.

The Expected Reaction of Industry Members in Defending against New Entry

A second factor affecting the threat of entry relates to the ability and willingness of industry incumbents to launch strong defensive maneuvers to maintain their positions and make it harder for a newcomer to compete successfully and profitably. Entry candidates may have second thoughts about attempting entry if they conclude that existing firms will mount well-funded campaigns to hamper (or even defeat) a newcomer's attempt to gain a market foothold big enough to compete successfully. Such campaigns can include any of the "competitive weapons" listed in Table 3.2, such as ramping up advertising expenditures, offering special price discounts to the very customers a newcomer is seeking to attract, or adding attractive new product features (to match or beat the newcomer's product offering). Such actions can raise a newcomer's cost of entry along with the risk of failing, making the prospect of entry less appealing. The result is that even the expectation on the part of new entrants that industry incumbents will contest a newcomer's entry may be enough to dissuade entry candidates from going forward. Microsoft can be counted on to fiercely defend the position that Windows enjoys in computer operating systems and that Microsoft Office has in office productivity software. This may well have contributed to Microsoft's ability to continuously dominate this market space.

However, there are occasions when industry incumbents have nothing in their competitive arsenal that is formidable enough to either discourage entry or put obstacles in a newcomer's path that will defeat its strategic efforts to become a viable competitor. In the restaurant industry, for example, existing restaurants in a given geographic market have few actions they can take to discourage a new restaurant from opening or to block it from attracting enough patrons to be profitable. Fierce competitors like Nike and Adidas have been unable to prevent the entry of sneaker start-ups such as Nothing New, Lane Eight, and Allbirds that emphasize sustainable materials. Furthermore, there are occasions when industry incumbents can be expected to refrain from taking or initiating any actions specifically aimed at contesting a newcomer's entry. In large industries, entry by small startup enterprises normally poses no immediate or direct competitive threat to industry incumbents and their entry is not likely to provoke defensive actions. For instance, a new online retailer with sales prospects of maybe $5 to $10 million annually can reasonably expect to escape competitive retaliation from much larger online retailers selling similar goods. The less that a newcomer's entry will adversely impact the sales and profitability of industry incumbents, the more reasonable it is for potential entrants to expect industry incumbents to refrain from reacting defensively.

Figure 3.5 summarizes the factors that cause the overall competitive pressure from potential entrants to be strong or weak. An analysis of these factors can help managers determine whether the threat of entry into their industry is high or low, *in general.* But certain kinds of companies—those with sizable financial resources, proven competitive capabilities, and a respected brand name—may be able to hurdle an industry's entry barriers even when they are high.[4] For example, when Honda opted to enter the U.S. lawn-mower market in competition against Toro, Snapper, Craftsman, John Deere, and others, it was easily able to hurdle entry barriers that would have been formidable to other newcomers because it had long-standing expertise in gasoline engines and a reputation for quality and durability in automobiles that gave it instant credibility with homeowners. As a result, Honda had to spend relatively little on inducing dealers to handle the Honda lawn-mower line or attracting customers. Similarly, Samsung's brand reputation in televisions, DVD players, and other electronics products gave it strong credibility in entering the market for smartphones—Samsung's Galaxy smartphones are now a formidable rival of Apple's iPhone.

> Even high entry barriers may not suffice to keep out certain kinds of entrants: those with resources and capabilities that enable them to leap over or bypass the barriers.

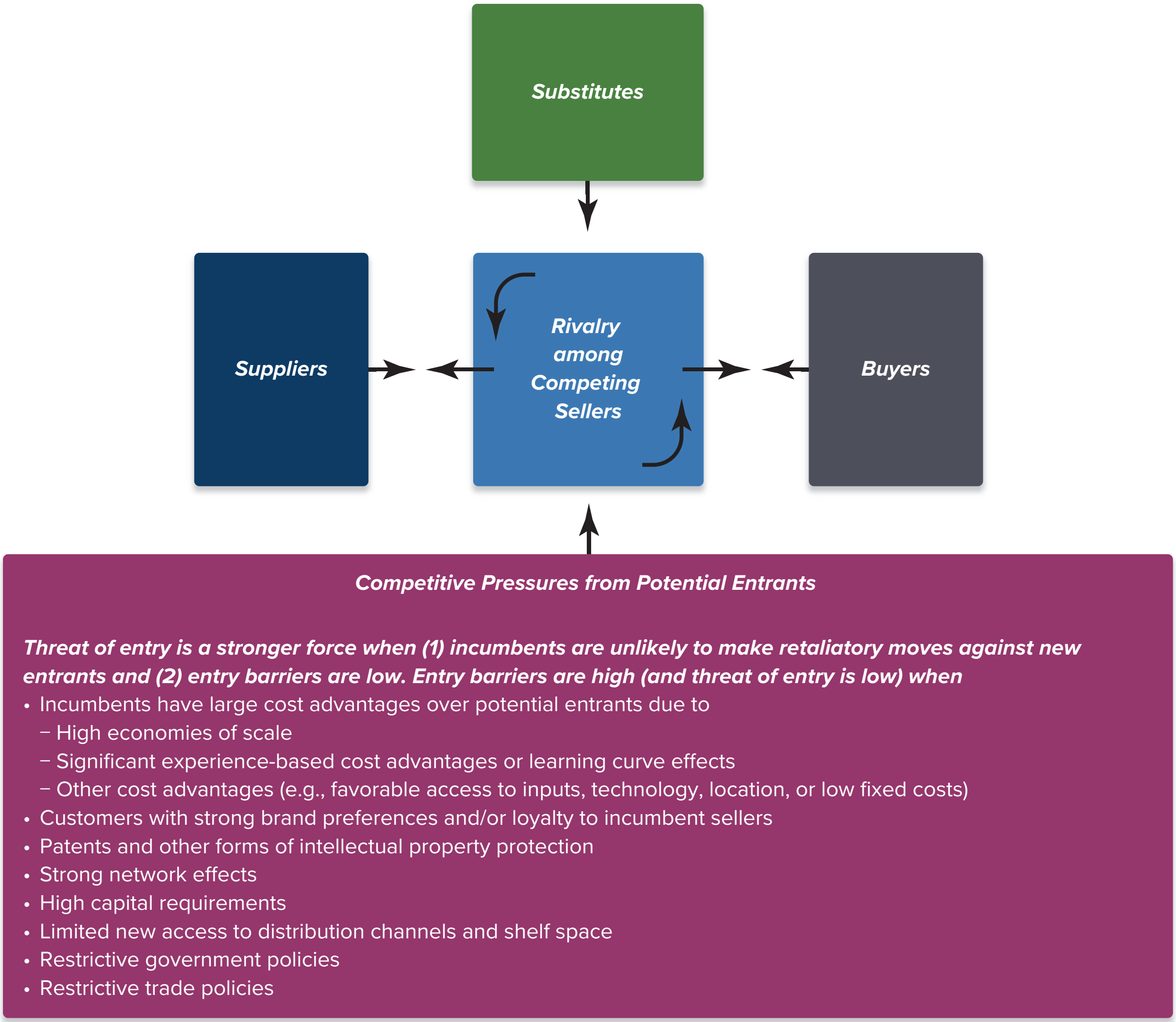
It is also important to recognize that the barriers to entering an industry can become stronger or weaker over time. For example, once key patents preventing new entry in the market for functional 3-D printers expired, the way was open for new competition to enter this industry. On the other hand, new strategic actions by incumbent firms to increase advertising, strengthen distributor–dealer relations, step up R&D, or improve product quality can erect higher roadblocks to entry.

> High entry barriers and weak entry threats today do not always translate into high entry barriers and weak entry threats tomorrow.

Competitive Pressures from the Sellers of Substitute Products

Companies in one industry are vulnerable to competitive pressure from the actions of companies in a closely adjoining industry whenever buyers view the products of the two industries as good substitutes. Substitutes do *not* include other brands within your industry; this type of pressure comes from *outside* the industry. Substitute

FIGURE 3.5 Factors Affecting the Threat of Entry

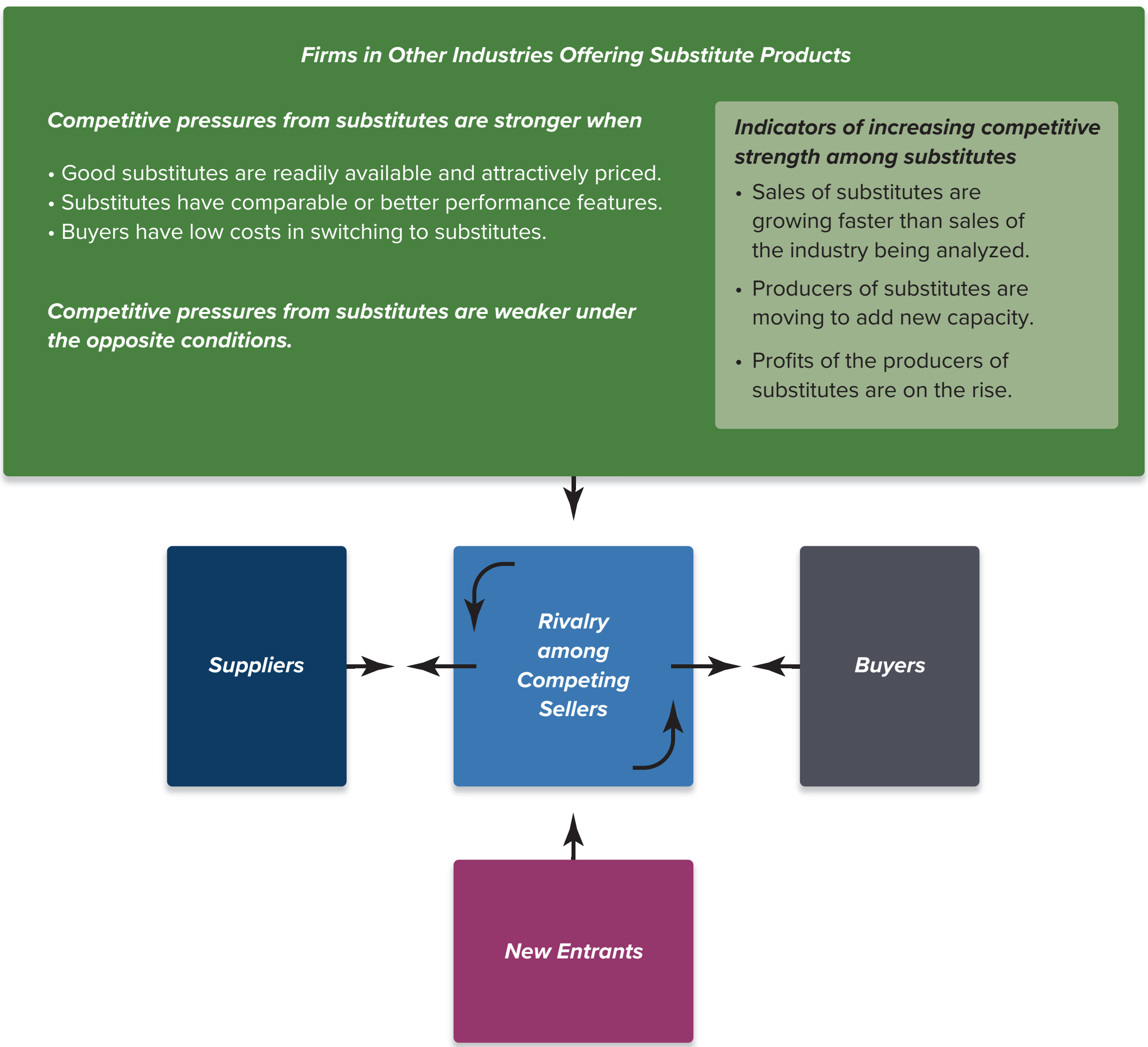


products from outside the industry are those that can perform the same or similar functions for the consumer as products within your industry. For instance, the producers of eyeglasses and contact lenses face competitive pressures from the doctors who do corrective laser surgery. Similarly, the producers of sugar experience competitive pressures from the producers of sugar substitutes (high-fructose corn syrup, agave syrup, and artificial sweeteners). Internet providers of news-related information have put brutal competitive pressure on the publishers of newspapers. Similarly, cable television networks and providers are finding it more difficult to maintain their relevance to subscribers who find greater value in streaming devices and services.

As depicted in Figure 3.6, three factors determine whether the competitive pressures from substitute products are strong or weak. Competitive pressures are stronger when

1. *Good substitutes are readily available and attractively priced.* The presence of readily available and attractively priced substitutes creates competitive pressure by placing a ceiling on the prices industry members can charge without risking sales erosion. This price ceiling, at the same time, puts a lid on the profits that industry members can earn unless they find ways to cut costs.
2. *Buyers view the substitutes as comparable or better in terms of quality, performance, and other relevant attributes.* The availability of substitutes inevitably invites customers to compare performance, features, ease of use, and other attributes besides price. The users of paper cartons constantly weigh the price-performance trade-offs

FIGURE 3.6 Factors Affecting Competition from Substitute Products



with plastic containers and metal cans, for example. Movie enthusiasts are increasingly weighing whether to go to movie theaters to watch newly released movies or wait until they can watch the same movies streamed to their home TV by Netflix, Amazon Prime, cable providers, and other on-demand sources.

3. *The costs that buyers incur in switching to the substitutes are low.* Low switching costs make it easier for the sellers of attractive substitutes to lure buyers to their offerings; high switching costs deter buyers from purchasing substitute products.

Some signs that the competitive strength of substitute products is increasing include (1) whether the sales of substitutes are growing faster than the sales of the industry being analyzed, (2) whether the producers of substitutes are investing in added capacity, and (3) whether the producers of substitutes are earning progressively higher profits.

But before assessing the competitive pressures coming from substitutes, company managers must identify the substitutes, which is less easy than it sounds since it involves (1) determining where the industry boundaries lie and (2) figuring out which other products or services can address the same basic customer needs as those produced by industry members. Deciding on the industry boundaries is necessary for determining which firms are direct rivals and which produce substitutes. This is a matter of perspective—there are no hard-and-fast rules, other than to say that other brands of the same basic product constitute rival products and not substitutes. Ultimately, it's simply the buyer who decides what can serve as a good substitute.

Competitive Pressures Stemming from Supplier Bargaining Power

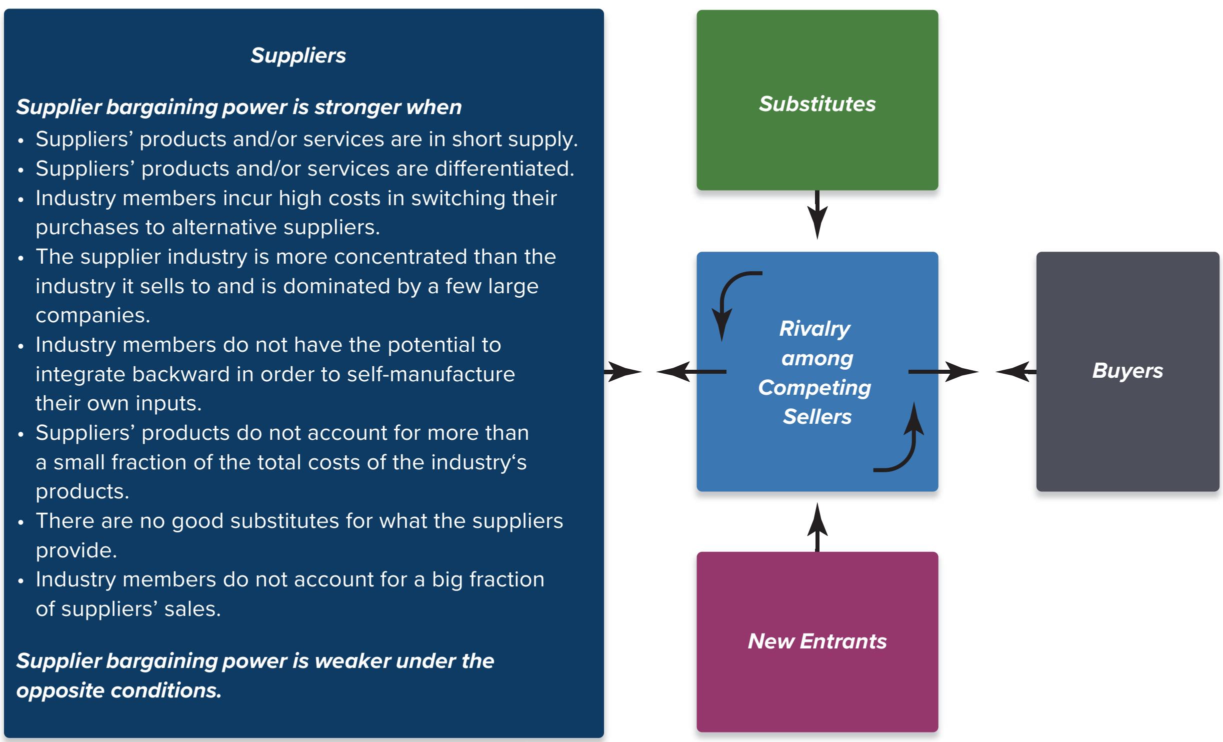
Whether the suppliers of industry members represent a weak or strong competitive force depends on the degree to which suppliers have sufficient *bargaining power* to influence the terms and conditions of supply in their favor. Suppliers with strong bargaining power are a source of competitive pressure because of their ability to charge industry members higher prices, pass costs on to them, and limit their opportunities to find better deals. For instance, Microsoft and Intel, both of which supply PC makers with essential components, have been known to use their dominant market status not only to charge PC makers premium prices but also to leverage their power over PC makers in other ways. The bargaining power of these two companies over their customers is so great that both companies have faced antitrust charges on numerous occasions. Prior to a legal agreement ending the practice, Microsoft pressured PC makers to load only Microsoft products on the PCs they shipped. Intel has defended itself against similar antitrust charges, but in filling orders for newly introduced Intel chips, it continues to give top priority to PC makers that use the biggest percentages of Intel chips in their PC models. Being on Intel's list of preferred customers helps a PC maker get an early allocation of Intel's latest chips and thus allows the PC maker to get new models to market ahead of rivals.

Small-scale retailers often must contend with the power of manufacturers whose products enjoy well-known brand names, since consumers expect to find these products on the shelves of the retail stores where they shop. This provides the manufacturer with a degree of pricing power and often the ability to push hard for favorable shelf displays. Supplier bargaining power is also a competitive factor in industries where unions have been able to organize the workforce (which supplies labor). Air pilot unions, for example, have employed their bargaining power to increase pilots' wages and benefits in the air transport industry. The growing clout of the largest healthcare union in the United States has led to better wages and working conditions in nursing homes.

As shown in Figure 3.7, a variety of factors determine the strength of suppliers' bargaining power. Supplier power is stronger when

- *Demand for suppliers' products is high and the products are in short supply.* A surge in the demand for particular items shifts the bargaining power to the suppliers of those products; suppliers of items in short supply have pricing power.
- *Suppliers provide differentiated inputs that enhance the performance of the industry's product.* The more valuable a particular input is in terms of enhancing the performance or quality of the products of industry members, the more bargaining leverage suppliers have. In contrast, the suppliers of commodities are in a weak bargaining position, since industry members have no reason other than price to prefer one supplier over another.
- *It is difficult or costly for industry members to switch their purchases from one supplier to another.* Low switching costs limit supplier bargaining power by enabling industry members to change suppliers if any one supplier attempts to raise prices by more than the costs of switching. Thus, the higher the switching costs of industry members, the stronger the bargaining power of their suppliers.
- *The supplier industry is dominated by a few large companies and it is more concentrated than the industry it sells to.* Suppliers with sizable market shares and strong demand for the items they supply generally have sufficient bargaining power to charge high prices and deny requests from industry members for lower prices or other concessions.

FIGURE 3.7 Factors Affecting the Bargaining Power of Suppliers



- *Industry members are incapable of integrating backward to self-manufacture items they have been buying from suppliers.* As a rule, suppliers are safe from the threat of self-manufacture by their customers until the volume of parts a customer needs becomes large enough for the customer to justify backward integration into self-manufacture of the component. When industry members can threaten credibly to self-manufacture suppliers' goods, their bargaining power over suppliers increases proportionately.
- *Suppliers provide an item that accounts for no more than a small fraction of the costs of the industry's product.* The more that the cost of a particular part or component affects the final product's cost, the more that industry members will be sensitive to the actions of suppliers to raise or lower their prices. When an input accounts for only a small proportion of total input costs, buyers will be less sensitive to price increases. Thus, suppliers' power increases when the inputs they provide do *not* make up a large proportion of the cost of the final product.
- *Good substitutes are not available for the suppliers' products.* The lack of readily available substitute inputs increases the bargaining power of suppliers by increasing the dependence of industry members on the suppliers.
- *Industry members are not major customers of suppliers.* As a rule, suppliers have less bargaining leverage when their sales to members of the industry constitute a big percentage of their total sales. In such cases, the well-being of suppliers is closely tied to the well-being of their major customers, and their dependence upon them increases. The bargaining power of suppliers is stronger, then, when they are *not* bargaining with major customers.

In identifying the degree of supplier power in an industry, it is important to recognize that different types of suppliers are likely to have different amounts of bargaining power. Thus, the first step is for managers to identify the different types of suppliers, paying particular attention to those that provide the industry with important inputs. The next step is to assess the bargaining power of each type of supplier separately.

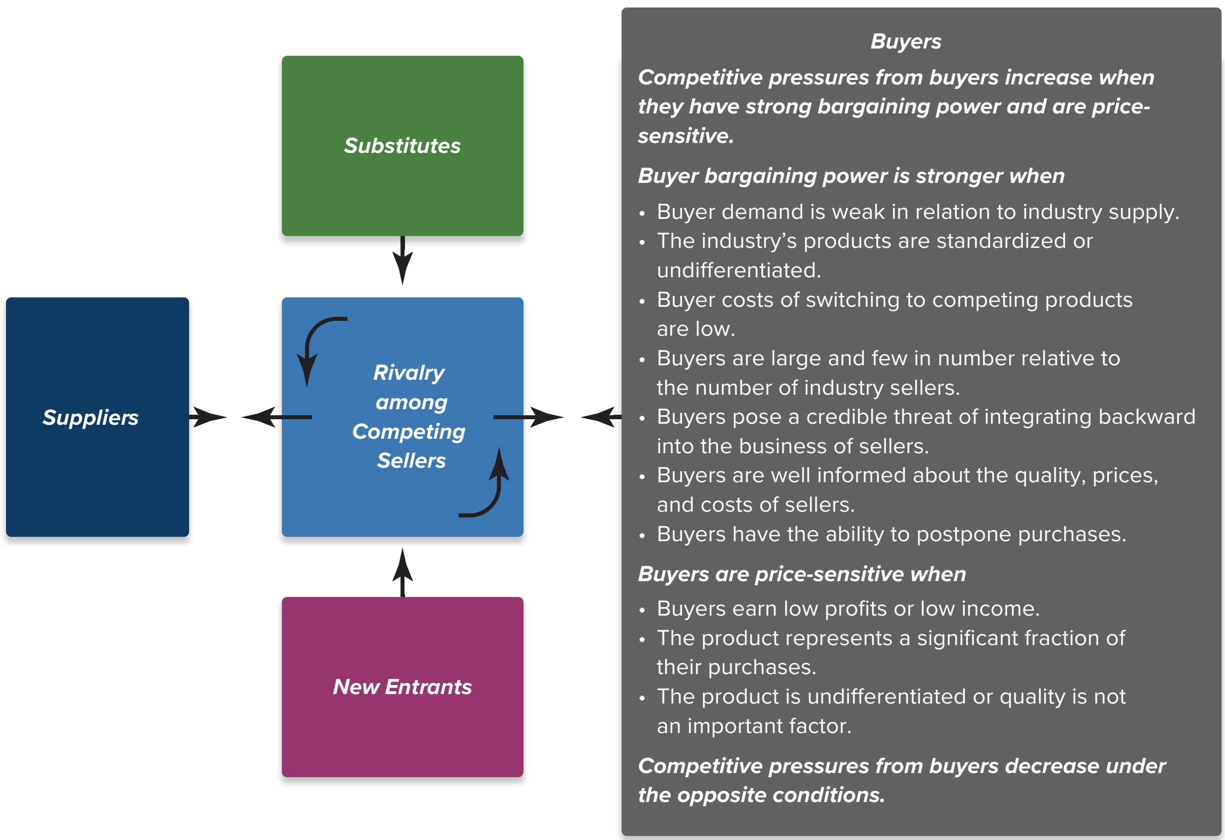
Competitive Pressures Stemming from Buyer Bargaining Power and Price Sensitivity

Whether buyers are able to exert strong competitive pressures on industry members depends on (1) the degree to which buyers have bargaining power and (2) the extent to which buyers are price-sensitive. Buyers with strong bargaining power can limit industry profitability by demanding price concessions, better payment terms, or additional features and services that increase industry members' costs. Buyer price sensitivity limits the profit potential of industry members by restricting the ability of sellers to raise prices without losing revenue due to lost sales.

As with suppliers, the leverage that buyers have in negotiating favorable terms of sale can range from weak to strong. Individual consumers seldom have much bargaining power in negotiating price concessions or other favorable terms with sellers. However, their price sensitivity varies by individual and by the type of product they are buying (whether it's a necessity or a discretionary purchase, for example). Similarly, small businesses usually have weak bargaining power because of the small-size orders they place with sellers. Many relatively small wholesalers and retailers join buying groups to pool their purchasing power and approach manufacturers for better terms than could be gotten individually. Large business buyers, in contrast, can have considerable bargaining power. For example, large retail chains like Walmart, Best Buy, Staples, and Home Depot typically have considerable bargaining power in purchasing products from manufacturers, not only because they buy in large quantities, but also because of manufacturers' need for access to their broad base of customers. Major supermarket chains like Kroger, Publix, Albertsons, Hannaford, and Aldi have sufficient bargaining power to demand promotional allowances and lump-sum payments (called *slotting fees*) from food products manufacturers in return for stocking certain brands or putting them in the best shelf locations. Motor vehicle manufacturers have strong bargaining power in negotiating to buy original-equipment tires from tire makers such as Bridgestone, Goodyear, Michelin, Continental, and Pirelli, partly because they buy in large quantities and partly because consumers are more likely to buy replacement tires that match the tire brand on their vehicle at the time of its purchase. The starting point for the analysis of buyers as a competitive force is to identify the different types of buyers along the value chain—then proceed to analyzing the bargaining power and price sensitivity of each type separately. It is important to recognize that *not all buyers of an industry's product have equal degrees of bargaining power with sellers, and some may be less sensitive than others to price, quality, or service differences.*

Figure 3.8 summarizes the factors determining the strength of buyer power in an industry. The top of this chart lists the factors that increase buyers' bargaining power,

FIGURE 3.8 Factors Affecting the Power of Buyers



which we discuss next. Note that the first five factors are the mirror image of those determining the bargaining power of suppliers.

Buyer bargaining power is stronger when

- *Buyer demand is weak in relation to the available supply.* Weak or declining demand and the resulting excess supply create a "buyers' market," in which bargain-hunting buyers have leverage in pressing industry members for better deals and special treatment. Conversely, strong or rapidly growing market demand creates a "sellers' market" characterized by tight supplies or shortages—conditions that put buyers in a weak position to wring concessions from industry members.
- *Industry goods are standardized or differentiation is weak.* In such circumstances, buyers make their selections on the basis of price, which increases price competition among vendors.
- *Buyers' costs of switching to competing brands or substitutes are relatively low.* Switching costs put a cap on how much industry producers can raise prices or reduce quality before they will lose the buyer's business.
- *Buyers are large and few in number relative to the number of sellers.* The larger the buyers, the more important their business is to the seller and the more sellers will be willing to grant concessions.
- *Buyers pose a credible threat of integrating backward into the business of sellers.* Beer producers like Anheuser Busch InBev SA/NV (whose brands include Budweiser, Molson Coors, and Heineken) have partially integrated backward into metal-can manufacturing to gain bargaining power in obtaining the balance of their can requirements from otherwise powerful metal-can manufacturers.
- *Buyers are well informed about the product offerings of sellers (product features and quality, prices, buyer reviews) and the cost of production (an indicator of markup).* The more information buyers have, the better bargaining position they are in. The mushrooming availability of product information on the Internet (and its ready access on smartphones) is giving added bargaining power to consumers, since they can use this to find or negotiate better deals. Apps such as ShopSavvy and BuyVia are now making comparison shopping even easier.
- *Buyers have discretion to delay their purchases or perhaps even not make a purchase at all.* Consumers often have the option to delay purchases of durable goods (cars, major appliances), or decline to buy discretionary goods (massages, concert tickets) if they are not happy with the prices offered. Business customers may also be able to defer their purchases of certain items, such as plant equipment or maintenance services. This puts pressure on sellers to provide concessions to buyers so that the sellers can keep their sales numbers from dropping off.

Whether Buyers Are More or Less Price-Sensitive Consumers with lower incomes and budget-constrained consumers are almost always price-sensitive; bargain-hunting consumers are highly price-sensitive by nature. Most consumers grow more price-sensitive as the price tag of an item becomes a bigger fraction of their spending budget. Similarly, business buyers besieged by weak sales, intense competition, and other factors squeezing their profit margins are price-sensitive. Price sensitivity also grows among businesses as the cost of an item becomes a bigger fraction of their cost structure. Rising prices of frequently purchased items heighten the price sensitivity of all types of buyers. On the other hand, the price sensitivity of all types of buyers decreases the more that the quality of the product matters.

The following factors increase buyer price sensitivity and result in greater competitive pressures on the industry as a result:

- *Buyer price sensitivity increases when buyers are earning low profits or have low income.* Price is a critical factor in the purchase decisions of consumers with lower incomes and companies that are barely scraping by. In such cases, their high price sensitivity limits the ability of sellers to charge high prices.
- *Buyers are more price-sensitive if the product represents a large fraction of their total purchases.* When a purchase eats up a large portion of a buyer's budget or represents a significant part of their cost structure, the buyer cares more about price than might otherwise be the case.
- *Buyers are more price-sensitive when the quality of the product is not uppermost in their considerations.* Quality matters little when products are relatively undifferentiated, leading buyers to focus more on price. But when quality affects performance, or can reduce a business buyer's other costs (by saving on labor, materials, etc.), price will matter less.

Is the Collective Strength of the Five Competitive Forces Conducive to Good Profitability?

Assessing whether each of the five competitive forces gives rise to strong, moderate, or weak competitive pressures sets the stage for evaluating whether, overall, the strength of the five forces is conducive to good profitability. Is any of the competitive forces sufficiently powerful to undermine industry profitability? Can companies in this industry reasonably expect to earn decent profits in light of the prevailing competitive forces?

The most extreme case of a "competitively unattractive" industry occurs when all five forces are producing strong competitive pressures: Rivalry among sellers is vigorous, low entry barriers allow new rivals to gain a market foothold, competition from substitutes is intense, and both suppliers and buyers are able to exercise considerable leverage. Strong competitive pressures coming from all five directions drive industry profitability to unacceptably low levels, frequently producing losses for many industry members and forcing some out of business. But an industry can be competitively unattractive without all five competitive forces being strong. In fact, *intense competitive pressures from just one of the five forces may suffice to destroy the conditions for good profitability and prompt some companies to exit the business.*

As a rule, *the strongest competitive forces determine the extent of the competitive pressure on industry profitability.* Thus, in evaluating the strength of the five forces overall and their effect on industry profitability, managers should look to the strongest forces. Having more than one strong force will not worsen the effect on industry profitability, but it does mean that the industry has multiple competitive challenges with which to cope. In that sense, an industry with three to five strong forces is even more "unattractive" as a place to compete. Especially intense competitive conditions due to multiple strong forces seem to be the norm in tire manufacturing, apparel, and commercial airlines, three industries where profit margins have historically been thin.

CORE CONCEPT

The strongest of the five forces determines the extent of the downward pressure on an industry's profitability.

In contrast, when the overall impact of the five competitive forces is moderate to weak, an industry is "attractive" in the sense that the *average* industry member can reasonably expect to earn good profits and a nice return on investment. The ideal competitive environment for earning superior profits is one in which both suppliers and customers have limited power, there are no good substitutes, high barriers block further entry, and rivalry among present sellers is muted. Weak competition is the best of all possible worlds for also-ran companies because even they can usually eke out a decent profit—if a company can't make a decent profit when competition is weak, then its business outlook is indeed grim.

Matching Company Strategy to Competitive Conditions

A company's strategy is strengthened the more it provides insulation from competitive pressures, shifts the competitive battle in the company's favor, and positions the firm to take advantage of attractive growth opportunities.

Working through the five forces model step by step not only aids strategy makers in assessing whether the intensity of competition allows good profitability but also promotes sound strategic thinking about how to better match company strategy to the specific competitive character of the marketplace. Effectively matching a company's business strategy to prevailing competitive conditions has two aspects:

1. Pursuing avenues that shield the firm from as many of the different competitive pressures as possible.
2. Initiating actions calculated to shift the competitive forces in the company's favor by altering the underlying factors driving the five forces.

But making headway on these two fronts first requires identifying competitive pressures, gauging the relative strength of each of the five competitive forces, and gaining a deep enough understanding of the state of competition in the industry to know which strategy buttons to push.

COMPLEMENTORS AND THE VALUE NET

Not all interactions among industry participants are necessarily competitive in nature. Some have the potential to be cooperative, as the value net framework demonstrates. Like the five forces framework, the value net includes an analysis of buyers, suppliers, and substitutors (see Figure 3.9). But it differs from the five forces framework in several important ways.

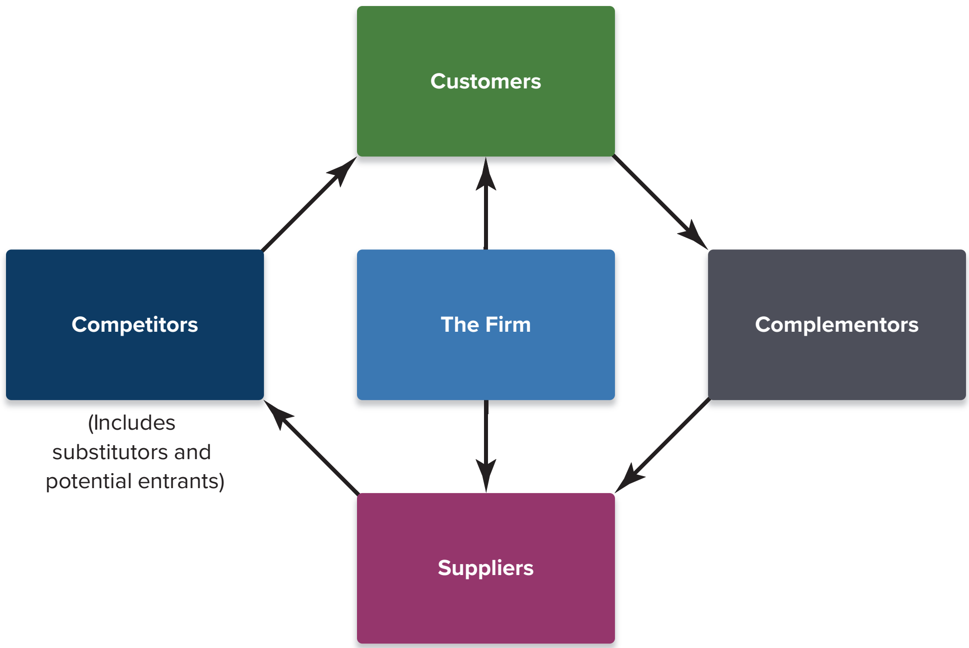
CORE CONCEPT

Complementors are the producers of complementary products, which are products that enhance the value of the focal firm's products when they are used together.

First, the analysis focuses on the interactions of industry participants with a particular company. Thus, it places that firm in the center of the framework, as Figure 3.9 shows. Second, the category of "competitors" is defined to include not only the focal firm's direct competitors or industry rivals but also the sellers of substitute products and potential entrants. Third, the value net framework introduces a new category of industry participant that is not found in the five forces framework—that of "complementors." **Complementors** are the producers of complementary products, which are products that enhance the value of the focal firm's products when they are used together. Some examples include snorkels and swim fins or shoes and shoelaces.

The inclusion of complementors draws particular attention to the fact that success in the marketplace need not come at the expense of other industry participants. Interactions among industry participants may be cooperative in nature rather than competitive. In the case of complementors, an increase in sales for them is likely to increase the sales of the focal firm as well. But the value net framework also encourages managers to consider other forms of cooperative interactions and realize that value is created jointly by all industry participants. For example, a company's success in the marketplace depends on establishing a reliable supply chain for its inputs, which

FIGURE 3.9 The Value Net



implies the need for cooperative relations with its suppliers. Often a firm works hand in hand with its suppliers to ensure a smoother, more efficient operation for both parties. Newell-Rubbermaid and Procter & Gamble, for example, work cooperatively as suppliers to companies such as Walmart, Target, and Kohl's. Even direct rivals may work cooperatively if they participate in industry trade associations or engage in joint lobbying efforts. Value net analysis can help managers discover the potential to improve their position through cooperative as well as competitive interactions.

INDUSTRY DYNAMICS AND THE FORCES DRIVING CHANGE

While it is critical to understand the nature and intensity of competitive and cooperative forces in an industry, it is equally critical to understand that the intensity of these forces is fluid and subject to change. All industries are affected by new developments and ongoing trends that alter industry conditions, some more speedily than others. The popular hypothesis that industries go through a life cycle of takeoff, rapid growth, maturity, market saturation and slowing growth, followed by stagnation or decline is but one aspect of industry change—many other new developments and emerging trends cause industry change.[5] Any strategies devised by management will therefore play out in a dynamic industry environment, so it's imperative that managers consider the factors driving industry change and how they might affect the industry environment. Moreover, with early notice, managers may be able to influence the direction or scope of environmental change and improve the outlook.

CORE CONCEPT

Driving forces are the major underlying causes of change in industry and competitive conditions.

Industry and competitive conditions change because forces are enticing or pressuring certain industry participants (competitors, customers, suppliers, complementors) to alter their actions in important ways. The most powerful of the change agents are called **driving forces** because they have the biggest influences in reshaping the industry landscape and altering competitive conditions. Some driving forces originate in the outer ring of the company's macro-environment (see Figure 3.2), but most originate in the company's more immediate industry and competitive environment.

Driving-forces analysis has three steps: (1) identifying what the driving forces are; (2) assessing whether the drivers of change are, on the whole, acting to make the industry more or less attractive; and (3) determining what strategy changes are needed to prepare for the impact of the driving forces. All three steps merit further discussion.

Identifying the Forces Driving Industry Change

Many developments can affect an industry powerfully enough to qualify as driving forces. Some drivers of change are unique and specific to a particular industry situation, but most drivers of industry and competitive change fall into one of the following categories:

- *Changes in an industry's long-term growth rate.* Shifts in industry growth up or down have the potential to affect the balance between industry supply and buyer demand, entry and exit, and the character and strength of competition. Whether demand is growing or declining is one of the key factors influencing the intensity of rivalry in an industry, as explained earlier. But the strength of this effect will depend on how changes in the industry growth rate affect entry and exit in the industry. If entry barriers are low, then growth in demand will attract new entrants, increasing the number of industry rivals and changing the competitive landscape.
- *Increasing globalization.* Globalization can be precipitated by such factors as the blossoming of consumer demand in developing countries, the availability of lower-cost foreign inputs, and the reduction of trade barriers, as has occurred recently in many parts of Latin America and Asia. Significant differences in labor costs among countries give manufacturers a strong incentive to locate plants for labor-intensive products in low-wage countries and use these plants to supply market demand across the world. Wages in China, India, Vietnam, Mexico, and Brazil, for example, are much lower than those in the United States, Germany, and Japan. The forces of globalization are sometimes such a strong driver that companies find it highly advantageous, if not necessary, to spread their operating reach into more and more country markets. Globalization is very much a driver of industry change in such industries as energy, mobile phones, steel, social media, public accounting, commercial aircraft, electric power generation equipment, and pharmaceuticals.
- *Emerging new Internet capabilities and applications.* Mushrooming use of high-speed Internet service and Voice-over-Internet-Protocol (VoIP) technology, growing acceptance of online shopping, and the exploding popularity of Internet applications ("apps") have been major drivers of change in industry after industry. The Internet has allowed online discount stock brokers, such as E*TRADE, and TD Ameritrade to mount a strong challenge against full-service firms such as Edward Jones and Merrill Lynch. The newspaper industry has yet to figure out a strategy for surviving the advent of online news.

Massive open online courses (MOOCs) facilitated by organizations such as Coursera, edX, and Udacity are profoundly affecting higher education. The "Internet of things" will feature faster speeds, dazzling applications, and billions of connected gadgets performing an array of functions, thus driving further industry and competitive changes. But Internet-related impacts vary from industry to industry. The challenges are to assess precisely how emerging Internet developments are altering a particular industry's landscape and to factor these impacts into the strategy-making equation.

- *Shifts in who buys the products and how the products are used.* Shifts in buyer demographics and the ways products are used can greatly alter competitive conditions. Longer life expectancies and growing percentages of relatively well-to-do retirees, for example, are driving demand growth in such industries as cosmetic surgery, assisted living residences, and vacation travel. The burgeoning popularity of streaming video has affected broadband providers, wireless phone carriers, and television broadcasters, and created opportunities for such new entertainment businesses as Hulu and Netflix.
- *Technological change and manufacturing process innovation.* Advances in technology can cause disruptive change in an industry by introducing substitutes or can alter the industry landscape by opening up whole new industry frontiers. For instance, revolutionary change in autonomous system technology has put Google, Tesla, Apple, and every major automobile manufacturer into a race to develop viable self-driving vehicles.
- *Product innovation.* An ongoing stream of product innovations tends to alter the pattern of competition in an industry by attracting more first-time buyers, rejuvenating industry growth, and/or increasing product differentiation, with concomitant effects on rivalry, entry threat, and buyer power. Product innovation has been a key driving force in the smartphone industry, which in an ever more connected world is driving change in other industries. Philips Lighting Hue bulbs now allow homeowners to use a smartphone app to remotely turn lights on and off, blink if an intruder is detected, and create a wide range of white and color ambiances. Wearable action-capture cameras and unmanned aerial view drones are rapidly becoming a disruptive force in the digital camera industry by enabling photography shots and videos not feasible with handheld digital cameras.
- *Marketing innovation.* When firms are successful in introducing new ways to market their products, they can spark a burst of buyer interest, widen industry demand, increase product differentiation, and lower unit costs—any or all of which can alter the competitive positions of rival firms and force strategy revisions. Consider, for example, the growing propensity of advertisers to place a bigger percentage of their ads on social media sites like Facebook and Twitter.
- *Entry or exit of major firms.* Entry by a major firm thus often produces a new ball game, not only with new key players but also with new rules for competing. Similarly, exit of a major firm changes the competitive structure by reducing the number of market leaders and increasing the dominance of the leaders who remain.
- *Diffusion of technical know-how across companies and countries.* As knowledge about how to perform a particular activity or execute a particular manufacturing technology spreads, products tend to become more commodity-like. Knowledge diffusion can occur through scientific journals, trade publications, onsite plant tours, word of mouth among suppliers and customers, employee migration, and Internet sources.
- *Changes in cost and efficiency.* Widening or shrinking differences in the costs among key competitors tend to dramatically alter the state of competition. Declining costs of producing tablets have enabled price cuts and spurred tablet sales (especially lower-priced models) by making them more affordable to

lower-income households worldwide. Lower cost e-books are cutting into sales of costlier hardcover books as increasing numbers of consumers have laptops, iPads, Kindles, and other brands of tablets.

- *Reductions in uncertainty and business risk.* Many companies are hesitant to enter industries with uncertain futures or high levels of business risk because it is unclear how much time and money it will take to overcome various technological hurdles and achieve acceptable production costs (as is the case in the solar power industry). Over time, however, diminishing risk levels and uncertainty tend to stimulate new entry and capital investments on the part of growth-minded companies seeking new opportunities, thus dramatically altering industry and competitive conditions.
- *Regulatory influences and government policy changes.* Government regulatory actions can often mandate significant changes in industry practices and strategic approaches—as has recently occurred in the world's banking industry. New rules and regulations pertaining to government-sponsored health insurance programs are driving changes in the health care industry. In international markets, host governments can drive competitive changes by opening their domestic markets to foreign participation or closing them to protect domestic companies.
- *Changing societal concerns, attitudes, and lifestyles.* Emerging social issues as well as changing attitudes and lifestyles can be powerful instigators of industry change. Growing concern about the effects of climate change has emerged as a major driver of change in the energy industry. Concerns about the use of chemical additives and the nutritional content of food products have been driving changes in the restaurant and food industries. Shifting societal concerns, attitudes, and lifestyles alter the pattern of competition, favoring those players that respond with products targeted to the new trends and conditions.

The most important part of driving-forces analysis is to determine whether the collective impact of the driving forces will increase or decrease market demand, make competition more or less intense, and lead to higher or lower industry profitability.

While many forces of change may be at work in a given industry, *no more than three or four* are likely to be true driving forces powerful enough to qualify as the *major determinants* of why and how the industry is changing. Thus, company strategists must resist the temptation to label every change they see as a driving force. Table 3.3 lists the most common driving forces.

TABLE 3.3 The Most Common Drivers of Industry Change

- Changes in the long-term industry growth rate
- Increasing globalization
- Emerging new Internet capabilities and applications
- Shifts in buyer demographics
- Technological change and manufacturing process innovation
- Product and marketing innovation
- Entry or exit of major firms
- Diffusion of technical know-how across companies and countries
- Changes in cost and efficiency
- Reductions in uncertainty and business risk
- Regulatory influences and government policy changes
- Changing societal concerns, attitudes, and lifestyles

Assessing the Impact of the Forces Driving Industry Change

The second step in driving-forces analysis is to determine whether the prevailing change drivers, on the whole, are acting to make the industry environment more or less attractive. Three questions need to be answered:

The real payoff of driving-forces analysis is to help managers understand what strategy changes are needed to prepare for the impacts of the driving forces.

1. Are the driving forces, on balance, acting to cause demand for the industry's product to increase or decrease?
2. Is the collective impact of the driving forces making competition more or less intense?
3. Will the combined impacts of the driving forces lead to higher or lower industry profitability?

Getting a handle on the collective impact of the driving forces requires looking at the likely effects of each factor separately, since the driving forces may not all be pushing change in the same direction. For example, one driving force may be acting to spur demand for the industry's product while another is working to curtail demand. Whether the net effect on industry demand is up or down hinges on which change driver is the most powerful.

Adjusting the Strategy to Prepare for the Impacts of Driving Forces

The third step in the strategic analysis of industry dynamics—where the real payoff for strategy making comes—is for managers to draw some conclusions about *what strategy adjustments will be needed to deal with the impacts of the driving forces.* But taking the "right" kinds of actions to prepare for the industry and competitive changes being wrought by the driving forces first requires accurate diagnosis of the forces driving industry change and the impacts these forces will have on both the industry environment and the company's business. To the extent that managers are unclear about the drivers of industry change and their impacts, or if their views are off-base, the chances of making astute and timely strategy adjustments are slim. So driving-forces analysis is not something to take lightly; it has practical value and is basic to the task of thinking strategically about where the industry is headed and how to prepare for the changes ahead.

STRATEGIC GROUP ANALYSIS

LO 3-3

Map the market positions of key groups of industry rivals.

Within an industry, companies commonly sell in different price/quality ranges, appeal to different types of buyers, have different geographic coverage, and so on. Some are more attractively positioned than others. Understanding which companies are strongly positioned and which are weakly positioned is an integral part of analyzing an industry's competitive structure. The best technique for revealing the market positions of industry competitors is **strategic group mapping.**

Using Strategic Group Maps to Assess the Market Positions of Key Competitors

A **strategic group** consists of those industry members with similar competitive approaches and positions in the market. Companies in the same strategic group can

CORE CONCEPT

Strategic group mapping is a technique for displaying the different market or competitive positions that rival firms occupy in the industry.

resemble one another in a variety of ways. They may have comparable product-line breadth, sell in the same price/quality range, employ the same distribution channels, depend on identical technological approaches, compete in much the same geographic areas, or offer buyers essentially the same product attributes or similar services and technical assistance.[6] Evaluating strategy options entails examining what strategic groups exist, identifying the companies within each group, and determining if a competitive "white space" exists where industry competitors are able to create and capture altogether new demand. As part of this process, the number of strategic groups in an industry and their respective market positions can be displayed on a strategic group map.

The procedure for constructing a *strategic group map* is straightforward:

CORE CONCEPT

A **strategic group** is a cluster of industry rivals that have similar competitive approaches and market positions.

- Identify the competitive characteristics that delineate strategic approaches used in the industry. Typical variables used in creating strategic group maps are price/quality range (high, medium, low), geographic coverage (local, regional, national, global), product-line breadth (wide, narrow), degree of service offered (no frills, limited, full), use of distribution channels (retail, wholesale, Internet, multiple), degree of vertical integration (none, partial, full), and degree of diversification into other industries (none, some, considerable).
- Plot the firms on a two-variable map using pairs of these variables.
- Assign firms occupying about the same map location to the same strategic group.
- Draw circles around each strategic group, making the circles proportional to the size of the group's share of total industry sales revenues.

This produces a two-dimensional diagram like the one for the U.S. food delivery service industry in Illustration Capsule 3.2.

Several guidelines need to be observed in creating strategic group maps. First, the two variables selected as axes for the map should *not* be highly correlated; if they are, the circles on the map will fall along a diagonal and reveal nothing more about the relative positions of competitors than would be revealed by comparing the rivals on just one of the variables. For instance, if companies with broad product lines use multiple distribution channels while companies with narrow lines use a single distribution channel, then looking at the differences in distribution-channel approaches adds no new information about positioning.

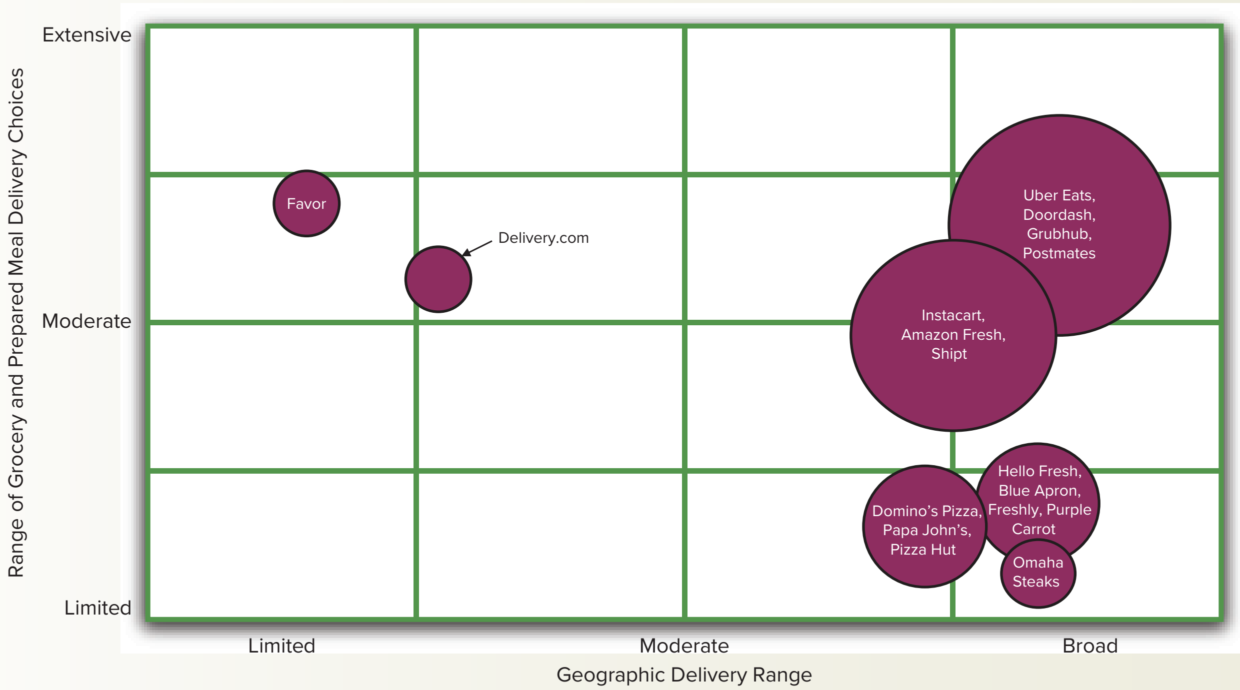
Second, the variables chosen as axes for the map should reflect important differences among rival approaches—when rivals differ on both variables, the locations of the rivals will be scattered, thus showing how they are positioned differently. Third, the variables used as axes don't have to be either quantitative or continuous; rather, they can be discrete variables, defined in terms of distinct classes and combinations. Fourth, drawing the sizes of the circles on the map proportional to the combined sales of the firms in each strategic group allows the map to reflect the relative sizes of each strategic group. Fifth, if more than two good variables can be used as axes for the map, then it is wise to draw several maps to give different exposures to the competitive positioning relationships present in the industry's structure—there is not necessarily one best map for portraying how competing firms are positioned.

Strategic group maps reveal which companies are close competitors and which are distant competitors.

The Value of Strategic Group Maps

Strategic group maps are revealing in several respects. The most important has to do with identifying which industry members are close rivals and which are distant rivals. Firms in the same strategic group are the closest rivals; the next

ILLUSTRATION CAPSULE 3.2 Comparative Market Positions of Selected Food Delivery Services: A Strategic Group Map Example



Note: Circles are drawn roughly proportional to the sizes of the chains, based on revenues.

closest rivals are in the immediately adjacent groups. Often, firms in strategic groups that are far apart on the map hardly compete at all. For instance, Walmart's clientele, merchandise selection, and pricing points are much too different to justify calling Walmart a close competitor of Neiman Marcus or Saks Fifth Avenue. For the same reason, the beers produced by Yuengling are really not in competition with the beers produced by Pabst.

The second thing to be gleaned from strategic group mapping is that *not all positions on the map are equally attractive.*[7] Two reasons account for why some positions can be more attractive than others:

1. *Prevailing competitive pressures from the industry's five forces may cause the profit potential of different strategic groups to vary.* The profit prospects of firms in different strategic groups can vary from good to poor because of differing degrees of competitive rivalry within strategic groups, differing pressures from potential entrants to each group, differing degrees of exposure to competition from substitute products outside the industry, and differing degrees of supplier or customer bargaining power from group to group. For instance, in the ready-to-eat cereal industry, there are significantly higher entry barriers (capital requirements, brand loyalty, etc.) for the strategic group comprising the large branded-cereal makers than for the group of generic-cereal makers or the group of small natural-cereal producers. Differences among the branded rivals versus the generic cereal makers make rivalry stronger

within the generic-cereal strategic group. Among apparel retailers, the competitive battle between H&M, Uniqlo, Gap, Inc., and J.Crew is more intense (with consequently smaller profit margins) than the rivalry among Tory Burch, Carolina Herrera, Dolce & Gabbana, and other high-end fashion retailers.

2. *Industry driving forces may favor some strategic groups and hurt others.* Likewise, industry driving forces can boost the business outlook for some strategic groups and adversely impact the business prospects of others. In the energy industry, producers of renewable energy, such as solar and wind power, are gaining ground over fossil fuel-based producers due to improvements in technology and increased concern over climate change. Firms in strategic groups that are being adversely impacted by driving forces may try to shift to a more favorably situated position. If certain firms are known to be trying to change their competitive positions on the map, then attaching arrows to the circles showing the targeted direction helps clarify the picture of competitive maneuvering among rivals.

Some strategic groups are more favorably positioned than others because they confront weaker competitive forces and/or because they are more favorably impacted by industry driving forces.

Thus, part of strategic group map analysis always entails drawing conclusions about where on the map is the "best" place to be and why. Which companies/strategic groups are destined to prosper because of their positions? Which companies/strategic groups seem destined to struggle? What accounts for why some parts of the map are better than others? Since some strategic groups are more attractive than others, one might ask why less well-positioned firms do not simply migrate to the more attractive position. The answer is that **mobility barriers** restrict movement between groups in the same way that entry barriers prevent easy entry into attractive industries. The most profitable strategic groups may be protected from entry by high mobility barriers.

CORE CONCEPT

Mobility barriers restrict firms in one strategic group from entering another more attractive strategic group in the same industry.

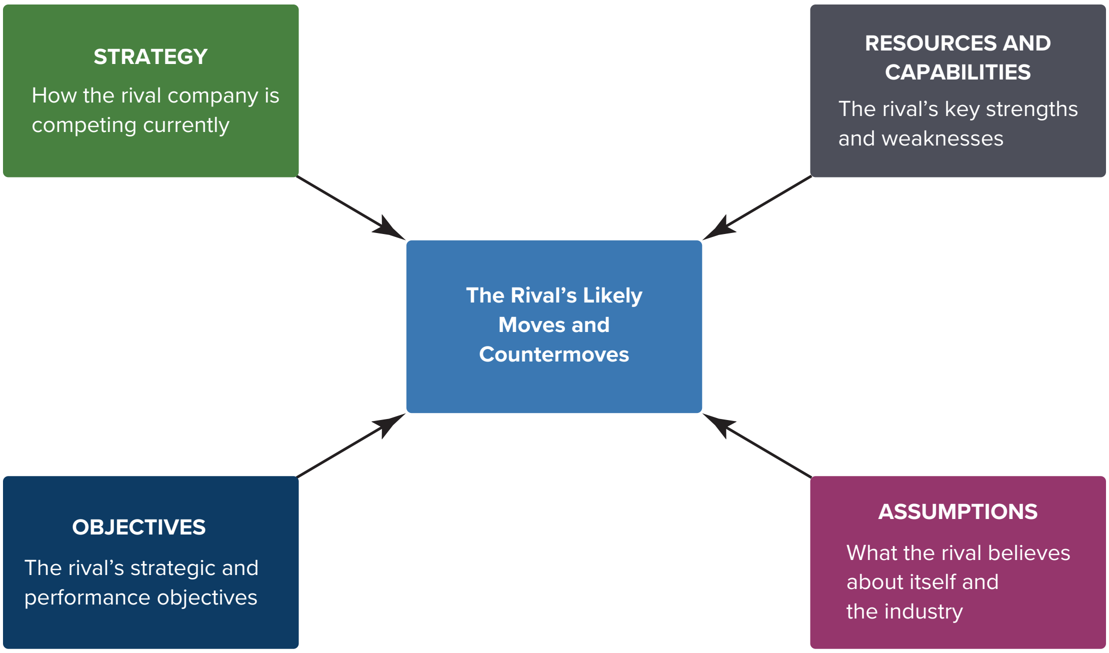
COMPETITOR ANALYSIS AND THE SOAR FRAMEWORK

Studying competitors' past behavior and preferences provides a valuable assist in anticipating what moves rivals are likely to make next and outmaneuvering them in the marketplace.

Unless a company pays attention to the strategies and situations of competitors and has some inkling of what moves they will be making, it ends up flying blind into competitive battle. As in sports, scouting the opposition is an essential part of game plan development. Gathering competitive intelligence about the strategic direction and likely moves of key competitors allows a company to prepare defensive countermoves, to craft its own strategic moves with some confidence about what market maneuvers to expect from rivals in response, and to exploit any openings that arise from competitors' missteps. The question is where to look for such information, since rivals rarely reveal their strategic intentions openly. If information is not directly available, what are the best indicators?

Michael Porter's **SOAR Framework for Competitor Analysis** points to four indicators of a rival's likely strategic moves and countermoves. These include a rival's *Strategy, Objectives, Assumptions* about itself and the industry, and *Resources and capabilities,* as shown in Figure 3.10. A strategic profile of a competitor that provides good clues to its behavioral proclivities can be constructed by characterizing the rival along these four dimensions. By "behavioral proclivities," we mean what competitive moves a rival is likely to make and how they are likely to react to the competitive moves of your company—its probable actions and reactions. By listing all that you know about a competitor (or a set of competitors) with respect to each of the four elements of the SOAR framework, you are likely to gain some insight about how the rival will behave

FIGURE 3.10 The SOAR Framework for Competitor Analysis



in the near term. And knowledge of this sort can help you to predict how this will affect you, and how you should position yourself to respond. That is, what should you do to protect yourself or gain advantage now (in advance); and what should you do in response to your rivals next moves?

Current Strategy To succeed in predicting a competitor's next moves, company strategists need to have a good understanding of each rival's current strategy, as an indicator of its pattern of behavior and best strategic options. Questions to consider include: How is the competitor positioned in the market? What is the basis for its competitive advantage (if any)? What kinds of investments is it making (as an indicator of its growth trajectory)?

Objectives An appraisal of a rival's objectives should include not only its financial performance objectives but strategic ones as well (such as those concerning market share). What is even more important is to consider the extent to which the rival is meeting these objectives and whether it is under pressure to improve. Rivals with good financial performance are likely to continue their present strategy with only minor fine-tuning. Poorly performing rivals are virtually certain to make fresh strategic moves.

Resources and Capabilities A rival's strategic moves and countermoves are both enabled and constrained by the set of resources and capabilities the rival has at hand. Thus, a rival's resources and capabilities (and efforts to acquire new resources and capabilities) serve as a strong signal of future strategic actions (and reactions to your company's moves). Assessing a rival's resources and capabilities involves sizing up not only its strengths in this respect but its weaknesses as well.

Assumptions How a rival's top managers think about their strategic situation can have a big impact on how the rival behaves. Banks that believe they are "too big to fail," for example, may take on more risk than is financially prudent. Assessing a rival's assumptions entails considering its assumptions about itself as well as about the industry it participates in.

Information regarding these four analytic components can often be gleaned from company press releases, information posted on the company's website (especially the presentations management has recently made to securities analysts), and such public documents as annual reports and 10-K filings. Many companies also have a competitive intelligence unit that sifts through the available information to construct up-to-date strategic profiles of rivals.[8]

Doing the necessary detective work can be time-consuming, but scouting competitors well enough to anticipate their next moves allows managers to prepare effective countermoves (perhaps even beat a rival to the punch) and to take rivals' probable actions into account in crafting their own best course of action. Despite the importance of gathering such information, these activities should never cross the bounds of ethical impropriety (see Illustration Capsule 3.3).

KEY SUCCESS FACTORS

CORE CONCEPT

Key success factors are the strategy elements, product and service attributes, operational approaches, resources, and competitive capabilities that are essential to surviving and thriving in the industry.

An industry's **key success factors (KSFs)** are those competitive factors that most affect industry members' ability to survive and prosper in the marketplace: the particular strategy elements, product attributes, operational approaches, resources, and competitive capabilities that spell the difference between being a strong competitor and a weak competitor—and between profit and loss. KSFs by their very nature are so important to competitive success that *all firms* in the industry must pay close attention to them or risk becoming an industry laggard or failure. To indicate the significance of KSFs another way, how well the elements of a company's strategy measure up against an industry's KSFs determines whether the company can meet the basic criteria for surviving and thriving in the industry. Identifying KSFs, in light of the prevailing and anticipated industry and competitive conditions, is therefore always a top priority in analytic and strategy-making considerations. Company strategists need to understand the industry landscape well enough to separate the factors most important to competitive success from those that are less important.

Key success factors vary from industry to industry, and even from time to time within the same industry, as change drivers and competitive conditions change. But regardless of the circumstances, an industry's key success factors can always be deduced by asking the same three questions:

1. On what basis do buyers of the industry's product choose between the competing brands of sellers? That is, what product attributes and service characteristics are crucial?
2. Given the nature of competitive rivalry prevailing in the marketplace, what resources and competitive capabilities must a company have to be competitively successful?
3. What shortcomings are almost certain to put a company at a significant competitive disadvantage?

Only rarely are there more than five key factors for competitive success. And even among these, two or three usually outrank the others in importance. Managers should therefore bear in mind the purpose of identifying key success factors—to determine which factors are most important to competitive success—and resist the temptation to label a factor that has only minor importance as a KSF.

In the beer industry, for example, although there are many types of buyers (wholesale, retail, end consumer), it is most important to understand the preferences and buying behavior of the beer drinkers. Their purchase decisions are driven by price, taste, convenient access, and marketing. Thus, the KSFs include a *strong network of wholesale distributors* (to get the company's brand stocked and favorably displayed in retail outlets, bars, restaurants, and stadiums, where beer is sold) and *clever advertising* (to induce beer drinkers to buy the company's brand and thereby pull beer sales through the established wholesale and retail channels). Because there is a potential for strong buyer power on the part of large distributors and retail chains, competitive success depends on some mechanism to offset that power, of which advertising (to create demand pull) is one. Thus, the KSFs also include *superior product differentiation* (as in microbrews) or *superior firm size and branding capabilities* (as in national brands). The KSFs also include *full utilization of brewing capacity* (to keep manufacturing costs low and offset the high costs of advertising, branding, and product differentiation).

Correctly diagnosing an industry's KSFs also raises a company's chances of crafting a sound strategy. The key success factors of an industry point to those things that every firm in the industry needs to attend to in order to retain customers and weather the competition. If the company's strategy cannot deliver on the key success factors of its industry, it is unlikely to earn enough profits to remain a viable business.

THE INDUSTRY OUTLOOK FOR PROFITABILITY

LO 3-4

Determine whether an industry's outlook presents a company with sufficiently attractive opportunities for growth and profitability.

Each of the frameworks presented in this chapter—PESTEL, five forces analysis, driving forces, strategy groups, competitor analysis, and key success factors—provides a useful perspective on an industry's outlook for future profitability. Putting them all together provides an even richer and more nuanced picture. Thus, the final step in evaluating the industry and competitive environment is to use the results of each of the analyses performed to determine whether the industry presents the company with strong prospects for competitive success and attractive profits. The important factors on which to base a conclusion include

- How the company is being impacted by the state of the macro-environment.
- Whether strong competitive forces are squeezing industry profitability to subpar levels.
- Whether the presence of complementors and the possibility of cooperative actions improve the company's prospects.
- Whether industry profitability will be favorably or unfavorably affected by the prevailing driving forces.
- Whether the company occupies a stronger market position than rivals.
- Whether this is likely to change in the course of competitive interactions.
- How well the company's strategy delivers on the industry key success factors.

As a general proposition, *the anticipated industry environment is fundamentally attractive if it presents a company with good opportunity for above-average profitability; the industry outlook is fundamentally unattractive if a company's profit prospects are unappealingly low.*

However, it is a mistake to think of a particular industry as being equally attractive or unattractive to all industry participants and all potential entrants.[9] Attractiveness is relative, not absolute, and conclusions one way or the other have to be drawn from the perspective of a particular company. For instance, a favorably positioned competitor may see ample opportunity to capitalize on the vulnerabilities of weaker rivals even though industry conditions are otherwise somewhat dismal. At the same time, industries attractive to insiders may be unattractive to outsiders because of the difficulty of challenging current market leaders or because they have more attractive opportunities elsewhere.

The degree to which an industry is attractive or unattractive is not the same for all industry participants and all potential entrants.

When a company decides an industry is fundamentally attractive and presents good opportunities, a strong case can be made that it should invest aggressively to capture the opportunities it sees and to improve its long-term competitive position in the business. When a strong competitor concludes an industry is becoming less attractive, it may elect to simply protect its present position, investing cautiously—if at all—and looking for opportunities in other industries. A competitively weak company in an unattractive industry may see its best option as finding a buyer, perhaps a rival, to acquire its business.

KEY POINTS

Thinking strategically about a company's external situation involves probing for answers to the following questions:

1. *What are the strategically relevant factors in the macro-environment, and how do they impact an industry and its members?* Industries differ significantly as to how they are affected by conditions and developments in the broad macro-environment. Using PESTEL analysis to identify which of these factors is strategically relevant is the first step to understanding how a company is situated in its external environment.
2. *What kinds of competitive forces are industry members facing, and how strong is each force?* The strength of competition is a composite of five forces: (1) rivalry within the industry, (2) the threat of new entry into the market, (3) inroads being made by the sellers of substitutes, (4) supplier bargaining power, and (5) buyer power. All five must be examined force by force, and their collective strength evaluated. One strong force, however, can be sufficient to keep average industry profitability low. Working through the five forces model aids strategy makers in assessing how to insulate the company from the strongest forces, identify attractive arenas for expansion, or alter the competitive conditions so that they offer more favorable prospects for profitability.
3. *What cooperative forces are present in the industry, and how can a company harness them to its advantage?* Interactions among industry participants are not only competitive in nature but cooperative as well. This is particularly the case when complements to the products or services of an industry are important. The Value Net framework assists managers in sizing up the impact of cooperative as well as competitive interactions on their firm.

4. *What factors are driving changes in the industry, and what impact will they have on competitive intensity and industry profitability?* Industry and competitive conditions change because certain forces are acting to create incentives or pressures for change. The first step is to identify the three or four most important drivers of change affecting the industry being analyzed (out of a much longer list of potential drivers). Once an industry's change drivers have been identified, the analytic task becomes one of determining whether they are acting, individually and collectively, to make the industry environment more or less attractive.
5. *What market positions do industry rivals occupy—who is strongly positioned and who is not?* Strategic group mapping is a valuable tool for understanding the similarities, differences, strengths, and weaknesses inherent in the market positions of rival companies. Rivals in the same or nearby strategic groups are close competitors, whereas companies in distant strategic groups usually pose little or no immediate threat. The lesson of strategic group mapping is that some positions on the map are more favorable than others. The profit potential of different strategic groups may not be the same because industry driving forces and competitive forces likely have varying effects on the industry's distinct strategic groups. Moreover, mobility barriers restrict movement between groups in the same way that entry barriers prevent easy entry into attractive industries.
6. *What strategic moves are rivals likely to make next?* Anticipating the actions of rivals can help a company prepare effective countermoves. Using the SOAR Framework for Competitor Analysis is helpful in this regard.
7. *What are the key factors for competitive success?* An industry's key success factors (KSFs) are the particular strategy elements, product attributes, operational approaches, resources, and competitive capabilities that all industry members must have in order to survive and prosper in the industry. For any industry, they can be deduced by answering three basic questions: (1) On what basis do buyers of the industry's product choose between the competing brands of sellers, (2) what resources and competitive capabilities must a company have to be competitively successful, and (3) what shortcomings are almost certain to put a company at a significant competitive disadvantage?
8. *Is the industry outlook conducive to good profitability?* The last step in industry analysis is summing up the results from applying each of the frameworks employed in answering questions 1 to 7: PESTEL, five forces analysis, Value Net, driving forces, strategic group mapping, competitor analysis, and key success factors. Applying multiple lenses to the question of what the industry outlook looks like offers a more robust and nuanced answer. If the answers from each framework, seen as a whole, reveal that a company's profit prospects in that industry are above-average, then the industry environment is basically attractive *for that company.* What may look like an attractive environment for one company may appear to be unattractive from the perspective of a different company.

Clear, insightful diagnosis of a company's external situation is an essential first step in crafting strategies that are well matched to industry and competitive conditions. To do cutting-edge strategic thinking about the external environment, managers must know what questions to pose and what analytic tools to use in answering these questions. This is why this chapter has concentrated on suggesting the right questions to ask, explaining concepts and analytic approaches, and indicating the kinds of things to look for.

ASSURANCE OF LEARNING EXERCISES

LO 3-2

1. Prepare a brief analysis of the organic food industry using the information provided by the Organic Trade Association at **www.ota.com** and other sources you might find on the worldwide web. That is, based on the information provided on these websites, draw a five forces diagram for the organic food industry and briefly discuss the nature and strength of each of the five competitive forces.

Mc Graw Hill connect
LO 3-3

2. Based on the strategic group map in Illustration Capsule 3.2, which food delivery services are Uber Eats closest competitors? With which strategic group does Shipt compete the least, according to this map? In which direction should **Delivery.com** move to grow their business?

LO 3-1, LO 3-4

3. TouchBistro publishes an annual report on trends in the restaurant industry that can be found at **www.touchbistro.com**. The National Restaurant Association also publishes an annual report that may be found by Googling "State of the Restaurant Industry" for the current year. Based on information in the latest report, does it appear that macro-environmental factors and the economic characteristics of the industry will present industry participants with attractive opportunities for growth and profitability? Explain.

EXERCISES FOR SIMULATION PARTICIPANTS

Mc Graw Hill connect

LO 3-1

1. Which of the factors listed in Table 3.1 might have the most strategic relevance for your industry?

LO 3-2

2. Which of the five competitive forces is creating the strongest competitive pressures for your company?

LO 3-3

3. What are the "weapons of competition" that rival companies in your industry can use to gain sales and market share? See Table 3.2 to help you identify the various competitive factors.

LO 3-4

4. What are the factors affecting the intensity of rivalry in the industry in which your company is competing? Use Figure 3.4 and the accompanying discussion to help you in pinpointing the specific factors most affecting competitive intensity. Would you characterize the rivalry and jockeying for better market position, increased sales, and market share among the companies in your industry as fierce, very strong, strong, moderate, or relatively weak? Why?

LO 3-2

5. Are there any driving forces in the industry in which your company is competing? If so, what impact will these driving forces have? Will they cause competition to be more or less intense? Will they act to boost or squeeze profit margins? List at least two actions your company should consider taking in order to combat any negative impacts of the driving forces.

LO 3-3

6. Draw a strategic group map showing the market positions of the companies in your industry. Which companies do you believe are in the most attractive position on the map? Which companies are the most weakly positioned? Which companies do you believe are likely to try to move to a different position on the strategic group map?

LO 3-4

7. What do you see as the key factors for being a successful competitor in your industry? List at least three.

LO 3-4

8. Does your overall assessment of the industry suggest that industry rivals have sufficiently attractive opportunities for growth and profitability? Explain.

ENDNOTES

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[3] Ibid.

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[5] For a more extended discussion of the problems with the life-cycle hypothesis, see Porter, *Competitive Strategy,* pp. 157–162.

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[7] Avi Fiegenbaum and Howard Thomas, "Strategic Groups as Reference Groups: Theory, Modeling and Empirical Examination of Industry and Competitive Strategy," *Strategic Management Journal* 16 (1995), pp. 461–476; S. Ade Olusoga, Michael P. Mokwa, and Charles H. Noble, "Strategic Groups, Mobility Barriers, and Competitive Advantage," *Journal of Business Research* 33 (1995), pp. 153–164.

[8] Larry Kahaner, *Competitive Intelligence* (New York: Simon & Schuster, 1996).

[9] B. Wernerfelt and C. Montgomery, "What Is an Attractive Industry?" *Management Science* 32, no. 10 (October 1986), pp. 1223–1230.

chapter 4

Evaluating a Company's Resources, Capabilities, and Competitiveness

Learning Objectives

After reading this chapter, you should be able to

LO 4-1 Evaluate how well a company's strategy is working.

LO 4-2 Assess the company's strengths and weaknesses in light of market opportunities and external threats.

LO 4-3 Explain why a company's resources and capabilities are critical for gaining a competitive edge over rivals.

LO 4-4 Understand how value chain activities affect a company's cost structure and customer value proposition.

LO 4-5 Explain how a comprehensive evaluation of a company's competitive situation can assist managers in making critical decisions about their next strategic moves.

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Crucial, of course, is having a difference that matters in the industry.

Cynthia Montgomery—*Professor and author*

If you don't have a competitive advantage, don't compete.

Jack Welch—*Former CEO of General Electric*

Superior resources and capabilities are the foundation of competitive advantage

Constance Helfat—*Professor and thought leader*

Chapter 3 described how to use the tools of industry and competitor analysis to assess a company's external environment and lay the groundwork for matching a company's strategy to its external situation. This chapter discusses techniques for evaluating a company's internal situation, including its collection of resources and capabilities and the activities it performs along its value chain. Internal analysis enables managers to determine whether their strategy is likely to give the company a significant competitive edge over rival firms (given external conditions). Combined with external analysis, it facilitates an understanding of how to reposition a firm to take advantage of new opportunities and to cope with emerging competitive threats. The analytic spotlight will be trained on six questions:

1. How well is the company's present strategy working?
2. What are the company's strengths and weaknesses in relation to the market opportunities and external threats?
3. What are the company's most important resources and capabilities, and will they give the company a lasting competitive advantage over rival companies?
4. How do a company's value chain activities impact its cost structure and customer value proposition?
5. Is the company competitively stronger or weaker than key rivals?
6. What strategic issues and problems merit front-burner managerial attention?

In probing for answers to these questions, five analytic tools—resource and capability analysis, SWOT analysis, value chain analysis, benchmarking, and competitive strength assessment—will be used. All five are valuable techniques for revealing a company's competitiveness and for helping company managers match their strategy to the company's particular circumstances. Accordingly, this will enable the company to pass the first of the three tests of a *winning strategy* (the Fit Test), as discussed in Chapter 1.

QUESTION 1: HOW WELL IS THE COMPANY'S PRESENT STRATEGY WORKING?

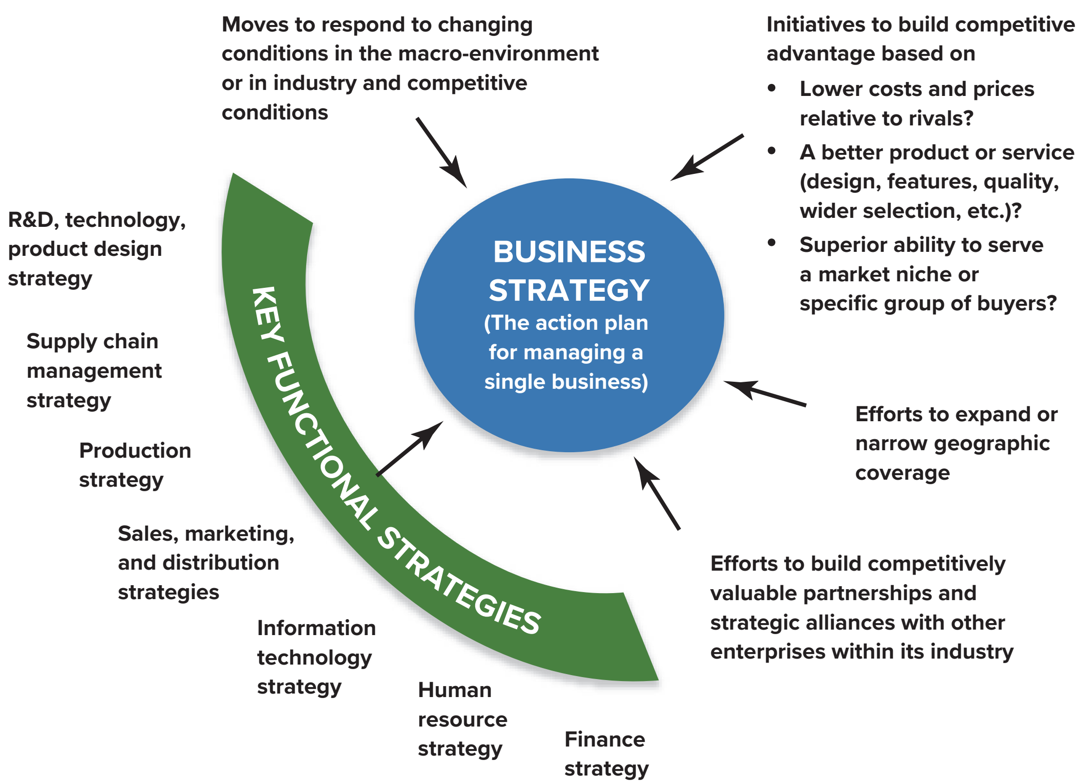
LO 4-1

Evaluate how well a company's strategy is working.

Before evaluating how well a company's present strategy is working, it is best to start with a clear view of what the strategy entails. The first thing to examine is the company's competitive approach. What moves has the company made recently to attract customers and improve its market position—for instance, has it cut prices, improved the design of its product, added new features, stepped up advertising, entered a new geographic market, or merged with a competitor? Is it striving for a competitive advantage based on low costs or a better product offering? Is it concentrating on serving a broad spectrum of customers or a narrow market niche? The company's functional strategies in R&D, production, marketing, finance, human resources, information technology, and so on further characterize company strategy, as do any efforts to establish alliances with other enterprises. Figure 4.1 shows the key components of a single-business company's strategy.

A determination of the effectiveness of this strategy requires a more in-depth type of analysis. The two best indicators of how well a company's strategy is working are (1) whether the company is recording gains in financial strength and profitability, and (2) whether the company's competitive strength and market standing are improving. Persistent shortfalls in meeting company performance targets and weak marketplace

FIGURE 4.1 Identifying the Components of a Single-Business Company's Strategy



performance relative to rivals are reliable warning signs that the company has a weak strategy, suffers from poor strategy execution, or both. Specific indicators of how well a company's strategy is working include

- Trends in the company's sales and earnings growth.
- Trends in the company's stock price.
- The company's overall financial strength.
- The company's customer retention rate.
- The rate at which new customers are acquired.
- Evidence of improvement in internal processes such as defect rate, order fulfillment, delivery times, days of inventory, and employee productivity.

The stronger a company's current overall performance, the more likely it has a well-conceived, well-executed strategy. The weaker a company's financial performance and market standing, the more its current strategy must be questioned and the more likely radical changes are needed. Table 4.1 provides a compilation of the financial ratios most commonly used to evaluate a company's financial performance and balance sheet strength.

Sluggish financial performance and second-rate market accomplishments almost always signal weak strategy, weak execution, or both.

TABLE 4.1 Key Financial Ratios: How to Calculate Them and What They Mean

Ratio	How Calculated	What It Shows
Profitability ratios		
1. Gross profit margin	$\frac{\text{Sales revenues} - \text{Cost of goods sold}}{\text{Sales revenues}}$	Shows the percentage of revenues available to cover operating expenses and yield a profit.
2. Operating profit margin (or return on sales)	$\frac{\text{Sales revenues} - \text{Operating expenses}}{\text{Sales revenues}}$ *or* $\frac{\text{Operating income}}{\text{Sales revenues}}$	Shows the profitability of current operations without regard to interest charges and income taxes. Earnings before interest and taxes is known as *EBIT* in financial and business accounting.
3. Net profit margin (or net return on sales)	$\frac{\text{Profits after taxes}}{\text{Sales revenues}}$	Shows after-tax profits per dollar of sales.
4. Total return on assets	$\frac{\text{Profits after taxes} + \text{Interest}}{\text{Total assets}}$	A measure of the return on total investment in the enterprise. Interest is added to after-tax profits to form the numerator, since total assets are financed by creditors as well as by stockholders.
5. Net return on total assets (ROA)	$\frac{\text{Profits after taxes}}{\text{Total assets}}$	A measure of the return earned by stockholders on the firm's total assets.
6. Return on stockholders' equity (ROE)	$\frac{\text{Profits after taxes}}{\text{Total stockholders' equity}}$	The return stockholders are earning on their capital investment in the enterprise. A return in the 12% to 15% range is average.
7. Return on invested capital (ROIC)—sometimes referred to as return on capital employed (ROCE)	$\frac{\text{Profits after taxes}}{\text{Long-term debt} + \text{Total stockholders' equity}}$	A measure of the return that shareholders are earning on the monetary capital invested in the enterprise. A higher return reflects greater bottom-line effectiveness in the use of long-term capital.

(continued)

TABLE 4.1 *(continued)*

Ratio	How Calculated	What It Shows
Liquidity ratios		
1. Current ratio	$\frac{\text{Current assets}}{\text{Current liabilites}}$	Shows a firm's ability to pay current liabilities using assets that can be converted to cash in the near term. Ratio should be higher than 1.0.
2. Working capital	Current assets − Current liabilities	The cash available for a firm's day-to-day operations. Larger amounts mean the company has more internal funds to (1) pay its current liabilities on a timely basis and (2) finance inventory expansion, additional accounts receivable, and a larger base of operations without resorting to borrowing or raising more equity capital.
Leverage ratios		
1. Total debt-to-assets ratio	$\frac{\text{Total debt}}{\text{Total assets}}$	Measures the extent to which borrowed funds (both short-term loans and long-term debt) have been used to finance the firm's operations. A low ratio is better—a high fraction indicates overuse of debt and greater risk of bankruptcy.
2. Long-term debt-to-capital ratio	$\frac{\text{Long-term debt}}{\text{Long-term debt + Total stockholders' equity}}$	A measure of creditworthiness and balance sheet strength. It indicates the percentage of capital investment that has been financed by both long-term lenders and stockholders. A ratio below 0.25 is preferable since the lower the ratio, the greater the capacity to borrow additional funds. Debt-to-capital ratios above 0.50 indicate an excessive reliance on long-term borrowing, lower creditworthiness, and weak balance sheet strength.
3. Debt-to-equity ratio	$\frac{\text{Total debt}}{\text{Total stockholders' equity}}$	Shows the balance between debt (funds borrowed both short term and long term) and the amount that stockholders have invested in the enterprise. The further the ratio is below 1.0, the greater the firm's ability to borrow additional funds. Ratios above 1.0 put creditors at greater risk, signal weaker balance sheet strength, and often result in lower credit ratings.
4. Long-term debt-to-equity ratio	$\frac{\text{Long-term debt}}{\text{Total stockholders' equity}}$	Shows the balance between long-term debt and stockholders' equity in the firm's *long-term* capital structure. Low ratios indicate a greater capacity to borrow additional funds if needed.
5. Times-interest-earned (or coverage) ratio	$\frac{\text{Operating income}}{\text{Interest expenses}}$	Measures the ability to pay annual interest charges. Lenders usually insist on a minimum ratio of 2.0, but ratios above 3.0 signal progressively better creditworthiness.
Activity ratios		
1. Days of inventory	$\frac{\text{Inventory}}{\text{Cost of goods sold} \div 365}$	Measures inventory management efficiency. Fewer days of inventory are better.

TABLE 4.1 *(continued)*

Ratio	How Calculated	What It Shows
2. Inventory turnover	$\frac{\text{Cost of goods sold}}{\text{Inventory}}$	Measures the number of inventory turns per year. Higher is better.
3. Average collection period	$\frac{\text{Accounts receivable}}{\text{Total sales} \div 365}$ *or* $\frac{\text{Accounts receivable}}{\text{Average daily sales}}$	Indicates the average length of time the firm must wait after making a sale to receive cash payment. A shorter collection time is better.
Other important measures of financial performance		
1. Dividend yield on common stock	$\frac{\text{Annual dividends per share}}{\text{Current market price per share}}$	A measure of the return that shareholders receive in the form of dividends. A "typical" dividend yield is 2% to 3%. The dividend yield for fast-growth companies is often below 1%; the dividend yield for slow-growth companies can run 4% to 5%.
2. Price-to-earnings (P/E) ratio	$\frac{\text{Current market price per share}}{\text{Earnings per share}}$	P/E ratios above 20 indicate strong investor confidence in a firm's outlook and earnings growth; firms whose future earnings are at risk or likely to grow slowly typically have ratios below 12.
3. Dividend payout ratio	$\frac{\text{Annual divdends per share}}{\text{Earnings per share}}$	Indicates the percentage of after-tax profits paid out as dividends.
4. Internal cash flow	After-tax profits + Depreciation	A rough estimate of the cash a company's business is generating after payment of operating expenses, interest, and taxes. Such amounts can be used for dividend payments or funding capital expenditures.
5. Free cash flow	After-tax profits + Depreciation − Capital expenditures − Dividends	A rough estimate of the cash a company's business is generating after payment of operating expenses, interest, taxes, dividends, and desirable reinvestments in the business. The larger a company's free cash flow, the greater its ability to internally fund new strategic initiatives, repay debt, make new acquisitions, repurchase shares of stock, or increase dividend payments.

QUESTION 2: WHAT ARE THE COMPANY'S STRENGTHS AND WEAKNESSES IN RELATION TO THE MARKET OPPORTUNITIES AND EXTERNAL THREATS?

An examination of the financial and other indicators discussed previously can tell you how well a strategy is working, but they tell you little about the underlying reasons—*why* it's working or not. The simplest and most easily applied tool for gaining some

LO 4-2

Assess the company's strengths and weaknesses in light of market opportunities and external threats.

insight into the reasons for the success of a strategy or lack thereof is known as **SWOT analysis.** SWOT is an acronym that stands for a company's internal **S**trengths and **W**eaknesses, market **O**pportunities, and external **T**hreats. Another name for SWOT analysis is Situational Analysis. A first-rate SWOT analysis can help explain why a strategy is working well (or not) by taking a good hard look a company's strengths in relation to its weaknesses and in relation to the strengths and weaknesses of competitors. Are the company's strengths great enough to make up for its weaknesses? Has the company's strategy built on these strengths and shielded the company from its weaknesses? Do the company's strengths exceed those of its rivals or have they been overpowered? Similarly, a SWOT analysis can help determine whether a strategy has been effective in fending off external threats and positioning the firm to take advantage of market opportunities.

CORE CONCEPT

SWOT analysis, or Situational Analysis, is a popular, easy-to-use tool for sizing up a company's strengths and weaknesses, its market opportunities, and external threats.

Basing a company's strategy on its most competitively valuable strengths gives the company its best chance for market success.

SWOT analysis has long been one of the most popular and widely used diagnostic tools for strategists. It is used fruitfully by organizations that range in type from large corporations to small businesses, to government agencies to nonprofits such as churches and schools. Its popularity stems in part from its ease of use, but also because it can be used not only to evaluate the efficacy of a strategy, but also as the basis for crafting a strategy from the outset that capitalizes on the company's strengths, overcomes its weaknesses, aims squarely at capturing the company's best opportunities, and defends against competitive and macro-environmental threats. Moreover, a SWOT analysis can help a company with a strategy that is working well in the present determine whether the company is in a position to pursue new market opportunities and defend against emerging threats to its future well-being.

Identifying a Company's Internal Strengths

An internal **strength** is something a company is good at doing or an attribute that enhances its competitiveness in the marketplace.

One way to appraise a company's strengths is to ask: What activities does the company perform well? This question directs attention to the company's skill level in performing key pieces of its business—such as supply chain management, R&D, production, distribution, sales and marketing, and customer service. A company's skill or proficiency in performing different facets of its operations can range from the extreme of having minimal ability to perform an activity (perhaps having just struggled to do it the first time) to the other extreme of being able to perform the activity better than any other company in the industry.

CORE CONCEPT

A **competence** is an activity that a company has learned to perform with proficiency.

A **distinctive competence** is a capability that enables a company to perform a particular set of activities better than its rivals.

When a company's proficiency rises from that of mere ability to perform an activity to the point of being able to perform it consistently well and at acceptable cost, it is said to have a **competence**—a true *capability,* in other words. If a company's competence level in some activity domain is superior to that of its rivals it is known as a **distinctive competence.** A **core competence** is a proficiently performed internal activity that is *central* to a company's strategy and is typically distinctive as well. A core competence is a more competitively valuable strength than a competence because of the activity's key role in the company's strategy and the contribution it makes to the company's market success and profitability. Often, core competencies can be leveraged to create new markets or new product demand, as the engine behind a company's growth. Procter and Gamble has a core competence in brand management, which has led to an ever-increasing portfolio of market-leading consumer products, including Charmin, Tide, Crest, Tampax, Olay, Febreze, Luvs, Pampers, and Swiffer. Nike has a core competence in designing and marketing innovative athletic footwear and sports apparel. Kellogg has a core competence in developing, producing, and marketing breakfast cereals.

CORE CONCEPT

A **core competence** is an activity that a company performs proficiently and that is also central to its strategy and competitive success.

Identifying Company Internal Weaknesses

CORE CONCEPT

A company's **strengths** represent its competitive assets; its **weaknesses** are shortcomings that constitute competitive liabilities.

An internal **weakness** is something a company lacks or does poorly (in comparison to others) or a condition that puts it at a disadvantage in the marketplace. It can be thought of as a competitive deficiency. A company's internal weaknesses can relate to (1) inferior or unproven skills, expertise, or intellectual capital in competitively important areas of the business, or (2) deficiencies in competitively important physical, organizational, or intangible assets. Nearly all companies have competitive deficiencies of one kind or another. Whether a company's internal weaknesses make it competitively vulnerable depends on how much they matter in the marketplace and whether they are offset by the company's strengths.

Table 4.2 lists many of the things to consider in compiling a company's strengths and weaknesses. Sizing up a company's complement of strengths and deficiencies is akin to constructing a *strategic balance sheet,* where strengths represent *competitive assets* and weaknesses represent *competitive liabilities.* Obviously, the ideal condition is for the company's competitive assets to outweigh its competitive liabilities by an ample margin!

Identifying a Company's Market Opportunities

Market opportunity is a big factor in shaping a company's strategy. Indeed, managers can't properly tailor strategy to the company's situation without first identifying its market opportunities and appraising the growth and profit potential each one holds. Depending on the prevailing circumstances, a company's opportunities can be plentiful or scarce, fleeting or lasting, and can range from wildly attractive to marginally interesting or unsuitable.

Newly emerging and fast-changing markets sometimes present stunningly big or "golden" opportunities, but it is typically hard for managers at one company to peer into "the fog of the future" and spot them far ahead of managers at other companies.[1] But as the fog begins to clear, golden opportunities are nearly always seized rapidly—and the companies that seize them are usually those that have been staying alert with diligent market reconnaissance and preparing themselves to capitalize on shifting market conditions swiftly. Table 4.2 displays a sampling of potential market opportunities.

Identifying External Threats

Simply listing a company's strengths, weaknesses, opportunities, and threats is not enough; the payoff from SWOT analysis comes from the conclusions about a company's situation and the implications for strategy improvement that flow from the four lists.

Often, certain factors in a company's external environment pose *threats* to its profitability and competitive well-being. Threats can stem from such factors as the emergence of cheaper or better technologies, the entry of lower-cost competitors into a company's market stronghold, new regulations that are more burdensome to a company than to its competitors, unfavorable demographic shifts, and political upheaval in a foreign country where the company has facilities.

External threats may pose no more than a moderate degree of adversity (all companies confront some threatening elements in the course of doing business), or they may be imposing enough to make a company's situation look tenuous. On

TABLE 4.2 What to Look for in Identifying a Company's Strengths, Weaknesses, Opportunities, and Threats

Strengths and Competitive Assets	Weaknesses and Competitive Deficiencies
• Ample financial resources to grow the business • Strong brand-name image or reputation • Distinctive core competencies • Cost advantages over rivals • Attractive customer base • Proprietary technology, superior technological skills, important patents • Strong bargaining power over suppliers or buyers • Superior product quality • Wide geographic coverage and/or strong global distribution capability • Alliances and/or joint ventures that provide access to valuable technology, competencies, and/or attractive geographic markets	• No distinctive core competencies • Lack of attention to customer needs • Inferior product quality • Weak balance sheet, too much debt • Higher costs than competitors • Too narrow a product line relative to rivals • Weak brand image or reputation • Lack of adequate distribution capability • Lack of management depth • A plague of internal operating problems or obsolete facilities • Too much underutilized plant capacity
Market Opportunities	**External Threats**
• Meet sharply rising buyer demand for the industry's product • Serve additional customer groups or market segments • Expand into new geographic markets • Expand the company's product line to meet a broader range of customer needs • Enter new product lines or new businesses • Take advantage of falling trade barriers in attractive foreign markets • Take advantage of an adverse change in the fortunes of rival firms • Acquire rival firms or companies with attractive technological expertise or competencies • Take advantage of emerging technological developments to innovate • Enter into alliances or other cooperative ventures	• Increased intensity of competition • Slowdowns in market growth • Likely entry of potent new competitors • Growing bargaining power of customers or suppliers • A shift in buyer needs and tastes away from the industry's product • Adverse demographic changes that threaten to curtail demand for the industry's product • Adverse economic conditions that threaten critical suppliers or distributors • Changes in technology—particularly disruptive technology that can undermine the company's distinctive competencies • Restrictive foreign trade policies • Costly new regulatory requirements • Tight credit conditions • Rising prices on energy or other key inputs

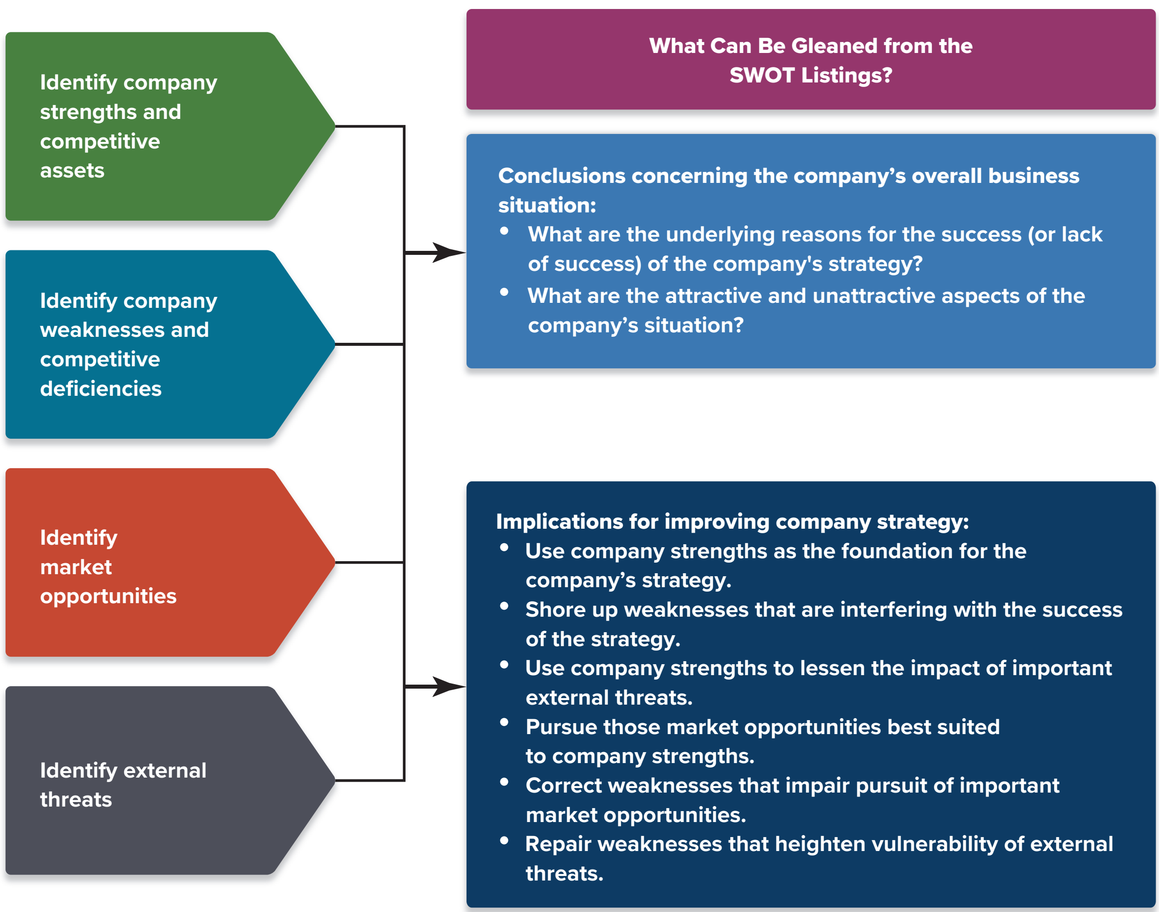
rare occasions, market shocks can give birth to a *sudden-death* threat that throws a company into an immediate crisis and a battle to survive. Many of the world's major financial institutions were plunged into unprecedented crisis in 2008–2009 by the aftereffects of high-risk mortgage lending, inflated credit ratings on subprime mortgage securities, the collapse of housing prices, and a market flooded with mortgage-related investments (collateralized debt obligations) whose values suddenly evaporated. It is management's job to identify the threats to the company's future prospects and to evaluate what strategic actions can be taken to neutralize or lessen their impact.

What Do the SWOT Listings Reveal?

SWOT analysis involves more than making four lists. In crafting a new strategy, it offers a strong foundation for understanding how to position the company to build on its strengths in seizing new business opportunities and how to mitigate external threats by shoring up its competitive deficiencies. In assessing the effectiveness of an existing strategy, it can be used to glean insights regarding the company's overall business situation (thus the name Situational Analysis); and it can help translate these insights into recommended strategic actions. Figure 4.2 shows the steps involved in gleaning insights from SWOT analysis.

The beauty of SWOT analysis is its simplicity; but this is also its primary limitation. For a deeper and more accurate understanding of a company's situation, more sophisticated tools are required. Chapter 3 introduced you to a set of tools for analyzing a company's external situation. In the rest of this chapter, we look more deeply at a company's internal situation, beginning with the company's resources and capabilities.

FIGURE 4.2 The Steps Involved in SWOT Analysis: Identify the Four Components of SWOT, Draw Conclusions, Translate Implications into Strategic Actions



QUESTION 3: WHAT ARE THE COMPANY'S MOST IMPORTANT RESOURCES AND CAPABILITIES, AND WILL THEY GIVE THE COMPANY A LASTING COMPETITIVE ADVANTAGE?

CORE CONCEPT

A company's resources and capabilities represent its **competitive assets** and are determinants of its competitiveness and ability to succeed in the marketplace.

Resource and capability analysis is a powerful tool for sizing up a company's competitive assets and determining whether the assets can support a sustainable competitive advantage over market rivals.

An essential element of a company's internal environment is the nature of resources and capabilities. A company's resources and capabilities are its **competitive assets** and determine whether its competitive power in the marketplace will be impressively strong or disappointingly weak. Companies with second-rate competitive assets nearly always are relegated to a trailing position in the industry.

Resource and capability analysis provides managers with a powerful tool for sizing up the company's competitive assets and determining whether they can provide the foundation necessary for competitive success in the marketplace. This is a two-step process. The first step is to identify the company's resources and capabilities. The second step is to examine them more closely to ascertain which are the most competitively important and whether they can support a sustainable competitive advantage over rival firms.[2] This second step involves applying the *four tests of a resource's competitive power.*

Identifying the Company's Resources and Capabilities

LO 4-3

Explain why a company's resources and capabilities are critical for gaining a competitive edge over rivals.

A firm's resources and capabilities are the fundamental building blocks of its competitive strategy. In crafting strategy, it is essential for managers to know how to take stock of the company's full complement of resources and capabilities. But before they can do so, managers and strategists need a more precise definition of these terms.

In brief, a **resource** is a productive input or competitive asset that is owned or controlled by the firm. Firms have many different types of resources at their disposal that vary not only in kind but in quality as well. Some are of a higher quality than others, and some are more competitively valuable, having greater potential to give a firm a competitive advantage over its rivals. For example, a company's brand is a resource, as is an R&D team—yet some brands such as Coca-Cola and Xerox are well known, with enduring value, while others have little more name recognition than generic products. In similar fashion, some R&D teams are far more innovative and productive than others due to the outstanding talents of the individual team members, the team's composition, its experience, and its chemistry.

CORE CONCEPT

A **resource** is a competitive asset that is owned or controlled by a company; a **capability** (or **competence**) is the capacity of a firm to perform some internal activity competently. Organizational capabilities are developed and enabled through the deployment of a company's resources.

A **capability** is the capacity of a firm to perform some internal activity competently. A capability may also be referred to as a **competence.** Organizational capabilities, like resources, vary in form, quality, and competitive importance, with some being more competitively valuable than others. American Express displays superior capabilities in brand management and marketing; Starbucks's employee management, training, and real estate capabilities are the drivers behind its rapid growth; Microsoft's competences are in developing operating systems for computers and user software like Microsoft Office®.

Organizational capabilities are developed and enabled through the deployment of a company's resources.[3] For example, Nestlè's brand management capabilities for its 2,000 + food, beverage, and pet care brands draw on the knowledge of the company's brand managers, the expertise of its marketing department, and the company's relationships with retailers in nearly 200 countries. W. L. Gore's product innovation capabilities in its fabrics and medical and industrial product businesses result from the personal initiative, creative talents, and technological expertise of its associates and the company's culture that encourages accountability and creative thinking.

Types of Company Resources A useful way to identify a company's resources is to look for them within categories, as shown in Table 4.3. Broadly speaking, resources can be divided into two main categories: **tangible** and **intangible** resources. Although *human resources* make up one of the most important parts of a company's resource base, we include them in the intangible category to emphasize the role played by the skills, talents, and knowledge of a company's human resources.

Tangible resources are the most easily identified, since tangible resources are those that can be *touched* or *quantified* readily. Obviously, they include various types of *physical resources* such as manufacturing facilities and mineral resources, but they also include a company's *financial resources, technological resources,* and *organizational resources* such as the company's communication and control systems. Note that technological resources are included among tangible resources, *by convention,* even though some types, such as trade secrets, might be more logically categorized as intangible.

Intangible resources are harder to discern, but they are often among the most important of a firm's competitive assets. They include various sorts of *human assets*

TABLE 4.3 Types of Company Resources

Tangible resources
• *Physical resources:* land and real estate; manufacturing plants, equipment, and/or distribution facilities; the locations of stores, plants, or distribution centers, including the overall pattern of their physical locations; ownership of or access rights to natural resources (such as mineral deposits) • *Financial resources:* cash and cash equivalents; marketable securities; other financial assets such as a company's credit rating and borrowing capacity • *Technological assets:* patents, copyrights, production technology, innovation technologies, technological processes • *Organizational resources:* IT and communication systems (satellites, servers, workstations, etc.); other planning, coordination, and control systems; the company's organizational design and reporting structure
Intangible resources
• *Human assets and intellectual capital:* the education, experience, knowledge, and talent of the workforce, cumulative learning, and tacit knowledge of employees; collective learning embedded in the organization, the intellectual capital and know-how of specialized teams and work groups; the knowledge of key personnel concerning important business functions; managerial talent and leadership skill; the creativity and innovativeness of certain personnel • *Brands, company image, and reputational assets:* brand names, trademarks, product or company image, buyer loyalty and goodwill; company reputation for quality, service, and reliability; reputation with suppliers and partners for fair dealing • *Relationships:* alliances, joint ventures, or partnerships that provide access to technologies, specialized know-how, or geographic markets; networks of dealers or distributors; the trust established with various partners • *Company culture and incentive system:* the norms of behavior, business principles, and ingrained beliefs within the company; the attachment of personnel to the company's ideals; the compensation system and the motivation level of company personnel

and intellectual capital, as well as a company's *brands, image, and reputational assets.* While intangible resources have no material existence on their own, they are often embodied in something material. Thus, the skills and knowledge resources of a firm are embodied in its managers and employees; a company's brand name is embodied in the company logo or product labels. Other important kinds of intangible resources include a company's *relationships* with suppliers, buyers, or partners of various sorts, and the *company's culture and incentive system.*

Listing a company's resources category by category can prevent managers from inadvertently overlooking some company resources that might be competitively important. At times, it can be difficult to decide exactly how to categorize certain types of resources. For example, resources such as a work group's specialized expertise in developing innovative products can be considered to be technological assets or human assets or intellectual capital and knowledge assets; the work ethic and drive of a company's workforce could be included under the company's human assets or its culture and incentive system. In this regard, it is important to remember that *it is not exactly how a resource is categorized that matters but, rather, that all of the company's different types of resources are included in the inventory.* The real purpose of using categories in identifying a company's resources is *to ensure that none of a company's resources go unnoticed when sizing up the company's competitive assets.*

Identifying Organizational Capabilities Organizational capabilities are more complex entities than resources; indeed, they are built up through the use of resources and draw on some combination of the firm's resources as they are exercised. Virtually all organizational capabilities are *knowledge-based, residing in people and in a company's intellectual capital, or in organizational processes and systems, which embody tacit knowledge.* For example, Amazon's speedy delivery capabilities rely on the knowledge of its fulfillment center managers, its relationship with the United Parcel Service, and the experience of its merchandisers to correctly predict inventory flow. Bose's capabilities in auditory system design arise from the talented engineers that form the R&D team as well as the company's strong culture, which celebrates innovation and beautiful design.

Because of their complexity, organizational capabilities are harder to categorize than resources and more challenging to search for as a result. There are, however, two approaches that can make the process of uncovering and identifying a firm's capabilities more systematic. The first method takes the completed listing of a firm's resources as its starting point. Since organizational capabilities are built from resources and utilize resources as they are exercised, a firm's resources can provide a strong set of clues about the types of capabilities the firm is likely to have accumulated. This approach simply involves looking over the firm's resources and considering whether (and to what extent) the firm has built up any related capabilities. So, for example, a fleet of trucks, the latest RFID tracking technology, and a set of large automated distribution centers may be indicative of sophisticated capabilities in logistics and distribution. R&D teams composed of top scientists with expertise in genomics may suggest organizational capabilities in developing new gene therapies or in biotechnology more generally.

The second method of identifying a firm's capabilities takes a functional approach. Many organizational capabilities relate to fairly specific functions; these draw on a limited set of resources and typically involve a single department or organizational unit. Capabilities in injection molding or continuous casting or metal stamping are manufacturing-related; capabilities in direct selling, promotional pricing, or database marketing all connect to the sales and marketing functions; capabilities in basic research, strategic innovation, or new product development link to a company's R&D function.

This approach requires managers to survey the various functions a firm performs to find the different capabilities associated with each function.

A problem with this second method is that many of the most important capabilities of firms are inherently *cross-functional.* Cross-functional capabilities draw on a number of different kinds of resources and are multidimensional in nature—they spring from the effective collaboration among people with different types of expertise working in different organizational units. Warby Parker draws from its cross-functional design process to create its popular eyewear. Its design capabilities are not just due to its creative designers, but are the product of their capabilities in market research and engineering as well as their relations with suppliers and manufacturing companies. Cross-functional capabilities and other complex capabilities involving numerous linked and closely integrated competitive assets are sometimes referred to as **resource bundles.**

CORE CONCEPT

A **resource bundle** is a linked and closely integrated set of competitive assets centered around one or more cross-functional capabilities.

It is important not to miss identifying a company's resource bundles, since they can be the most competitively important of a firm's competitive assets. Resource bundles can sometimes pass the four tests of a resource's competitive power (described below) even when the individual components of the resource bundle cannot. Although PetSmart's supply chain and marketing capabilities are matched well by rival Petco, the company continues to outperform competitors through its customer service capabilities (including animal grooming and veterinary and day care services). Nike's bundle of styling expertise, marketing research skills, professional endorsements, brand name, and managerial know-how has allowed it to remain number one in the athletic footwear and apparel industry for more than 20 years.

Assessing the Competitive Power of a Company's Resources and Capabilities

To assess a company's competitive power, one must go beyond merely identifying its resources and capabilities to probe its *caliber.*[4] Thus, the second step in resource and capability analysis is designed to ascertain which of a company's resources and capabilities are competitively superior and to what extent they can support a company's quest for a sustainable competitive advantage over market rivals. When a company has competitive assets that are central to its strategy and superior to those of rival firms, they can support a competitive advantage, as defined in Chapter 1. If this advantage proves durable despite the best efforts of competitors to overcome it, then the company is said to have a *sustainable* **competitive advantage.** While it may be difficult for a company to achieve a sustainable competitive advantage, it is an important strategic objective because it imparts a potential for attractive and long-lived profitability.

CORE CONCEPT

Recall that a **competitive advantage** means that you can produce more value (V) for the customer than rivals can, or the same value at lower cost (C). In other words, your **V-C** is *greater than* the **V-C** of competitors. **V-C** is what we call the *Total Economic Value* produced by a company.

The Four Tests of a Resource's Competitive Power

The competitive power of a resource or capability is measured by how many of four specific tests it can pass.[5] These tests are referred to as the **VRIN tests for sustainable competitive advantage**—*VRIN* is a shorthand reminder standing for *Valuable, Rare, Inimitable,* and *Nonsubstitutable.* The first two tests determine whether a resource or capability can support a competitive advantage. The last two determine whether the competitive advantage can be sustained.

CORE CONCEPT

The **VRIN tests for sustainable competitive advantage** ask whether a resource is valuable, rare, inimitable, and nonsubstitutable.

1. *Is the resource or organizational capability competitively* ***Valuable?*** To be competitively valuable, a resource or capability must be directly relevant to the company's strategy, making the company a more effective competitor. Unless the resource

CORE CONCEPT

The **Total Economic Value** produced by a company is equal to **V-C**. It is the difference between the buyer's perceived value regarding a product or service and what it costs the company to produce it.

or capability contributes to the effectiveness of the company's strategy, it cannot pass this first test. An indicator of its effectiveness is whether the resource enables the company to strengthen its business model by improving its customer value proposition and/or profit formula (see Chapter 1). Google failed in converting its technological resources and software innovation capabilities into success for Google Wallet, which incurred losses of more than $300 million before being abandoned in 2016. While these resources and capabilities have made Google the world's number-one search engine, they proved to be less valuable in the mobile payments industry.

2. *Is the resource or capability* ***Rare****—is it something rivals lack?* Resources and capabilities that are common among firms and widely available cannot be a source of competitive advantage. All makers of branded cereals have valuable marketing capabilities and brands, since the key success factors in the ready-to-eat cereal industry demand this. They are not rare. However, the brand strength of Oreo cookies is uncommon and has provided Kraft Foods with greater market share as well as the opportunity to benefit from brand extensions such as Gluten Free Oreos, Golden Oreos, Oreo Thins, and Mega Stuf Oreos. A resource or capability is considered rare if it is held by only a small percentage of firms in an industry or specific competitive domain. Thus, while general management capabilities are not rare in an absolute sense, they are relatively rare in some of the less developed regions of the world and in some business domains.

3. *Is the resource or capability* ***Inimitable****—is it hard to copy?* The more difficult and more costly it is for competitors to imitate a company's resource or capability, the more likely that it can also provide a *sustainable* competitive advantage. Tom's Shoes lost its advantage (and was taken over by its creditors) when competitors, like Bob's Shoes from Skechers, copied its designs while others copied its one-for-one giving practices. Resources and capabilities tend to be difficult to copy when they are unique (a fantastic real estate location, patent-protected technology, an unusually talented and motivated labor force), when they must be built over time in ways that are difficult to imitate (a well-known brand name, mastery of a complex process technology, years of cumulative experience and learning), and when they entail financial outlays or large-scale operations that few industry members can undertake (a global network of dealers and distributors). Imitation is also difficult for resources and capabilities that reflect a high level of **social complexity** (company culture, interpersonal relationships among the managers or R&D teams, trust-based relations with customers or suppliers) and **causal ambiguity,** a term that signifies the hard-to-disentangle nature of the complex resources, such as a web of intricate processes enabling new drug discovery. Hard-to-copy resources and capabilities are important competitive assets, contributing to the longevity of a company's market position and offering the potential for sustained profitability.

CORE CONCEPT

Social complexity and **causal ambiguity** are two factors that inhibit the ability of rivals to imitate a firm's most valuable resources and capabilities. Causal ambiguity makes it very hard to figure out how a complex resource contributes to competitive advantage and therefore exactly what to imitate.

4. *Is the resource or capability* ***Nonsubstitutable****—is it invulnerable to the threat of substitution from different types of resources and capabilities?* Even resources that are competitively valuable, rare, and costly to imitate may lose much of their ability to offer competitive advantage if rivals possess equivalent substitute resources. For example, manufacturers relying on automation to gain a cost-based advantage in production activities may find their technology-based advantage nullified by rivals' use of low-wage offshore manufacturing. Resources can contribute to a sustainable competitive advantage only when resource substitutes aren't on the horizon.

The vast majority of companies are not well endowed with standout resources or capabilities, capable of passing all four tests with high marks. Most firms have a mixed bag of resources—one or two quite valuable, some good, many satisfactory to mediocre. Resources and capabilities that are valuable pass the first of the four tests. As key contributors to the effectiveness of the strategy, they are relevant to the firm's competitiveness but are no guarantee of competitive advantage. They may offer no more than competitive parity with competing firms.

Passing both of the first two tests requires more—it requires resources and capabilities that are not only valuable but also rare. This is a much higher hurdle that can be cleared only by resources and capabilities that are *competitively superior.* Resources and capabilities that are competitively superior are the company's true strategic assets. They provide the company with a competitive advantage over its competitors, if only in the short run.

To pass the last two tests, a resource must be able to maintain its competitive superiority in the face of competition. It must be resistant to imitative attempts and efforts by competitors to find equally valuable substitute resources. Assessing the availability of substitutes is the most difficult of all the tests since substitutes are harder to recognize, but the key is to look for resources or capabilities held by other firms or being developed that *can serve the same function* as the company's core resources and capabilities.[6]

Very few firms have resources and capabilities that can pass all four tests, but those that do enjoy a sustainable competitive advantage with far greater profit potential. Costco is a notable example, with strong employee incentive programs and capabilities in supply chain management that have surpassed those of its warehouse club rivals for over 35 years. Lincoln Electric Company, less well known but no less notable in its achievements, has been the world leader in welding products for over 100 years as a result of its unique piecework incentive system for compensating production workers and the unsurpassed worker productivity and product quality that this system has fostered.

A Company's Resources and Capabilities Must Be Managed Dynamically Even companies like Costco and Lincoln Electric cannot afford to rest on their laurels. Rivals that are initially unable to replicate a key resource may develop better and better substitutes over time. Resources and capabilities can depreciate like other assets if they are managed with benign neglect. Disruptive changes in technology, customer preferences, distribution channels, or other competitive factors can also destroy the value of key strategic assets, turning resources and capabilities "from diamonds to rust."[7]

Resources and capabilities must be continually strengthened and nurtured to sustain their competitive power and, at times, may need to be broadened and deepened to allow the company to position itself to pursue emerging market opportunities.[8] Organizational resources and capabilities that grow stale can impair competitiveness unless they are refreshed, modified, or even phased out and replaced in response to ongoing market changes and shifts in company strategy. Management's challenge in managing the firm's resources and capabilities dynamically has two elements: (1) attending to the ongoing modification of existing competitive assets, and (2) casting a watchful eye for opportunities to develop totally new kinds of capabilities.

> A company requires a dynamically evolving portfolio of resources and capabilities to sustain its competitiveness and help drive improvements in its performance.

The Role of Dynamic Capabilities Companies that know the importance of recalibrating and upgrading their most valuable resources and capabilities ensure that these activities are done on a continual basis. By incorporating these activities into their routine managerial functions, they gain the experience necessary to be able to do them consistently well. At that point, their ability to freshen and renew their competitive assets becomes a capability in itself—a **dynamic capability.** A dynamic capability is the ability to modify, deepen, or augment the company's

> **CORE CONCEPT**
>
> A **dynamic capability** is an ongoing capacity of a company to modify its existing resources and capabilities or create new ones.

existing resources and capabilities.[9] This includes the capacity to improve existing resources and capabilities incrementally, in the way that Toyota aggressively upgrades the company's capabilities in fuel-efficient hybrid engine technology and constantly fine-tunes its famed Toyota Production System to enhance the company's already proficient capabilities in manufacturing top-quality vehicles at relatively low costs. Likewise, management at BMW developed new organizational capabilities in hybrid engine design that allowed the company to launch its highly touted all-electric i4 and iX models. A dynamic capability also includes the capacity to add new resources and capabilities to the company's competitive asset portfolio. One way to do this is through alliances and acquisitions. An example is General Motor's partnership with Korean electronics firm LG Corporation, which enabled GM to develop a manufacturing and engineering platform for producing electric vehicles. This enabled GM to beat the likes of Tesla and Nissan to market with the first affordable all-electric car with good driving range—the Chevy Bolt EV. Bristol-Myers Squibb's famed "string of pearls" acquisition strategy has enabled it to replace degraded resources such as expiring patents with new patents and newly acquired capabilities in drug discovery for new disease domains.

QUESTION 4: HOW DO VALUE CHAIN ACTIVITIES IMPACT A COMPANY'S COST STRUCTURE AND CUSTOMER VALUE PROPOSITION?

LO 4-4

Understand how value chain activities can affect a company's cost structure and customer value proposition.

Company managers are often stunned when a competitor cuts its prices to "unbelievably low" levels or when a new market entrant introduces a great new product at a surprisingly low price. While less common, new entrants can also storm the market with a product that ratchets the quality level up so high that customers will abandon competing sellers even if they have to pay more for the new product. This is what seems to have happened when Apple first introduced its iPhone and iMac computers.

Regardless of where on the quality spectrum a company competes, it must remain competitive in terms of its customer value proposition in order to stay in the game. Patagonia's value proposition, for example, remains attractive to customers who value quality, wide selection, and corporate environmental responsibility over cheaper outerwear alternatives. Since its inception in 1925, the *New Yorker*'s customer value proposition has withstood the test of time by providing readers with an amalgam of well-crafted and topical writing. Similarly, Target's customer value proposition has withstood the Walmart low-price juggernaut by attending to product design, image, and attractive store layouts in addition to efficiency.

The greater the amount of customer value that a company can offer profitably relative to close rivals, the less competitively vulnerable the company becomes.

Recall from our discussion of the Customer Value Proposition in Chapter 1: The value (V) provided to the customer depends on how well a customer's needs are met for the price paid (V-P). How well customer needs are met depends on the perceived quality of a product or service as well as on other, more tangible attributes. The greater the amount of customer value that the company can offer profitably compared to its rivals, the less vulnerable it will be to competitive attack. For managers, the key is to keep close track of how *cost-effectively* the company can deliver value to customers relative to its competitors. If it can deliver the same amount of value with lower expenditures (or more value at the same cost), it will maintain a competitive edge.

The higher a company's costs are above those of close rivals, the more competitively vulnerable the company becomes.

Two analytic tools are particularly useful in determining whether a company's costs and customer value proposition are competitive: value chain analysis and benchmarking.

The Concept of a Company Value Chain

CORE CONCEPT

A company's **value chain** identifies the primary activities and related support activities that create customer value.

Every company's business consists of a collection of activities undertaken in the course of producing, marketing, delivering, and supporting its product or service. All the various activities that a company performs internally combine to form a **value chain**—so called because the underlying intent of a company's activities is ultimately to *create value for buyers.*

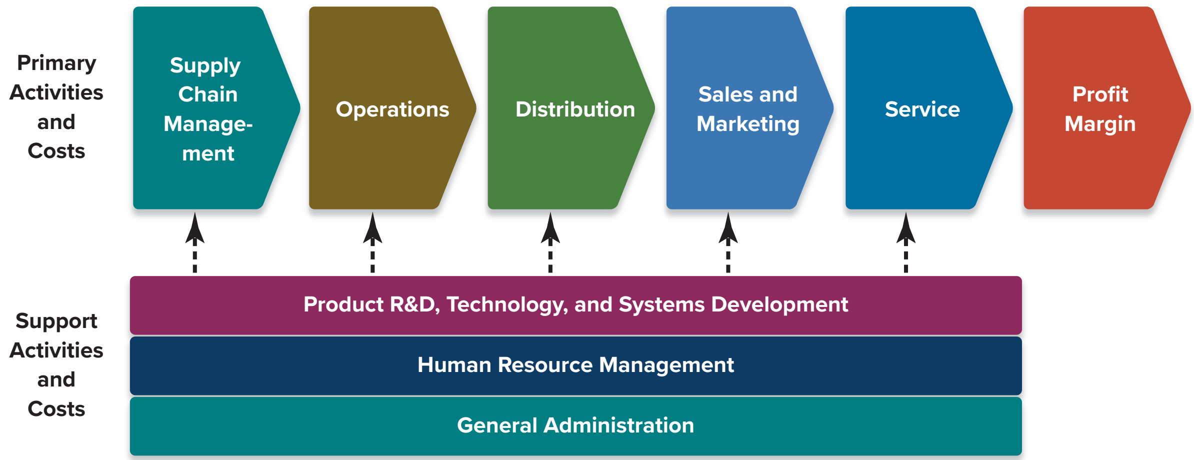
As shown in Figure 4.3, a company's value chain consists of two broad categories of activities: the *primary activities* foremost in creating value for customers and the requisite *support activities* that facilitate and enhance the performance of the primary activities.[10] The kinds of primary and secondary activities that constitute a company's value chain vary according to the specifics of a company's business; hence, the listing of the primary and support activities in Figure 4.3 is illustrative rather than definitive. For example, the primary activities and cost drivers for a department store retailer such as Nordstrom include merchandise selection and buying, store layout and product display, advertising, and customer service. Its support activities that affect customer value and costs include hiring and training, store maintenance, plus the usual assortment of administrative activities. The primary value chain activities and costs of a hotel operator like Marriott International mainly comprise reservations and hotel operations (check-in and check-out, maintenance and housekeeping, dining and room service, and conventions and meetings). Principal support activities that drive costs and impact customer value include accounting, hiring and training hotel staff, and general administration. Supply chain management is a crucial activity for Boeing and Amazon but is not a value chain component at Direct TV, WhatsApp, or Goldman Sachs. Sales and marketing are dominant activities at Ford Motor Company and J.Crew, but have only minor roles at oil-drilling companies and natural gas pipeline companies. Customer delivery is a crucial activity at Domino's Pizza and Blue Apron but insignificant at Starbucks and Dunkin Donuts.

With its focus on value-creating activities, the value chain is an ideal tool for examining the workings of a company's customer value proposition and business model. It permits a deep look at the company's cost structure and ability to offer low prices. It reveals the emphasis that a company places on activities that enhance differentiation and support higher prices, such as service and marketing. It also includes a profit margin component (P-C), since profits are necessary to compensate the company's owners and investors, who bear risks and provide capital. Tracking the profit margin along with the value-creating activities is critical because unless an enterprise succeeds in delivering customer value profitably (with a sufficient return on invested capital), it can't survive for long. Attention to a company's profit formula in addition to its customer value proposition is the essence of a sound business model, as described in Chapter 1.

Illustration Capsule 4.1 shows representative costs for various value chain activities performed by Everlane, Inc., an American clothing retailer that sells primarily online.

Comparing the Value Chains of Rival Companies Value chain analysis facilitates a comparison of how rivals, activity by activity, deliver value to customers. Even rivals in the same industry may differ significantly in terms of the activities they perform. For instance, the "operations" component of the value chain for a manufacturer that makes all of its own parts and components and assembles them into a finished product differs from the "operations" of a rival producer that buys the needed parts and components from outside suppliers and performs only assembly operations. How each activity is performed may affect a company's relative cost position as well as its capacity for differentiation. Thus, even a simple comparison of how the activities of rivals' value chains differ can reveal competitive differences.

FIGURE 4.3 A Representative Company Value Chain



PRIMARY ACTIVITIES

- **Supply Chain Management**—Activities, costs, and assets associated with purchasing fuel, energy, raw materials, parts and components, merchandise, and consumable items from vendors; receiving, storing, and disseminating inputs from suppliers; inspection; and inventory management.
- **Operations**—Activities, costs, and assets associated with converting inputs into final product form (production, assembly, packaging, equipment maintenance, facilities, operations, quality assurance, environmental protection).
- **Distribution**—Activities, costs, and assets dealing with physically distributing the product to buyers (finished goods warehousing, order processing, order picking and packing, shipping, delivery vehicle operations, establishing and maintaining a network of dealers and distributors).
- **Sales and Marketing**—Activities, costs, and assets related to sales force efforts, advertising and promotion, market research and planning, and dealer/distributor support.
- **Service**—Activities, costs, and assets associated with providing assistance to buyers, such as installation, spare parts delivery, maintenance and repair, technical assistance, buyer inquiries, and complaints.

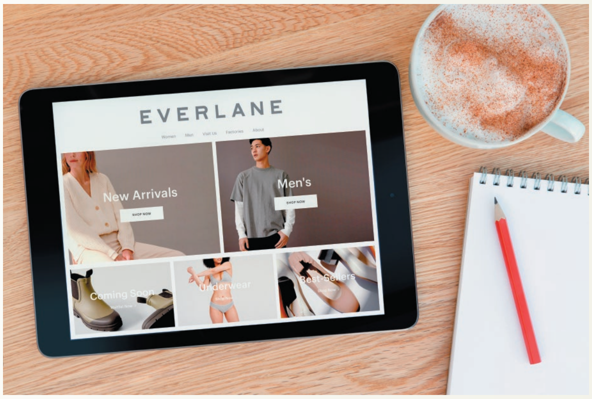
SUPPORT ACTIVITIES

- **Product R&D, Technology, and Systems Development**—Activities, costs, and assets relating to product R&D, process R&D, process design improvement, equipment design, computer software development, telecommunications systems, computer-assisted design and engineering, database capabilities, and development of computerized support systems.
- **Human Resource Management**—Activities, costs, and assets associated with the recruitment, hiring, training, development, and compensation of all types of personnel; labor relations activities; and development of knowledge-based skills and core competencies.
- **General Administration**—Activities, costs, and assets relating to general management, accounting and finance, legal and regulatory affairs, safety and security, management information systems, forming strategic alliances and collaborating with strategic partners, and other "overhead" functions.

Source: Based on the discussion in Michael E. Porter, *Competitive Advantage* (New York: Free Press, 1985), pp. 37–43.

ILLUSTRATION CAPSULE 4.1 The Value Chain for Everlane, Inc.

Everlane, Inc. prides itself on producing casual clothing, designed to last, in ethically managed factories, under a policy of what they call "radical transparency." From the start, they have made their cost and margin breakdowns readily available on their website. Following is such a breakdown for a pair of their slim-fit denim jeans:



M4OS Photos/Alamy Stock Photo

Materials (13 oz. denim - 98% cotton; 2% elastane)	$10.89	
Hardware (metal fasteners, trim)	1.99	
Labor	3.48	
Cost of Goods		**16.36**
Transport	.52	
Import Duties	2.72	
Total Cost		**19.60**
Everlane Retail Price		**88.00**
Everlane Profit Margin (Retail Price – Total Cost)	**68.40**	
Average Traditional Retailer's Price		**103.00**

Source: Everlane.com/ (accessed 1/19/23).

A Company's Primary and Secondary Activities Identify the Major Components of Its Internal Cost Structure The combined costs of all the various primary and support activities constituting a company's value chain define its internal cost structure. Further, the cost of each activity contributes to whether the company's overall cost position relative to rivals is favorable or unfavorable. The roles of value chain analysis and benchmarking are to develop the data for comparing a company's costs activity by activity against the costs of key rivals and to learn which internal activities are a source of cost advantage or disadvantage.

Evaluating a company's cost-competitiveness involves using what accountants call *activity-based costing* to determine the costs of performing each value chain activity.[11] The degree to which a company's total costs should be broken down into costs for specific activities depends on how valuable it is to know the costs of specific activities versus broadly defined activities. At the very least, cost estimates are needed for each broad category of primary and support activities, but cost estimates for more specific activities within each broad category may be needed if a company discovers that it has a cost disadvantage vis-à-vis rivals and wants to pin down the exact source or activity causing the cost disadvantage. However, a company's own *internal costs* may be insufficient to assess whether its product offering and customer value proposition are competitive with those of rivals. Cost and price differences among competing companies can have their origins in activities performed by suppliers or by distribution allies involved in getting the product to the final customers or end users of the product, in which case the company's entire *value chain system* becomes relevant.

A company's cost-competitiveness depends not only on the costs of internally performed activities (its own value chain) but also on costs in the value chains of its suppliers and distribution-channel allies.

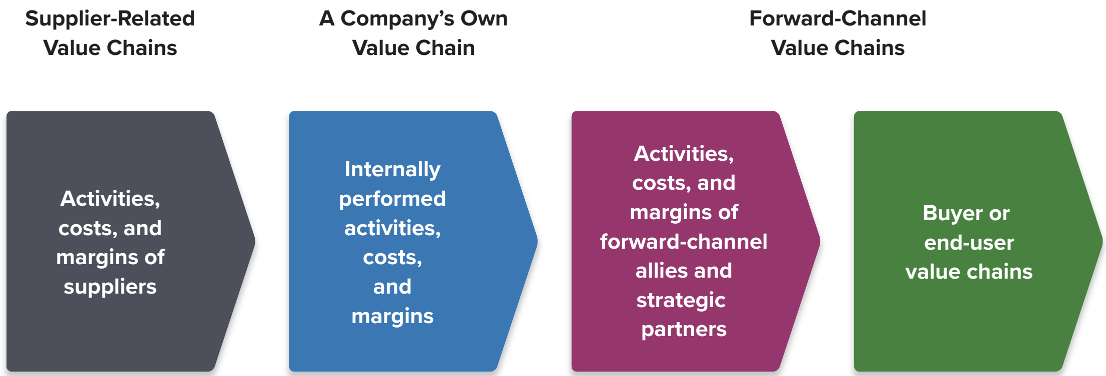
The Value Chain System for an Entire Industry

A company's value chain is embedded in a larger system of activities that includes the value chains of its suppliers and the value chains of whatever wholesale distributors and retailers it utilizes in getting its product or service to end users. This *value chain system* (sometimes called a vertical chain) has implications that extend far beyond the company's costs. It can affect attributes like product quality that enhance differentiation and have importance for the company's customer value proposition, as well as its profitability.[12] Suppliers' value chains are relevant because suppliers perform activities and incur costs in creating and delivering the purchased inputs utilized in a company's own value-creating activities. The costs, performance features, and quality of these inputs influence a company's own costs and product differentiation capabilities. Anything a company can do to help its suppliers drive down the costs of their value chain activities or improve the quality and performance of the items being supplied can enhance its own competitiveness—a powerful reason for working collaboratively with suppliers in managing supply chain activities.[13] For example, automakers have encouraged their automotive parts suppliers to build plants near the auto assembly plants to facilitate just-in-time deliveries, reduce warehousing and shipping costs, and promote close collaboration on parts design and production scheduling. Irrigation equipment companies, suppliers of grape-harvesting and wine-making equipment, and firms making barrels, wine bottles, caps, corks, and labels all have facilities in the California wine country to be close to the nearly 4,400 wineries they supply.

Similarly, the value chains of a company's forward channel allies are relevant because (1) the costs and margins of a company's distributors and retail dealers are part of the price the ultimate consumer pays and (2) the quality of the activities that such distribution allies perform affect sales volumes and customer satisfaction. For these reasons, companies that don't sell directly to the end consumer work closely with their distribution allies (including their direct customers) to perform value chain activities in mutually beneficial ways. For instance, motor vehicle manufacturers have a competitive interest in working closely with their forward channel allies (local automobile dealers) to promote higher sales volumes and better customer satisfaction with dealers' repair and maintenance services. Producers of kitchen cabinets are heavily dependent on the sales and promotional activities of their distributors and building supply retailers and on whether distributors and retailers operate cost-effectively enough to be able to sell at prices that lead to attractive sales volumes.

As a consequence, *accurately assessing a company's competitiveness entails scrutinizing the nature and costs of value chain activities throughout the entire value chain system for delivering its products or services to end-use customers.* A typical value chain system that incorporates the value chains of suppliers, business buyers, and other forward-channel allies (if any) is shown in Figure 4.4. As was the case with company value chains, the specific activities constituting value chain systems vary significantly from industry to industry. The primary value chain system activities in the pulp and paper industry (timber farming, logging, pulp mills, and papermaking) differ from the primary value chain system activities in the home appliance industry (parts and components manufacture, assembly, wholesale distribution, retail sales) and yet again from the cloud computing industry (IT hardware infrastructure, systems software infrastructure, application development, and application hosting, management, and security services). Some value chains may also include strategic partners whose activities may likewise affect both the value and cost of the end product.

FIGURE 4.4 A Representative Value Chain System



Source: Based in part on the single-industry value chain displayed in Michael E. Porter, *Competitive Advantage* (New York: Free Press, 1985), p. 35.

Benchmarking: A Tool for Assessing the Costs and Effectiveness of Value Chain Activities

Benchmarking entails comparing how different companies perform various value chain activities—how materials are purchased, how inventories are managed, how products are assembled, how fast the company can get new products to market, how customer orders are filled and shipped—and then making cross-company comparisons of the costs and effectiveness of these activities.[14] The comparison is often made between companies in the same industry, but benchmarking can also involve comparing how activities are done by companies in other industries. The objectives of benchmarking are simply to identify the best means of performing an activity and to emulate those best practices. It can be used to benchmark the activities of a company's internal value chain or the activities within an entire value chain system.

CORE CONCEPT

Benchmarking is a potent tool for improving a value chain activities that is based on learning how other companies perform them and borrowing their "best practices."

A **best practice** is a method of performing an activity or business process that consistently delivers superior results compared to other approaches.[15] To qualify as a legitimate best practice, the method must have been employed by at least one enterprise and shown to be *consistently more effective* in lowering costs, improving quality or performance, shortening time requirements, enhancing safety, or achieving some other highly positive operating outcome. Best practices thus identify a path to operating excellence with respect to value chain activities.

CORE CONCEPT

A **best practice** is a method of performing an activity that consistently delivers superior results compared to other approaches.

Xerox pioneered the use of benchmarking to become more cost-competitive, deciding not to restrict its benchmarking efforts to its office equipment rivals but to extend them to *any company regarded as "world class"* in performing *any activity* relevant to Xerox's business. Other companies quickly picked up on Xerox's approach. Toyota managers got their idea for just-in-time inventory deliveries by studying how U.S. supermarkets replenished their shelves. Southwest Airlines reduced the turnaround time of its aircraft at each scheduled stop by studying pit crews on the auto racing circuit. More than 80 percent of Fortune 500 companies reportedly use benchmarking for comparing themselves against rivals on cost and other competitively important measures. Illustration Capsule 4.2 describes benchmarking practices in the solar industry.

ILLUSTRATION CAPSULE 4.2 Benchmarking in the Solar Industry

The cost of solar power production is dropping rapidly, leading to lower solar power prices for consumers and an expanding market for solar companies. U.S. solar capacity is expected to grow from 129 GW in 2022 to 336 GW by 2027, according to the Solar Energy Industries Association and Wood Mackenzie. Simultaneously, the solar landscape is becoming more competitive. The number of solar power businesses increased by 18.3 percent since 2021 to 359 companies.

As competition grows, benchmarking plays an increasingly critical role in assessing a solar company's relative costs and price positioning compared to other firms. This is often measured using the all-in installation and production costs per kilowatt hour generated by a solar asset, called the "Levelized Cost of Energy" (LCOE). Kilowatt hours are the units of electricity that are sold to consumers.

In 2008, SunPower—one of the largest solar firms in the United States—used benchmarking to target a 50 percent decrease in its solar LCOE by 2012. This early benchmarking strategy helped the company to defend against new market entrants offering lower prices. But in the ensuing years, the overall industry solar LCOE fell by 78 percent, leading the company to conclude that an even more aggressive approach was needed to manage downward pricing pressure. SunPower's response was to compete on benchmark prices by simplifying its company structure; divesting from non-core assets; and diversifying beyond the low-cost, large-scale utility solar market and into residential and commercial solar where it could compete more easily on price. This strategy has enabled them to enhance their reputation as a premium global solar provider, listed among the best solar companies in 2023.

Geniusksy/Shutterstock

Continuing to anticipate and adapt to falling solar prices requires reliable industry data on benchmark costs. The National Renewable Energy Laboratory (NREL) Quarterly U.S. Solar Photovoltaic System Cost Benchmark breaks down industry solar costs by inputs, including solar modules, structural hardware, and electrical components, as well as soft costs like labor and land expenses. This enables firms like SunPower to assess how their component costs compare to benchmarks and informs SunPower's outlook for how solar prices will continue to fall over time.

For solar to play a major role in U.S. power generation, costs must keep decreasing. As solar companies race toward lower costs, benchmarking will continue to be a core strategic tool in determining pricing and market positioning.

Note: Developed with Mathew O'Sullivan.

Sources: **https://www.pv-magazine.com/2022/09/12/us-poised-to-hit-336-gw-of-solar-by-2027**; Solar Power World, "Top 500 Solar Contractors" (2017); SunPower, "The Drivers of the Levelized Cost of Electricity for Utility-Scale Photovoltaics" (2008); Lazard, "Levelized Cost of Energy Analysis, Version 8.0" (2014). **https://www.forbes.com/home-improvement/solar/best-solar-companies/the** 9 best solar panel installation companies of 2023.

The tough part of benchmarking is not whether to do it but, rather, how to gain access to information about other companies' practices and costs. Sometimes benchmarking can be accomplished by collecting information from published reports, trade groups, and industry research firms or by talking to knowledgeable industry analysts, customers, and suppliers. Sometimes field trips to the facilities of competing or noncompeting companies can be arranged to observe how things are done, compare practices and processes, and perhaps exchange data on productivity and other cost components. However, such companies, even if they agree to host facilities tours and answer questions, are unlikely to share

ILLUSTRATION CAPSULE 4.3 Benchmarking and Ethical Conduct

Because discussions between benchmarking partners can involve competitively sensitive data, conceivably raising questions about possible restraint of trade or improper business conduct, the Strategic Planning Institute's Council on Benchmarking and the Global Benchmarking Network urge all individuals and organizations involved in benchmarking to abide by a code of conduct grounded in ethical business behavior. The code is based on the following principles:

- Principle of Legality. Avoid discussions or actions that might lead to or imply an interest in restraint of trade: market or customer allocation schemes, price fixing, dealing arrangements, bid rigging, bribery, or misappropriation. Do not discuss costs with competitors if costs are an element of pricing.
- Principle of Exchange. Be willing to provide the same level of information that you request, in any benchmarking exchange.
- Principle of Confidentiality. Treat benchmarking interchange as something confidential to the individuals and organizations involved. Information obtained must not be communicated outside the partnering organizations without prior consent of participating benchmarking partners. An organization's participation in a study should not be communicated externally without their permission.
- Principle of Use. Use information obtained through benchmarking partnering only for the purpose of improvement of operations within the partnering companies themselves. External use or communication of a benchmarking partner's name with their data or observed practices requires permission of that partner. Do not, as a consultant or client, extend one company's benchmarking study findings to another without the first company's permission.
- Principle of First Party Contact. Initiate contacts, whenever possible, through a benchmarking contact designated by the partner company. Obtain mutual agreement with the contact on any hand off of communication or responsibility to other parties.
- Principle of Third Party Contact. Obtain an individual's permission before providing their name in response to a contact request.
- Principle of Preparation. Demonstrate commitment to the efficiency and effectiveness of the benchmarking process with adequate preparation at each process step; particularly, at initial partnering contact.

Source: BPIR.com (Business Performance Improvement Resource), **https://www.bpir.com/benchmarking-code-of-conduct-bpir.com/menu-id-56.html** (accessed 2/08/20).

competitively sensitive cost information. Furthermore, comparing two companies' costs may not involve comparing apples to apples if the two companies employ different cost accounting principles to calculate the costs of particular activities.

However, a third and fairly reliable source of benchmarking information has emerged. The explosive interest of companies in benchmarking costs and identifying best practices has prompted consulting organizations (e.g., Accenture, A. T. Kearney, Benchnet—The Benchmarking Exchange, and Best Practices, LLC) and several associations (e.g., the QualServe Benchmarking Clearinghouse, and the Strategic Planning Institute's Council on Benchmarking) to gather benchmarking data, distribute information about best practices, and provide comparative cost data without identifying the names of particular companies. Having an independent group gather the information and report it in a manner that disguises the names of individual companies protects competitively sensitive data and lessens the potential for unethical behavior on the part of company personnel in gathering their own data about competitors. The ethical dimension of benchmarking is discussed in Illustration Capsule 4.3.

> Benchmarking the costs of company activities against those of rivals provides hard evidence of whether a company is cost-competitive.

Industry associations are another source of data that may be used for benchmarking purposes. In the cement industry, for example, the Portland Cement Association publishes key plant level data for the industry that enables companies to understand whether their own plants are cost leaders or laggards. Benchmarking data is also provided by some government agencies; data of this sort plays an important role in electricity pricing, for example.

Strategic Options for Remedying a Cost or Value Disadvantage

The results of value chain analysis and benchmarking may disclose cost or value disadvantages relative to key rivals. Such information is vital in crafting strategic actions to eliminate any such disadvantages and improve profitability. Information of this nature can also help a company find new avenues for enhancing its competitiveness through lower costs or a more attractive customer value proposition. There are three main areas in a company's total value chain system where company managers can try to improve its efficiency and effectiveness in delivering customer value: (1) a company's own internal activities, (2) suppliers' part of the value chain system, and (3) the forward-channel portion of the value chain system.

Improving Internally Performed Value Chain Activities Managers can pursue any of several strategic approaches to reduce the costs of internally performed value chain activities and improve a company's cost-competitiveness:

1. Implement the use of best practices throughout the company, particularly for high-cost activities.
2. Try to eliminate some cost-producing activities by revamping the value chain. Many retailers have found that donating returned items to charitable organizations and taking the appropriate tax deduction results in a smaller loss than incurring the costs of the value chain activities involved in reverse logistics.
3. Relocate high-cost activities (such as manufacturing) to geographic areas such as China, Latin America, or Eastern Europe where they can be performed more cheaply.
4. Outsource certain internally performed activities to vendors or contractors if they can perform them more cheaply than can be done in-house.
5. Invest in productivity-enhancing, cost-saving technological improvements (robotics, flexible manufacturing techniques, state-of-the-art electronic networking).
6. Find ways to detour around the activities or items where costs are high. Computer chip makers regularly design around the patents held by others to avoid paying royalties; automakers have substituted lower-cost plastic for metal at many exterior body locations.
7. Redesign the product and/or some of its components to facilitate speedier and more economical manufacture or assembly.
8. Try to make up the internal cost disadvantage by reducing costs in the supplier or forward channel portions of the industry value chain—usually a last resort.

Rectifying a weakness in a company's customer value proposition can be accomplished by applying one or more of the following approaches:

1. Implement the use of best practices throughout the company, particularly for activities that are important for creating customer value—product design, product quality, or customer service.
2. Adopt best practices for marketing, brand management, and customer relationship management to improve brand image and customer loyalty.

3. Reallocate resources to activities having a significant impact on value delivered to customers—larger R&D budgets, new state-of-the-art production facilities, new distribution centers, modernized service centers, or enhanced budgets for marketing campaigns.

Additional approaches to managing value chain activities to lower costs and/or enhance customer value are discussed in Chapter 5.

Improving Supplier-Related Value Chain Activities Supplier-related cost disadvantages can be attacked by pressuring suppliers for lower prices, switching to lower-priced substitute inputs, and collaborating closely with suppliers to identify mutual cost-saving opportunities.[16] For example, just-in-time deliveries from suppliers can lower a company's inventory and internal logistics costs and may also allow suppliers to economize on their warehousing, shipping, and production scheduling costs—a win–win outcome for both. In a few instances, companies may find that it is cheaper to integrate backward into the business of high-cost suppliers and make the item in-house instead of buying it from outsiders.

Similarly, a company can enhance its customer value proposition through its supplier relationships. Some approaches include selecting and retaining suppliers that meet higher-quality standards, providing quality-based incentives to suppliers, and integrating suppliers into the design process. Fewer defects in parts from suppliers not only improve quality throughout the value chain system but can lower costs as well since less waste and disruption occur in the production processes.

Improving Value Chain Activities of Forward Channel Allies Any of three means can be used to achieve better cost-competitiveness in the forward portion of the industry value chain:

1. Pressure distributors, dealers, and other forward-channel allies to reduce their costs and markups.
2. Collaborate with them to identify win–win opportunities to reduce costs—for example, Walmart and Target require suppliers to meet a two-day shipping arrival window, which not only improves distribution center operating efficiency but also reduces costly unloading wait times for the shipper.
3. Change to a more economical distribution strategy, including switching to cheaper distribution channels (e.g. selling direct via the Internet) or integrating forward into company-owned retail outlets.

The means to enhancing differentiation through activities at the forward end of the value chain system include (1) engaging in cooperative advertising and promotions with forward allies (dealers, distributors, retailers, etc.), (2) creating exclusive arrangements with downstream sellers or utilizing other mechanisms that increase their incentives to enhance delivered customer value, and (3) creating and enforcing standards for downstream activities and assisting in training channel partners in business practices. Harley-Davidson, for example, enhances the shopping experience and perceptions of buyers by selling through retailers that sell Harley-Davidson motorcycles exclusively and meet Harley-Davidson standards. Papa John's International is consistently rated highly by customers for its pizza quality, convenient ordering systems, and responsive customer service across its 5,000 company-owned and franchised units. The company's marketing campaigns and extensive employee training and development programs enhance its value proposition and the unit sales and operating profit for its franchisees in all 50 states and 45 countries.

Translating Proficient Performance of Value Chain Activities into Competitive Advantage

A company that does a *first-rate job* of managing the activities of its value chain or value chain system *relative to competitors* stands a good chance of profiting from its competitive advantage. A company's value-creating activities can offer a competitive advantage in one of two ways (or both):

1. They can contribute to greater efficiency and lower costs relative to competitors.
2. They can provide a basis for differentiation, so customers are willing to pay relatively more for the company's goods and services.

Achieving a cost-based competitive advantage requires determined management efforts to be cost-efficient in performing value chain activities. Such efforts have to be ongoing and persistent, and they have to involve each and every value chain activity. The goal must be continuous cost reduction, not a one-time or on-again-off-again effort. Companies like Dollar General, Nucor Steel, Irish airline Ryanair, TJX Companies, and French discount retailer Carrefour have been highly successful in managing their value chains in a low-cost manner.

Ongoing and persistent efforts are also required for a competitive advantage based on differentiation. Superior reputations and brands are built up slowly over time, through continuous investment and activities that deliver consistent, reinforcing messages. Differentiation based on quality requires vigilant management of activities for quality assurance throughout the value chain. While the basis for differentiation (e.g., status, design, innovation, customer service, reliability, image) may vary widely among companies pursuing a differentiation advantage, companies that succeed do so on the basis of a commitment to coordinated value chain activities aimed purposefully at this objective. Examples include Rolex (status), Braun (design), Room and Board (craftsmanship), Zappos and L.L. Bean (customer service), Salesforce.com and Tesla (innovation), and FedEx (reliability).

How Value Chain Activities Relate to Resources and Capabilities There is a close relationship between the value-creating activities that a company performs and its resources and capabilities. An organizational capability or competence implies a *capacity* for action; in contrast, a value-creating activity *initiates* the action. With respect to resources and capabilities, activities are "where the rubber hits the road." When companies engage in a value-creating activity, they do so by drawing on specific company resources and capabilities that underlie and enable the activity. For example, brand-building activities depend on human resources, such as experienced brand managers (including their knowledge and expertise in this arena), as well as organizational capabilities in advertising and marketing. Cost-cutting activities may derive from organizational capabilities in inventory management, for example, and resources such as inventory tracking systems.

> Value chain analysis and benchmarking provide the type of data needed to assess objectively whether a company's resources and capabilities are competitively superior.

Because of this correspondence between activities and supporting resources and capabilities, value chain analysis can complement resource and capability analysis as another tool for assessing a company's competitive advantage. Resources and capabilities that are *both valuable and rare* provide a company with *what it takes* for competitive advantage. For a company with competitive assets of this sort, the potential is there. When these assets are deployed in the form of a value-creating activity, that potential is realized due to their competitive superiority.

Resource analysis is one tool for identifying competitively superior resources and capabilities. But their value and the competitive superiority of that value can be assessed objectively only *after* they are deployed. Value chain analysis and benchmarking provide the type of data needed to make that objective assessment.

Performing value chain activities with capabilities that permit the company to either outmatch rivals on differentiation or beat them on costs will give the company a competitive advantage.

There is also a dynamic relationship between a company's activities and its resources and capabilities. Value-creating activities are more than just the embodiment of a resource's or capability's potential. They also contribute to the formation and development of organizational capabilities. The road to competitive advantage begins with management efforts to build organizational expertise in performing certain competitively important value chain activities. With consistent practice and continuous investment of company resources, these activities rise to the level of a reliable organizational capability or a competence. To the extent that top management makes the growing capability a cornerstone of the company's strategy, this capability becomes a core competence for the company. Later, with further organizational learning and gains in proficiency, the core competence may evolve into a distinctive competence, giving the company superiority over rivals in performing an important value chain activity. Such superiority, if it gives the company significant competitive clout in the marketplace, can produce an attractive competitive edge over rivals. Whether the resulting competitive advantage is on the cost side or on the differentiation side (or both) will depend on the company's choice of which types of competence-building activities to engage in over this time period.

QUESTION 5: IS THE COMPANY COMPETITIVELY STRONGER OR WEAKER THAN KEY RIVALS?

LO 4-5

Explain how a comprehensive evaluation of a company's competitive situation can assist managers in making critical decisions about their next strategic moves.

Using resource analysis, value chain analysis, and benchmarking to determine a company's competitiveness on value and cost is necessary but not sufficient. A more comprehensive assessment needs to be made of the company's *overall* competitive strength. The answers to two questions are of particular interest: First, how does the company rank relative to competitors on each of the important factors that determine market success? Second, all things considered, does the company have a *net* competitive advantage or disadvantage versus major competitors?

An easy-to-use method for answering these two questions involves developing quantitative strength ratings for the company and its key competitors on each industry key success factor and each competitively pivotal resource, capability, and value chain activity. Much of the information needed for doing a competitive strength assessment comes from previous analyses. Industry and competitive analyses reveal the key success factors and competitive forces that separate industry winners from losers. Benchmarking data and scouting key competitors provide a basis for judging the competitive strength of rivals on such factors as cost, key product attributes, customer service, image and reputation, financial strength, technological skills, distribution capability, and other factors. Resource and capability analysis reveals which of these are competitively important, given the external situation, and whether the company's competitive advantages are sustainable. SWOT analysis provides a more general forward-looking picture of the company's overall situation.

Step 1 in doing a competitive strength assessment is to make a list of the industry's key success factors and other telling measures of competitive strength or weakness (6 to 10 measures usually suffice). Step 2 is to assign weights to each of the measures of competitive strength based on their perceived importance. (The sum of the weights for each measure must add up to 1.) Step 3 is to calculate weighted strength ratings by scoring each competitor on each strength measure (using a 1-to-10 rating scale, where 1 is very weak and 10 is very strong) and multiplying the assigned rating by the assigned weight. Step 4 is to sum the weighted strength ratings on each factor to get an overall measure of competitive strength for each company being rated. Step 5 is to use the overall strength ratings to draw conclusions about the size and extent of the company's net competitive advantage or disadvantage and to take specific note of areas of strength and weakness.

Table 4.4 provides an example of competitive strength assessment in which a hypothetical company (ABC Company) competes against two rivals. In the example, relative cost is the most telling measure of competitive strength, and the other strength measures are of lesser importance. The company with the highest rating on a given measure has an implied competitive edge on that measure, with the size of its edge

TABLE 4.4 A Representative Weighted Competitive Strength Assessment

		Competitive Strength Assessment (rating scale: 1 = very weak, 10 = very strong)					
		ABC Co.		Rival 1		Rival 2	
Key Success Factor/ Strength Measure	**Importance Weight**	**Strength Rating**	**Weighted Score**	**Strength Rating**	**Weighted Score**	**Strength Rating**	**Weighted Score**
Quality/product performance	0.10	8	0.80	5	0.50	1	0.10
Reputation/image	0.10	8	0.80	7	0.70	1	0.10
Manufacturing capability	0.10	2	0.20	10	1.00	5	0.50
Technological skills	0.05	10	0.50	1	0.05	3	0.15
Dealer network/ distribution capability	0.05	9	0.45	4	0.20	5	0.25
New product innovation capability	0.05	9	0.45	4	0.20	5	0.25
Financial resources	0.10	5	0.50	10	1.00	3	0.30
Relative cost position	0.30	5	1.50	10	3.00	1	0.30
Customer service capabilities	0.15	5	0.75	7	1.05	1	0.15
Sum of importance weights	**1.00**						
Overall weighted competitive strength rating			**5.95**		**7.70**		**2.10**

reflected in the difference between its weighted rating and rivals' weighted ratings. For instance, Rival 1's 3.00 weighted strength rating on relative cost signals a considerable cost advantage over ABC Company (with a 1.50 weighted score on relative cost) and an even bigger cost advantage over Rival 2 (with a weighted score of 0.30). The measure-by-measure ratings reveal the competitive areas in which a company is strongest and weakest, and against whom.

The overall competitive strength scores indicate how all the different strength measures add up—whether the company is at a net overall competitive advantage or disadvantage against each rival. The higher a company's *overall weighted strength rating,* the stronger its *overall competitiveness* versus rivals. The bigger the difference between a company's overall weighted rating and the scores of *lower-rated* rivals, the greater is its implied *net competitive advantage.* Thus, Rival 1's overall weighted score of 7.70 indicates a greater net competitive advantage over Rival 2 (with a score of 2.10) than over ABC Company (with a score of 5.95). Conversely, the bigger the difference between a company's overall rating and the scores of *higher-rated* rivals, the greater its implied *net competitive disadvantage.* Rival 2's score of 2.10 gives it a smaller net competitive disadvantage against ABC Company (with an overall score of 5.95) than against Rival 1 (with an overall score of 7.70).

High-weighted competitive strength ratings signal a strong competitive position and possession of competitive advantage; low ratings signal a weak position and competitive disadvantage.

Strategic Implications of Competitive Strength Assessments

In addition to showing how competitively strong or weak a company is relative to rivals, the strength ratings provide guidelines for designing wise offensive and defensive strategies. For example, if ABC Company wants to go on the offensive to win additional sales and market share, such an offensive probably needs to be aimed directly at winning customers away from Rival 2 (which has a lower overall strength score) rather than Rival 1 (which has a higher overall strength score). Moreover, while ABC has high ratings for technological skills (a 10 rating), dealer network/distribution capability (a 9 rating), new product innovation capability (a 9 rating), quality/product performance (an 8 rating), and reputation/image (an 8 rating), these strength measures have low importance weights—meaning that ABC has strengths in areas that don't translate into much competitive clout in the marketplace. Even so, it outclasses Rival 2 in all five areas, plus it enjoys substantially lower costs than Rival 2 (ABC has a 5 rating on relative cost position versus a 1 rating for Rival 2)—and relative cost position carries the highest importance weight of all the strength measures. ABC also has greater competitive strength than Rival 3 regarding customer service capabilities (which carries the second-highest importance weight). Hence, because ABC's strengths are in the very areas where Rival 2 is weak, ABC is in a good position to attack Rival 2. Indeed, ABC may well be able to persuade a number of Rival 2's customers to switch their purchases over to its product.

A company's competitive strength scores pinpoint its strengths and weaknesses against rivals and point directly to the kinds of offensive and defensive actions it can use to exploit its competitive strengths and reduce its competitive vulnerabilities.

But ABC should be cautious about cutting price aggressively to win customers away from Rival 2, because Rival 1 could interpret that as an attack by ABC to win away Rival 1's customers as well. And Rival 1 is in far and away the best position to compete on the basis of low price, given its high rating on relative cost in an industry where low costs are competitively important (relative cost carries an importance weight of 0.30). Rival 1's strong relative cost position vis-à-vis both ABC and Rival 2 arms it with the ability to use its lower-cost advantage to thwart any price cutting on ABC's part.

Clearly ABC is vulnerable to any retaliatory price cuts by Rival 1—Rival 1 can easily defeat both ABC and Rival 2 in a price-based battle for sales and market share. If ABC wants to defend against its vulnerability to potential price cutting by Rival 1, then it needs to aim a portion of its strategy at lowering its costs.

The point here is that a competitively astute company should utilize the strength scores in deciding what strategic moves to make. When a company has important competitive strengths in areas where one or more rivals are weak, it makes sense to consider offensive moves to exploit rivals' competitive weaknesses. When a company has important competitive weaknesses in areas where one or more rivals are strong, it makes sense to consider defensive moves to curtail its vulnerability.

QUESTION 6: WHAT STRATEGIC ISSUES AND PROBLEMS MERIT FRONT-BURNER MANAGERIAL ATTENTION?

The final and most important analytic step is to zero in on exactly what strategic issues company managers need to address—and resolve—for the company to be more financially and competitively successful in the years ahead. This step involves drawing on the results of both industry analysis and the evaluations of the company's internal situation. The task here is to get a clear fix on exactly what strategic and competitive challenges confront the company, which of the company's competitive shortcomings need fixing, and what specific problems merit company managers' front-burner attention. *Pinpointing the specific issues that management needs to address sets the agenda for deciding what actions to take next to improve the company's performance and business outlook.*

> Compiling a "priority list" of problems creates an agenda of strategic issues that merit prompt managerial attention.

> A good strategy must contain ways to deal with all the strategic issues and obstacles that stand in the way of the company's financial and competitive success in the years ahead.

The "priority list" of issues and problems that have to be wrestled with can include such things as *how* to stave off market challenges from new foreign competitors, *how* to combat the price discounting of rivals, *how* to reduce the company's high costs, *how* to sustain the company's present rate of growth in light of slowing buyer demand, *whether* to correct the company's competitive deficiencies by acquiring a rival company with the missing strengths, *whether* to expand into foreign markets, *whether* to reposition the company and move to a different strategic group, *what to do* about growing buyer interest in substitute products, and *what to do* to combat the aging demographics of the company's customer base. The priority list thus always centers on such concerns as "how to . . . ," "what to do about . . . ," and "whether to . . ." The purpose of the priority list is to identify the specific issues and problems that management needs to address, not to figure out what specific actions to take. Deciding what to do—which strategic actions to take and which strategic moves to make—comes later (when it is time to craft the strategy and choose among the various strategic alternatives).

If the items on the priority list are relatively minor—which suggests that the company's strategy is mostly on track and reasonably well matched to the company's overall situation—company managers seldom need to go much beyond fine-tuning the present strategy. If, however, the problems confronting the company are serious and indicate the present strategy is not well suited for the road ahead, the task of crafting a better strategy needs to be at the top of management's action agenda.

KEY POINTS

There are six key questions to consider in evaluating a company's ability to compete successfully against market rivals:

1. *How well is the present strategy working?* This involves evaluating the strategy in terms of the company's financial performance and market standing. The stronger a company's current overall performance, the less likely the need for radical strategy changes. The weaker a company's performance, the more its current strategy must be questioned.
2. *What is the company's overall situation, in terms of its internal strengths and weaknesses in relation to its market opportunities and external threats?* The answer to this question comes from performing a SWOT analysis. A company's strengths and competitive assets are strategically relevant because they are the most logical and appealing building blocks for strategy; internal weaknesses are important because they may represent vulnerabilities that need correction. External opportunities and threats come into play because a good strategy necessarily aims at capturing a company's most attractive opportunities and at defending against threats to its well-being.
3. *What are the company's most important resources and capabilities and can they give the company a sustainable advantage?* A company's resources can be identified using the tangible/intangible typology presented in this chapter. Its capabilities can be identified either by starting with its resources to look for related capabilities or by looking for them within the company's different functional domains.

   The answer to the second part of the question comes from conducting the four tests of a resource's competitive power—the VRIN tests. If a company has resources and capabilities that are competitively *valuable* and *rare,* the firm will have a competitive advantage over market rivals. If its resources and capabilities are also hard to copy *(inimitable),* with no good substitutes *(nonsubstitutable),* then the firm may be able to sustain this advantage even in the face of active efforts by rivals to overcome it.
4. *Are the company's cost structure and value proposition competitive?* One telling sign of whether a company's situation is strong or precarious is whether its costs are competitive with those of industry rivals. Another sign is how the company compares with rivals in terms of differentiation—how effectively it delivers on its customer value proposition. Value chain analysis and benchmarking are essential tools in determining whether the company is performing particular functions and activities well, whether its costs are in line with those of competitors, whether it is differentiating in ways that really enhance customer value, and whether particular internal activities and business processes need improvement. They complement resource and capability analysis by providing data at the level of individual activities that provide more objective evidence of whether individual resources and capabilities, or bundles of resources and linked activity sets, are competitively superior.
5. *On an overall basis, is the company competitively stronger or weaker than key rivals?* The key appraisals here involve how the company matches up against key rivals on industry key success factors and other chief determinants of competitive success and whether and why the company has a *net* competitive advantage or disadvantage. Quantitative competitive strength assessments, using the method presented in Table 4.4, indicate where a company is competitively strong and weak and provide

insight into the company's ability to defend or enhance its market position. As a rule, a company's competitive strategy should be built around its competitive strengths and should aim at shoring up areas where it is competitively vulnerable. When a company has important competitive strengths in areas where one or more rivals are weak, it makes sense to consider offensive moves to exploit rivals' competitive weaknesses. When a company has important competitive weaknesses in areas where one or more rivals are strong, it makes sense to consider defensive moves to curtail its vulnerability.

6. *What strategic issues and problems merit front-burner managerial attention?* This analytic step zeros in on the strategic issues and problems that stand in the way of the company's success. It involves using the results of industry analysis as well as resource and value chain analysis of the company's competitive situation to identify a "priority list" of issues to be resolved for the company to be financially and competitively successful in the years ahead. Actually deciding on a strategy and what specific actions to take is what comes after developing the list of strategic issues and problems that merit front-burner management attention.

Like good industry analysis, solid analysis of the company's competitive situation vis-à-vis its key rivals is a valuable precondition for good strategy making.

ASSURANCE OF LEARNING EXERCISES

connect

LO 4-1

1. Using the financial ratios provided in Table 4.1 and following the financial statement information presented for Urban Outfitters, Inc., calculate the following ratios for Urban Outfitters for both 2018 and 2019:
   - **a.** Gross profit margin
   - **b.** Operating profit margin
   - **c.** Net profit margin
   - **d.** Times-interest-earned (or coverage) ratio
   - **e.** Return on stockholders' equity
   - **f.** Return on assets
   - **g.** Debt-to-equity Long-term debt-to-equity ratio
   - **h.** Days of inventory
   - **i.** Inventory turnover ratio
   - **j.** Average collection period

   Based on these ratios, did Urban Outfitter's financial performance improve, weaken, or remain about the same from 2018 to 2019?

Consolidated Income Statements for Urban Outfitters, Inc., 2021–2022 (in thousands, except per share data)

	2021	2022
Net sales (total revenue)	$3,449,749	$4,548,763
Cost of sales	2,587,843	3,054,813
Selling, general, and administrative	857,934	1,085,384

	2021	2022
Operating income	$ 3,972	$ 408,566
Other income (expense)		
Other expenses	(3,578)	(6,278)
Interest income and other, net	3,119	2,343
Income before income taxes	3,513	404,631
Provision for income taxes	2,277	94,015
Net income	$ 1,236	$310,616
Basic earnings per share	$ 0.01	$ 3.17
Diluted earnings per share	$ 0.01	$ 3.13

Source: Urban Outfitters, Inc., 2019.

Consolidated Balance Sheets for Urban Outfitters, Inc., 2021–2022 (in millions, except per share data)

	January 31, 2021	January 31, 2022
Assets		
Current Assets		
Cash and cash equivalents	$ 395,635	$ 206,575
Short-term investments	174,695	239,420
Receivables, net	89,952	63,760
Merchandise inventories	389,618	569,699
Prepaid expenses and other current assets	173,432	206,293
Total current assets	1,223,332	1,285,747
Net property and equipment	1,145,085	967,422
Deferred income taxes and Other assets	1,355,591	1,360,515
Total assets	$3,546,345	$3,791,347
Liabilities and Shareholders' Equity		
Current Liabilities		
Accounts payable	$ 237,386	$ 304,246
Accrued salaries and benefits	54,796	89,914
Accrued expenses and Other current liabilities	613,950	587,513
Total current liabilities	$ 906,132	981,473

(continued)

	January 31, 2021	January 31, 2022
Long-term debt	0	0
Deferred rent and other liabilities	1,162,855	1,064,134
Total liabilities	2,068,987	2,045,607
Commitments and Contingencies		
Equity		
Preferred stock $.0001 par value; 10,000,000 shares authorized; no shares issued and outstanding	0	0
Common stock $.0001 par value; 200,000,000 shares authorized; 105,642,283 and 108,248,568 shares issued and outstanding	10	10
Additional paid-in capital	$ 19,360	$ 0
Retained earnings	1,475,108	1,770,560
Accumulated other comprehensive loss	(17,120)	(24,830)
Total stockholders' equity	1,477,358	1,745,740
Total Liabilities and Equity	$3,546,345	$3,791,347

Source: Urban Outfitters, Inc., 2019 10-K.

LO 4-2, LO 4-3

2. REI operates more than 179 sporting goods and outdoor recreation stores in 42 states and the District of Columbia. How many of the four tests of the competitive power of a resource does the retail store network pass? Explain your answer. Using your general knowledge of this industry, perform a SWOT analysis. Explain your answers.

connect
LO 4-4

3. Review the information in Illustration Capsule 4.1 concerning Everlane's average costs of producing and selling a pair of denim jeans, and compare this with the representative value chain depicted in Figure 4.3. Then answer the following questions:

a. Which of the company's costs correspond to the primary value chain activities depicted in Figure 4.3?

b. Which of the company's costs correspond to the support activities described in Figure 4.3?

c. What value chain activities might be important in securing or maintaining Everlane's advantage? Explain your answer.

LO 4-5

4. Using the methodology illustrated in Table 4.3 and your knowledge as an automobile owner, prepare a competitive strength assessment for General Motors and its rivals Ford, Chrysler, Toyota, and Honda. Each of the five automobile manufacturers should be evaluated on the key success factors and strength measures of cost-competitiveness, product-line breadth, product quality and reliability, financial resources and profitability, and customer service. What does your competitive strength assessment disclose about the overall competitiveness of each automobile manufacturer? What factors account most for Toyota's competitive success? Does Toyota have competitive weaknesses that were disclosed by your analysis? Explain.

EXERCISES FOR SIMULATION PARTICIPANTS connect

1. Using the formulas in Table 4.1 and the data in your company's latest financial statements, calculate the following measures of financial performance for your company: LO 4-1
   a. Operating profit margin
   b. Total return on total assets
   c. Current ratio
   d. Working capital
   e. Long-term debt-to-capital ratio
   f. Price-to-earnings ratio
2. On the basis of your company's latest financial statements and all the other available data regarding your company's performance that appear in the industry report, list the three measures of financial performance on which your company did best and the three measures on which your company's financial performance was worst. LO 4-1
3. What hard evidence can you cite that indicates your company's strategy is working fairly well (or perhaps not working so well, if your company's performance is lagging that of rival companies)? LO 4-1
4. What internal strengths and weaknesses does your company have? What external market opportunities for growth and increased profitability exist for your company? What external threats to your company's future well-being and profitability do you and your co-managers see? What does the preceding SWOT analysis indicate about your company's present situation and future prospects—where on the scale from "exceptionally strong" to "alarmingly weak" does the attractiveness of your company's situation rank? LO 4-2, LO 4-3
5. Does your company have any core competencies? If so, what are they? LO 4-2, LO 4-3
6. What are the key elements of your company's value chain? Refer to Figure 4.3 in developing your answer. LO 4-4
7. Using the methodology presented in Table 4.4, do a weighted competitive strength assessment for your company and two other companies that you and your co-managers consider to be very close competitors. LO 4-5

ENDNOTES

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[2] Birger Wernerfelt, "A Resource-Based View of the Firm," *Strategic Management Journal* 5, no. 5 (September–October 1984), pp. 171–180; Jay Barney, "Firm Resources and Sustained Competitive Advantage," *Journal of Management* 17, no. 1 (1991), pp. 99–120.
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chapter **5**

The Five Generic Competitive Strategies

Learning Objectives

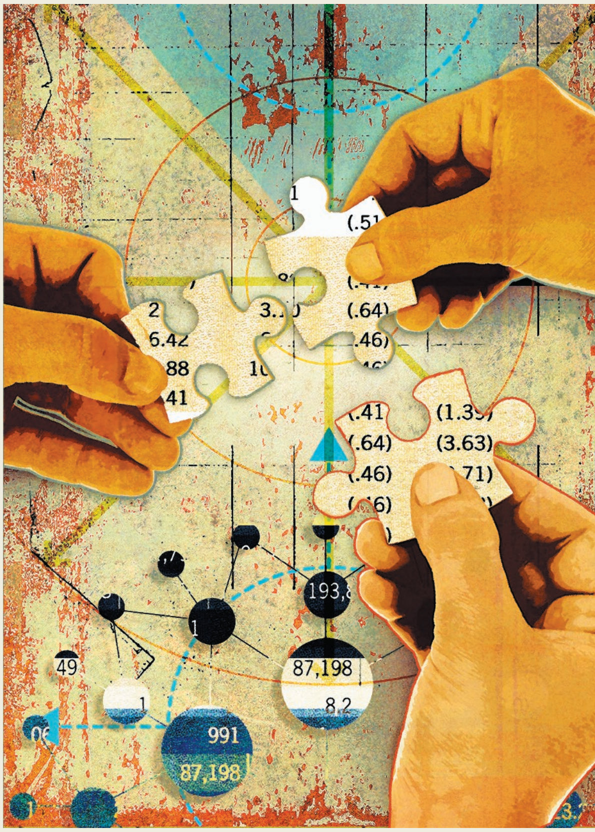
After reading this chapter, you should be able to

LO 5-1 Understand what distinguishes each of the five generic strategies and explain why some of these strategies work better in certain kinds of competitive conditions than in others.

LO 5-2 Recognize the major avenues for achieving a competitive advantage based on lower costs.

LO 5-3 Identify the major avenues to a competitive advantage based on differentiating a company's product or service offering from the offerings of rivals.

LO 5-4 Explain the attributes of a best-cost strategy—a hybrid of low-cost and differentiation strategies.



Roy Scott/Media Bakery

It's all about strategic positioning and competition.

Michele Hutchins—*Consultant*

Strategic positioning means performing different activities from rivals or performing similar activities in different ways.

Michael E. Porter—*Professor, author, and cofounder of Monitor Consulting*

I learnt the hard way about positioning in business, about catering to the right segments.

Shaffi Mather—*Social entrepreneur*

A company can employ any of several basic approaches to gaining a competitive advantage over rivals, but they all involve *delivering more value* to customers than rivals or *delivering value more efficiently* than rivals (or both). More value for customers can mean a good product at a lower price, a superior product worth paying more for, or a best-value offering that represents an attractive combination of price, features, service, and other appealing attributes. Greater efficiency means delivering a given level of value to customers at a lower cost to the company. But whatever approach to delivering value the company takes, it nearly always requires performing value chain activities differently than rivals and building competitively valuable resources and capabilities that rivals cannot readily match or outdo.

This chapter describes the five *generic competitive strategy options*. Each of the five generic strategies represents a distinctly different approach to competing in the marketplace. Which of the five to employ is a company's first and foremost choice in crafting an overall strategy and beginning its quest for competitive advantage.

TYPES OF GENERIC COMPETITIVE STRATEGIES

A company's **competitive strategy** *deals exclusively with the specifics of management's game plan for competing successfully*—its efforts to strengthen its market position, please customers, counter the maneuvers of rivals, respond to shifting market conditions, and achieve a particular kind of competitive advantage. The chances are remote that any two companies—even companies in the same industry—will employ competitive strategies that are exactly alike in every detail. However, when one strips away the details to get at the real substance, the two biggest factors that distinguish one competitive strategy from another boil down to (1) whether a company's market target is broad or narrow and (2) whether the company is pursuing a competitive advantage linked to lower costs or differentiation. These two factors give rise to four distinct competitive strategy options, plus one hybrid option, as shown in Figure 5.1 and listed next.[1]

LO 5-1

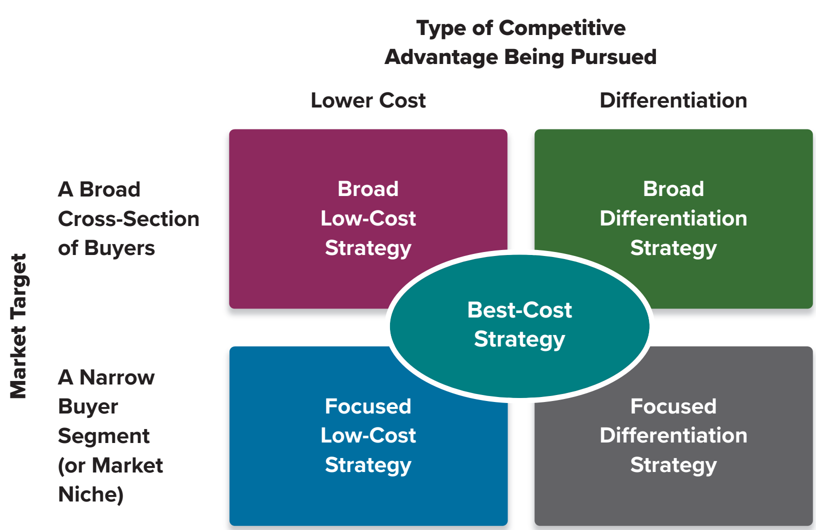
Understand what distinguishes each of the five generic strategies and explain why some of these strategies work better in certain kinds of competitive conditions than in others.

1. *A broad, low-cost strategy*—striving to achieve broad lower overall costs than rivals on comparable products that attract a broad spectrum of buyers, usually by underpricing rivals.
2. *A broad differentiation strategy*—seeking to differentiate the company's product offering from rivals' with attributes that will appeal to a broad spectrum of buyers.
3. *A focused low-cost strategy*—concentrating on the needs and requirements of a narrow buyer segment (or market niche) and striving to meet these needs at lower costs than rivals (thereby being able to serve niche members at a lower price).
4. *A focused differentiation strategy*—concentrating on a narrow buyer segment (or market niche) and offering niche members customized attributes that meet their tastes and requirements better than rivals' products.

CORE CONCEPT

A **competitive strategy** concerns the specifics of management's game plan for strengthening its market position and securing a competitive advantage over rivals in the industry.

FIGURE 5.1 The Five Generic Competitive Strategies



Source: This is an expanded version of a three-strategy classification discussed in Michael E. Porter, *Competitive Strategy* (New York: Free Press, 1980).

5. *A best-cost strategy*—striving to incorporate upscale differentiated product attributes at a lower cost than rivals. Being the "best-cost" producer of a superior, multifeatured product allows a company to *give customers more value for their money* by underpricing rivals whose products have similar upscale, multifeatured attributes. This competitive approach is a *hybrid* strategy that *blends elements of the low cost and differentiation strategies* in a unique and often effective way. It may be focused or broad in its appeal.

The remainder of this chapter explores the ins and outs of these five generic competitive strategies and how they differ.

BROAD LOW-COST STRATEGIES

LO 5-2

Recognize the major avenues for achieving a competitive advantage based on lower costs.

Striving to achieve lower costs than rivals targeting a broad spectrum of buyers is an especially effective competitive approach in markets with many price-sensitive buyers. A company achieves **low-cost leadership** when it becomes the industry's lowest-cost producer rather than just being one of perhaps several competitors with comparatively low costs. But a low-cost producer's foremost strategic objective is *meaningfully* lower costs than rivals—*not necessarily the absolutely lowest possible cost.* In striving for a cost advantage over rivals, company managers must incorporate features and services that buyers consider essential. A product offering that is too frills-free can be viewed by consumers as offering little value regardless of its pricing.

CORE CONCEPT

The essence of a **broad, low-cost strategy,** also called **low cost leadership,** is to produce goods or services for a broad base of buyers at a lower cost than rivals.

A company has two options for translating a low-cost advantage over rivals into superior profit performance. Option 1 is to use the lower-cost edge to underprice competitors and attract price-sensitive buyers in great enough numbers to increase total profits. Option 2 is to maintain the present price, be content with the present market share, and use the lower-cost edge to raise total profits by earning a higher profit margin on each unit sold.

While many companies are inclined to exploit a low-cost advantage by using option 1 (attacking rivals with lower prices), this strategy can backfire if rivals respond with retaliatory price cuts (in order to protect their customer base and defend against a loss of sales). A rush to cut prices can often trigger a price war that lowers the profits of all price discounters. The bigger the risk that rivals will respond with matching price cuts, the more appealing it becomes to employ the second option for using a low-cost advantage to achieve higher profitability.

The Two Major Avenues for Achieving a Cost Advantage

A low-cost advantage over rivals can translate into superior profitability through lower price and higher market share or by matching price yet earning higher profit margins.

To achieve a low-cost edge over rivals, a firm's cumulative costs across its overall value chain must be lower than competitors' cumulative costs. There are two major avenues for accomplishing this:[2]

1. Perform internal value chain activities and/or value chain system activities more cost-effectively than rivals.
2. Revamp the firm's overall value chain to eliminate or bypass some cost-producing activities.

Cost-Efficient Management of Value Chain Activities For a company to do a more cost-effective job of managing its value chain than rivals, managers must diligently search out cost-saving opportunities in every part of the value chain.

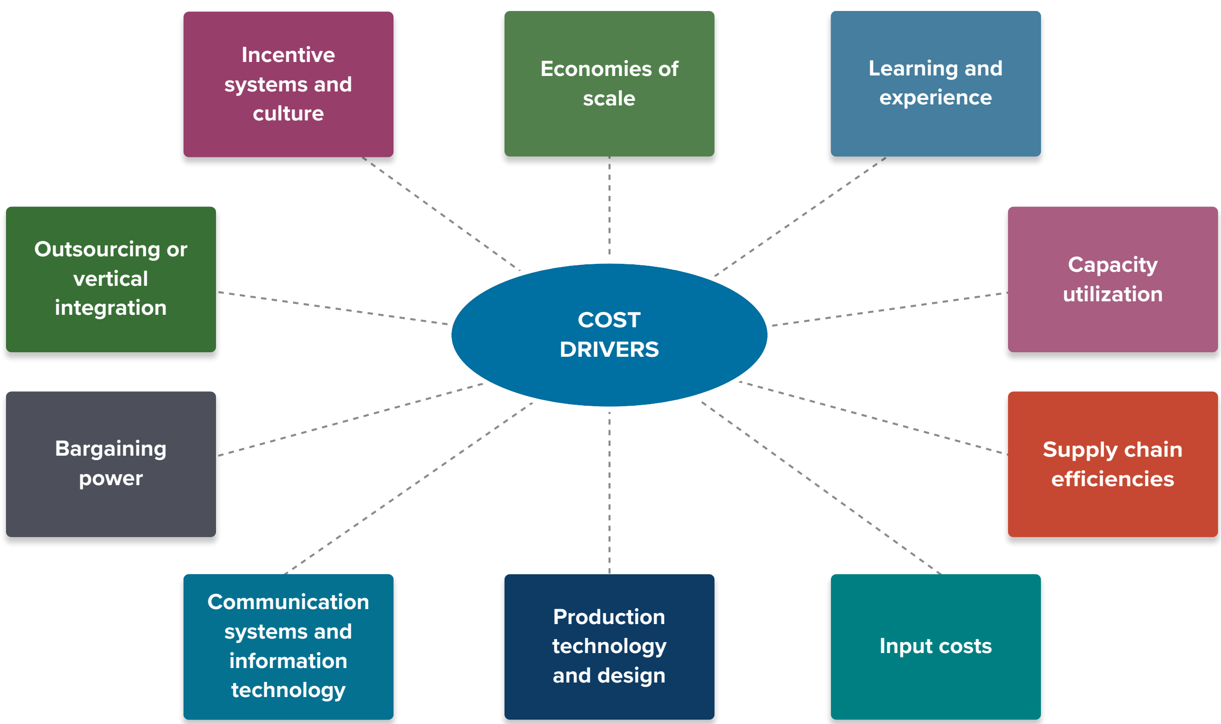
No activity can escape cost-saving scrutiny, and all company personnel must be expected to use their talents and ingenuity to come up with innovative and effective ways to keep down costs. Particular attention must be paid to a set of factors known as **cost drivers** that have a strong effect on a company's costs and can be used as levers to lower costs. Figure 5.2 shows the most important cost drivers. Cost-cutting approaches that demonstrate an effective use of the cost drivers include

CORE CONCEPT

A **cost driver** is a factor that has a strong influence on a company's costs.

1. *Capturing all available economies of scale.* Economies of scale stem from an ability to lower unit costs by increasing the scale of operation. Economies of scale may be available at different points along a company's value chain (both internally and elsewhere along its value chain system). Often, a large plant is more economical to operate than a small one, particularly if it can be operated round the clock robotically. Economies of scale may be available due to a large warehouse operation on the input side or a large distribution center on the output side. In global industries, selling a mostly standard product worldwide tends to lower unit costs as opposed to making separate products (each at lower scale) for each country market. There are economies of scale in advertising as well. For example, Anheuser-Busch InBev SA/NV could afford to pay the $7 million cost of a 30-second Super Bowl ad in 2023 because the cost could be spread out over the millions of cases of Budweiser, Stella Artois, Michelob, Corona, Beck's, and Bud Light that the company sells.

FIGURE 5.2 Cost Drivers: The Keys to Driving Down Company Costs



Source: Adapted from Michael E. Porter, *Competitive Advantage: Creating and Sustaining Superior Performance* (New York: Free Press, 1985).

2. *Taking full advantage of experience and learning-curve effects.* The cost of performing an activity can decline over time as the learning and experience of company personnel build. Learning and experience economies can stem from debugging and mastering newly introduced technologies, using the experiences and suggestions of workers to install more efficient plant layouts and assembly procedures, and the added speed and effectiveness that accrues from repeatedly picking sites for and building new plants, distribution centers, or retail outlets.
3. *Operating facilities at full capacity.* Whether a company is able to operate at or near full capacity has a big impact on unit costs when its value chain contains activities associated with substantial fixed costs. Higher rates of capacity utilization allow depreciation and other fixed costs to be spread over a larger unit volume, thereby lowering fixed costs per unit. The more capital-intensive the business and the higher the fixed costs as a percentage of total costs, the greater the unit-cost penalty for operating at less than full capacity.
4. *Improving supply chain efficiency.* Partnering with suppliers to streamline the ordering and purchasing process, to reduce inventory carrying costs via just-in-time inventory practices, to economize on shipping and materials handling, and to ferret out other cost-saving opportunities is a much-used approach to cost reduction. A company with a distinctive competence in cost-efficient supply chain management, such as Colgate-Palmolive or Unilever (leading consumer products companies), can sometimes achieve a sizable cost advantage over less adept rivals.
5. *Substituting lower-cost inputs wherever there is little or no sacrifice in product quality or performance.* If the costs of certain raw materials and parts are "too high," a company can switch to using lower-cost items or maybe even design the high-cost components out of the product altogether.
6. *Using the company's bargaining power vis-à-vis suppliers or others in the value chain system to gain concessions.* Home Depot, for example, has sufficient bargaining clout with suppliers to win price discounts on large-volume purchases.
7. *Using online systems and sophisticated software to achieve operating efficiencies.* For example, sharing data and production schedules with suppliers, coupled with the use of enterprise resource planning (ERP) and manufacturing execution system (MES) software, can reduce parts inventories, trim production times, and lower labor requirements.
8. *Improving process design and employing advanced production technology.* Often, production costs can be cut by (1) using design for manufacture (DFM) procedures and computer-assisted design (CAD) techniques that enable more integrated and efficient production methods, (2) investing in highly automated robotic production technology, and (3) shifting to a mass-customization production process. Dell's highly automated PC assembly plant in Austin, Texas, is a prime example of the use of advanced product and process technologies. Many companies are ardent users of total quality management (TQM) systems, business process reengineering, Six Sigma methodology, and other business process management techniques that aim at boosting efficiency and reducing costs. These systems and processes are covered in more detail in Chapter 11.
9. *Being alert to the cost advantages of outsourcing or vertical integration.* Outsourcing the performance of certain value chain activities can be more economical than performing them in-house if outside specialists, by virtue of their expertise and volume, can perform the activities at lower cost. On the other hand, there can be times when integrating into the activities of either suppliers or distribution-channel allies

can lower costs through greater production efficiencies, reduced transaction costs, or a better bargaining position.

10. *Motivating employees through incentives and company culture.* A company's incentive system can encourage not only greater worker productivity but also cost-saving innovations that come from worker suggestions. The culture of a company can also spur worker pride in productivity and continuous improvement. Companies that are well known for their cost-reducing incentive systems and culture include Nucor Steel, which characterizes itself as a company of "20,000 teammates," Hubspot, Target, and DHL Express (rival of FedEx).

Revamping of the Value Chain System to Lower Costs Dramatic cost advantages can often emerge from redesigning the company's value chain system in ways that eliminate costly work steps and entirely bypass certain cost-producing value chain activities. Such value chain revamping can include

- *Selling direct to consumers and bypassing the activities and costs of distributors and dealers.* To circumvent the need for distributors and dealers, a company can create its own direct sales force, which adds the costs of maintaining and supporting a sales force but may be cheaper than using independent distributors and dealers to access buyers. Alternatively, they can conduct sales operations at the company's website, since the costs for website operations and shipping may be substantially cheaper than going through distributor-dealer channels). Costs in the wholesale and retail portions of the value chain frequently represent 35 to 50 percent of the final price consumers pay, so establishing a direct sales force or selling online may offer big cost savings.
- *Streamlining operations by eliminating low-value-added or unnecessary work steps and activities.* At Walmart, some items supplied by manufacturers are delivered directly to retail stores rather than being routed through Walmart's distribution centers and delivered by Walmart trucks. In other instances, Walmart unloads incoming shipments from manufacturers' trucks arriving at its distribution centers and loads them directly onto outgoing Walmart trucks headed to particular stores without ever moving the goods into the distribution center. Many supermarket chains have greatly reduced in-store meat butchering and cutting activities by shifting to meats that are cut and packaged at the meatpacking plant and then delivered to their stores in ready-to-sell form.
- *Reducing materials-handling and shipping costs by having suppliers locate their plants or warehouses close to the company's own facilities.* Having suppliers locate their plants or warehouses close to a company's own plant facilitates just-in-time deliveries of parts and components to the exact workstation where they will be used in assembling the company's product. This not only lowers incoming shipping costs but also curbs or eliminates the company's need to build and operate storerooms for incoming parts and to have plant personnel move the inventories to the workstations as needed for assembly.

Illustration Capsule 5.1 describes the path that Vanguard has followed in achieving its position as the low-cost leader of the investment management industry.

Examples of Companies That Revamped Their Value Chains to Reduce Costs

Nucor Corporation, the most profitable steel producer in the United States and one of the largest steel producers worldwide, drastically revamped the value chain process for

ILLUSTRATION CAPSULE 5.1

Vanguard's Path to Becoming the Low-Cost Leader in Investment Management

Vanguard is now one of the world's largest investment management companies. It became an industry giant by leading the way in low-cost passive index investing. In active trading, an investment manager is compensated for making an educated decision on which stocks to sell and which to buy. This incurs both transactional and management fees. In contrast, passive index portfolios aim to mirror the movements of a major market index like the S&P 500, Dow Jones Industrial Average, or NASDAQ. Passive portfolios incur fewer fees and can be managed with lower operating costs. A measure used to compare operating costs in this industry is known as the expense ratio, which is the percentage of an investment that goes toward expenses. In 2022, Vanguard's average mutual fund expense ratio was 0.09 percent. Industry average mutual fund expense ratio was 0.54 percent. All averages are asset weighted. Vanguard was the first to capitalize on what was at the time an under-appreciated fact: over long horizons, well-managed index funds, with their lower costs and fees, typically outperform their actively trading competitors.

Vanguard provides low-cost investment options for its clients in several ways. By creating funds that track index(es) over a long horizon, the client does not incur transaction and management fees normally charged in actively managed funds. Possibly more important, Vanguard was created with a unique client-owner structure. When you invest with Vanguard you become an owner of Vanguard. This structure effectively cuts out traditional shareholders who seek to share in profits. Under client ownership, any returns in excess of operating costs are returned to the clients/investors.

Vanguard keeps its costs low in several other ways. One notable one is its focus on its employees and very flat organizational structure. In several instances Vanguard has been able to capitalize on being a fast follower. They launched several product lines after their competitors introduced those products. Being a fast follower allowed them to develop superior products and reach scale more quickly—both further lowering their cost structure.

Kristoffer Tripplaar/Alamy Stock Photo

The low-cost structure has not come at the expense of performance. Vanguard now has 430 funds, over 50 million investors, has surpassed $7.7 trillion in AUM (assets under management), and is growing faster than all its competitors combined. When *Money* published its January 2020 list of recommended investment funds, 44 percent of the funds listed were Vanguard funds.

Vanguard's low-cost strategy has been so successful that industry experts now refer to The Vanguard Effect. This refers to the pressure that this investment management giant has put on competitors to lower their fees in order to compete with Vanguard's low-cost value proposition.

Note: Developed with Vedrana B. Greatorex.

Sources: **https://www.nytimes.com/2017/04/14/business/mutfund/vanguard-mutual-index-funds-growth.html; https://investor.vanguard.com**; Sunderam, A., Viceira, L., & Ciechanover, A. (2016) *The Vanguard Group, Inc. in 2015: Celebrating 40.* HBS No. 9-216-026. Boston, MA: Harvard Business School Publishing; Money.com; About Vanguard.com/Fast Facts About Vanguard.

Success in achieving a low-cost edge over rivals comes from out-managing rivals in finding ways to perform value chain activities faster, more accurately, and more cost-effectively.

manufacturing steel products by using relatively inexpensive electric arc furnaces and continuous casting processes. Using electric arc furnaces to melt recycled scrap steel eliminated many of the steps used by traditional steel mills that made their steel products from iron ore, coke, limestone, and other ingredients using costly coke ovens, basic oxygen blast furnaces, ingot casters, and multiple types of finishing facilities—plus Nucor's value chain system required far fewer employees.

As a consequence, Nucor produces steel with a far lower capital investment, a far smaller workforce, and far lower operating costs than traditional steel mills. Nucor's strategy to replace the traditional steelmaking value chain with its simpler, quicker value chain approach has made it one of the world's lowest-cost producers of steel, allowing it to take a huge amount of market share away from traditional steel companies and earn attractive profits. This approach has allowed the company to remain steadily profitable even as a flood of illegally subsidized imports wreaked havoc on the rest of the North American steel market.

Southwest Airlines has achieved considerable cost savings by reconfiguring the traditional value chain of commercial airlines, thereby permitting it to offer travelers lower fares. Its mastery of fast turnarounds at the gates (about 25 minutes versus 45 minutes for rivals) allows its planes to fly more hours per day. This translates into being able to schedule more flights per day with fewer aircraft, allowing Southwest to generate more revenue per plane on average than rivals. Southwest does not offer assigned seating, baggage transfer to connecting airlines, or first-class seating and service, thereby eliminating all the cost-producing activities associated with these features.

The Keys to a Successful Broad Low-Cost Strategy

While broad, low-cost companies are champions of frugality, they seldom hesitate to spend aggressively on resources and capabilities *that promise to drive costs out of the business.* Indeed, having competitive assets of this type and ensuring that they remain competitively superior is essential for achieving competitive advantage as a broad, low-cost leader. Walmart, for example, has been an early adopter of state-of-the-art technology throughout its operations; however, the company *carefully estimates the cost savings of new technologies before it rushes to invest in them.* By continuously investing in complex, cost-saving technologies that are hard for rivals to match, Walmart has sustained its low-cost advantage for over 45 years.

> A low-cost producer is in the best position to win the business of price-sensitive buyers, set the floor on market price, and still earn a profit.

Uber and Lyft, employing a formidable low-cost provider strategy and an innovative business model, have stormed their way into hundreds of locations across the world, totally disrupting and seemingly forever changing competition in the taxi markets where they have a presence. And, most significantly, the ultra-low fares charged by Uber and Lyft have resulted in dramatic increases in the demand for taxi services, particularly those provided by these two low-cost providers. Other companies noted for their successful use of broad low-cost strategies include Spirit Airlines, EasyJet, and Ryanair in airlines; Briggs & Stratton in small gasoline engines; Huawei in networking and telecommunications equipment; Bic in ballpoint pens; Stride Rite in footwear; and Poulan in chain saws.

When a Low-Cost Strategy Works Best

A low-cost strategy becomes increasingly appealing and competitively powerful when

1. *Price competition among rival sellers is vigorous.* Low-cost leaders are in the best position to compete offensively on the basis of price, to gain market share at the expense of rivals, to win the business of price-sensitive buyers, to remain profitable despite strong price competition, and to survive price wars.
2. *The products of rival sellers are essentially identical and readily available from many eager sellers.* Look-alike products and/or overabundant product supply set the stage

for lively price competition; in such markets, it is the less efficient, higher-cost companies whose profits get squeezed the most.

3. *There are few ways to achieve product differentiation that have value to buyers.* When the differences between product attributes or brands do not matter much to buyers, buyers are nearly always sensitive to price differences, and industry-leading companies tend to be those with the lowest-priced brands.
4. *Buyers incur low costs in switching their purchases from one seller to another.* Low switching costs give buyers the flexibility to shift purchases to lower-priced sellers having equally good products or to attractively priced substitute products. A low-cost leader is well positioned to use low price to induce potential customers to switch to its brand.
5. *Buyers are price-sensitive or have the power to bargain down prices.* When buyers are focused primarily on price or have substantial bargaining power, then a low-cost strategy becomes something of a necessity!

Pitfalls to Avoid in Pursuing a Low-Cost Strategy

Perhaps the biggest mistake a low-cost producer can make is getting carried away with overly aggressive price cutting. *Higher unit sales and market shares do not automatically translate into higher profits.* Reducing price results in earning a lower profit margin on each unit sold. Thus, reducing price improves profitability *only if* the lower price increases unit sales enough to offset the loss in revenues due to the lower per unit profit margin. A simple numerical example tells the story: Suppose a firm selling 1,000 units at a price of $10, a cost of $9, and a profit margin of $1 opts to cut price 5 percent to $9.50—which reduces the firm's profit margin to $0.50 per unit sold. If unit costs remain at $9, then it takes a 100 percent sales increase to 2,000 units just to offset the narrower profit margin and get back to total profits of $1,000. Hence, whether a price cut will result in higher or lower profitability depends on how big the resulting sales gains will be and how much, if any, unit costs will fall as sales volumes increase.

A second pitfall is *relying on cost reduction approaches that can be easily copied by rivals.* If rivals find it relatively easy or inexpensive to imitate the leader's low-cost methods, then the leader's advantage will be too short-lived to yield a valuable edge in the marketplace.

Reducing price does not lead to higher total profits unless the added gains in unit sales are large enough to offset the loss in revenues due to lower margins per unit sold.

A low-cost producer's product offering must always contain enough attributes to be attractive to prospective buyers—low price, by itself, is not always appealing to buyers.

A third pitfall is *becoming too fixated on cost reduction.* Low costs cannot be pursued so zealously that a firm's offering ends up being too feature-poor to generate buyer appeal. Furthermore, a company driving hard to push down its costs has to guard against ignoring declining buyer sensitivity to price, increased buyer interest in added features or service, or new developments that alter how buyers use the product. Otherwise, it risks losing market ground if buyers start opting for more upscale or feature-rich products.

Even if these mistakes are avoided, a low-cost strategy still entails risk. An innovative rival may discover an even lower-cost value chain approach. Important cost-saving technological breakthroughs may suddenly emerge. And if a low-cost producer has heavy investments in its present means of operating, then it can prove costly to quickly shift to the new value chain approach or a new technology.

BROAD DIFFERENTIATION STRATEGIES

LO 5-3

Identify the major avenues to a competitive advantage based on differentiating a company's product or service offering from the offerings of rivals.

Differentiation strategies are attractive whenever buyers' needs and preferences are too diverse to be fully satisfied by a standardized product offering. Successful product differentiation requires careful study to determine what attributes buyers will find appealing, valuable, and worth paying for.[3] Then the company must incorporate a combination of these desirable features into its product or service that will be different enough to stand apart from the product or service offerings of rivals. A broad differentiation strategy achieves its aim when a wide range of buyers find the company's offering more appealing than that of rivals and worth a somewhat higher price.

Successful differentiation allows a firm to do one or more of the following:

- Command a premium price for its product.
- Increase unit sales (because additional buyers are won over by the differentiating features).
- Gain buyer loyalty to its brand (because buyers are strongly attracted to the differentiating features and bond with the company and its products).

CORE CONCEPT

The essence of a **broad differentiation strategy** is to offer unique product attributes that a wide range of buyers find appealing and worth paying more for.

Differentiation enhances profitability whenever a company's product can command a sufficiently higher price or generate sufficiently bigger unit sales *to more than cover the added costs of achieving the differentiation.* Company differentiation strategies fail when buyers don't place much value on the brand's uniqueness and/or when a company's differentiating features are easily matched by its rivals.

Companies can pursue differentiation from many angles: a unique taste (Red Bull, Listerine); multiple features (Microsoft Office, Apple Watch); wide selection and one-stop shopping (Home Depot, Alibaba.com); superior service (Ritz-Carlton, Nordstrom); spare parts availability (John Deere; Morgan Motors); engineering design and performance (Mercedes, BMW); high fashion design (Prada, LVMH, Chanel); product reliability (Whirlpool, LG, and Bosch in large home appliances); quality manufacture (Michelin); technological leadership (3M Corporation in bonding and coating products); a full range of services (Charles Schwab in stock brokerage); and wide product selection (Campbell's soups; Frito-Lay snack foods.).

Managing the Value Chain in Ways That Enhance Differentiation

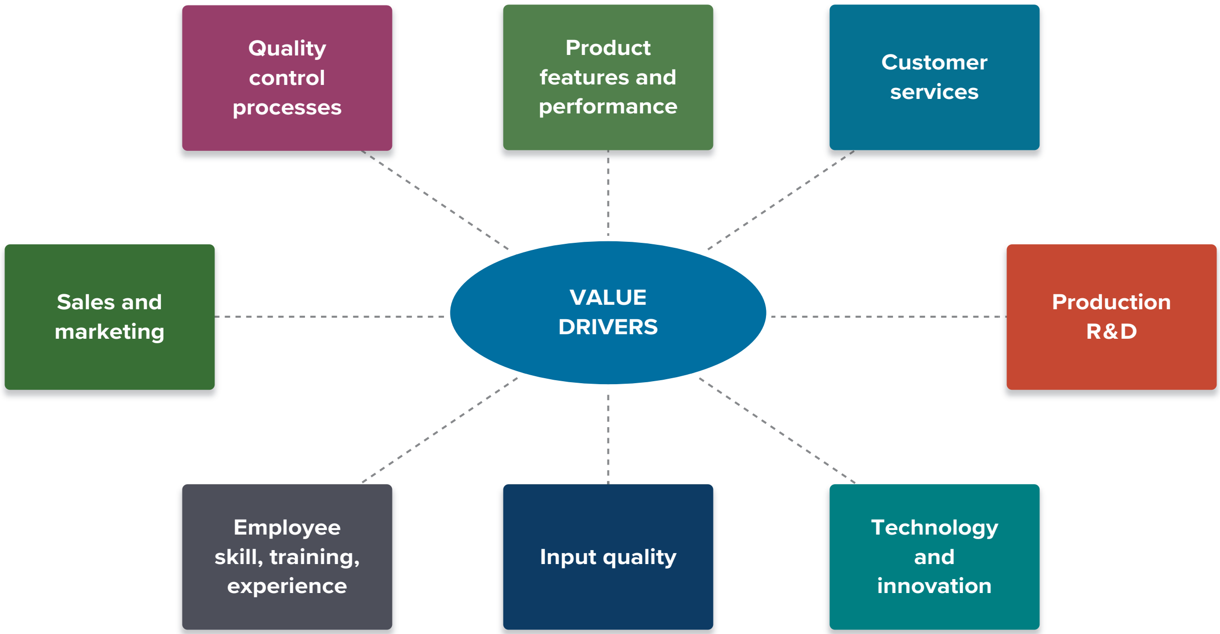
Differentiation is not something in marketing and advertising departments, nor is it limited to the catchalls of quality and service. Differentiation opportunities can exist in activities all along a company's value chain and value chain system. The most systematic approach that managers can take, however, involves focusing on the **value drivers,** a set of factors—analogous to cost drivers—that are particularly effective in creating differentiation. Figure 5.3 contains a list of important value drivers. Ways that managers can enhance differentiation based on value drivers include the following:

CORE CONCEPT

A **value driver** is a factor that is particularly effective in creating differentiation.

1. *Create product features and performance attributes that appeal to a wide range of buyers.* The physical and functional features of a product have a big influence on differentiation, including features such as added user safety or enhanced environmental protection. Styling and appearance are big differentiating factors in the

FIGURE 5.3 Value Drivers: The Keys to Creating a Differentiation Advantage



Source: Adapted from Michael E. Porter, *Competitive Advantage: Creating and Sustaining Superior Performance* (New York: Free Press, 1985).

apparel and motor vehicle industries. Graphics resolution and processing speed matter in video game consoles. Size and weight matter in binoculars and mobile devices. Most companies employing broad differentiation strategies make a point of incorporating innovative and novel features in their product or service offering, especially those that improve performance and functionality.

2. *Improve customer service or add extra services.* Better customer services, in areas such as delivery, returns, and repair, can be as important in creating differentiation as superior product features. Examples include superior technical assistance to buyers, higher-quality maintenance services, more and better product information provided to customers, more and better training materials for end users, better credit terms, quicker order processing, and greater customer convenience.
3. *Invest in production-related R&D activities.* Engaging in production R&D may permit custom-order manufacture at an efficient cost, provide wider product variety and selection through product "versioning," or improve product quality. Many manufacturers have developed flexible manufacturing systems that allow different models and product versions to be made on the same assembly line. Being able to provide buyers with made-to-order products can be a potent differentiating capability.
4. *Strive for innovation and technological advances.* Successful innovation is the route to more frequent first-on-the-market victories and is a powerful differentiator. If the innovation proves hard to replicate, through patent protection or other means, it can provide a company with a first-mover advantage that is sustainable.
5. *Pursue continuous quality improvement.* Quality control processes reduce product defects, prevent premature product failure, extend product life, make it economical to offer longer warranty coverage, improve economy of use, result in more end-user

convenience, or enhance product appearance. Companies whose quality management systems meet certification standards, such as the ISO 9001 standards, can enhance their reputation for quality with customers.

6. *Increase marketing and brand-building activities.* Marketing and advertising can have a tremendous effect on the value perceived by buyers and therefore their willingness to pay more for the company's offerings. They can create differentiation even when little tangible differentiation exists otherwise. For example, blind taste tests show that even the most loyal Pepsi or Coke drinkers have trouble telling one cola drink from another.[4] Brands create customer loyalty, which increases the perceived "cost" of switching to another product.
7. *Seek out high-quality inputs.* Input quality can ultimately spill over to affect the performance or quality of the company's end product. Starbucks, for example, gets high ratings on its coffees partly because it has very strict specifications on the coffee beans purchased from suppliers.
8. *Emphasize human resource management activities that improve the skills, expertise, and knowledge of company personnel.* A company with high-caliber intellectual capital often has the capacity to generate the kinds of ideas that drive product innovation, technological advances, better product design and product performance, improved production techniques, and higher product quality. Well-designed incentive compensation systems can often unleash the efforts of talented personnel to develop and implement new and effective differentiating attributes.

Revamping the Value Chain System to Increase Differentiation Just as pursuing a cost advantage can involve the entire value chain system, the same is true for a differentiation advantage. Activities performed upstream by suppliers or downstream by distributors and retailers can have a meaningful effect on customers' perceptions of a company's offerings and its value proposition. Approaches to enhancing differentiation through changes in the value chain system include

- *Coordinating with downstream channel allies to enhance customer value.* Coordinating with downstream partners such as distributors, dealers, brokers, and retailers can contribute to differentiation in a variety of ways. Methods that companies use to influence the value chain activities of their channel allies include setting standards for downstream partners to follow, providing them with templates to standardize the selling environment or practices, training channel personnel, or cosponsoring promotions and advertising campaigns. Coordinating with retailers is important for enhancing the buying experience and building a company's image. Coordinating with distributors or shippers can mean quicker delivery to customers, more accurate order filling, and/or lower shipping costs. The Coca-Cola Company considers coordination with its bottler-distributors so important that it has at times taken over a troubled bottler to improve its management and upgrade its plant and equipment before releasing it again.[5]
- *Coordinating with suppliers to better address customer needs.* Collaborating with suppliers can also be a powerful route to a more effective differentiation strategy. Coordinating and collaborating with suppliers can improve many dimensions affecting product features and quality. This is particularly true for companies that engage only in assembly operations, such as Dell in PCs and Ducati in motorcycles. Close coordination with suppliers can also enhance differentiation by speeding up new product development cycles or speeding delivery to end customers. Strong relationships with suppliers can also mean that the company's supply requirements are prioritized when industry supply is insufficient to meet overall demand.

Delivering Superior Value via a Broad Differentiation Strategy

Differentiation strategies depend on meeting customer needs in unique ways or creating new needs through activities such as innovation or persuasive advertising. The objective is to offer customers something that rivals can't—at least in terms of the level of satisfaction. There are four basic routes to achieving this aim:

The first route is to incorporate product attributes and user features that *lower the buyer's overall costs* of using the company's product. This is the least obvious and most overlooked route to a differentiation advantage. It is a differentiating factor since it can help *business buyers* be more competitive in their markets and more profitable. Producers of materials and components often win orders for their products by reducing a buyer's raw-material waste (providing cut-to-size components), reducing a buyer's inventory requirements (providing just-in-time deliveries), using online systems to reduce a buyer's procurement and order-processing costs, and providing free technical support. This route to differentiation can also appeal to *individual consumers* who are looking to economize on their overall costs of consumption. Making a company's product more economical for a consumer to use can be done by incorporating energy-efficient features (energy-saving appliances and lightbulbs help cut buyers' utility bills; fuel-efficient vehicles cut buyer costs for gasoline) and/or by increasing maintenance intervals and product reliability to lower buyer costs for maintenance and repairs.

A second route is to incorporate *tangible* features that increase customer satisfaction with the product, such as product specifications, functions, and styling. This can be accomplished by including attributes that add functionality; enhance the design; save time for the user; are more reliable; or make the product cleaner, safer, quieter, simpler to use, more portable, more convenient, or longer-lasting than rival brands. Smartphone manufacturers are in a race to introduce next-generation devices capable of being used for more purposes and having simpler menu functionality.

Differentiation can be based on *tangible* or *intangible* attributes.

A third route to a differentiation-based competitive advantage is to incorporate *intangible* features that enhance buyer satisfaction in noneconomic ways. Tesla's ability to appeal to environmentally conscious and performance-minded motorists allowed the Model Y to enter the top 20 best-selling automobile list in 2021 with sales nearly exceeding that of the Honda Accord and Jeep Wrangler. Bentley, Ralph Lauren, Louis Vuitton, Burberry, Cartier, and Coach have differentiation-based competitive advantages linked to buyer desires for status, image, prestige, upscale fashion, superior craftsmanship, and the finer things in life. Intangibles that contribute to differentiation can extend beyond product attributes to the reputation of the company and to customer relations or trust.

The fourth route is to *signal the value* of the company's product offering to buyers. The value of certain differentiating features is rather easy for buyers to detect, but in some instances buyers may have trouble assessing what their experience with the product will be. Successful differentiators go to great lengths to make buyers knowledgeable about a product's value and employ various signals of value. Typical signals of value include a high price (in instances where high price implies high quality and performance), more appealing or fancier packaging than competing products, ad content that emphasizes a product's standout attributes, the quality of brochures and sales presentations, and the luxuriousness and ambience of a seller's facilities. The nature of a company's facilities are important for high-end retailers and other types of companies whose facilities are frequented by customers; they make potential buyers aware of the professionalism, appearance, and personalities of the seller's employees and/or make potential buyers realize that a company has prestigious customers. Signaling value is particularly important (1) when the nature of differentiation is based on intangible features and is therefore subjective or hard to quantify, (2) when buyers are making a first-time purchase and are unsure what their experience with the product will be, (3) when repurchase is infrequent, and (4) when buyers are unsophisticated.

Regardless of the approach taken, achieving a successful differentiation strategy requires, first, that the company have capabilities in areas such as customer service, marketing, brand management, and technology that can create and support differentiation. That is, the resources, competencies, and value chain activities of the company must be well matched to the requirements of the strategy. For the strategy to result in competitive advantage, the company's competencies must also be sufficiently unique in delivering value to buyers that they help set its product offering apart from those of rivals. They must be competitively superior. There are numerous examples of companies that have differentiated themselves on the basis of distinctive capabilities. Health care facilities like M.D. Anderson, Mayo Clinic, and Cleveland Clinic have specialized expertise and equipment for treating certain diseases that most hospitals and health care providers cannot afford to emulate. When a major news event occurs, many people turn to Fox News and CNN because they have the capabilities to get reporters on the scene quickly, break away from their regular programming (without suffering a loss of advertising revenues associated with regular programming), and devote extensive air time to newsworthy stories.

The most successful approaches to differentiation are those that are difficult for rivals to duplicate. Resourceful competitors can, in time, clone almost any product or feature or attribute. If Toyota introduces lane departure warning or adaptive cruise control features, so can Ford and Honda. Socially complex intangible attributes such as company reputation, long-standing relationships with buyers, and image are much harder to imitate. Differentiation that creates switching costs that lock in buyers can also provide a route to sustainable advantage. For example, if a buyer makes a substantial investment in learning to use one type of system, that buyer is less likely to switch to a competitor's system. (This has kept many users from switching away from Microsoft Office products, despite the fact that there are other applications with superior features.) As a rule, differentiation yields a longer-lasting and more profitable competitive edge when it is based on a well-established brand image, patent-protected product innovation, complex technical superiority, a reputation for superior product quality and reliability, relationship-based customer service, and unique competitive capabilities.

Easy-to-copy differentiating features cannot produce sustainable competitive advantage.

When a Differentiation Strategy Works Best

Differentiation strategies tend to work best in market circumstances where

- *Buyer needs and uses of the product are diverse.* Diverse buyer preferences allow industry rivals to set themselves apart with product attributes that appeal to particular buyers. For instance, the diversity of consumer preferences for menu selection, ambience, pricing, and customer service gives restaurants exceptionally wide latitude in creating a differentiated product offering. Other industries with diverse buyer needs include magazine publishing, automobile manufacturing, footwear, and kitchen appliances.
- *There are many ways to differentiate the product or service that have value to buyers.* Industries in which competitors have opportunities to add features to products

and services are well suited to differentiation strategies. For example, hotel chains can differentiate on such features as location, size of room, range of guest services, in-hotel dining, and the quality and luxuriousness of bedding and furnishings. Similarly, cosmetics producers are able to differentiate based on prestige and image, formulations that fight the signs of aging, UV light protection, exclusivity of retail locations, the inclusion of antioxidants and natural ingredients, or prohibitions against animal testing. Basic commodities, such as chemicals, mineral deposits, and agricultural products, provide few opportunities for differentiation.

- *Few rival firms are following a similar differentiation approach.* The best differentiation approaches involve trying to appeal to buyers on the basis of attributes that rivals are not emphasizing. A differentiator encounters less head-to-head rivalry when it goes its own separate way in creating value and does not try to out-differentiate rivals on the very same attributes. When many rivals base their differentiation efforts on the same attributes, the most likely result is weak brand differentiation and "strategy overcrowding"—competitors end up chasing much the same buyers with much the same product offerings.
- *Technological change is fast-paced and competition revolves around rapidly evolving product features.* Rapid product innovation and frequent introductions of next-version products heighten buyer interest and provide space for companies to pursue distinct differentiating paths. In smartphones and wearable Internet devices, drones for hobbyists and commercial use, automobile lane detection sensors, and battery-powered cars, rivals are locked into an ongoing battle to set themselves apart by introducing the best next-generation products. Companies that fail to come up with new and improved products and distinctive performance features quickly lose out in the marketplace.

Pitfalls to Avoid in Pursuing a Differentiation Strategy

Any differentiating feature that works well is a magnet for imitators.

Differentiation strategies can fail for any of several reasons. *A differentiation strategy keyed to product or service attributes that are easily and quickly copied is always suspect.* Rapid imitation means that no rival achieves differentiation, since whenever one firm introduces some value-creating aspect that strikes the fancy of buyers, fast-following copycats quickly reestablish parity. This is why a firm must seek out sources of value creation that are time-consuming or burdensome for rivals to match if it hopes to use differentiation to win a sustainable competitive edge.

Differentiation strategies can also falter when buyers see little value in the unique attributes of a company's product. Thus, even if a company succeeds in setting its product apart from those of rivals, its strategy can result in disappointing sales and profits if the product does not deliver adequate perceived value to buyers. Anytime many potential buyers look at a company's differentiated product offering with indifference, the company's differentiation strategy is in deep trouble.

The third big pitfall is overspending on efforts to differentiate the company's product offering, thus eroding profitability. Company efforts to achieve differentiation nearly always raise costs—often substantially, since marketing and R&D are expensive undertakings. The key to profitable differentiation is either to keep the unit cost of achieving differentiation below the price premium that the differentiating attributes can command (thus increasing the profit margin per unit sold) or to offset thinner profit margins per unit by selling enough additional units to increase total profits. If a company goes overboard in pursuing costly differentiation, it could be saddled with unacceptably low profits or even losses.

Other common mistakes in crafting a differentiation strategy include

Over-differentiating and overcharging are fatal differentiation strategy mistakes. *A low-cost strategy can defeat a differentiation strategy when buyers are satisfied with a basic product and don't think "extra" attributes are worth a higher price.*

- *Offering only trivial improvements in quality, service, or performance features vis-à-vis rivals' products.* Trivial differences between rivals' product offerings may not be visible or important to buyers. If a company wants to generate the fiercely loyal customer following needed to earn superior profits and open up a differentiation-based competitive advantage over rivals, then its strategy must result in *strong rather than weak product differentiation.* In markets where differentiators do no better than achieve weak product differentiation, customer loyalty is weak, the costs of brand switching are low, and no one company has enough of a differentiation edge to command a price premium over rival brands.
- *Over-differentiating so that product quality, features, or service levels exceed the needs of most buyers.* A dazzling array of features and options not only drives up product price but also runs the risk that many buyers will conclude that a less deluxe and lower-priced brand is a better value since they have little occasion to use the deluxe attributes.
- *Charging too high a price premium.* While buyers may be intrigued by a product's deluxe features, they may nonetheless see it as being overpriced relative to the value delivered by the differentiating attributes. A company must guard against turning off would-be buyers with what is perceived as "price gouging." Normally, the bigger the price premium for the differentiating extras, the harder it is to keep buyers from switching to the lower-priced offerings of competitors.

FOCUSED (OR MARKET NICHE) STRATEGIES

What sets focused strategies apart from broad low-cost and broad differentiation strategies is concentrated attention on a narrow piece of the total market. The target segment, or niche, can be in the form of a geographic segment (such as New England), or a customer segment (such as young urban creatives or "yuccies"), or a product segment (such as a class of models or some version of the overall product type). Community Coffee, the largest family-owned specialty coffee retailer in the United States, has a geographic focus on the state of Louisiana and communities across the Gulf of Mexico. Community holds only a small share of the national coffee market but has recorded sales in excess of $100 million and has won a strong following in the Southeastern United States. Examples of firms that concentrate on a well-defined market niche keyed to a particular product or buyer segment include Zipcar (hourly and daily car rental in urban areas), Airbnb and HomeAway (owner of VRBO) (by-owner lodging rental), Fox News Channel and HGTV (cable TV), Blue Nile (online jewelry), Tesla Motors (electric cars), and CGA, Inc. (a specialist in providing insurance to cover the cost of lucrative hole-in-one prizes at golf tournaments). Microbreweries, local bakeries, bed-and-breakfast inns, and retail boutiques have also scaled their operations to serve narrow or local customer segments.

A Focused Low-Cost Strategy

A focused low-cost strategy aims at securing a competitive advantage by serving buyers in the target market niche at a lower cost (and usually lower price) than those of rival competitors. This strategy has considerable attraction when a firm can lower costs significantly by limiting its customer base to a well-defined buyer segment. The avenues to achieving a cost advantage over rivals also serving the target market niche are the

ILLUSTRATION CAPSULE 5.2 Clinícas del Azúcar's Focused Low-Cost Strategy

Though diabetes is a manageable condition, it is the leading cause of death in Mexico. Over 14 million adults (14 percent of all adults) have diabetes, 3.5 million cases remain undiagnosed, and more than 80,000 die due to related complications each year. The key driver behind this public health crisis is limited access to affordable, high-quality care. Approximately 90 percent of the population cannot access diabetes care due to financial and time constraints; private care can cost upward of $1,000 USD per year (approximately 45 percent of Mexico's population has an annual income less than $2,000 USD) while average wait times alone at public clinics surpass five hours. Clinícas del Azúcar (CDA), however, is quickly scaling a solution that uses a *focused low-cost strategy* to provide affordable and convenient care to patients with lower incomes.

By relentlessly focusing only on the needs of its target population, CDA has reduced the cost of diabetes care by more than 70 percent and clinic visit times by over 80 percent. The key has been the use of proprietary technology and a streamlined care system. First, CDA leverages evidence-based algorithms to diagnose patients for a fraction of the costs of traditional diagnostic tests. Similarly, its mobile outreach significantly reduces the costs of supporting patients in managing their diabetes after leaving CDA facilities. Second, CDA has redesigned the care process to implement a streamlined "patient process flow" that eliminates the need for multiple referrals to other care providers and brings together the necessary professionals and equipment into one facility. Consequently, CDA has become a one-stop shop for diabetes care, providing every aspect of diabetes treatment under one roof.

Rob Marmion/Shutterstock

The bottom line: CDA's cost structure allows it to keep its prices for diabetes treatment very low, saving patients both time and money. Patients choose from three different care packages, ranging from preventive to comprehensive care, paying an annual fee that runs between approximately $70 and $200 USD. Given this increase in affordability and convenience, CDA estimates that it has saved its patients over $2 million USD in medical costs and will soon increase access to affordable, high-quality care for 10 to 80 percent of the population. These results have attracted investment from major funders including Endeavor, Echoing Green, and the Clinton Global Initiative. As a result, CDA and others expect CDA to grow from five clinics serving approximately 5,000 patients to more than 50 clinics serving over 100,000 patients throughout Mexico by 2020.

Note: Developed with David B. Washer.

Sources: **www.clinicasdelazucar.com;** "Funding Social Enterprises Report," *Echoing Green,* June 2014; Jude Webber, "Mexico Sees Poverty Climb Despite Rise in Incomes," *Financial Times* online, July 2015, **www.ft.com/intl/cms/s/3/98460bbc-31e1-11e5-8873-775ba7c2ea3d.html#axzz3zz8grtec;** "Javier Lozano," Schwab Foundation for Social Entrepreneurship online, 2016, **www.schwabfound.org/content/javier-lozano.**

same as those for broad low-cost leadership—use the cost drivers to perform value chain activities more efficiently than rivals and search for innovative ways to bypass nonessential value chain activities. The only real difference between a broad low-cost strategy and a focused low-cost strategy is the size of the buyer group to which a company is appealing—the former involves a product offering that appeals to almost all buyer groups and market segments, whereas the latter aims at just meeting the needs of buyers in a narrow market segment.

Focused low-cost strategies are fairly common. Costco, BJ's, and Sam's Club sell large lots of goods at wholesale prices to small businesses and bargain-hunters.

Producers of private-label goods are able to achieve low costs in product development, marketing, distribution, and advertising by concentrating on making generic items imitative of name-brand merchandise and selling directly to retail chains wanting a low-priced store brand. The Perrigo Company Plc has become a leading manufacturer of over-the-counter health care products and self-care, with 2018 sales of nearly $5 billion, by focusing on producing private-label brands for retailers such as Walmart, CVS, Walgreens, Rite Aid, and Safeway. Budget motel chains, like Motel 6, Sleep Inn, and Super 8, cater to price-conscious travelers who just want to pay for a clean, no-frills place to spend the night. Illustration Capsule 5.2 describes how Clinícas del Azúcar's focus on lowering the costs of diabetes care is allowing it to address a major health issue in Mexico.

A Focused Differentiation Strategy

Focused differentiation strategies involve offering superior products or services tailored to the unique preferences and needs of a narrow, well-defined group of buyers. Successful use of a focused differentiation strategy depends on (1) the existence of a buyer segment that is looking for special product or service attributes and (2) a firm's ability to create a product or service offering that stands apart from that of rivals competing in the same target market niche.

Companies like Molton Brown in bath, body, and beauty products, Bugatti in high-performance automobiles, and Four Seasons Hotels and Resorts in lodging employ successful differentiation-based focused strategies targeted at upscale buyers wanting products and services with world-class attributes. Indeed, most markets contain a buyer segment willing to pay a big price premium for the very finest items available, thus opening the strategic window for some competitors to pursue differentiation-based focused strategies aimed at the very top of the market pyramid. Whole Foods Market, which was acquired by Amazon in 2017, became the largest organic and natural foods supermarket chain in the United States by catering to health-conscious consumers who prefer organic, natural, minimally processed, and locally grown foods. Whole Foods prides itself on stocking the highest-quality organic and natural foods it can find; the company defines quality by evaluating the ingredients, freshness, taste, nutritive value, appearance, and safety of the products it carries. Illustration Capsule 5.3 describes how Canada Goose has become a popular winter apparel brand with a focused differentiation strategy.

When a Focused Low-Cost or Focused Differentiation Strategy Is Attractive

A focused strategy aimed at securing a competitive edge based on either low costs or differentiation becomes increasingly attractive as more of the following conditions are met:

- The target market niche is big enough to be profitable and offers good growth potential.
- Industry leaders have chosen not to compete in the niche—in which case focusers can avoid battling head to head against the industry's biggest and strongest competitors.
- It is costly or difficult for multisegment competitors to meet the specialized needs of niche buyers and at the same time satisfy the expectations of their mainstream customers.

ILLUSTRATION CAPSULE 5.3 Canada Goose's Focused Differentiation Strategy

Open up a winter edition of *People* and you will probably see photos of a celebrity sporting a Canada Goose parka. Recognizable by a distinctive red, white, and blue arm patch, the brand's parkas have been spotted on movie stars like Emma Stone and Bradley Cooper, on New York City streets, and on the cover of *Sports Illustrated.* Lately, Canada Goose has become extremely successful thanks to a focused differentiation strategy that enables it to thrive within its niche in the $1.2 trillion fashion industry. By targeting upscale buyers and providing a uniquely functional and stylish jacket, Canada Goose can charge nearly $1,000 per jacket and never need to put its products on sale.

While Canada Goose was founded in 1957, its recent transition to a focused differentiation strategy allowed it to rise to the top of the luxury parka market. In 2001, CEO Dani Reiss took control of the company and made two key decisions. First, he cut private-label and non-outerwear production in order to focus on the branded outerwear portion of Canada Goose's business. Second, Reiss decided to remain in Canada despite many North American competitors moving production to Asia to increase profit margins. Fortunately for him, these two strategy decisions have led directly to the company's current success. While other luxury brands, like Moncler, are priced similarly, no competitor's products fulfill the promise of handling harsh winter weather quite like a Canada Goose "Made in Canada" parka. The Canadian heritage, use of down sourced from rural Canada, real coyote fur (humanely trapped), and promise to provide warmth in sub-25°F temperatures have let Canada Goose break away from the pack when it comes to selling parkas. The company's distinctly Canadian product has made it a hit among buyers, which is reflected in the willingness to pay a steep premium for extremely high-quality and warm winter outerwear.

Lindsay Lipscombe/Alamy Stock Photo

Since Canada Goose's shift to a focused differentiation strategy, the company has seen a boom in revenue and appeal across the globe. Prior to Reiss's strategic decisions in 2001, Canada Goose had annual revenue of about $3 million. Within a decade, the company had experienced over 4,000 percent growth in annual revenue; by the end of 2019, revenues from purchases in more than 50 countries had exceeded $830 million. At this pace, it looks like Canada Goose will remain a hot commodity as long as winter temperatures remain cold.

Note: Developed with Arthur J. Santry.

Sources: Drake Bennett, "How Canada Goose Parkas Migrated South," *Bloomberg Businessweek,* March 13, 2015, **www.bloomberg.com;** Hollie Shaw, "Canada Goose's Made-in-Canada Marketing Strategy Translates into Success," *Financial Post,* May 18, 2012, **www.financialpost.com;** "The Economic Impact of the Fashion Industry," *The Economist,* June 13, 2015, **www.maloney.house.gov;** and company website (accessed January 26, 2020).

- The industry has many different niches and segments, thereby allowing a focuser to pick the niche best suited to its resources and capabilities. Also, with more niches there is room for focusers to concentrate on different market segments and avoid competing in the same niche for the same customers.
- Few if any rivals are attempting to specialize in the same target segment—a condition that reduces the risk of segment overcrowding.

The advantages of focusing a company's entire competitive effort on a single market niche are considerable, especially for smaller and medium-sized companies that may lack the breadth and depth of resources to tackle going after a broader customer base with a more complex set of needs. YouTube became a household name by concentrating on short video clips posted online. Papa John's, Little Caesars, and Domino's Pizza have created impressive businesses by focusing on the home delivery segment.

The Risks of a Focused Low-Cost or Focused Differentiation Strategy

Focusing carries several risks. One is the chance that competitors outside the niche will find effective ways to match the focused firm's capabilities in serving the target niche—perhaps by coming up with products or brands specifically designed to appeal to buyers in the target niche or by developing expertise and capabilities that offset the focuser's strengths. In the lodging business, large chains like Marriott and Hilton have launched multibrand strategies that allow them to compete effectively in several lodging segments simultaneously. Hilton has flagship hotels with a full complement of services and amenities that allow it to attract travelers and vacationers going to major resorts; it has Waldorf Astoria, Conrad Hotels & Resorts, Hilton Hotels & Resorts, and DoubleTree hotels that provide deluxe comfort and service to business and leisure travelers; it has Homewood Suites, Embassy Suites, and Home2 Suites designed as a "home away from home" for travelers staying five or more nights; and it has over 750 Hilton Garden Inn and 2360 Hampton by Hilton locations that cater to travelers looking for quality lodging at an "affordable" price. Tru by Hilton is the company's newly introduced brand focused on value-conscious travelers seeking basic accommodations. Hilton has also added Curio Collection, Tapestry Collection, and Canopy by Hilton hotels that offer stylish, distinctive decors and personalized services that appeal to young professionals seeking distinctive lodging alternatives. Multibrand strategies are attractive to large companies such as Hilton precisely because they enable a company to enter a market niche and siphon business away from companies that employ a focus strategy.

A second risk of employing a focused strategy is the potential for the preferences and needs of niche members to shift over time toward the product attributes desired by buyers in the mainstream portion of the market. An erosion of the differences across buyer segments lowers entry barriers into a focuser's market niche and provides an open invitation for rivals in adjacent segments to begin competing for the focuser's customers. A third risk is that the segment may become so attractive that it is soon inundated with competitors, intensifying rivalry and splintering segment profits. And there is always the risk for segment growth to slow to such a small rate that a focuser's prospects for future sales and profit gains become unacceptably dim.

BEST-COST (HYBRID) STRATEGIES

To profitably employ a best-cost strategy, a company *must have the capability to incorporate upscale attributes into its product offering at a lower cost than rivals.* When a company can incorporate more appealing features, good to excellent product performance or quality, or more satisfying customer service into its product offering *at a lower cost than rivals,* then it enjoys "best-cost" status—it is the low-cost provider of a product or service with *upscale attributes.* A best-cost producer can use its low-cost advantage to underprice rivals whose products or services have similarly upscale attributes and still earn attractive profits. As Figure 5.1 indicates, **best-cost strategies** are a hybrid of low-cost and differentiation strategies, incorporating features of both simultaneously. They may address either a broad or narrow (focused)

CORE CONCEPT

Best-cost strategies are a *hybrid* of low-cost and differentiation strategies, incorporating features of both simultaneously.

customer base. This permits companies to aim squarely at the sometimes great mass of value-conscious buyers looking for a better product or service at a somewhat lower price. Value-conscious buyers frequently shy away from both cheap low-end products and expensive high-end products, but they are quite willing to pay a "fair" price for extra features and functionality they find appealing and useful. The essence of a best-cost strategy is giving customers *more value for the money* by satisfying buyer desires for appealing features and charging a lower price for these attributes compared to rivals with similar-caliber product offerings.[6]

A best-cost strategy is different from a low-cost strategy because the additional attractive attributes entail additional costs (which a low-cost producer can avoid by offering buyers a basic product with few frills). Moreover, the two strategies aim at a distinguishably different market target. *The target market for a best-cost producer is value-conscious buyers*—buyers who are looking for appealing extras and functionality at a comparatively low price, regardless of whether they represent a broad or more focused segment of the market. Value-hunting buyers (as distinct from *price-conscious buyers* looking for a basic product at a bargain-basement price) often constitute a very sizable part of the overall market for a product or service. A best-cost strategy differs from a differentiation strategy because it entails the ability to produce upscale features at a lower cost than other high-end producers. This implies the ability to profitably offer the buyer more value for the money.

Best-cost producers generally don't offer the highest end products and services; more often the quality levels are simply better than average. Positioning of this sort permits companies to aim squarely at the sometimes great mass of value-conscious buyers looking for a better product or service at an economical price. Value-conscious buyers frequently shy away from both cheap low-end products and expensive high-end products, but they are quite willing to pay a "fair" price for extra features and functionality they find appealing and useful. The essence of a best-cost strategy is the ability to provide *more value for the money* by satisfying buyer desires for better quality while charging a lower price compared to rivals with similar-caliber product offerings.

Toyota has employed a classic best-cost strategy for its Lexus line of motor vehicles. It has designed an array of high-performance characteristics and upscale features into its Lexus models to make them comparable in performance and luxury to Mercedes, BMW, Audi, Jaguar, Cadillac, and Lincoln models. To signal its positioning in the luxury market segment, Toyota established a network of Lexus dealers, separate from Toyota dealers, dedicated to providing exceptional customer service. Most important, though, Toyota has drawn on its considerable know-how in making high-quality vehicles at low cost to produce its high-tech upscale-quality Lexus models at substantially lower costs than other luxury vehicle makers have been able to achieve in producing their models. To capitalize on its lower manufacturing costs, Toyota prices its Lexus models below those of comparable Mercedes, BMW, Audi, and Jaguar models to induce value-conscious luxury car buyers to purchase a Lexus instead.

When a Best-Cost Strategy Works Best

LO 5-4

Explain the attributes of a best-cost strategy—a hybrid of low-cost and differentiation strategies.

A best-cost strategy works best in markets where product differentiation is the norm and an attractively large number of value-conscious buyers can be induced to purchase midrange products rather than cheap, basic products or expensive, top-of-the-line products. In markets such as these, a best-cost producer needs to position itself *near the middle of the market* with either a medium-quality product at a below-average price or a high-quality product at an average or slightly higher price. But as the Lexus example

ILLUSTRATION CAPSULE 5.4 Trader Joe's Focused Best-Cost Strategy

Over the last 50 years, Trader Joe's has built a cult-like following by offering a limited selection of highly popular private-label products at great prices, under the Trader Joe's brand. By pursuing a *focused best-cost* strategy, Trader Joe's has been able to thrive in the notoriously low-margin grocery business. Today, Trader Joe's earns over $2,000 of annual sales per square foot—nearly double that of Whole Foods.

One key to Trader Joe's success, and a major part of its strategy, is its unique approach to product selection. By selling mainly private label goods under its own brand, Trader Joe's keeps its costs low, enabling it to offer lower prices. By being very selective about the particular products that it carries, it has also managed to ensure that its brand is associated with very high quality. The company's policy is to swiftly replace any product that does not prove popular with another more appealing product. This has paid off: when you ask U.S. consumers which grocery store represents quality, Trader Joe's tops the list. On a recent YouGov Brand Index poll, nearly 40 percent of consumers ranked Trader Joe's best for quality—the highest among its competitors. While Trader Joe's offers far fewer stock-keeping units (SKUs) than a typical grocery store—only 4,000 SKUs as compared to 50,000 + in a Kroger or Safeway—the upside for customers is that this also helps to keep costs and prices low. It results in higher inventory turns (a key measure of efficiency in retail), lower inventory costs, and lower rents since stores in any given location can be smaller.

Roman Tiraspolsky/Shutterstock

Trader Joe's also intentionally locates its stores in areas with value-focused customers who appreciate quality. Trader Joe's identifies potential sites for expansion by evaluating demographic information. This enables Trader Joe's to focus on serving young educated singles and couples who may not be able to afford more expensive groceries but prefer organics and ready-to-eat products. Given that it occupies smaller sized retail spaces, Trader Joe's can locate in walkable areas and urban centers, the very same neighborhoods in which its chosen customer base lives. Because of its focused best-cost strategy, it is unlikely that the company's loyal customers will quit lining up to buy its tasty corn salsa or organic cold brew coffee any time soon.

Note: Developed with Stephanie K. Berger.

Sources: Company website; Beth Kowitt, "Inside the Secret World of Trader Joe's," *Fortune* (August 2010); Elain Watson, "Quirky, Cult-life, Aspirational, but Affordable: The Rise and Rise of Trader Joes," Food Navigator USA (April 2014); Janie Ryan, "The Surprising Secrets Behind Trader Joe's Supply Chain," Elementum.com (December 13, 2018).

shows, a firm with the capabilities to produce top-of-the-line products more efficiently than its rivals, would also do well to pursue a best-cost strategy. Best-cost strategies also work well in recessionary times, when masses of buyers become more value-conscious and are attracted to economically priced products and services with more appealing attributes. However, unless a company has the resources, know-how, and capabilities to incorporate upscale product or service attributes at a lower cost than rivals, adopting a best-cost strategy is ill-advised. Illustration Capsule 5.4 describes how Trader Joe's has applied the principles of a focused best-cost strategy to thrive in the competitive grocery store industry.

The Risk of a Best-Cost Strategy

A company's biggest vulnerability in employing a best-cost strategy is getting squeezed between the strategies of firms using low-cost and high-end differentiation strategies. Low-cost producers may be able to siphon customers away with the appeal of a lower price (despite less appealing product attributes). High-end differentiators may be able to steal customers away with the appeal of better product attributes (even though their products carry a higher price tag). Thus, to be successful, a firm employing a best-cost strategy must achieve significantly lower costs in providing upscale features so that it can outcompete high-end differentiators on the basis of a *significantly* lower price. Likewise, it must offer buyers *significantly* better product attributes to justify a price above what low-cost leaders are charging. In other words, it must offer buyers a more attractive customer value proposition.

THE CONTRASTING FEATURES OF THE GENERIC COMPETITIVE STRATEGIES

A company's competitive strategy should be well matched to its internal situation and predicated on leveraging its collection of competitively valuable resources and capabilities.

Deciding which generic competitive strategy should serve as the framework on which to hang the rest of the company's strategy is not a trivial matter. Each of the five generic competitive strategies *positions* the company differently in its market and competitive environment. Each establishes a *central theme* for how the company will endeavor to outcompete rivals. Each creates some boundaries or guidelines for maneuvering as market circumstances unfold and as ideas for improving the strategy are debated. Each entails differences in terms of product line, production emphasis, marketing emphasis, and means of maintaining the strategy, as shown in Table 5.1.

Thus, a choice of which generic strategy to employ spills over to affect many aspects of how the business will be operated and the manner in which value chain activities must be managed. Deciding which generic strategy to employ is perhaps the most important strategic commitment a company makes—it tends to drive the rest of the strategic actions a company decides to undertake.

Successful Generic Strategies Are Resource-Based

For a company's competitive strategy to succeed in delivering good performance and gain a competitive edge over rivals, it has to be well matched to a company's internal situation and underpinned by an appropriate set of resources, know-how, and competitive capabilities. To succeed in employing a low-cost strategy, a company must have the resources and capabilities to keep its costs below those of its competitors. This means having the expertise to cost-effectively manage value chain activities better than rivals by leveraging the cost drivers more effectively, and/or having the innovative capability to bypass certain value chain activities being performed by rivals. To succeed in a differentiation strategy, a company must have the resources and capabilities to leverage value drivers more effectively than rivals and incorporate attributes into its product offering that a broad range of buyers will find appealing. Successful focus strategies (both low cost and differentiation) require the capability to do an outstanding job of satisfying the needs and expectations of niche buyers. Success in employing a best-cost strategy requires the resources and capabilities to incorporate upscale product or service attributes at a lower cost than rivals. *For all types of generic strategies, success in sustaining the competitive edge depends on having resources and capabilities that rivals have trouble duplicating and for which there are no good substitutes.*

TABLE 5.1 Distinguishing Features of the Five Generic Competitive Strategies

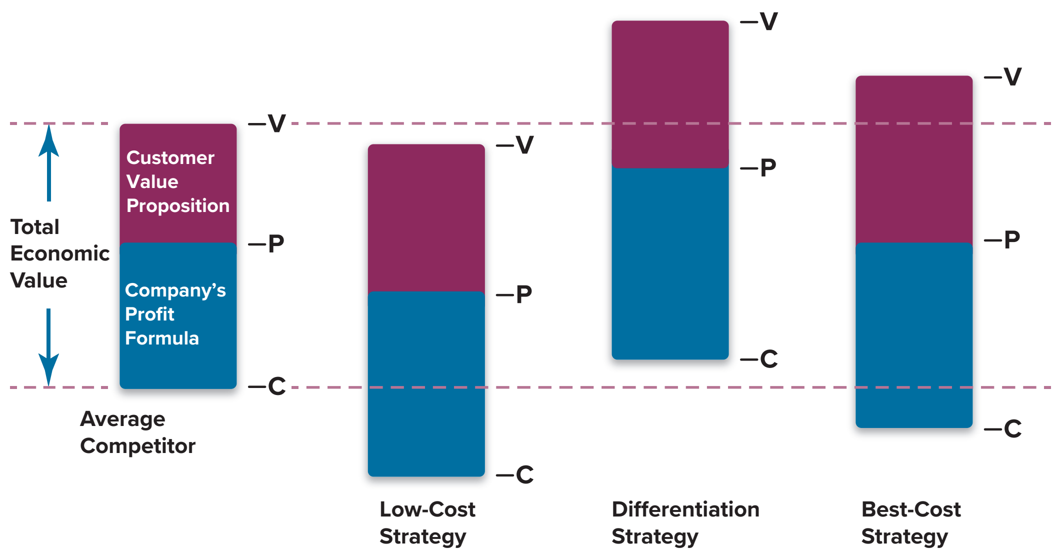
	Broad Low-Cost	Broad Differentiation	Focused Low-Cost	Focused Differentiation	Best-Cost
Strategic target	• A broad cross-section of the market.	• A broad cross-section of the market.	• A narrow market niche where buyer needs and preferences are distinctively different.	• A narrow market niche where buyer needs and preferences are distinctively different.	• A broad or narrow range of value-conscious buyers.
Basis of competitive strategy	• Lower overall costs than competitors.	• Ability to offer buyers something attractively different from competitors' offerings.	• Lower overall cost than rivals in serving niche members.	• Attributes that appeal specifically to niche members.	• Ability to incorporate upscale features and attributes at lower costs than rivals.
Product line	• A good basic product with few frills (acceptable quality and limited selection).	• Many product variations, wide selection; emphasis on differentiating features.	• Features and attributes tailored to the tastes and requirements of niche members.	• Features and attributes tailored to the tastes and requirements of niche members.	• Items with appealing attributes and assorted features; better quality, not necessarily best.
Production emphasis	• A continuous search for cost reduction without sacrificing acceptable quality and essential features.	• Build in whatever differentiating features buyers are willing to pay for; strive for product superiority.	• A continuous search for cost reduction for products that meet basic needs of niche members.	• Small-scale production or custom-made products that match the tastes and requirements of niche members.	• Build in appealing features and better quality at lower cost than rivals.
Marketing emphasis	• Low prices, good value. • Try to make a virtue out of product features that lead to low cost.	• Tout differentiating features. • Charge a premium price to cover the extra costs of differentiating features.	• Communicate attractive features of a budget-priced product offering that fits niche buyers' expectations.	• Communicate how product offering does the best job of meeting niche buyers' expectations.	• Emphasize delivery of best value for the money.
Keys to maintaining the strategy	• Strive to manage costs down, year after year, in every area of the business.	• Stress continuous improvement in products or services and constant innovation to stay ahead of imitative competitors.	• Stay committed to serving the niche at the lowest overall cost; don't blur the firm's image by entering other market segments or adding other products to widen market appeal.	• Stay committed to serving the niche better than rivals; don't blur the firm's image by entering other market segments or adding other products to widen market appeal.	• Stress continuous improvement in products or services and constant innovation, along with continuous efforts to improve efficiency.
Resources and capabilities required	• Capabilities for driving costs out of the value chain system. • *Examples:* large-scale automated plants, an efficiency-oriented culture, bargaining power.	• Capabilities concerning quality, design, intangibles, and innovation. • *Examples:* marketing capabilities, R&D teams, technology.	• Capabilities to lower costs on niche goods. • *Examples:* lower input costs for the specific product desired by the niche, batch production capabilities.	• Capabilities to meet the highly specific needs of niche members. • *Examples:* custom production, close customer relations.	• Capabilities to simultaneously deliver lower cost and higher-quality/differentiated features. • *Examples:* TQM practices, mass customization.

Generic Strategies and the Three Different Approaches to Competitive Advantage

Just as a company's resources and capabilities underlie its choice of generic strategy, its generic strategy determines its approach to gaining a competitive advantage. There are three such approaches. Clearly, low-cost strategies aim for a cost advantage over rivals, differentiation strategies strive to create relatively more perceived value for consumers, while best-cost strategies aim to do better than the average rival on both dimensions. Whether the strategy is broad based or focused makes no difference as to the basic approach employed (see Figure 5.1).

Exactly how this works is best understood with the use of the value-price-cost framework, first introduced in Chapter 1 in the context of different kinds of business models. Figure 5.4 illustrates the three basic approaches to competitive advantage in terms of the value-price-cost framework. The left figure in the diagram represents an average competitor's cost (C) of producing a good, how highly the customer values it (V), and its price (P). The difference between the good's value to the customer (V) and its cost (C) is the total economic value (V-C) produced by the average competitor. And as explained in Chapter 4, a company has a competitive advantage over another if its strategy generates *more total economic value.* It is this excess in total economic value over rivals that allows the company to offer customers a better value proposition or earn larger profits (or both). The dashed yellow lines facilitate a comparison of the average competitor's costs (C) and perceived value (V) with the costs and value produced by each of the three basic types of generic strategies (low cost, differentiation, best cost). In this way, it also facilitates a comparison of the total economic value generated by each of the three representative generic strategies in relation to the average competitor, thereby shedding light on the nature of each strategy's competitive advantage.

FIGURE 5.4 Three Approaches to Competitive Advantage and the Value-Price-Cost Framework



As Figure 5.4 shows, a low-cost generic strategy aims to achieve lower costs than an average competitor, at the sacrifice of some of the perceived value to the consumer. If the decrease in costs is less than the decrease in perceived value, then the total economic value (V-C) for the low-cost leader will be greater than the total economic value produced by its average rival and the low-cost leader will have a competitive advantage. This is clearly the case for the example of a low-cost strategy depicted in Figure 5.4. As is common with low-cost strategies, the example company has chosen to charge a lower price than its average rival. The result is that even with a lower V, the low-cost leader offers the consumer a more attractive (larger) consumer value proposition (depicted in mauve) and finds itself with a better profit formula (depicted in blue).

In contrast, the example of a differentiation strategy shows that costs might well exceed those of the average competitor. But with a successful differentiation strategy, that disadvantage is more than made up for by the rise in the perceived value (V) of the differentiated good, giving the differentiator a clear competitive advantage over the average rival (greater V-C). And while the price charged in this example is a good deal higher in comparison with the average rival's price, this differentiation strategy enables both a larger consumer value proposition (in mauve) as well as greater profits (in blue).

The depiction of a best-cost strategy shows a company pursuing the middle ground of offering neither the most highly valued goods in the market nor the lowest costs. But in comparison with the average rival, it does better on both scores, resulting in more total economic value (V-C) and a substantial competitive advantage. Once again, the example shows both a larger customer value proposition as well as a more attractive profit formula.

The last thing to note is that the generic strategies depicted in Figure 5.4 are examples of *successful* generic strategies. Being successful with a generic strategy depends on much more than positioning. It depends on the competitive context (the company's external situation) and on the company's internal situation, including its complement of resources and capabilities. Importantly, it also depends on how well the strategy is executed—the topic of this text's three concluding chapters.

KEY POINTS

1. Deciding which of the five generic competitive strategies to employ—broad low-cost, broad differentiation, focused low-cost, focused differentiation, or best-cost—is perhaps the most important strategic commitment a company makes. It tends to drive the remaining strategic actions a company undertakes and sets the whole tone for pursuing a competitive advantage over rivals.
2. In employing a broad low-cost strategy and trying to achieve a low-cost advantage over rivals, a company must do a better job than rivals of cost-effectively managing value chain activities and/or it must find innovative ways to eliminate cost-producing activities. An effective use of cost drivers is key. Low-cost strategies work particularly well when price competition is strong and the products of rival sellers are virtually identical, when there are not many ways to differentiate, when buyer switching costs are low, and when buyers are price-sensitive or have the power to bargain down prices.
3. Broad differentiation strategies seek to produce a competitive edge by incorporating attributes that set a company's product or service offering apart from rivals in ways that buyers consider valuable and worth paying for. This depends on the appropriate use of value drivers. Successful differentiation allows a firm to

(1) command a premium price for its product, (2) increase unit sales (if additional buyers are won over by the differentiating features), and/or (3) gain buyer loyalty to its brand (because some buyers are strongly attracted to the differentiating features and bond with the company and its products). Differentiation strategies work best when buyers have diverse product preferences, when few other rivals are pursuing a similar differentiation approach, and when technological change is fast-paced and competition centers on rapidly evolving product features. A differentiation strategy is doomed when competitors are able to quickly copy the appealing product attributes, when a company's differentiation efforts fail to interest many buyers, and when a company overspends on efforts to differentiate its product offering or tries to overcharge for its differentiating extras.

4. A focused strategy delivers competitive advantage either by achieving lower costs than rivals in serving buyers constituting the target market niche or by developing a specialized ability to offer niche buyers an appealingly differentiated offering that meets their needs better than rival brands do. A focused strategy based on either low cost or differentiation becomes increasingly attractive when the target market niche is big enough to be profitable and offers good growth potential, when it is costly or difficult for multisegment competitors to meet the specialized needs of the target market niche and at the same time satisfy the expectations of their mainstream customers, when there are one or more niches that present a good match for a focuser's resources and capabilities, and when few other rivals are attempting to specialize in the same target segment.
5. Best-cost strategies create competitive advantage on the basis of their capability to incorporate attractive or upscale attributes at a lower cost than rivals. Best-cost strategies can be either broad or focused. A best-cost strategy works best in broad or narrow market segments with value-conscious buyers desirous of purchasing better products and services for less money.
6. In all cases, competitive advantage depends on having competitively superior resources and capabilities that are a good fit for the chosen generic strategy. A sustainable advantage depends on maintaining that competitive superiority with resources, capabilities, and value chain activities that rivals have trouble matching and for which there are no good substitutes.

ASSURANCE OF LEARNING EXERCISES

LO 5-1, LO 5-2, LO 5-3, LO 5-4

1. Best Buy is the largest consumer electronics retailer in the United States, with fiscal 2022 sales of nearly $48 billion. The company competes aggressively on price with such rivals as Costco, Sam's Club, Walmart, and Target, but it is also known by consumers for its first-rate customer service. Best Buy customers have commented that the retailer's sales staff is exceptionally knowledgeable about the company's products and can direct them to the exact location of difficult-to-find items. Best Buy customers also appreciate that demonstration models of PC monitors, digital media players, and other electronics are fully powered and ready for in-store use. Best Buy's Geek Squad tech support and installation services are additional customer service features that are valued by many customers.

   How would you characterize Best Buy's competitive strategy? Should it be classified as a low-cost strategy? A differentiation strategy? A best-cost strategy? Also, has the company chosen to focus on a narrow piece of the market, or does it appear to pursue a broad market approach? Explain your answer.

2. Illustration Capsule 5.1 discusses Vanguard's position as the low-cost leader in the investment management industry. Based on information provided in the capsule, explain how Vanguard built its low-cost advantage in the industry and why a low-cost strategy can succeed in the industry. LO 5-2

3. USAA is a Fortune 500 insurance and financial services company with 2022 annual sales exceeding $35 billion. The company was founded in 1922 by 25 Army officers who decided to insure each other's vehicles and continues to limit its membership to active-duty and retired military members, officer candidates, and adult children and spouses of military-affiliated USAA members. The company has received countless awards, including being listed among *Fortune*'s World's Most Admired Companies in 2014 through 2022 and 100 Best Companies to Work For in 2010 through 2022. You can read more about the company's history and strategy at **www.usaa.com**. LO 5-1, LO 5-2, LO 5-3, LO 5-4

   How would you characterize USAA's competitive strategy? Should it be classified as a low-cost strategy? A differentiation strategy? A best-cost strategy? Also, has the company chosen to focus on a narrow piece of the market, or does it appear to pursue a broad market approach? Explain your answer.

4. Explore Kendra Scott's website at **www.kendrascott.com** and see if you can identify at least three ways in which the company seeks to differentiate itself from rival jewelry firms. Is there reason to believe that Kendra Scott's differentiation strategy has been successful in producing a competitive advantage? Why or why not? LO 5-3

EXERCISES FOR SIMULATION PARTICIPANTS

1. Which one of the five generic competitive strategies can best be utilized to compete successfully in the business simulation by your company? LO 5-1, LO 5-2, LO 5-3, LO 5-4
2. Which rival companies appear to be employing a low-cost strategy?
3. Which rival companies appear to be employing a differentiation strategy?
4. Which rival companies appear to be employing a best-cost strategy?
5. Which cost drivers and/or value drivers are important for creating superior total economic value in the business simulation?
6. What is your company's action plan to achieve a sustainable competitive advantage over rival companies? List at least three (preferably more than three) specific kinds of decision entries on specific decision screens that your company has made or intends to make to win this kind of competitive edge over rivals.

ENDNOTES

[1] Michael E. Porter, *Competitive Strategy: Techniques for Analyzing Industries and Competitors* (New York: Free Press, 1980), chap. 2; Michael E. Porter, "What Is Strategy?" *Harvard Business Review* 74, no. 6 (November–December 1996).

[2] Michael E. Porter, *Competitive Advantage: Creating and Sustaining Superior Performance* (New York: Free Press, 1985).

[3] Richard L. Priem, "A Consumer Perspective on Value Creation," *Academy of Management Review* 32, no. 1 (2007), pp. 219–235.

[4] **jrscience.wcp.muohio.edu/nsfall01/FinalArticles/Final-IsitWorthitBrandsan.html.**

[5] D. Yoffie, "Cola Wars Continue: Coke and Pepsi in 2006," Harvard Business School case 9-706-447.

[6] Peter J. Williamson and Ming Zeng, "Value-for-Money Strategies for Recessionary Times," *Harvard Business Review* 87, no. 3 (March 2009), pp. 66–74.

chapter 6

Strengthening a Company's Competitive Position

Strategic Moves, Timing, and Scope of Operations

Learning Objectives

After reading this chapter, you should be able to

LO 6-1 Understand whether, how, and when to deploy offensive or defensive strategic moves.

LO 6-2 Identify when being a first mover, a fast follower, or a late mover can lead to competitive advantage.

LO 6-3 Explain the strategic benefits and risks of expanding a company's horizontal scope through mergers and acquisitions.

LO 6-4 Comprehend the advantages and disadvantages of extending the company's scope of operations via vertical integration.

LO 6-5 Recognize the conditions that favor farming out certain value chain activities to outside parties.

LO 6-6 Understand how to capture the benefits and minimize the drawbacks of strategic alliances and partnerships.

Fanatic Studio/Getty Images

Acquisitions, as opposed to internal development, can increase the speed of achieving scale economies, and product or geographic market entry.

Asli M. Arikan—*Professor and Consultant*

In a world of ecosystems, your approach to partners is as important as your approach to customers.

Ron Adner—*Professor, Author, and Consultant*

The important thing about outsourcing . . . is that it becomes a very powerful tool to leverage talent, improve productivity, and reduce work cycles.

Azim Premji—*Founder of Wipro Limited (India's third-largest outsourcer)*

Once a company has settled on which of the five generic competitive strategies to employ, attention turns to what ***other strategic actions*** it can take to complement its competitive approach and maximize the power of its overall strategy. The first set of decisions concerns whether to undertake offensive or defensive competitive moves, and the timing of such moves. The second set concerns expanding or contracting the breadth of a company's activities (or its ***scope*** of operations along an industry's entire value chain). All in all, the following measures to strengthen a company's competitive position must be considered:

- Whether and when to go on the offensive and initiate aggressive strategic moves to improve the company's market position.
- Whether and how to employ defensive strategies to protect the company's market position.
- When to undertake new strategic initiatives—based upon whether it is advantageous to be a first mover, a fast follower, or a late mover.
- Whether to bolster the company's market position by merging with or acquiring another company in the same industry.
- Whether to integrate backward or forward into more stages of the industry value chain system.
- Which value chain activities, if any, should be outsourced.
- Whether to enter into strategic alliances or partnership arrangements with other enterprises.

This chapter presents the pros and cons of each of these strategy-enhancing measures.

LAUNCHING STRATEGIC OFFENSIVES TO IMPROVE A COMPANY'S MARKET POSITION

LO 6-1

Understand whether, how, and when to deploy offensive or defensive strategic moves.

No matter which of the five generic competitive strategies a firm employs, there are times when a company should *go on the offensive* to improve its market position and performance. **Strategic offensives** are called for when a company spots opportunities to gain profitable market share at its rivals' expense or when a company has no choice but to try to whittle away at a strong rival's competitive advantage. Companies like Samsung, Amazon, AutoNation, and Google play hardball, aggressively pursuing competitive advantage and trying to reap the benefits a competitive edge offers—a leading market share, excellent profit margins, and rapid growth.[1] The best offensives tend to incorporate several principles: (1) focusing relentlessly on building competitive advantage and then striving to convert it into a sustainable advantage, (2) applying resources where rivals are least able to defend themselves, (3) employing the element of surprise as opposed to doing what rivals expect and are prepared for, and (4) displaying a capacity for swift and decisive actions to overwhelm rivals.[2]

Sometimes a company's best strategic option is to seize the initiative, go on the attack, and launch a strategic offensive to improve its market position.

Choosing the Basis for Competitive Attack

As a rule, challenging rivals on competitive grounds where they are strong is an uphill struggle.[3] Offensive initiatives that exploit competitor weaknesses stand a better chance of succeeding than do those that challenge competitor strengths, especially if the weaknesses represent important vulnerabilities and weak rivals can be caught by surprise with no ready defense.

The best offensives use a company's most powerful resources and capabilities to attack rivals in the areas where they are competitively weakest.

Strategic offensives should exploit the power of a company's strongest competitive assets—its most valuable resources and capabilities such as a better-known brand name, a more efficient production or distribution system, greater technological capability, or a superior reputation for quality. But a consideration of the company's strengths should not be made without also considering the rival's strengths and weaknesses. A strategic offensive should be based on those areas of strength where the company has its greatest competitive advantage over the targeted rivals. If a company has especially good customer service capabilities, it can make special sales pitches to the customers of those rivals that provide subpar customer service. Likewise, it may be beneficial to pay special attention to buyer segments that a rival is neglecting or is weakly equipped to serve. The best offensives use a company's most powerful resources and capabilities to attack rivals in the areas where they are weakest.

Ignoring the need to tie a strategic offensive to a company's competitive strengths and what it does best is like going to war with a popgun—the prospects for success are dim. For instance, it is foolish for a company with relatively high costs to employ a price-cutting offensive. Likewise, it is ill-advised to pursue a product innovation offensive without having proven expertise in R&D and new product development.

The principal offensive strategy options include the following:

1. *Offering an equally good or better product at a lower price.* Lower prices can produce market share gains if competitors don't respond with price cuts of their own and if the challenger convinces buyers that its product is just as good or better. However, such a strategy increases total profits only if the gains in additional unit sales are enough to offset the impact of thinner margins per unit sold. Price-cutting offensives should be initiated only by companies that have *first achieved a cost advantage.*[4] British airline EasyJet used this strategy successfully against rivals such as

British Air, Alitalia, and Air France by first cutting costs to the bone and then targeting leisure passengers who care more about low price than in-flight amenities and service.[5] Spirit Airlines is using this strategy in the U.S. airline market.

2. *Leapfrogging competitors by being first to market with next-generation products.* In technology-based industries, the opportune time to overtake an entrenched competitor is when there is a shift to the next generation of the technology. Eero got its whole-home Wi-Fi system to market nearly one year before Linksys and Netgear developed competing systems, helping it build a sizable market share and develop a reputation for cutting-edge innovation in Wi-Fi systems.
3. *Pursuing continuous product innovation to draw sales and market share away from less innovative rivals.* Ongoing introductions of new and improved products can put rivals under tremendous competitive pressure, especially when rivals' new product development capabilities are weak. But such offensives can be sustained only if a company can keep its pipeline full with new product offerings that spark buyer enthusiasm.
4. *Pursuing disruptive product innovations to create new markets.* While this strategy can be riskier and more costly than a strategy of continuous innovation, it can be a game changer if successful. Disruptive innovation involves perfecting a new product with a few trial users and then quickly rolling it out to the whole market in an attempt to get many buyers to embrace an altogether new and better value proposition quickly. Examples include online universities, Twitter, Venmo, CampusBookRentals, and Waymo (Alphabet's self-driving tech company).
5. *Adopting and improving on the good ideas of other companies (rivals or otherwise).* The idea of warehouse-type home improvement centers did not originate with Home Depot cofounders Arthur Blank and Bernie Marcus; they got the "big-box" concept from their former employer, Handy Dan Home Improvement. But they were quick to improve on Handy Dan's business model and take Home Depot to the next plateau in terms of product-line breadth and customer service. Offensive-minded companies are often quick to adopt any good idea (not nailed down by a patent or other legal protection) and build on it to create competitive advantage for themselves.
6. *Using hit-and-run or guerrilla warfare tactics to grab market share from complacent or distracted rivals.* Options for "guerrilla offensives" include occasionally lowballing on price (to win a big order or steal a key account from a rival), surprising rivals with sporadic but intense bursts of promotional activity (offering a discounted trial offer to draw customers away from rival brands), or undertaking special campaigns to attract the customers of rivals plagued with a strike or problems in meeting buyer demand.[6] Guerrilla offensives are particularly well suited to small challengers that have neither the resources nor the market visibility to mount a full-fledged attack on industry leaders.
7. *Launching a preemptive strike to secure an industry's limited resources or capture a rare opportunity.*[7] What makes a move preemptive is its one-of-a-kind nature—whoever strikes first stands to acquire competitive assets that rivals can't readily match. Examples of preemptive moves include (1) securing the best distributors in a particular geographic region or country; (2) obtaining the most favorable site at a new interchange or intersection, in a new shopping mall, and so on; (3) tying up the most reliable, high-quality suppliers via exclusive partnerships, long-term contracts, or acquisition; and (4) moving swiftly to acquire the assets of distressed rivals at bargain prices. To be successful, a preemptive move doesn't have to totally block rivals from following; it merely needs to give a firm a prime position that is not easily circumvented.

How long it takes for an offensive action to yield good results varies with the competitive circumstances.[8] It can be short if buyers respond immediately (as can occur with a dramatic cost-based price cut, an imaginative ad campaign, or a disruptive innovation). Securing a competitive edge can take much longer if winning consumer acceptance of the company's product will take some time or if the firm needs several years to debug a new technology or put a new production capacity in place. But how long it takes for an offensive move to improve a company's market standing—and whether the move will prove successful—depends in part on whether market rivals recognize the threat and begin a counterresponse. Whether rivals will respond depends on whether they are capable of making an effective response and if they believe that a counterattack is worth the expense and the distraction.[9]

Choosing Which Rivals to Attack

Offensive-minded firms need to analyze which of their rivals to challenge as well as how to mount the challenge. The following are the best targets for offensive attacks:[10]

- *Market leaders that are vulnerable.* Offensive attacks make good sense when a company that leads in terms of market share is not a true leader in terms of serving the market well. Signs of leader vulnerability include unhappy buyers, an inferior product line, aging technology or outdated plants and equipment, a preoccupation with diversification into other industries, and financial problems. Caution is well advised in challenging strong market leaders—there's a significant risk of squandering valuable resources in a futile effort or precipitating a fierce and profitless industrywide battle for market share.
- *Runner-up firms with weaknesses in areas where the challenger is strong.* Runner-up firms are an especially attractive target when a challenger's resources and capabilities are well suited to exploiting their weaknesses.
- *Struggling enterprises that are on the verge of going under.* Challenging a hard-pressed rival in ways that further sap its financial strength and competitive position can weaken its resolve and hasten its exit from the market. In this type of situation, it makes sense to attack the rival in the market segments where it makes the most profits, since this will threaten its survival the most.
- *Small local and regional firms with limited capabilities.* Because small firms typically have limited expertise and resources, a challenger with broader and/or deeper capabilities is well positioned to raid their biggest and best customers—particularly those that are growing rapidly, have increasingly sophisticated requirements, and may already be thinking about switching to a supplier with a more full-service capability.

CORE CONCEPT

A **blue-ocean strategy** offers growth in revenues and profits by discovering or inventing new industry segments that create altogether new demand.

Blue-Ocean Strategy—a Special Kind of Offensive

A **blue-ocean strategy** seeks to gain a dramatic competitive advantage by abandoning efforts to beat out competitors in existing markets and, instead, *inventing a new market segment that allows a company to create and capture altogether new demand.*[11] This strategy views the business universe as consisting of two distinct types of market space. One is where industry boundaries are well defined, the competitive rules of the game are understood, and companies try to outperform rivals by capturing a bigger share of existing demand. In such markets, intense competition constrains a company's prospects for rapid growth and superior profitability since rivals move quickly to either imitate or counter the successes of competitors. The second type of market space is a "blue ocean," where the industry does not really exist yet, is untainted by competition, and offers wide-open opportunity for profitable and rapid growth if a company can create new demand with a new type of product offering. The "blue ocean" represents wide-open opportunity, offering smooth sailing in uncontested waters for the company first to venture out upon it.

A terrific example of such blue-ocean market space is the online auction industry that eBay created and now dominates. Other companies that have created blue-ocean market spaces include NetJets in fractional jet ownership, Drybar in hair blowouts, Tune Hotels in limited service "backpacker" hotels, Uber and Lyft in ride-sharing services, and Cirque du Soleil in live entertainment. Cirque du Soleil "reinvented the circus" by pulling in a whole new group of customers—adults and corporate clients—who not only were noncustomers of traditional circuses (like Ringling Brothers) but also were willing to pay several times more than the price of a conventional circus ticket to have a "sophisticated entertainment experience" featuring stunning visuals and star-quality acrobatic acts. Australian winemaker Casella Wines used a blue-ocean strategy to find some uncontested market space for its Yellow Tail brand. By creating a product designed to appeal to wider market—one that also includes beer and spirit drinkers—Yellow Tail was able to unlock substantial new demand, becoming the fastest growing wine brand in U.S. history. Illustration Capsule 6.1 discusses the way that Etsy used a blue-ocean strategy to open up new competitive space in online retailing.

Blue-ocean strategies provide a company with a great opportunity in the short run but they don't guarantee a company's long-term success, which depends more on whether a company can protect the market position it opened up and sustain its early advantage. Gilt Groupe serves as an example of a company that opened up new competitive space in online luxury retailing only to see its blue-ocean waters ultimately turn red. Its competitive success early on prompted an influx of fast followers into the luxury flash-sale industry, including HauteLook, RueLaLa, Lot18, and MyHabit.com. The new rivals not only competed for online customers, who could switch costlessly from site to site (since memberships were free), but also competed for unsold designer inventory. Once valued at over $1 billion, Gilt Groupe was finally sold to Hudson's Bay, the owner of Sak's Fifth Avenue, for just $250 million in 2016.

DEFENSIVE STRATEGIES—PROTECTING MARKET POSITION AND COMPETITIVE ADVANTAGE

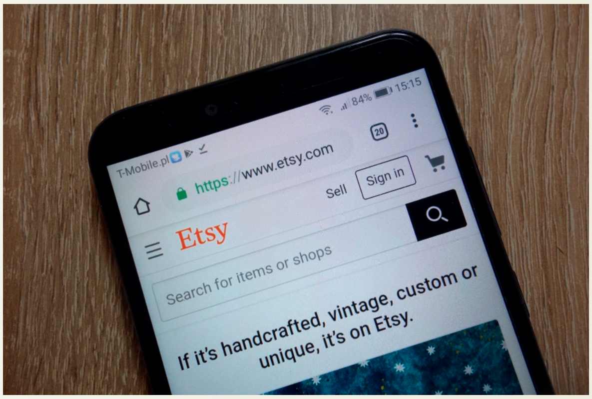
In a competitive market, all firms are subject to offensive challenges from rivals. The purposes of defensive strategies are to lower the risk of being attacked, weaken the impact of any attack that occurs, and induce challengers to aim their efforts at other rivals. While defensive strategies usually don't enhance a firm's competitive advantage, they can definitely help fortify the firm's competitive position, protect its most valuable resources and capabilities from imitation, and defend whatever competitive advantage it might have. Defensive strategies can take either of two forms: actions to block challengers or actions to signal the likelihood of strong retaliation.

ILLUSTRATION CAPSULE 6.1

Etsy's Blue Ocean Strategy in Online Retailing of Handmade Crafts

Etsy, the online artisanal marketplace, was the inspirational idea of three New York entrepreneurs who saw that eBay had become too large and ineffective for craftsman and artisans who wished to sell their one-of-a-kind products online. While eBay's timed auction format made for an exciting experience for bargain-hunting consumers, Etsy in contrast promoted its ability to connect thoughtful consumers with artisans selling unique hand-crafted items. Typical Etsy buyers valued craftsmanship and wanted to know how items were made and who made them. The ability to develop a direct relationship with the seller was important to many Etsy buyers who enjoyed a personalized shopping experience. Purchases made by Etsy buyers ranged from $5 ornaments to $50 hand-made clothing items to $2,000 custom-made coffee tables.

Etsy thrived in what was initially uncontested competitive space. In 2015, to the surprise of many, theirs was the largest venture capital backed IPO (Initial Public Offering) to have come out of New York City. By 2018, they had 39 million active buyers and 2.1 million crafters and artisans offering their products. The company's gross merchandise sales totaled more than $3.9 billion that same year. Etsy charged sellers a 3.5 percent transaction fee and a 20-cent listing fee and generated additional revenue from payment processing fees and the sales of shipping labels. The company's revenues had grown from $74.6 million in 2012 to $603.7 million in 2018.



Piotr Swat/Shutterstock

The tremendous success of the company's Blue Ocean Strategy had not gone unnoticed. Amazon announced in May 2016 that it would launch a site featuring artisan goods named Handmade. Amazon believed that its free 2-day shipping to Prime members would give it an advantage over Etsy. Etsy's share price took a steep dive in 2016, but by late 2019, the company's stock was back up to nearly three times its IPO first-day closing price of $22.24. The strength of its strategy and the quality of its execution would determine if Etsy would be able to continue to thrive despite well-funded new entrants into its specialty online retailing sector.

Note: Developed with Rochelle R. Brunson and Marlene M. Reed.

Blocking the Avenues Open to Challengers

Good defensive strategies can help protect a competitive advantage but rarely are the basis for creating one.

The most frequently employed approach to defending a company's present position involves actions that restrict a challenger's options for initiating a competitive attack. There are any number of obstacles that can be put in the path of would-be challengers. A defender can introduce new features, add new models, or broaden its product line to close off gaps and vacant niches to opportunity-seeking challengers. It can thwart rivals' efforts to attack with a lower price by maintaining its own lineup of economy-priced options. It can discourage buyers from trying competitors' brands by lengthening warranties, making early announcements about impending new products or price changes, offering free training and support services, or providing coupons and sample giveaways to buyers most prone to experiment. It can induce potential buyers to reconsider switching. It can challenge the quality or safety of rivals' products. Finally, a defender can grant volume discounts or better financing terms to dealers and distributors to discourage them from experimenting with other suppliers, or it can convince them to handle its product line *exclusively* and force competitors to use other distribution outlets.

Signaling Challengers That Retaliation Is Likely

The goal of signaling challengers that strong retaliation is likely in the event of an attack is either to dissuade challengers from attacking at all or to divert them to less threatening options. Either goal can be achieved by letting challengers know the battle will cost more than it is worth. Signals to would-be challengers can be given by

- Publicly announcing management's commitment to maintaining the firm's present market share.
- Publicly committing the company to a policy of matching competitors' terms or prices.
- Maintaining a war chest of cash and marketable securities.
- Making an occasional strong counterresponse to the moves of weak competitors to enhance the firm's image as a tough defender.

To be an effective defensive strategy signaling needs to be accompanied by a *credible commitment* to follow through.

To be an effective defensive strategy, however, signaling needs to be accompanied by a *credible commitment* to follow through.

TIMING A COMPANY'S STRATEGIC MOVES

CORE CONCEPT

Because of **first-mover advantages and disadvantages,** competitive advantage can spring from *when* a move is made as well as from what move is made.

LO 6-2

Identify when being a first mover, a fast follower, or a late mover can lead to competitive advantage.

When to make a strategic move is often as crucial as *what* move to make. Timing is especially important when **first-mover advantages and disadvantages** exist. Under certain conditions, being first to initiate a strategic move can have a high payoff in the form of a competitive advantage that later movers can't dislodge. Moving first is no guarantee of success, however, since first movers also face some significant disadvantages. Indeed, there are circumstances in which it is more advantageous to be a fast follower or even a late mover. Because the timing of strategic moves can be consequential, it is important for company strategists to be aware of the nature of first-mover advantages and disadvantages and the conditions favoring each type of move.[12]

Sometimes, though, markets are slow to accept the innovative product offering of a first mover, in which case a fast follower with substantial resources and marketing muscle can overtake a first mover. CNN had enjoyed a powerful first mover advantage in cable news for more than 20 years, until it was surpassed by Fox News as the number one cable news network. Fox has used innovative programming and intriguing hosts to expand its demographic appeal to retain its number one ranking since 2002. Sometimes furious technological change or product innovation makes a first mover vulnerable to quickly appearing next-generation technology or products. For instance, former market leaders in mobile phones Nokia and BlackBerry have been victimized by far more innovative iPhone and Android models. Hence, there are no guarantees that a first mover will win sustainable competitive advantage.

The Potential for First-Mover Advantages

Market pioneers and other types of first movers typically bear greater risks and greater development costs than firms that move later. If the market responds well to its initial move, the pioneer will benefit from a monopoly position (by virtue of being first to market) that enables it to recover its investment costs and make an attractive profit. If the firm's pioneering move gives it a competitive advantage that can be sustained even after other firms enter the market space, its first-mover advantage will be greater still. The extent of this type of advantage, however, will depend on whether and how fast follower firms can piggyback on the pioneer's success and either imitate or improve on its move.

There are six such conditions in which first-mover advantages are most likely to arise:

1. *When pioneering helps build a firm's reputation and creates strong brand loyalty.* Customer loyalty to an early mover's brand can create a tie that binds, limiting the success of later entrants' attempts to poach from the early mover's customer base and steal market share. For example, Open Table's early move as an online restaurant-reservation service built a strong brand that has since fueled its expansion worldwide.
2. *When a first mover's customers will thereafter face significant switching costs.* Switching costs can protect first movers when consumers make large investments in learning how to use a specific company's product or in purchasing complementary products that are also brand-specific. Switching costs can also arise from loyalty programs or long-term contracts that give customers incentives to remain with an initial provider. FreshDirect, for example, offers its grocery-delivery customers bigger savings, the longer they keep their service subscription.
3. *When property rights protections thwart rapid imitation of the initial move.* In certain types of industries, property rights protections in the form of patents, copyrights, and trademarks prevent the ready imitation of an early mover's initial moves. First-mover advantages in pharmaceuticals, for example, are heavily dependent on patent protections, and patent races in this industry are common. In other industries, however, patents provide limited protection and can frequently be circumvented. Property rights protections also vary among nations, since they are dependent on a country's legal institutions and enforcement mechanisms.
4. *When an early lead enables the first mover to reap scale economies or move down the learning curve ahead of rivals.* If significant scale-based advantages are available to an early mover, later entrants (with a smaller market share) will face relatively higher production costs. This disadvantage will make it even harder for later entrants to gain share and overcome the first-mover scale advantage. When there is a steep learning curve and when learning can be kept *proprietary,* a first mover can benefit from volume-based cost advantages that grow ever larger as its experience accumulates and its scale of operations increases. This type of first-mover advantage is self-reinforcing and, as such, can preserve a first mover's competitive advantage over long periods of time. Honda's advantage in small multiuse motorcycles has been attributed to such an effect.
5. *When a first mover can set the technical standard for the industry.* In many technology-based industries, the market will converge around a single technical standard. By establishing the industry standard, a first mover can gain a powerful advantage that, like experience-based advantages, builds over time. The lure of such an advantage, however, can result in standard wars among early movers, as each strives to set the industry standard. The key to winning such wars is to enter early on the basis of strong fast-cycle product development capabilities, gain the support of key customers and suppliers, employ penetration pricing, and make allies of the producers of complementary products.

6. *When strong network effects compel increasingly more consumers to choose the first mover's product or service.* As we described in Chapter 3, network effects are at work whenever consumers benefit from having other consumers use the same product or service that they use—a benefit that increases with the number of consumers using the product. An example is FaceTime, developed by Apple, Inc. The more that people you know have FaceTime on their phones or devices, the more that you are able to have a video conversation with them if you also have FaceTime—a benefit that grows with the number of users in your circle. Network effects can also occur with respect to suppliers. eBay has enjoyed a considerable first-mover advantage for years, not just because of early brand name recognition but also because of powerful network effects on the supply and demand side. The more suppliers choose to auction their items on eBay, the more attractive it is for others to do so as well, since the greater number of items being auctioned attracts more and more potential buyers, which in turn attracts more and more items being auctioned. Strong network effects are self-reinforcing and may lead to a winner-take-all situation for the first mover.

Illustration Capsule 6.2 describes how Tinder achieved a first-mover advantage in the field of mobile dating.

The Potential for Late-Mover Advantages or First-Mover Disadvantages

In some instances there are advantages *to being an adept follower* rather than a first mover. Late-mover advantages (or *first-mover disadvantages*) arise in six instances:

1. When the costs of pioneering are high relative to the benefits accrued—a condition that allows a follower to end up with lower costs than the first mover. This is often the case when second movers can learn from a pioneer's experience and avoid making the same costly mistakes as the pioneer.
2. When an innovator's products are somewhat primitive and do not live up to buyer expectations, thus allowing a follower with better-performing products to win disenchanted buyers away from the leader.
3. When rapid market evolution (due to fast-paced changes in either technology or buyer needs) gives second movers the opening to leapfrog a first mover's products with more attractive next-version products.
4. When market uncertainties make it difficult to ascertain what will eventually succeed, allowing late movers to wait until these needs are clarified.
5. When customer loyalty to the pioneer is low and a first mover's skills, know-how, and actions are easily copied or even surpassed.
6. When the first mover must make a risky investment in complementary assets or infrastructure (and these may be enjoyed at low cost or risk by followers).

To Be a First Mover or Not

In weighing the pros and cons of being a first mover versus a fast follower versus a late mover, it matters whether the race to market leadership in a particular industry is a 10-year marathon or a 2-year sprint. In marathons, a slow mover is not unduly penalized—first-mover advantages can be fleeting, and there's ample time for fast followers and sometimes even late movers to catch up.[13] Thus, the speed at which the

ILLUSTRATION CAPSULE 6.2 Tinder Swipes Right for First-Mover Success

Tinder, a simple, swipe-based dating app, entered the market in 2012 with a bang, gaining over a million monthly active users in less than a year. While other dating apps were already in existence, Tinder started the swiping phenomenon, thereby easing the process of finding love online and making the use of dating apps commonplace. By 2014, Tinder was processing over a billion swipes daily and users were spending an average of an hour and a half on the app each day. (Today, the average user spends about an hour on Facebook, Instagram, Snapchat, and Twitter—combined.)

Tinder's fast start had much to do with the fact that it was easy-to-use, without the time-consuming questionnaires of other dating services, and fun, with a game-like aspect that many called addictive. In addition, Tinder was rolled out on college campuses using viral marketing techniques that helped it to quickly gain acceptance among social circles such as fraternities and sororities, in which "key influencers" boosted its popularity to the point where it reached a critical mass. But its sustained success has had more to do with the fact that it has been able to reap the benefits of a first mover advantage, as the first major entrant into the field of mobile dating.

In the dating service industry, efficacy is wholly dependent on network effects (where users of an app benefit increasingly as the number of users of that same app increases). By focusing first on ensuring high usage among local social domains, Tinder benefited from strong local network effects. As its popularity spread, users increasingly found Tinder to be the most attractive app to use, since so many others were using it—thereby strengthening the network effect advantage, and drawing ever more people to download the Tinder app. With increased volume, Tinder gained other classic first mover advantages, such as enhanced reputational benefits, learning curve efficiencies, and increased interest from investors. By 2019, Tinder had nearly 8 million users, making the app the most popular online dating app in the United States.

BigTunaOnline/Shutterstock

Tinder's first mover advantage has not kept others from entering the mobile dating market. In fact, Tinder's phenomenal success has led to a surge in new entrants, with many imitating the Tinder's most popular features. Despite this, Tinder's first mover advantage has proven protective in many ways. Tinder's user base far outstrips the user base of rivals. And while other apps have been trying to play catch up, Tinder has been introducing new subscription products and other paid features to turn its market share advantage into a profitability advantage. As it stands, most analysts see Tinder as the mobile dating application with the highest commercial potential. And with a valuation of $3B and the distinction of Apple's *top-grossing* app in August 2017, it seems that Tinder is here to stay.

Note: Developed with Lindsey Wilcox and Charles K. Anumonwo.

Sources: **https://www.inc.com/issie-lapowsky/how-tinder-is-winning-the-mobile-dating-wars.html**; **http://www.adweek.com/digital/mediakix-time-spent-social-media-infographic/**; **www.pewresearch.org/fact-tank/2016/02/29/5-facts-about-online-dating/**; **https://www.forbes.com/sites/stevenbertoni/2017/08/31/tinder-hits-3-billion-valuation-after-match-group-converts-options/#653a516f34f9**; company website; J. Clement. Statista, November 22, 2019.

pioneering innovation is likely to catch on matters considerably as companies struggle with whether to pursue an emerging market opportunity aggressively (as a first mover) or cautiously (as a late mover). For instance, it took 5.5 years for worldwide mobile phone use to grow from 10 million to 100 million, and it took close to 10 years for the number of at-home broadband subscribers to grow to 100 million worldwide.

The lesson here is that there is a market penetration curve for every emerging opportunity. Typically, the curve has an inflection point at which all the pieces of the business model fall into place, buyer demand explodes, and the market takes off. The inflection point can come early on a fast-rising curve (like the use of email and watching movies streamed over the Internet) or farther up on a slow-rising curve (as with battery-powered motor vehicles, solar and wind power, and textbook rental for college students). Any company that seeks competitive advantage by being a first mover thus needs to ask some hard questions:

- Does market takeoff depend on the development of complementary products or services that currently are not available?
- Is new infrastructure required before buyer demand can surge?
- Will buyers need to learn new skills or adopt new behaviors?
- Will buyers encounter high switching costs in moving to the newly introduced product or service?
- Are there influential competitors in a position to delay or derail the efforts of a first mover?

When the answers to any of these questions are yes, then a company must be careful not to pour too many resources into getting ahead of the market opportunity—the race is likely going to be closer to a 10-year marathon than a 2-year sprint.[14] On the other hand, if the market is a winner-take-all type of market, where powerful first-mover advantages insulate early entrants from competition and prevent later movers from making any headway, then it may be best to move quickly despite the risks.

STRENGTHENING A COMPANY'S MARKET POSITION VIA ITS SCOPE OF OPERATIONS

Apart from considerations of competitive moves and their timing, there is another set of managerial decisions that can affect the strength of a company's market position. These decisions concern the scope of a company's operations—the breadth of its activities and the extent of its market reach. Decisions regarding the **scope of the firm** focus on which activities a firm will perform internally and which it will not.

> **CORE CONCEPT**
>
> The **scope of the firm** refers to the range of activities that the firm performs internally, the breadth of its product and service offerings, the extent of its geographic market presence, and its mix of businesses.

Consider, for example, Ralph Lauren Corporation. In contrast to Mixology Clothing Company, a fashionable women's clothing company with a small chain of retail stores, Ralph Lauren operates over 500 retail stores and more than 700 concession-based shops within shops in more than 50 countries. Scope decisions also concern which segments of the market to serve—decisions that can include geographic market segments as well as product and service segments. Over 50 percent of Ralph Lauren's sales are made outside North America, and its product line includes apparel, fragrances, home furnishings, eyewear, watches and jewelry, and handbags and other leather goods. Its lineup of brands includes Polo, Lauren, Chaps, and Double RL, as well as its Ralph Lauren Collection brands.

Decisions such as these, in essence, determine where the boundaries of a firm lie and the degree to which the operations within those boundaries cohere. They also have much to do with the direction and extent of a business's growth. In this chapter, we discuss different types of decisions regarding the scope of the company in relation to a company's business-level strategy. In the next two chapters, we develop two additional dimensions of a firm's scope; Chapter 7 focuses on

CORE CONCEPT

Horizontal scope is the range of product and service segments that a firm serves within its focal market.

CORE CONCEPT

Vertical scope is the extent to which a firm's internal activities encompass the range of activities that make up an industry's entire value chain system, from raw-material production to final sales and service activities.

CORE CONCEPT

Outsourcing involves contracting out certain value chain activities to outside specialists or strategic allies.

international expansion—a matter of extending the company's geographic scope into foreign markets; Chapter 8 takes up the topic of corporate strategy, which concerns diversifying into a mix of different businesses. *Scope issues are at the very heart of corporate-level strategy.*

Several dimensions of firm scope have relevance for business-level strategy in terms of their capacity to strengthen a company's position in a given market. These include the firm's **horizontal scope,** which is the range of product and service segments that the firm serves within its product or service market. Mergers and acquisitions involving other market participants provide a means for a company to expand its horizontal scope. Expanding the firm's vertical scope by means of vertical integration can also affect the success of its market strategy. **Vertical scope** is the extent to which the firm engages in the various activities that make up the industry's entire value chain system, from initial activities such as raw-material production all the way to retailing and after-sale service activities. **Outsourcing** decisions concern another dimension of scope since they involve narrowing the firm's boundaries with respect to its participation in value chain activities. We discuss the pros and cons of each of these options in the sections that follow. Because *strategic alliances and partnerships* provide an alternative to vertical integration and acquisition strategies and are sometimes used to facilitate outsourcing, we conclude this chapter with a discussion of the benefits and challenges associated with *cooperative arrangements* of this nature.

HORIZONTAL MERGER AND ACQUISITION STRATEGIES

LO 6-3

Explain the strategic benefits and risks of expanding a company's horizontal scope through mergers and acquisitions.

Mergers and acquisitions are much-used strategic options to strengthen a company's market position. A *merger* is the combining of two or more companies into a single corporate entity, with the newly created company often taking on a new name. An *acquisition* is a combination in which one company, the acquirer, purchases and absorbs the operations of another, the acquired. The difference between a merger and an acquisition relates more to the details of ownership, management control, and financial arrangements than to strategy and competitive advantage. The resources and competitive capabilities of the newly created enterprise end up much the same whether the combination is the result of an acquisition or a merger.

Horizontal mergers and acquisitions, which involve combining the operations of firms *within the same product or service market,* provide an effective means for firms to rapidly increase the scale and horizontal scope of their core business. For example, the merger of AMR Corporation (parent of American Airlines) with US Airways has increased the airlines' scale of operations and extended their reach geographically to create the world's largest airline (American Airlines Group), by revenue passenger mile, fleet size, and number of employees, as of 2022.

Merger and acquisition strategies typically set sights on achieving any of five objectives:[15]

1. *Creating a more cost-efficient operation out of the combined companies.* When a company acquires another company in the same industry, there's usually enough overlap in operations that less efficient plants can be closed or distribution and sales activities partly combined and downsized. Likewise, it is usually feasible to squeeze out cost savings in administrative activities, again by combining and downsizing

such administrative activities as finance and accounting, information technology, human resources, and so on. The combined companies may also be able to reduce supply chain costs because of greater bargaining power over common suppliers and closer collaboration with supply chain partners. By helping consolidate the industry and remove excess capacity, such combinations can also reduce industry rivalry and improve industry profitability.

2. *Expanding a company's geographic coverage.* One of the best and quickest ways to expand a company's geographic coverage is to acquire rivals with operations in the desired locations. Since a company's size increases with its geographic scope, another benefit is increased bargaining power with the company's suppliers or buyers. Greater geographic coverage can also contribute to product differentiation by enhancing a company's name recognition and brand awareness. The vacation rental marketplace, HomeAway, Inc., relied on an aggressive horizontal acquisition strategy to expand internationally, as well as to extend its reach across the United States. It now offers vacation rentals in 190 countries through its 50 websites in 23 languages. Travel company Expedia has since acquired HomeAway, thus extending its reach horizontally into the vacation rental product category—an objective described in the next point.
3. *Extending the company's business into new product categories.* Many times a company has gaps in its product line that need to be filled in order to offer customers a more effective product bundle or the benefits of one-stop shopping. For example, customers might prefer to acquire a suite of software applications from a single vendor that can offer more integrated solutions to the company's problems. Acquisition can be a quicker and more potent way to broaden a company's product line than going through the exercise of introducing a company's own new product to fill the gap. CocaCola's strategy to expand beyond carbonated soft drinks has been supported by acquisitions of producers of fruit juices, soy-based beverages, and bottled water.

   Airbnb grew their revenues to more than $8 billion in 2022 by acquiring such companies as HotelTonight (for last minute hotel bookings), Luxury Retreats International (for villa rental), and Urbandoor (offering extended stays to corporate clients).
4. *Gaining quick access to new technologies or other resources and capabilities.* Making acquisitions to bolster a company's technological know-how or to expand its skills and capabilities allows a company to bypass a time-consuming and expensive internal effort to build desirable new resources and capabilities. Over the course of its history, Cisco Systems has purchased over 200 companies to give it more technological reach and product breadth, thereby enhancing its standing as the world's largest provider of hardware, software, and services for building and operating Internet networks.
5. *Leading the convergence of industries whose boundaries are being blurred by changing technologies and new market opportunities.* In fast-cycle industries or industries whose boundaries are changing, companies can use acquisition strategies to hedge their bets about the direction that an industry will take, to increase their capacity to meet changing demands, and to respond flexibly to changing buyer needs and technological demands. The convergence of the pharmacy industry with health insurers and the benefits management industry led to the merger between Cigna and Express Scripts as well as that between CVS and Aetna.

Illustration Capsule 6.3 describes how Walmart employed a horizontal acquisition strategy to expand into the e-commerce domain.

ILLUSTRATION CAPSULE 6.3

Walmart's Expansion into E-Commerce via Horizontal Acquisition

As the boundaries between traditional retailing and online retailing have begun to blur, Walmart has responded by expanding its presence in e-commerce via horizontal acquisition. In 2016, Walmart acquired Jet.com, an innovative U.S. e-commerce start-up that was designed to compete with Amazon. Jet sold everything from household goods and electronics to beauty products, apparel, and toys from more than 2,400 retailers and brand partners. Jet.com rewarded customers for ordering multiple items, using a debit card instead of a credit card, or choosing a no-returns option; it passed its cost savings on to customers in the form of lower prices. The low-price approach of Jet.com fit well with Walmart's low-price strategy. In addition, Walmart hoped that the acquisition would help it to accelerate its growth in e-commerce, provide quick access to some valuable e-commerce knowledge and capabilities, increase its breadth of online product offerings, and attract new customer segments.

chrisdorney/Shutterstock

Walmart, like other brick and mortar retailers, was facing a myriad of issues caused by changing customer expectations. Consumers increasingly valued large assortments of products, a convenient shopping experience, and low prices. Price sensitivity was increasing due to the ease of comparing prices online. As a traditional retailer, Walmart was facing stiff competition from Amazon, the world's largest and fastest growing e-commerce company. Amazon's seemingly endless inventory of goods, excellent customer service, expertise in search engine marketing, and appeal to a wide consumer demographic added pressure on the overall global retail industry. Having invested heavily in their own online channel, Walmart.com, Walmart was looking for other ways to attract customers by lowering prices, broadening their product assortment, and offering the simplest, most convenient shopping experience. Jet's breadth of products, access to millennial and higher-income customer segments, and best-in-class pricing algorithm would accelerate Walmart's progress across all of these priorities.

After the acquisition, Jet continued to expand its own offerings with private-label groceries, further increasing competition with Amazon's Amazon Fresh grocery business. Walmart also made several other acquisitions of online apparel companies, thereby strengthening Jet's apparel offerings and further expanding Walmart's presence in e-commerce. These include ShoeBuy (a competitor of Amazon-owned Zappos), Bonobos in menswear, and Moosejaw in outdoor gear and apparel.

During the COVID pandemic, Walmart leveraged the capabilities of Jet.com to expand their e-commerce business by growing its curbside pickup and home delivery business. These investments have paid off. Walmart's e-commerce sales grew by 37 percent in 2019 and by 74 percent in the first quarter of 2020 By 2023, Walmart U.S. had e-commerce sales amounting to $53.4 billion. While Walmart's online sales still pale in comparison to Amazon, this represents a promising start for Walmart, as the retail industry continues to transform.

Note: Developed with Dipti Badrinath.

Sources: "Walmart Online Sales (2019-2023), Oberlo.com/statistics/walmart-online-sales#, accessed 9/6/23; **http://www.businessinsider.com/jet-walmart-weapon-vs-amazon-2017-9**; **https://news.walmart.com/2016/08/08/walmart-agrees-to-acquire-jetcom-one-of-the-fastest-growing-e-commerce-companies-in-the-us**; **https://www.fool.com/investing/2017/10/03/1-year-later-wal-marts-jetcom-acquisition-is-an-un.aspx**; **https://blog.walmart.com/business/20160919/five-big-reasons-walmart-bought-jetcom**.

Why Mergers and Acquisitions Sometimes Fail to Produce Anticipated Results

Despite many successes, mergers and acquisitions do not always produce the hoped-for outcomes.[16] Cost savings may prove smaller than expected. Gains in competitive capabilities may take substantially longer to realize or, worse, may never materialize at all. Efforts to mesh the corporate cultures can stall due to formidable resistance from organization members. Key employees at the acquired company can quickly become disenchanted and leave; the morale of company personnel who remain can drop to disturbingly low levels because they disagree with newly instituted changes. Differences in management styles and operating procedures can prove hard to resolve. In addition, the managers appointed to oversee the integration of a newly acquired company can make mistakes in deciding which activities to leave alone and which activities to meld into their own operations and systems.

A number of mergers and acquisitions have been notably unsuccessful. Three of the largest and most notorious failures are AOL's $165 billion acquisition of Time Warner, Citicorp's $83 billion merger with Travelers Group, and Daimler Benz and Chrysler's $37 billion merger. Incompatible visions and cultures were among the reasons that these mergers lasted for less than a decade. Amazon's $13.7 billion acquisition of Whole Foods Market in 2017 was intended to provide Amazon.com with quick entry and a strong position in the grocery industry and give Whole Foods new technology and online selling capabilities. Almost immediately after the acquisition, it became evident that Amazon's culture, which was focused on operating efficiency and incremental technological advances, was in direct conflict with Whole Foods' values-based culture focused on product quality and employee satisfaction. Whole Foods remained a division of Amazon as of this writing, but the misaligned cultures had dampened expectations for capturing the envisioned benefits of the acquisition.

VERTICAL INTEGRATION STRATEGIES

LO 6-4

Comprehend the advantages and disadvantages of extending the company's scope of operations via vertical integration.

Expanding the firm's vertical scope by means of a vertical integration strategy provides another possible way to strengthen the company's position in its core market. A **vertically integrated firm** is one that participates in multiple stages of an industry's value chain system. Thus, if a manufacturer invests in facilities to produce component parts that it had formerly purchased from suppliers, or if it opens its own chain of retail stores to bypass its former distributors, it is engaging in vertical integration. A good example of a vertically integrated firm is Maple Leaf Foods, the largest Canadian producer of fresh and processed meats, whose best-selling brands include Maple Leaf and Schneiders. Maple Leaf Foods participates in hog and poultry production, with company-owned hog and poultry farms; it has its own meat-processing and rendering facilities; it packages its products and distributes them from company-owned distribution centers; and it conducts marketing, sales, and customer service activities for its wholesale and retail buyers but does not otherwise participate in the final stage of the meat-processing vertical chain—the retailing stage.

CORE CONCEPT

A **vertically integrated firm** is one that performs value chain activities along more than one stage of an industry's value chain system.

A vertical integration strategy can expand the firm's range of activities *backward* into sources of supply and/or *forward* toward end users. When Tiffany & Co., a manufacturer and retailer of fine jewelry, began sourcing, cutting, and polishing its own diamonds, it integrated backward along the diamond supply chain. Mining giant De Beers Group and Canadian miner Aber Diamond integrated forward when they entered the diamond retailing business.

A firm can pursue vertical integration by starting its own operations in other stages of the vertical activity chain or by acquiring a company already performing the activities it wants to bring in-house. Vertical integration strategies can aim at *full integration* (participating in all stages of the vertical chain) or *partial integration* (building positions in selected stages of the vertical chain). Firms can also engage in *tapered integration* strategies, which involve a mix of in-house and outsourced activity in any given stage of the vertical chain. Oil companies, for instance, supply their refineries with oil from their own wells as well as with oil that they purchase from other producers—they engage in tapered backward integration. Coach, Inc., the maker of Coach handbags and accessories, engages in tapered forward integration since it operates full-price and factory outlet stores but also sells its products through third-party department store outlets.

The Advantages of a Vertical Integration Strategy

Under the right conditions, a vertical integration strategy can add materially to a company's technological capabilities, strengthen the firm's competitive position, and boost its profitability.[17] But it is important to keep in mind that vertical integration has no real payoff strategy-wise or profit-wise unless the extra investment can be justified by compensating improvements in company costs, differentiation, or competitive strength.

Integrating Backward to Achieve Greater Competitiveness It is harder than one might think to generate cost savings or improve profitability by integrating backward into activities such as the manufacture of parts and components (which could otherwise be purchased from suppliers with specialized expertise in making the parts and components). For **backward integration** to be a cost-saving and profitable strategy, a company must be able to (1) achieve the same scale economies as outside suppliers and (2) match or beat suppliers' production efficiency with no drop-off in quality. Neither outcome is easily achieved. To begin with, a company's in-house requirements are often too small to reach the optimum size for low-cost operation. For instance, if it takes a minimum production volume of 1 million units to achieve scale economies and a company's in-house requirements are just 250,000 units, then it falls far short of being able to match the costs of outside suppliers (which may readily find buyers for 1 million or more units). Furthermore, matching the production efficiency of suppliers is fraught with problems when suppliers have considerable production experience, when the technology they employ has elements that are hard to master, and/or when substantial R&D expertise is required to develop next-version components or keep pace with advancing technology in components production.

CORE CONCEPT

Backward integration involves entry into activities previously performed by suppliers or other enterprises positioned along earlier stages of the industry value chain system; forward integration involves entry into value chain system activities closer to the end user.

That said, occasions still arise when a company can gain or extend a competitive advantage by performing a broader range of industry value chain activities internally rather than having such activities performed by outside suppliers. There are several ways that backward vertical integration can contribute to a cost-based competitive advantage. When there are few suppliers and when the item being supplied is a major component, vertical integration can lower costs by limiting supplier power. Vertical integration can also lower costs by facilitating the coordination of production flows and avoiding bottlenecks and delays that disrupt production schedules. Furthermore, when a company has proprietary know-how that it wants to keep from rivals, then in-house performance of value-adding activities related to this know-how is beneficial even if such activities could otherwise be performed by outsiders.

Apple decided to integrate backward into producing its own chips for iPhones, chiefly because chips are a major cost component, suppliers have bargaining power, and in-house production would help coordinate design tasks and protect Apple's proprietary iPhone technology. International Paper Company backward integrates into pulp mills that it sets up near its paper mills and reaps the benefits of coordinated production flows, energy savings, and transportation economies. It does this, in part, because outside suppliers are generally unwilling to make a site-specific investment for a buyer.

Backward vertical integration can support a differentiation-based competitive advantage when performing activities internally contributes to a better-quality product or service offering, improves the caliber of customer service, or in other ways enhances the performance of the final product. On occasion, integrating into more stages along the industry value chain system can add to a company's differentiation capabilities by allowing it to strengthen its core competencies, better master key skills or strategy-critical technologies, or add features that deliver greater customer value. Spanish clothing maker Inditex has backward integrated into fabric making, as well as garment design and manufacture, for its successful Zara brand. By tightly controlling the process and postponing dyeing until later stages, Zara can respond quickly to changes in fashion trends and supply its customers with the hottest items. Amazon and Netflix backward integrated by establishing Amazon Studios and Netflix Originals to produce high-quality original content for their streaming services.

Integrating Forward to Enhance Competitiveness Like backward integration, **forward integration** can enhance competitiveness and contribute to competitive advantage on the cost side as well as the differentiation (or value) side. On the cost side, forward integration can lower costs by increasing efficiency and reducing or eliminating the bargaining power of companies that had wielded such power further along the value system chain. It can allow manufacturers to gain better access to end users, improve market visibility, and enhance brand name awareness. For example, Harley-Davidson's and Ducati's company-owned retail stores are essentially little museums, filled with iconography, that provide an environment conducive to selling not only motorcycles and gear but also memorabilia, clothing, and other items featuring the brand. Insurance companies and brokerages like Allstate and Edward Jones have the ability to make consumers' interactions with local agents and office personnel a differentiating feature by focusing on building relationships.

In many industries, independent sales agents, wholesalers, and retailers handle competing brands of the same product and have no allegiance to any one company's brand—they tend to push whatever offers the biggest profits. To avoid dependence on distributors and dealers with divided loyalties, Goodyear has integrated forward into company-owned and franchised retail tire stores. Consumer-goods companies like Under Armour, Pepperidge Farm, Bath & Body Works, Nike, Tommy Hilfiger, and Ann Taylor have integrated forward into retailing and operate their own branded stores in factory outlet malls, enabling them to move overstocked items, slow-selling items, and seconds.

Some producers have opted to integrate forward by selling directly to customers at the company's website. Indochino in custom men's suits, Warby Parker in eyewear, and Everlane in sustainable apparel are examples. Bypassing regular wholesale and retail channels in favor of direct sales and Internet retailing can have appeal if it reinforces the brand and enhances consumer satisfaction or if it lowers distribution costs, produces a relative cost advantage over certain rivals, and results in lower selling prices to end users. In addition, sellers are compelled to include the Internet as a retail channel when a sufficiently large number of buyers in an industry prefer to make purchases online. However, a company that is vigorously pursuing online sales to consumers at the same time that it is also heavily promoting sales to consumers through its network of wholesalers and retailers is *competing directly against its distribution allies.* Such actions constitute *channel conflict* and create a tricky route to negotiate. A company that is actively trying to expand online sales to consumers is signaling a weak strategic commitment to its dealers *and* a willingness to cannibalize dealers' sales and growth potential. The likely result is angry dealers and loss of dealer goodwill. Quite possibly, a company may stand to lose more sales by offending its dealers than it gains from its own online sales effort. Consequently, in industries where the strong support and goodwill of dealer networks is essential, companies may conclude that it is important to avoid channel conflict and that *their websites should be designed to partner with dealers rather than compete against them.*

The Disadvantages of a Vertical Integration Strategy

Vertical integration has some substantial drawbacks beyond the potential for channel conflict.[18] The most serious drawbacks to vertical integration include the following concerns:

- Vertical integration raises a firm's capital investment in the industry, thereby *increasing business risk* (what if industry growth and profitability unexpectedly go sour?).
- Vertically integrated companies are often *slow to adopt technological advances or more efficient production methods* when they are saddled with older technology or facilities. A company that obtains parts and components from outside suppliers can always shop the market for the newest, best, and cheapest parts, whereas a vertically integrated firm with older plants and technology may choose to continue making suboptimal parts rather than face the high costs of writing off undepreciated assets.
- Vertical integration can result in *less flexibility in accommodating shifting buyer preferences.* It is one thing to eliminate use of a component made by a supplier and another to stop using a component being made in-house (which can mean laying off employees and writing off the associated investment in equipment and facilities). Integrating forward or backward locks a firm into relying on its own in-house activities and sources of supply. Most of the world's automakers, despite their manufacturing expertise, have concluded that purchasing a majority of their parts and components from best-in-class suppliers results in greater design flexibility, higher quality, and lower costs than producing parts or components in-house.
- Vertical integration *may not enable a company to realize economies of scale* if its production levels are below the minimum efficient scale. Small companies in particular are likely to suffer a cost disadvantage by producing in-house.
- Vertical integration poses all kinds of *capacity-matching problems.* In motor vehicle manufacturing, for example, the most efficient scale of operation for making axles is different from the most economic volume for radiators, and different yet again for both engines and transmissions. Building the capacity to produce just the right number of axles, radiators, engines, and transmissions in-house—and doing so at the lowest unit costs for each—poses significant challenges and operating complications.

- Integration forward or backward typically *calls for developing new types of resources and capabilities.* Parts and components manufacturing, assembly operations, wholesale distribution and retailing, and direct sales via the Internet represent different kinds of businesses, operating in different types of industries, with different key success factors. Many manufacturers learn the hard way that company-owned wholesale and retail networks require skills that they lack, fit poorly with what they do best, and detract from their overall profit performance. Similarly, a company that tries to produce many components in-house is likely to find itself very hard-pressed to keep up with technological advances and cutting-edge production practices for each component used in making its product.

In today's world of close working relationships with suppliers and efficient supply chain management systems, relatively few companies can make a strong economic case for integrating backward into the business of suppliers. The best materials and components suppliers stay abreast of advancing technology and best practices and are adept in making good quality items, delivering them on time, and keeping their costs and prices as low as possible.

Weighing the Pros and Cons of Vertical Integration

All in all, therefore, a strategy of vertical integration can have both strengths and weaknesses. The tip of the scales depends on (1) whether vertical integration can enhance the performance of strategy-critical activities in ways that lower cost, build expertise, protect proprietary know-how, or increase differentiation; (2) what impact vertical integration will have on investment costs, flexibility, and response times; (3) what administrative costs will be incurred by coordinating operations across more vertical chain activities; and (4) how difficult it will be for the company to acquire the set of skills and capabilities needed to operate in another stage of the vertical chain. *Vertical integration strategies have merit according to which capabilities and value-adding activities truly need to be performed in-house and which can be performed better or cheaper by outsiders.* Absent solid benefits, integrating forward or backward is not likely to be an attractive strategy option.

Electric automobile maker Tesla, Inc. has made vertical integration a central part of its strategy, as described in Illustration Capsule 6.4.

CORE CONCEPT

Outsourcing involves contracting out certain value chain activities that are normally performed in-house to outside vendors.

OUTSOURCING STRATEGIES: NARROWING THE SCOPE OF OPERATIONS

LO 6-5

Recognize the conditions that favor farming out certain value chain activities to outside parties.

In contrast to vertical integration strategies, outsourcing strategies narrow the scope of a business's operations, in terms of what activities are performed internally. **Outsourcing** involves contracting out certain value chain activities that are normally performed in-house to outside vendors.[19] Many PC makers, for example, have shifted from assembling units in-house to outsourcing the entire assembly process to manufacturing specialists, which can operate more efficiently due to their greater scale, experience, and bargaining power over component makers. Nearly all name-brand apparel firms have in-house capability to design, market, and distribute their products but they outsource all fabric manufacture and garment-making activities. Starbucks finds purchasing coffee beans from independent growers far more advantageous than having its own coffee-growing operation, with locations scattered across most of the world's coffee-growing regions.

ILLUSTRATION CAPSULE 6.4 Tesla's Vertical Integration Strategy

Unlike many vehicle manufacturers, Tesla embraces vertical integration from component manufacturing all the way through vehicle sales and servicing. The majority of the company's $81.5 billion in 2022 revenue came from electric vehicle sales and leasing, with the remainder coming from servicing those vehicles and selling residential battery packs and solar energy systems.

At its core an electric vehicle manufacturer, Tesla uses both backward and forward vertical integration to achieve multiple strategic goals. In order to drive innovation in a critical part of its supply chain, Tesla has invested in a "gigafactory" that manufacturers the batteries that are essential for a long-lasting electric vehicle. According to Tesla's former VP of production, in-house manufacturing of key components and new parts that require frequent updates has enabled the company to learn quickly and launch new versions faster. Moreover, having closer relationships between engineering and manufacturing gives Tesla greater control over product design. Tesla uses forward vertical integration to improve the customer experience by owning the distribution and servicing of the vehicles it builds. Their network of dealerships allows Tesla to sell directly to consumers and handle maintenance needs without relying on third parties that sometimes have competing priorities.

Beyond vertically integrating the manufacture and distribution of their electric vehicles, Tesla uses the strategy to build the ecosystem that is necessary to support further adoption of their vehicles. As many consumers perceive electric cars to have limited range and long charging times that prevent long-distance travel, Tesla is building a network of Supercharger stations to overcome this pain point. By investing in this development themselves, Tesla does not need to wait for another company to deliver the critical infrastructure that drivers demand before they switch from traditional gasoline-powered cars. Similarly, Tesla sells solar power generation and storage products that make it easier for customers to make the switch to transportation powered by sustainable energy.

Jim West/Alamy Stock Photo

While Tesla's mission to accelerate the world's transition to sustainable energy has required large investments throughout the value chain, this strategy has not been without challenges. Unlike batteries, seats are of limited strategic importance, yet Tesla decided to manufacture their Model 3 seats in house. While there is no indication that the seats were the source of major production delays in 2017, diverting resources to develop new manufacturing capabilities could have added to the problem. Although Tesla's vertical integration strategy is not without downsides, it has enabled the firm to quickly roll out innovative new products and launch the network that is required for widespread vehicle adoption. Investors have rewarded Tesla for this bold strategy by lifting its valuation to $758 billion in 2023, higher than the other major American automakers.

Note: Developed with Edward J. Silberman.

Sources: Tesla 2017 Annual Report; G. Reichow, "Tesla's Secret Second Floor," *Wired,* October 18, 2017, **https://www.wired.com/story/teslas-secret-second-floor/**; A. Sage, "Tesla's Seat Strategy Goes Against the Grain. . . For Now," *Reuters,* October 26, 2017, **https://www.reuters.com/article/us-tesla-seats/teslas-seat-strategy-goes-against-the-grain-for-now-idUSKBN1CV0DS**; Yahoo Finance.

Outsourcing certain value chain activities makes strategic sense whenever

- *An activity can be performed better or more cheaply by outside specialists.* A company should generally *not* perform any value chain activity internally that can be performed more efficiently or effectively by outsiders—the chief exception occurs when a particular activity is strategically crucial and internal control over that activity is deemed essential. Dolce & Gabbana, for example, outsources the manufacture of its brand of sunglasses to Luxottica—a company considered to be the world's best sunglass manufacturing company, known for its Oakley, Oliver Peoples, and Ray-Ban brands. Colgate-Palmolive, for instance, has reduced its information technology operational costs by more than 10 percent annually through an outsourcing agreement with IBM.

- *The activity is not crucial to the firm's ability to achieve sustainable competitive advantage.* Outsourcing of support activities such as maintenance services, data processing, data storage, fringe-benefit management, and website operations has become commonplace. Many smaller companies, for example, find it advantageous to outsource HR activities such as benefit administration, training, recruiting, hiring and payroll to specialists, such as XcelHR, Insperity, Paychex, and Aon Hewitt.
- *The outsourcing improves organizational flexibility and speeds time to market.* Outsourcing gives a company the flexibility to switch suppliers in the event that its present supplier falls behind competing suppliers. Moreover, seeking out new suppliers with the needed capabilities already in place is frequently quicker, easier, less risky, and cheaper than hurriedly retooling internal operations to replace obsolete capabilities or trying to install and master new technologies.
- *It reduces the company's risk exposure to changing technology and buyer preferences.* When a company outsources certain parts, components, and services, its suppliers must bear the burden of incorporating state-of-the-art technologies and/or undertaking redesigns and upgrades to accommodate a company's plans to introduce next-generation products. If what a supplier provides falls out of favor with buyers, or is rendered unnecessary by technological change, it is the supplier's business that suffers rather than the company's.
- *It allows a company to concentrate on its core business, leverage its key resources, and do even better what it already does best.* A company is better able to enhance its own capabilities when it concentrates its full resources and energies on performing only those activities. United Colors of Benetton and Sisley, for example, outsource the production of handbags and other leather goods while devoting their energies to the clothing lines for which they are known. Apple outsources production of its iPod, iPhone, and iPad models to Chinese contract manufacturer Foxconn and concentrates in-house on design, marketing, and innovation. Hewlett-Packard and IBM have sold some of their manufacturing plants to outsiders and contracted to repurchase the output instead from the new owners.

Nearsourcing is simply outsourcing closer to home.

In recent years, companies have been turning more to *nearsourcing,* which is simply outsourcing closer to home base. The advantages of nearsourcing include similar time zones, lower costs of shipping, and greater control, since companies can visit their sites with more frequency, more convenience, and less expense. The rise in labor costs in Asia, along with higher custom duties, has contributed to the shift toward nearsourcing.

Whirlpool has long enjoyed the benefits of nearsourcing, after moving the manufacture of its home appliances to Mexico. But the strain on supply chains worldwide, during the pandemic, forced many more companies to turn to nearsourcing in an attempt to mitigate their problems. In 2020, for example, Boeing announced that it will begin manufacturing the interior of Boeing passenger aircraft in Mexico. Parkdale Mills, a textile company, is building a new yarn spinning facility in Honduras to replace their facilities in Asia.

Despite these benefits, nearsourcing is not always the preferred solution. Companies must carefully weigh the advantages and disadvantages concerning where and how they perform their value chain activities. And like outsourcing more generally, nearsourcing comes with risks.

The Risk of Outsourcing Value Chain Activities

A company must guard against outsourcing activities that hollow out the resources and capabilities that it needs to be a master of its own destiny.

The biggest danger of outsourcing is that a company will farm out the wrong types of activities and thereby hollow out its own capabilities.[20] For example, in recent years companies eager to reduce operating costs have opted to outsource such strategically important activities as product development, engineering design, and sophisticated manufacturing tasks—the very capabilities that underpin a company's ability to lead sustained product innovation. While these companies have apparently been able to lower their operating costs by outsourcing these functions to outsiders, *their ability to lead the development of innovative new products is weakened because so many of the cutting-edge ideas and technologies for next-generation products come from outsiders.*

Another risk of outsourcing comes from the lack of direct control. It may be difficult to monitor, control, and coordinate the activities of outside parties via contracts and arm's-length transactions alone. Unanticipated problems may arise that cause delays or cost overruns and become hard to resolve amicably. Moreover, contract-based outsourcing can be problematic because outside parties lack incentives to make investments specific to the needs of the outsourcing company's internal value chain.

Companies like Cisco Systems are alert to these dangers. Cisco guards against loss of control and protects its manufacturing expertise by designing the production methods that its contract manufacturers must use. Cisco keeps the source code for its designs proprietary, thereby controlling the initiation of all improvements and safeguarding its innovations from imitation. Furthermore, Cisco has developed online systems to monitor the factory operations of contract manufacturers around the clock so that it knows immediately when problems arise and can decide whether to get involved.

STRATEGIC ALLIANCES AND PARTNERSHIPS

LO 6-6

Understand how to capture the benefits and minimize the drawbacks of strategic alliances and partnerships.

Strategic alliances and cooperative partnerships provide one way to gain some of the benefits offered by vertical integration, outsourcing, and horizontal mergers and acquisitions while minimizing the associated problems. Companies frequently engage in cooperative strategies as an alternative to vertical integration or horizontal mergers and acquisitions. Increasingly, companies are also employing strategic alliances and partnerships to extend their scope of operations via international expansion and diversification strategies, as we describe in Chapters 7 and 8. Strategic alliances and cooperative arrangements are now a common means of narrowing a company's scope of operations as well, serving as a useful way to manage outsourcing (in lieu of traditional, purely price-oriented contracts).

For example, oil and gas companies engage in considerable vertical integration—but Shell Oil Company and Pemex (Mexico's state-owned petroleum company) have found that joint ownership of their Deer Park Refinery in Texas lowers their investment costs and risks in comparison to going it alone. The colossal failure of the Daimler–Chrysler merger formed an expensive lesson for Daimler AG about what can go wrong with horizontal mergers and acquisitions; the Renault–Nissan–Mitsubishi Alliance has proved more successful in developing the capabilities for the manufacture of plug-in electric vehicles and introducing the Nissan Leaf.

Many companies employ strategic alliances to manage the problems that might otherwise occur with outsourcing—Cisco's system of alliances guards against loss of control, protects its proprietary manufacturing expertise, and enables the company to monitor closely the assembly operations of its partners while devoting its energy to designing new generations of the switches, routers, and other Internet-related equipment for which it is known.

A **strategic alliance** is a formal agreement between two or more separate companies in which they agree to work collaboratively toward some strategically relevant objective. Typically, they involve shared financial responsibility, joint contribution of resources and capabilities, shared risk, shared control, and mutual dependence. They may be characterized by cooperative marketing, sales, or distribution; joint production; design collaboration; or projects to jointly develop new technologies or products. They can vary in terms of their duration and the extent of the collaboration; some are intended as long-term arrangements, involving an extensive set of cooperative activities, while others are designed to accomplish more limited, short-term objectives.

CORE CONCEPT

A **strategic alliance** is a formal agreement between two or more separate companies in which they agree to work cooperatively toward some common objective.

Collaborative arrangements may entail a contractual agreement, but they commonly stop short of formal ownership ties between the partners (although sometimes an alliance member will secure minority ownership of another member).

A special type of strategic alliance involving ownership ties is the **joint venture.** A joint venture entails forming a *new corporate entity that is jointly owned* by two or more companies that agree to share in the revenues, expenses, and control of the newly formed entity. Since joint ventures involve setting up a mutually owned business, they tend to be more durable but also riskier than other arrangements. In other types of strategic alliances, the collaboration between the partners involves a much less rigid structure in which the partners retain their independence from one another. If a strategic alliance is not working out, a partner can choose to simply walk away or reduce its commitment to collaborating at any time.

CORE CONCEPT

A **joint venture** is a type of strategic alliance that involves the establishment of an independent corporate entity that is jointly owned and controlled by the strategic allies.

An alliance becomes "strategic," as opposed to just a convenient business arrangement, when it serves any of the following purposes:[21]

1. It facilitates achievement of an important business objective (like lowering costs or delivering more value to customers in the form of better quality, added features, and greater durability).
2. It helps build, strengthen, or sustain a core competence or competitive advantage.
3. It helps remedy an important resource deficiency or competitive weakness.
4. It helps defend against a competitive threat, or mitigates a significant risk to a company's business.
5. It increases bargaining power over suppliers or buyers.
6. It helps open up important new market opportunities.
7. It speeds the development of new technologies and/or product innovations.

Strategic cooperation is a much-favored approach in industries where new technological developments are occurring at a furious pace along many different paths and where advances in one technology spill over to affect others (often blurring industry boundaries). Whenever industries are experiencing high-velocity technological advances in many areas simultaneously, firms find it virtually essential to have cooperative relationships with other enterprises to stay on the leading edge of technology, even in their own area of specialization. In industries like these, alliances are all about fast cycles of learning, gaining quick access to the latest round of technological know-how, and developing dynamic capabilities. In bringing together firms with different skills and knowledge bases, alliances open up learning opportunities that help partner firms better leverage their own resources and capabilities.[22]

Microsoft has been partnering with a variety of companies to advance technology in the healthcare industry. Its 2017 alliance with PAREXEL, a clinical research organization, aims to use their combined capabilities to accelerate drug development and bring new therapies to patients sooner. In 2018, it joined forces with immunosequencing company Adaptive Biotechnologies to find ways to detect cancers and other diseases earlier using Microsoft's artificial intelligence capabilities.

Companies that have formed a host of alliances need to manage their alliances like a portfolio.

The best alliances are highly selective, focusing on particular value chain activities and on obtaining a specific competitive benefit. They enable a firm to build on its strengths and to learn.

Because of the varied benefits of strategic alliances, many large corporations have become involved in 30 to 50 alliances, and a number have formed hundreds of alliances. Roche, the world's largest biotech company, has formed R&D alliances with more than 200 companies to boost its prospects for developing new cures for various diseases. In 2022, approximately 40 percent of its pharmaceutical sales came from partnered products. Companies that have formed a host of alliances need to manage their alliances like a portfolio—terminating those that no longer serve a useful purpose or that have produced meager results, forming promising new alliances, and restructuring existing alliances to correct performance problems and/or redirect the collaborative effort.

Capturing the Benefits of Strategic Alliances

The extent to which companies benefit from entering into alliances and partnerships seems to be a function of six factors:[23]

1. *Picking a good partner.* A good partner must bring complementary strengths to the relationship. To the extent that alliance members have nonoverlapping strengths, there is greater potential for synergy and less potential for coordination problems and conflict. In addition, a good partner needs to share the company's vision about the overall purpose of the alliance and to have specific goals that either match or complement those of the company. Strong partnerships also depend on good chemistry among key personnel and compatible views about how the alliance should be structured and managed.
2. *Being sensitive to cultural differences.* Cultural differences among companies can make it difficult for their personnel to work together effectively. Cultural differences can be problematic among companies from the same country, but when the partners have different national origins, the problems are often magnified. Unless there is respect among all the parties for cultural differences, including those stemming from different local cultures and local business practices, productive working relationships are unlikely to emerge.
3. *Recognizing that the alliance must benefit both sides.* Information must be shared as well as gained, and the relationship must remain forthright and trustful. If either partner plays games with information or tries to take advantage of the other, the resulting friction can quickly erode the value of further collaboration. Open, trustworthy behavior on both sides is essential for fruitful collaboration.
4. *Ensuring that both parties live up to their commitments.* Both parties have to deliver on their commitments for the alliance to produce the intended benefits. The division of work has to be perceived as fairly apportioned, and the caliber of the benefits received on both sides has to be perceived as adequate.

5. *Structuring the decision-making process so that actions can be taken swiftly when needed.* In many instances, the fast pace of technological and competitive changes dictates an equally fast decision-making process. If the parties get bogged down in discussions or in gaining internal approval from higher-ups, the alliance can turn into an anchor of delay and inaction.
6. *Managing the learning process and then adjusting the alliance agreement over time to fit new circumstances.* One of the keys to long-lasting success is adapting the nature and structure of the alliance to be responsive to shifting market conditions, emerging technologies, and changing customer requirements. Wise allies are quick to recognize the merit of an evolving collaborative arrangement, where adjustments are made to accommodate changing conditions and to overcome whatever problems arise in establishing an effective working relationship.

Most alliances that aim at sharing technology or providing market access turn out to be temporary, lasting only a few years. This is not necessarily an indicator of failure, however. Strategic alliances can be terminated after a few years simply because they have fulfilled their purpose; indeed, many alliances are intended to be of limited duration, set up to accomplish specific short-term objectives. Longer-lasting collaborative arrangements, however, may provide even greater strategic benefits. Alliances are more likely to be long-lasting when (1) they involve collaboration with partners that do not compete directly, such as suppliers or distribution allies; (2) a trusting relationship has been established; and (3) both parties conclude that continued collaboration is in their mutual interest, perhaps because new opportunities for learning are emerging.

The Drawbacks of Strategic Alliances and Their Relative Advantages

While strategic alliances provide a way of obtaining the benefits of vertical integration, mergers and acquisitions, and outsourcing, they also suffer from some of the same drawbacks. Anticipated gains may fail to materialize due to an overly optimistic view of the potential or a poor fit in terms of the combination of resources and capabilities. When outsourcing is conducted via alliances, there is no less risk of becoming dependent on other companies for essential expertise and capabilities—indeed, this may be the Achilles' heel of such alliances. Moreover, there are additional pitfalls to collaborative arrangements. The greatest danger is that a partner will gain access to a company's proprietary knowledge base, technologies, or trade secrets, enabling the partner to match the company's core strengths and costing the company its hard-won competitive advantage. This risk is greatest when the alliance is among industry rivals or when the alliance is for the purpose of collaborative R&D, since this type of partnership requires an extensive exchange of closely held information.

The question for managers is when to engage in a strategic alliance and when to choose an alternative means of meeting their objectives. The answer to this question depends on the relative advantages of each method and the circumstances under which each type of organizational arrangement is favored.

The principal advantages of strategic alliances over vertical integration or horizontal mergers and acquisitions are threefold:

1. They lower investment costs and risks for each partner by facilitating resource pooling and risk sharing. This can be particularly important when investment needs and uncertainty are high, such as when a dominant technology standard has not yet emerged.

2. They are more flexible organizational forms and allow for a more adaptive response to changing conditions. Flexibility is essential when environmental conditions or technologies are changing rapidly. Moreover, strategic alliances under such circumstances may enable the development of each partner's dynamic capabilities.
3. They are more rapidly deployed—a critical factor when speed is of the essence. Speed is of the essence when there is a winner-take-all type of competitive situation, such as the race for a dominant technological design or a race down a steep experience curve, where there is a large first-mover advantage.

The key advantages of using strategic alliances rather than arm's-length transactions to manage outsourcing are (1) the increased ability to exercise control over the partners' activities and (2) a greater willingness for the partners to make relationship-specific investments. Arm's-length transactions discourage such investments since they imply less commitment and do not build trust.

On the other hand, there are circumstances when other organizational mechanisms are preferable to alliances and partnering. Mergers and acquisitions are especially suited for situations in which strategic alliances or partnerships do not go far enough in providing a company with access to needed resources and capabilities. Ownership ties are more permanent than partnership ties, allowing the operations of the merger or acquisition participants to be tightly integrated and creating more in-house control and autonomy. Other organizational mechanisms are also preferable to alliances when there is limited property rights protection for valuable know-how and when companies fear being taken advantage of by opportunistic partners.

While it is important for managers to understand when strategic alliances and partnerships are most likely (and least likely) to prove useful, it is also important to know how to manage them.

How to Make Strategic Alliances Work

A surprisingly large number of alliances never live up to expectations. Even though the number of strategic alliances increases by about 25 percent annually, about 60 to 70 percent of alliances continue to fail each year.[24] The success of an alliance depends on how well the partners work together, their capacity to respond and adapt to changing internal and external conditions, and their willingness to renegotiate the bargain if circumstances so warrant. A successful alliance requires real in-the-trenches collaboration, not merely an arm's-length exchange of ideas. Unless partners place a high value on the contribution each brings to the alliance and the cooperative arrangement results in valuable win–win outcomes, it is doomed to fail.

While the track record for strategic alliances is poor on average, many companies have learned how to manage strategic alliances successfully and routinely defy this average. Samsung Group, which includes Samsung Electronics, successfully manages an ecosystem of over 1,300 partnerships that enable productive activities from global procurement to local marketing to collaborative R&D. Companies that have greater success in managing their strategic alliances and partnerships often credit the following factors:

- *They create a system for managing their alliances.* Companies need to manage their alliances in a systematic fashion, just as they manage other functions. This means setting up a process for managing the different aspects of alliance management from partner selection to alliance termination procedures. To ensure that the system is followed on a routine basis by all company managers, many companies create a set of explicit procedures, process templates, manuals, or the like.

- *They build relationships with their partners and establish trust.* Establishing strong interpersonal relationships is a critical factor in making strategic alliances work since such relationships facilitate opening up channels of communication, coordinating activity, aligning interests, and building trust.
- *They protect themselves from the threat of opportunism by setting up safeguards.* There are a number of means for preventing a company from being taken advantage of by an untrustworthy partner or unwittingly losing control over key assets. Contractual safeguards, including noncompete clauses, can provide other forms of protection.
- *They make commitments to their partners and see that their partners do the same.* When partners make credible commitments to a joint enterprise, they have stronger incentives for making it work and are less likely to "free-ride" on the efforts of other partners. Because of this, equity-based alliances tend to be more successful than nonequity alliances.[25]
- *They make learning a routine part of the management process.* There are always opportunities for learning from a partner, but organizational learning does not take place automatically. Whatever learning occurs cannot add to a company's knowledge base unless the learning is incorporated systematically into the company's routines and practices.

Managers should realize that alliance management is an organizational capability, much like any other. It develops over time, out of effort, experience, and learning. For this reason, it is wise to begin slowly, with simple alliances designed to meet limited, short-term objectives. Short-term partnerships that are successful often become the basis for much more extensive collaborative arrangements. Even when strategic alliances are set up with the hope that they will become long-term engagements, they have a better chance of succeeding if they are phased in so that the partners can learn how they can work together most fruitfully.

Lastly, companies should be mindful of the fact that their network of partners extends well beyond their strategic alliances. It includes their suppliers, distributors, retailers, customers, businesses they outsource to, sources of capital, and government agencies, such as regulators. This broader, complex network of interconnected players is known as a **business ecosystem**. Silicon Valley's entrepreneurial ecosystem serves as an example. And as with strategic alliances, companies need to develop the organizational capabilities that will enable them to navigate and manage their business ecosystem.

CORE CONCEPT

A **business ecosystem** is the complex network of interconnected players with which a business is interacting.

KEY POINTS

1. Once a company has settled on which of the five generic competitive strategies to employ, attention turns to how strategic choices regarding (1) competitive actions, (2) timing of those actions, and (3) scope of operations can complement its competitive approach and maximize the power of its overall strategy.
2. Strategic offensives should, as a general rule, be grounded in a company's strategic assets and employ a company's strengths to attack rivals in the competitive areas where they are weakest.
3. Companies have a number of offensive strategy options for improving their market positions: using a cost-based advantage to attack competitors on the basis of price

or value, leapfrogging competitors with next-generation technologies, pursuing continuous product innovation, adopting and improving the best ideas of others, using hit-and-run tactics to steal sales away from unsuspecting rivals, and launching preemptive strikes. A blue-ocean type of offensive strategy seeks to gain a dramatic new competitive advantage by inventing a new industry or distinctive market segment that renders existing competitors largely irrelevant and allows a company to create and capture altogether new demand in the absence of direct competitors.

4. The purposes of defensive strategies are to lower the risk of being attacked, weaken the impact of any attack that occurs, and influence challengers to aim their efforts at other rivals. Defensive strategies to protect a company's position usually take one of two forms: (1) actions to block challengers or (2) actions to signal the likelihood of strong retaliation.
5. The timing of strategic moves also has relevance in the quest for competitive advantage. Company managers are obligated to carefully consider the advantages or disadvantages that attach to being a first mover versus a fast follower versus a late mover.
6. Decisions concerning the scope of a company's operations—which activities a firm will perform internally and which it will not—can also affect the strength of a company's market position. The *scope of the firm* refers to the range of its activities, the breadth of its product and service offerings, the extent of its geographic market presence, and its mix of businesses. Companies can expand their scope horizontally (more broadly within their focal market) or vertically (up or down the industry value chain system that starts with raw-material production and ends with sales and service to the end consumer). Horizontal mergers and acquisitions (combinations of market rivals) provide a means for a company to expand its horizontal scope. Vertical integration expands a firm's vertical scope.
7. Horizontal mergers and acquisitions typically have any of five objectives: lowering costs, expanding geographic coverage, adding product categories, gaining new technologies or other resources and capabilities, and preparing for the convergence of industries.
8. Vertical integration, forward or backward, makes most strategic sense if it strengthens a company's position via either cost reduction or creation of a differentiation-based advantage. Otherwise, the drawbacks of vertical integration (increased investment, greater business risk, increased vulnerability to technological changes, less flexibility in making product changes, and the potential for channel conflict) are likely to outweigh any advantages.
9. Outsourcing involves contracting out pieces of the value chain formerly performed in-house to outside vendors, thereby narrowing the scope of the firm. Outsourcing can enhance a company's competitiveness whenever (1) an activity can be performed better or more cheaply by outside specialists; (2) the activity is not crucial to the firm's ability to achieve sustainable competitive advantage; (3) the outsourcing improves organizational flexibility, speeds decision making, and cuts cycle time; (4) it reduces the company's risk exposure; and (5) it permits a company to concentrate on its core business and focus on what it does best.
10. Strategic alliances and cooperative partnerships provide one way to gain some of the benefits offered by vertical integration, outsourcing, and horizontal mergers and acquisitions while minimizing the associated problems. They serve as an alternative to vertical integration and mergers and acquisitions, and as a

supplement to outsourcing, allowing more control relative to outsourcing via arm's-length transactions.

11. Companies that manage their alliances well generally (1) create a system for managing their alliances, (2) build relationships with their partners and establish trust, (3) protect themselves from the threat of opportunism by setting up safeguards, (4) make commitments to their partners and see that their partners do the same, and (5) make learning a routine part of the management process.

ASSURANCE OF LEARNING EXERCISES

1. Live Nation Entertainment operates music venues, provides management services to music artists, and promotes more than 40,000 shows and 100 festivals in 40 countries annually. The company acquired House of Blues, merged with Ticketmaster, and acquired concert and festival promoters in the United States, Australia, and Great Britain. How has the company used horizontal mergers and acquisitions to strengthen its competitive position? Are these moves primarily offensive or defensive? Has either Live Nation or Ticketmaster achieved any type of advantage based on the timing of its strategic moves? **LO 6-1, LO 6-2, LO 6-3**
2. Tesla, Inc. has rapidly become a stand-out among American car companies. Illustration Capsule 6.4 describes how Tesla has made vertical integration a central part of its strategy. What value chain segments has Tesla chosen to enter and perform internally? How has vertical integration and integration of its ecosystem aided the organization in building competitive advantage? Has vertical integration strengthened its market position? Explain why or why not. **LO 6-4**
3. Wipro is among the world's largest outsourcing firms, providing IT, customer service, and digital advertising services to companies in dozens of industries. Review its latest news and financial reports at **www.wipro.com** and describe what value chain activities it performs for two different client companies. Do any of these outsourcing agreements seem likely to threaten any of the client companies' competitive capabilities? **LO 6-5**
4. The airline industry's Star Alliance includes Lufthansa, United Airlines, Air Canada, and 23 smaller airlines operating throughout the world. The airlines participating in the Star Alliance offer 19,000 daily flights and use over 5,000 aircraft to serve more than 760 million passengers each year. Describe two benefits of the strategic alliances over horizontal or vertical integration. **LO 6-6**

EXERCISES FOR SIMULATION PARTICIPANTS

1. Has your company relied more on offensive or defensive strategies to achieve your rank in the industry? What options for being a first mover does your company have? Do any of these first-mover options hold competitive advantage potential? **LO 6-1, LO 6-2**
2. What would be an advantage of a horizontal merger within the industry? **LO 6-3**
3. What are the pros and cons of vertical integration in the industry? **LO 6-4**
4. What do you see as pros and cons of outsourcing in the business simulation? **LO 6-5**

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chapter 7

Strategies for Competing in International Markets

Learning Objectives

After reading this chapter, you should be able to

LO 7-1 Identify the primary reasons companies choose to compete in international markets.

LO 7-2 Understand how and why differing market conditions across countries influence a company's strategy choices in international markets.

LO 7-3 Identify the five primary modes of entry into foreign markets.

LO 7-4 Identify the three main strategic approaches for competing internationally.

LO 7-5 Explain how multinational enterprises (MNEs) are able to use international operations to improve overall competitiveness.

LO 7-6 Recognize the unique characteristics of competing in developing-country markets.

Fanatic Studio/Getty Images

Our key words now are globalization, new products and businesses, and speed.

Tsutomu Kanai—*Former chair and president of Hitachi*

One of the key firm capabilities to succeed in global markets is trust.

Aks Zaheer—*Professor and Thought Leader*

Increasingly, multinational enterprises focus on building new core competencies through learning from their foreign market operations.

Asli M. Arikan—*Professor and Consultant*

Any company that aspires to industry leadership in the 21st century must think in terms of global, not domestic, market leadership. The world economy is globalizing at an accelerating pace as ambitious, growth-minded companies race to build stronger competitive positions in the markets of more and more countries, as countries previously closed to foreign companies open up their markets, and as information technology shrinks the importance of geographic distance. The forces of globalization are changing the competitive landscape in many industries, offering companies attractive new opportunities and at the same time introducing new competitive threats. Companies in industries where these forces are greatest are therefore under considerable pressure to come up with a strategy for competing successfully in international markets.

This chapter focuses on strategy options for expanding beyond domestic boundaries and competing in the markets of either a few or a great many countries. In the process of exploring these options, we introduce such concepts as the Porter diamond of national competitive advantage; and discuss the specific market circumstances that support the adoption of multidomestic, transnational, and global strategies. The chapter also includes sections on cross-country differences in cultural, demographic, and market conditions; strategy options for entering foreign markets; the importance of locating value chain operations in the most advantageous countries; and the special circumstances of competing in developing markets such as those in China, India, Brazil, Egypt, and eastern Europe.

WHY COMPANIES DECIDE TO ENTER FOREIGN MARKETS

A company may opt to expand outside its domestic market for any of five major reasons:

LO 7-1

Identify the primary reasons companies choose to compete in international markets.

1. *To gain access to new customers.* Expanding into foreign markets offers potential for increased revenues, profits, and long-term growth; it becomes an especially attractive option when a company encounters dwindling growth opportunities in its home market. Companies often expand internationally to extend the life cycle of their products, as Honda has done with its classic 50-cc motorcycle, the Honda Cub. This product was introduced in Japan in 1958 and is still selling well in developing markets. A larger target market also offers companies the opportunity to earn a return on large investments more rapidly. This can be particularly important in R&D-intensive industries, where development is fast-paced or competitors imitate innovations rapidly.
2. *To achieve lower costs through economies of scale, experience, and increased purchasing power.* Many companies are driven to sell in more than one country because domestic sales volume alone is not large enough to capture fully economies of scale in product development, manufacturing, or marketing. Similarly, firms expand internationally to increase the rate at which they accumulate experience and move down the learning curve. International expansion can also lower a company's input costs through greater pooled purchasing power. The relatively small size of country markets in Europe and limited domestic volume explains why companies like Michelin, BMW, and Nestlé long ago began selling their products all across Europe and then moved into markets in North America and Latin America.
3. *To gain access to low-cost inputs of production.* Companies in industries based on natural resources (e.g., oil and gas, minerals, rubber, and lumber) often find it necessary to operate in the international arena since raw-material supplies are located in different parts of the world and can be accessed more cost-effectively at the source. Other companies enter foreign markets to access low-cost human resources; this is particularly true of industries in which labor costs make up a high proportion of total production costs.
4. *To further exploit its core competencies.* A company may be able to extend a market-leading position in its domestic market into a position of regional or global market leadership by leveraging its core competencies further. The Swedish company, H&M Group, is capitalizing on its considerable expertise in fashion retailing to expand its reach internationally. By 2022, it had more than 4,800 retail stores operating in 75 countries and was continuing to expand its global reach. Companies can often leverage their resources internationally by replicating a successful business model, using it as a basic blueprint for international operations, as Starbucks and McDonald's have done.[1]
5. *To gain access to resources and capabilities located in foreign markets.* An increasingly important motive for entering foreign markets is to acquire resources and capabilities that may be unavailable in a company's home market. Companies often make acquisitions abroad or enter into cross-border alliances to gain access to capabilities that complement their own or to learn from their partners.[2] In other cases, companies choose to establish operations in other countries to utilize local distribution networks, gain local managerial or marketing expertise, or acquire specialized technical knowledge.

In addition, companies that are the suppliers of other companies often expand internationally when their major customers do so, to meet their customers' needs abroad and retain their position as a key supply chain partner. For example, when motor vehicle companies have opened new plants in foreign locations, big automotive parts suppliers have frequently opened new facilities nearby to permit timely delivery of their parts and components to the plant. Similarly, Newell-Rubbermaid, one of Walmart's biggest suppliers of household products, has followed Walmart into foreign markets.

WHY COMPETING ACROSS NATIONAL BORDERS MAKES STRATEGY MAKING MORE COMPLEX

LO 7-2

Understand how and why differing market conditions across countries influence a company's strategy choices in international markets.

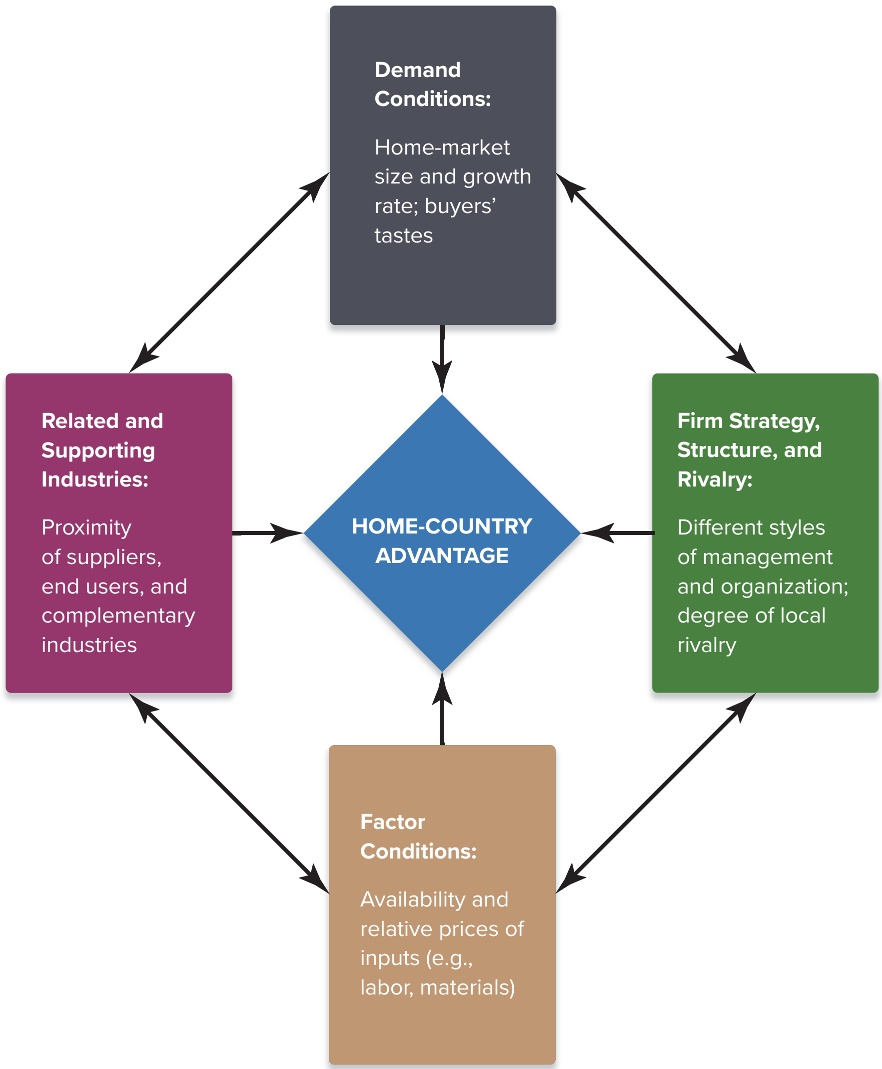
Crafting a strategy to compete in one or more countries of the world is inherently more complex for five reasons. First, different countries have different home-country advantages in different industries; competing effectively requires an understanding of these differences. Second, there are location-based advantages to conducting particular value chain activities in different parts of the world. Third, different political and economic conditions make the general business climate more favorable in some countries than in others. Fourth, companies face risk due to adverse shifts in currency exchange rates when operating in foreign markets. And fifth, differences in buyer tastes and preferences present a challenge for companies concerning customizing versus standardizing their products and services.

Home-Country Industry Advantages and the Diamond Model

Certain countries are known for their strengths in particular industries. For example, Chile has competitive strengths in industries such as copper, fruit, fish products, paper and pulp, chemicals, and wine. Japan is known for competitive strength in consumer electronics, automobiles, semiconductors, steel products, and specialty steel. Where industries are more likely to develop competitive strength depends on a set of factors that describe the nature of each country's business environment and vary from country to country. Because strong industries are made up of strong firms, the strategies of firms that expand internationally are usually grounded in one or more of these factors. The four major factors are summarized in a framework developed by Michael Porter and known as the *Diamond of National Competitive Advantage* (see Figure 7.1).[3]

Demand Conditions The demand conditions in an industry's home market include the relative size of the market, its growth potential, and the nature of domestic buyers' needs and wants. Differing population sizes, income levels, and other demographic factors give rise to considerable differences in market size and growth rates from country to country. Industry sectors that are larger and more important in their home market tend to attract more resources and grow faster than others. For example, owing to widely differing population demographics and income levels, there is a far bigger market for luxury automobiles in the United States and Germany than in Argentina, India, Mexico, and Poland. At the same time, in developing markets like India, China, Brazil, and Malaysia, market growth potential is far higher than it is in the more mature economies of Britain, Denmark, Canada, and Japan. The potential for market growth

FIGURE 7.1 The Diamond of National Competitive Advantage



Source: Adapted from Michael E. Porter, "The Competitive Advantage of Nations," *Harvard Business Review,* March–April 1990, pp. 73–93.

in automobiles is explosive in China, where 2022 sales of new vehicles amounted to 20.8 million, surpassing U.S. sales of 13.9 million and making China the world's largest market for the thirteenth year in a row.[4] Demanding domestic buyers for an industry's products spur greater innovativeness and improvements in quality. Such conditions foster the development of stronger industries, with firms that are capable of translating a home-market advantage into a competitive advantage in the international arena.

Factor Conditions Factor conditions describe the availability, quality, and cost of raw materials and other inputs (called *factors of production*) that firms in an industry require for producing their products and services. The relevant factors of production vary from industry to industry but can include different types of labor, technical or managerial knowledge, land, financial capital, and natural resources. Elements of a country's infrastructure may be included as well, such as its transportation, communication, and banking systems. For instance, in India there are efficient, well-developed national channels for distributing groceries to the country's 13 million grocery retailers (as of 2022), whereas in China distribution is primarily local and there is a limited national network for distributing most products. Competitively strong industries and firms develop where relevant factor conditions are favorable.

Related and Supporting Industries Robust industries often develop in locales where there is a cluster of related industries, including others within the same value chain system (e.g., suppliers of components and equipment, distributors) and the makers of complementary products or those that are technologically related. The sports car makers Ferrari and Maserati, for example, are located in an area of Italy known as the "engine technological district," which includes other firms involved in racing, such as Ducati Motorcycles, along with hundreds of small suppliers. The advantage to firms that develop as part of a related-industry cluster comes from the close collaboration with key suppliers and the greater knowledge sharing throughout the cluster, resulting in greater efficiency and innovativeness.

The Diamond Framework can be used to
1. predict from which countries foreign entrants are most likely to come
2. decide which foreign markets to enter first
3. choose the best country location for different value chain activities

Firm Strategy, Structure, and Rivalry Different country environments foster the development of different styles of management, organization, and strategy. For example, strategic alliances are a more common strategy for firms from Asian or Latin American countries, which emphasize trust and cooperation in their organizations, than for firms from North America, where individualism is more influential. In addition, countries vary in terms of the competitive rivalry of their industries. Fierce rivalry in home markets tends to hone domestic firms' competitive capabilities and ready them for competing internationally.

For an industry in a particular country to become competitively strong, all four factors must be favorable for that industry. When they are, the industry is likely to contain firms that are capable of competing successfully in the international arena. Thus, the diamond framework can be used to reveal the answers to several questions that are important for competing on an international basis. First, it can help predict *where foreign entrants into an industry are most likely to come from.* This can help managers prepare to cope with new foreign competitors, since the framework also reveals something about the basis of the new rivals' strengths. Second, it can reveal the countries in which foreign rivals are likely to be weakest and thus can help managers decide *which foreign markets to enter first.* And third, because it focuses on the attributes of a country's business environment that allow firms to flourish, it reveals something about the advantages of conducting particular business activities in that country. Thus, the diamond framework is an aid to deciding *where to locate different value chain activities most beneficially*—a topic that we address next.

Opportunities for Location-Based Advantages

Increasingly, companies are locating different value chain activities in different parts of the world to exploit location-based advantages that vary from country to country. This is particularly evident with respect to the location of manufacturing activities. Differences in wage rates, worker productivity, energy costs, and the like create sizable variations in manufacturing costs from country to country. By locating their plants in certain countries, firms in some industries can reap major manufacturing cost advantages because of lower input costs (especially labor), relaxed government regulations, the proximity of suppliers and technologically related industries, or unique natural resources. In such cases, the low-cost countries become principal production sites, with most of the output being exported to markets in other parts of the world. Companies that build production facilities in low-cost countries (or that source their products from contract manufacturers in these countries) gain a competitive advantage over rivals with plants in countries where costs are higher. The competitive role of low manufacturing costs is most evident in low-wage countries like China, India, Pakistan, Cambodia, Vietnam, Mexico, Brazil, Guatemala, the Philippines, and several countries in Africa and eastern Europe that have become production havens for manufactured goods with high labor content (especially textiles and apparel). Monthly compensation for manufacturing workers in 2022 averaged about $103 in India, $199 in Indonesia, $1138 in China, $528 in Mexico, $1806 in Taiwan, $855 in Bulgaria, $511 in Brazil, and $1031 in Croatia. In contrast, in 2022 average monthly wages for manufacturing workers were $3755 in New Zealand, $2729 in Japan, $3559 in Canada, $4106 in the United States, $4159 in Australia, and $4117 in Ireland.[5] China emerged as the manufacturing capital of the world in large part because of its (formerly) very low wages. But as its wages have risen, manufacturing has been moving to lower wage countries, such as Malaysia, India, and Vietnam.

For other types of value chain activities, input quality or availability are more important considerations. Tiffany & Co. entered the mining industry in Canada to access diamonds that could be certified as "conflict free" and not associated with either the funding of African wars or unethical mining conditions. Many U.S. companies locate call centers in countries such as India and Ireland, where English is spoken and the workforce is well educated. Other companies locate R&D activities in countries where there are prestigious research institutions and well-trained scientists and engineers. Likewise, concerns about short delivery times and low shipping costs make some countries better locations than others for establishing distribution centers.

The Impact of Government Policies and Economic Conditions in Host Countries

Cross-country variations in government policies and economic conditions affect both the opportunities available to a foreign entrant and the risks of operating within the host country. The governments of some countries are eager to attract foreign investments, and thus they go all out to create a business climate that outsiders will view as favorable. Governments eager to spur economic growth, create more jobs, and raise living standards for their citizens usually enact policies aimed at stimulating business innovation and capital investment; Ireland is a good example. They may provide such incentives as reduced taxes, low-cost loans, site location and site development assistance, and government-sponsored training for workers to encourage companies to construct production and distribution facilities. When new business-related issues or developments arise, "pro-business" governments make a practice of seeking advice and counsel from business leaders. When tougher business-related regulations are deemed appropriate, they endeavor to make the transition to more costly and stringent regulations somewhat business-friendly rather than adversarial.

On the other hand, governments sometimes enact policies that, from a business perspective, make locating facilities within a country's borders less attractive. For example, the nature of a company's operations may make it particularly costly to achieve compliance with a country's environmental regulations. Some governments provide subsidies and low-interest loans to domestic companies to enable them to better compete against foreign companies. To discourage foreign imports, governments may enact deliberately burdensome procedures and requirements regarding customs inspection for foreign goods and may impose tariffs or quotas on imports. Additionally, they may specify that a certain percentage of the parts and components used in manufacturing a product be obtained from local suppliers, require prior approval of capital spending projects, limit withdrawal of funds from the country, and require partial ownership of foreign company operations by local companies or investors. There are times when a government may place restrictions on exports to ensure adequate local supplies and regulate the prices of imported and locally produced goods. Such government actions make a country's business climate less attractive and in some cases may be sufficiently onerous as to discourage a company from locating facilities in that country or even selling its products there.

A country's business climate is also a function of the political and economic risks associated with operating within its borders. **Political risks** have to do with the instability of weak governments, growing possibilities that a country's citizenry will revolt against dictatorial government leaders, the likelihood of new onerous legislation or regulations on foreign-owned businesses, and the potential for future elections to produce corrupt or tyrannical government leaders. In industries that a government deems critical to the national welfare, there is sometimes a risk that the government will nationalize the industry and expropriate the assets of foreign companies. In 2017, for example, Venezuela nationalized a General Motors plant in Valencia employing nearly 2,700 workers. In 2023, France took over the country's largest electricity provider, Electricity de France, to stabilize energy prices in the wake of Russia's war on Ukraine. Other political risks include the loss of investments due to war or political unrest, regulatory changes that create operating uncertainties, security risks due to terrorism, and corruption. **Economic risks** have to do with instability of a country's economy and monetary system—whether inflation rates might skyrocket or whether uncontrolled deficit spending on the part of government or risky bank lending practices could lead to a breakdown of the country's monetary system and prolonged economic distress. In some countries, the threat of piracy and lack of protection for intellectual property are also sources of economic risk. Another is fluctuations in the value of different currencies—a factor that we discuss in more detail next.

CORE CONCEPT

Political risks stem from instability or weakness in national governments and hostility to foreign business. **Economic risks** stem from instability in a country's monetary system, economic and regulatory policies, and the lack of property rights protections.

The Risks of Adverse Exchange Rate Shifts

When companies produce and market their products and services in many different countries, they are subject to the impacts of sometimes favorable and sometimes unfavorable changes in currency exchange rates. The rates of exchange between different currencies can vary by as much as 20 to 40 percent annually, with the changes occurring sometimes gradually and sometimes swiftly. *Sizable shifts in exchange rates pose significant risks for two reasons:*

1. They are hard to predict because of the variety of factors involved and the uncertainties surrounding when and by how much these factors will change.
2. They create uncertainty regarding which countries represent the low-cost manufacturing locations and which rivals have the upper hand in the marketplace.

To illustrate the economic and competitive risks associated with fluctuating exchange rates, consider the case of a U.S. company that has located manufacturing facilities in

Brazil (where the currency is *reals*—pronounced "ray-alls") and that exports most of the Brazilian-made goods to markets in the European Union (where the currency is euros). To keep the numbers simple, assume that the exchange rate is 4 Brazilian reals for 1 euro and that the product being made in Brazil has a manufacturing cost of 4 Brazilian reals (or 1 euro). Now suppose that the exchange rate shifts from 4 reals per euro to 5 reals per euro (meaning that the real has declined in value and that the euro is stronger). Making the product in Brazil is now more cost-competitive because a Brazilian good costing 4 reals to produce has fallen to only 0.8 euro at the new exchange rate (4 reals divided by 5 reals per euro = 0.8 euro). This clearly puts the producer of the Brazilian-made good *in a better position to compete* against the European makers of the same good. On the other hand, should the value of the Brazilian real grow stronger in relation to the euro—resulting in an exchange rate of 3 reals to 1 euro—the same Brazilian-made good formerly costing 4 reals (or 1 euro) to produce now has a cost of 1.33 euros (4 reals divided by 3 reals per euro = 1.33 euros), putting the producer of the Brazilian-made good in a weaker competitive position vis-à-vis the European producers. Plainly, the attraction of manufacturing a good in Brazil and selling it in Europe is far greater when the euro is strong (an exchange rate of 1 euro for 5 Brazilian reals) than when the euro is weak and exchanges for only 3 Brazilian reals.

But there is one more piece to the story. When the exchange rate changes from 4 reals per euro to 5 reals per euro, not only is the cost-competitiveness of the Brazilian manufacturer stronger relative to European manufacturers of the same item but the Brazilian-made good that formerly cost 1 euro and now costs only 0.8 euro can also be sold to consumers in the European Union for a lower euro price than before. In other words, the combination of a stronger euro and a weaker real acts to *lower the price of Brazilian-made goods* in all the countries that are members of the European Union, which is likely to *spur sales of the Brazilian-made good in Europe and boost Brazilian exports to Europe.* Conversely, should the exchange rate shift from 4 reals per euro to 3 reals per euro—which makes the Brazilian manufacturer less cost-competitive with European manufacturers of the same item—the Brazilian-made good that formerly cost 1 euro and now costs 1.33 euros will sell for a higher price in euros than before, thus weakening the demand of European consumers for Brazilian-made goods and acting to reduce Brazilian exports to Europe. Brazilian exporters are likely to experience (1) rising demand for their goods in Europe whenever the Brazilian real grows weaker relative to the euro and (2) falling demand for their goods in Europe whenever the real grows stronger relative to the euro. Consequently, from the standpoint of a company with Brazilian manufacturing plants, *a weaker Brazilian real is a favorable exchange rate shift and a stronger Brazilian real is an unfavorable exchange rate shift.*

It follows from the previous discussion that shifting exchange rates have a big impact on the ability of domestic manufacturers to compete with foreign rivals. For example, U.S.-based manufacturers locked in a fierce competitive battle with low-cost foreign imports benefit from a *weaker* U.S. dollar. There are several reasons why this is so:

- Declines in the value of the U.S. dollar against foreign currencies raise the U.S. dollar costs of goods manufactured by foreign rivals at plants located in the countries whose currencies have grown stronger relative to the U.S. dollar. A *weaker* dollar acts to reduce or eliminate whatever cost advantage foreign manufacturers may have had over U.S. manufacturers (and helps protect the manufacturing jobs of U.S. workers).
- A *weaker* dollar makes foreign-made goods more expensive in dollar terms to U.S. consumers—this curtails U.S. buyer demand for foreign-made goods, stimulates

Fluctuating exchange rates pose significant economic risks to a company's competitiveness in foreign markets. Exporters are disadvantaged when the currency of the country where goods are being manufactured grows stronger relative to the currency of the importing country.

Domestic companies facing competitive pressure from lower-cost imports benefit when their government's currency grows weaker in relation to the currencies of the countries where the lower-cost imports are being made.

greater demand on the part of U.S. consumers for U.S.-made goods, and reduces U.S. imports of foreign-made goods.

- A *weaker* U.S. dollar enables the U.S.-made goods to be sold at lower prices to consumers in countries whose currencies have grown stronger relative to the U.S. dollar—such lower prices boost foreign buyer demand for the now relatively cheaper U.S.-made goods, thereby stimulating exports of U.S.-made goods to foreign countries and creating more jobs in U.S.-based manufacturing plants.
- A *weaker* dollar has the effect of increasing the dollar value of profits a company earns in foreign-country markets where the local currency is stronger relative to the dollar. For example, if a U.S.-based manufacturer earns a profit of €10 million on its sales in Europe, those €10 million convert to a larger number of dollars when the dollar grows weaker against the euro.

A weaker U.S. dollar is therefore an economically favorable exchange rate shift for manufacturing plants based in the United States. A decline in the value of the U.S. dollar strengthens the cost-competitiveness of U.S.-based manufacturing plants and boosts buyer demand for U.S.-made goods. When the value of the U.S. dollar is expected to remain weak for some time to come, foreign companies have an incentive to build manufacturing facilities in the United States to make goods for U.S. consumers rather than export the same goods to the United States from foreign plants where production costs in dollar terms have been driven up by the decline in the value of the dollar. Conversely, a *stronger* U.S. dollar is an *unfavorable exchange rate shift* for U.S.-based manufacturing plants because it makes such plants less cost-competitive with foreign plants and weakens foreign demand for U.S.-made goods. A strong dollar also weakens the incentive of foreign companies to locate manufacturing facilities in the United States to make goods for U.S. consumers. The same reasoning applies to companies that have plants in countries in the European Union where euros are the local currency. A weak euro versus other currencies enhances the cost-competitiveness of companies manufacturing goods in Europe vis-à-vis foreign rivals with plants in countries whose currencies have grown stronger relative to the euro; a strong euro versus other currencies weakens the cost-competitiveness of companies with plants in the European Union.

Cross-Country Differences in Demographic, Cultural, and Market Conditions

Buyer tastes for a particular product or service sometimes differ substantially from country to country. In France, consumers prefer top-loading washing machines, whereas in most other European countries consumers prefer front-loading machines. People in Hong Kong prefer compact appliances, but in Taiwan large appliances are more popular. Ice cream flavors like matcha, black sesame, and red beans have more appeal to East Asian customers than they have for customers in the United States and in Europe. Sometimes, product designs suitable in one country are inappropriate in another because of differing local standards—for example, in the United States electrical devices run on 110-volt electric systems, but in some European countries the standard is a 240-volt electric system, necessitating the use of different electrical designs and components. Cultural influences can also affect consumer demand for a product. For instance, in South Korea many parents are reluctant to purchase PCs even when they can afford them because of concerns that their children will be distracted from their schoolwork by surfing the Web and playing PC-based video games.[6]

Consequently, companies operating in an international marketplace have to wrestle with *whether and how much to customize their offerings in each country market to match local buyers' tastes and preferences or whether to pursue a strategy of offering a mostly standardized product worldwide.* While making products that are closely matched to local tastes makes them more appealing to local buyers, customizing a company's products country by country may raise production and distribution costs due to the greater variety of designs and components, shorter production runs, and the complications of added inventory handling and distribution logistics. Greater standardization of a global company's product offering, on the other hand, can lead to scale economies and learning-curve effects, thus reducing per-unit production costs and contributing to the achievement of a low-cost advantage. *The tension between the market pressures to localize a company's product offerings country by country and the competitive pressures to lower costs is one of the big strategic issues that participants in foreign markets have to resolve.*

STRATEGIC OPTIONS FOR ENTERING INTERNATIONAL MARKETS

LO 7-3

Identify the five primary modes of entry into foreign markets.

Once a company decides to expand beyond its domestic borders, it must consider the question of how to enter foreign markets. There are five primary *modes of entry* to choose among:

1. Maintain a home-country production base and *export* goods to foreign markets.
2. *License* foreign firms to produce and distribute the company's products abroad.
3. Employ a *franchising* strategy in foreign markets.
4. Establish a *subsidiary* in a foreign market via acquisition or internal development.
5. Rely on *strategic alliances* or joint ventures with foreign companies.

Which mode of entry to employ depends on a variety of factors, including the nature of the firm's strategic objectives, the firm's position in terms of whether it has the full range of resources and capabilities needed to operate abroad, country-specific factors such as trade barriers, and the transaction costs involved (the costs of contracting with a partner and monitoring its compliance with the terms of the contract, for example). The options vary considerably regarding the level of investment required and the associated risks—but higher levels of investment and risk generally provide the firm with the benefits of greater ownership and control.

Export Strategies

Using domestic plants as a production base for exporting goods to foreign markets is an excellent initial strategy for pursuing international sales. It is a conservative way to test the international waters. The amount of capital needed to begin exporting is often minimal; existing production capacity may well be sufficient to make goods for export. With an export-based entry strategy, a manufacturer can limit its involvement in foreign markets by contracting with foreign wholesalers experienced in importing to handle the entire distribution and marketing function in their countries or regions of the world. If it is more advantageous to maintain control over these functions, however, a manufacturer can establish its own distribution and sales organizations in some or all of the target foreign markets. Either way, a home-based production and export strategy helps the firm minimize its direct investments in foreign countries. Such strategies are commonly favored by Chinese, Korean, and Italian companies—products are designed and manufactured at home and then distributed through local channels in the importing countries. The primary functions performed abroad relate chiefly to establishing a network of distributors and perhaps conducting sales promotion and brand-awareness activities.

Whether an export strategy can be pursued successfully over the long run depends on the relative cost-competitiveness of the home-country production base. In some industries, firms gain additional scale economies and learning-curve benefits from centralizing production in plants whose output capability exceeds demand in any one country market; exporting enables a firm to capture such economies. However, an export strategy is vulnerable when (1) manufacturing costs in the home country are substantially higher than in foreign countries where rivals have plants, (2) the costs of shipping the product to distant foreign markets are relatively high, (3) adverse shifts occur in currency exchange rates, and (4) importing countries impose tariffs or erect other trade barriers. Unless an exporter can keep its production and shipping costs competitive with rivals' costs, secure adequate local distribution and marketing support of its products, and effectively hedge against unfavorable changes in currency exchange rates, its success will be limited.

Licensing Strategies

Licensing as an entry strategy makes sense when a firm with valuable technical know-how, an appealing brand, or a unique patented product has neither the internal organizational capability nor the resources to enter foreign markets. Licensing also has the advantage of avoiding the risks of committing resources to country markets that are unfamiliar, politically volatile, economically unstable, or otherwise risky. By licensing the technology, trademark, or production rights to foreign-based firms, a company can generate income from royalties while shifting the costs and risks of entering foreign markets to the licensee. One downside of the licensing alternative is that the partner who bears the risk is also likely to be the biggest beneficiary from any upside gain. Disney learned this lesson when it relied on licensing agreements to open its first foreign theme park, Tokyo Disneyland. When the venture proved wildly successful, it was its licensing partner, the Oriental Land Company, and not Disney who reaped the windfall. Another disadvantage of licensing is the risk of providing valuable technological know-how to foreign companies and thereby losing some degree of control over its use; monitoring licensees and safeguarding the company's proprietary know-how can prove quite difficult in some circumstances. But if the royalty potential is considerable and the companies to which the licenses are being granted are trustworthy and reputable, then licensing can be a very attractive option. Many software and pharmaceutical companies use licensing strategies to participate in foreign markets.

Franchising Strategies

While licensing works well for manufacturers and owners of proprietary technology, franchising is often better suited to the international expansion efforts of service and retailing enterprises. McDonald's, Yum! Brands (the parent of Pizza Hut, KFC, Taco Bell, and The Habit Burger Grill), the UPS Store, Roto-Rooter, 7-Eleven, and Hilton Hotels have all used franchising to build a presence in foreign markets. Franchising has many of the same advantages as licensing. The franchisee bears most of the costs and risks of establishing foreign locations; a franchisor has to expend only the resources to recruit, train, support, and monitor franchisees. The big problem a franchisor faces is maintaining quality control; foreign franchisees do not always exhibit strong commitment to consistency and standardization, especially when the local culture does not stress the same kinds of quality concerns. A question that can arise is whether to allow foreign franchisees to make modifications in the franchisor's product offering so as to better satisfy the tastes and expectations of local buyers. Should McDonald's give franchisees in each nation some leeway in what products they put on their menus? Should franchised KFC units in China be permitted to substitute spices that appeal to Chinese consumers? Or should the same menu offerings be rigorously and unvaryingly required of all franchisees worldwide?

Foreign Subsidiary Strategies

Very often companies electing to compete internationally prefer to have direct control over all aspects of operating in a foreign market. Companies that want to participate in direct performance of all essential value chain activities typically establish a wholly owned subsidiary, either by acquiring a local company or by establishing its own new operating organization from the ground up. A subsidiary business that is established internally from scratch is called an *internal startup* or a **greenfield venture.**

CORE CONCEPT

A **greenfield venture** (or internal startup) is a subsidiary business that is established by setting up the entire operation from the ground up.

Acquiring a local business is the quicker of the two options; it may be the least risky and most cost-efficient means of hurdling such entry barriers as gaining access to local distribution channels, building supplier relationships, and establishing working relationships with government officials and other key constituencies. Buying an ongoing operation allows the acquirer to move directly to the task of transferring resources and personnel to the newly acquired business, redirecting and integrating the activities of the acquired business into its own operation, putting its own strategy into place, and accelerating efforts to build a strong market position.

One thing an acquisition-minded firm must consider is whether to pay a premium price for a successful local company or to buy a struggling competitor at a bargain price. If the buying firm has little knowledge of the local market but ample capital, it is often better off purchasing a capable, strongly positioned firm. However, when the acquirer sees promising ways to transform a weak firm into a strong one and has the resources and managerial know-how to do so, a struggling company can be the better long-term investment.

Entering a new foreign country via a greenfield venture makes sense when a company already operates in a number of countries, has experience in establishing new subsidiaries and overseeing their operations, and has a sufficiently large pool of resources and capabilities to rapidly equip a new subsidiary with the personnel and what it needs otherwise to compete successfully and profitably. Four more conditions combine to make a greenfield venture strategy appealing:

1. When creating an internal startup is cheaper than making an acquisition.
2. When adding new production capacity will not adversely impact the supply–demand balance in the local market.
3. When a startup subsidiary has the ability to gain good distribution access (perhaps because of the company's recognized brand name).
4. When a startup subsidiary will have the size, cost structure, resources, and capabilities to compete head-to-head against local rivals.

Collaborative strategies involving alliances or joint ventures with foreign partners are a popular way for companies to edge their way into the markets of foreign countries.

Greenfield ventures in foreign markets can also pose problems, just as other entry strategies do. They represent a costly capital investment, subject to a high level of risk. They require numerous other company resources as well, diverting them from other uses. They do not work well in countries without strong, well-functioning markets and institutions that protect the rights of foreign investors and provide other legal protections. Moreover, an important disadvantage of greenfield ventures relative to other means of international expansion is that they are the slowest entry route—particularly if the objective is to achieve a sizable market share. On the other hand, successful greenfield ventures may offer higher returns to compensate for their high risk and slower path.

Alliance and Joint Venture Strategies

Strategic alliances, joint ventures, and other cooperative agreements with foreign companies are a widely used means of entering foreign markets.[7] A company can benefit immensely from a foreign partner's familiarity with local government regulations, its knowledge of the buying habits and product preferences of consumers, its distribution-channel relationships, and so on.[8] Both Japanese and American companies are actively forming alliances with European companies to better compete in the 27-nation European Union (and the eight countries that are candidates to become EU members). Many U.S. and European companies are allying with Asian companies in their efforts to enter markets in China, India, Thailand, Indonesia, and other Asian countries.

Cross-border alliances enable a growth-minded company to widen its geographic coverage and strengthen its competitiveness in foreign markets; at the same time, they offer flexibility and allow a company to retain some degree of autonomy and operating control.

Another reason for cross-border alliances is to capture economies of scale in production and/or marketing. By joining forces in producing components, assembling models, and marketing their products, companies can realize cost savings not achievable with their own small volumes. A third reason to employ a collaborative strategy is to share distribution facilities and dealer networks, thus mutually strengthening each partner's access to buyers. A fourth benefit of a collaborative strategy is the learning and added expertise that comes from performing joint research, sharing technological know-how, studying one another's manufacturing methods, and understanding how to tailor sales and marketing approaches to fit local cultures and traditions. A fifth benefit is that cross-border allies can direct their competitive energies more toward mutual rivals and less toward one another; teaming up may help them close the gap on leading companies. And, finally, alliances can be a particularly useful way for companies across the world to gain agreement on important technical standards—they have been used to arrive at standards for assorted PC devices, Internet-related technologies, high-definition televisions, and mobile phones.

What makes cross-border alliances an attractive strategic means of gaining the aforementioned types of benefits (as compared to merging with or acquiring foreign-based companies) is that they allow a company to preserve its independence (which is not the case with a merger) and avoid using scarce financial resources to fund acquisitions. Furthermore, an alliance offers the flexibility to readily disengage once its purpose has been served or if the benefits prove elusive, whereas mergers and acquisitions are more permanent arrangements.[9]

Alliances may also be used to pave the way for an intended merger; they offer a way to test the value and viability of a cooperative arrangement with a foreign partner before making a more permanent commitment. Illustration Capsule 7.1 shows how Walgreens pursued this strategy with Alliance Boots in order to facilitate its expansion abroad.

ILLUSTRATION CAPSULE 7.1 Walgreens Boots Alliance, Inc.: Entering Foreign Markets via Alliance Followed by Merger

Walgreens pharmacy began in 1901 as a single store on the South Side of Chicago and grew to become the largest chain of pharmacy retailers in America. Walgreens was an early pioneer of the "self-service" pharmacy and found success by moving quickly to build a vast domestic network of stores after the Second World War. This growth-focused strategy served Walgreens well up until the beginning of the 21st century, by which time it had nearly saturated the U.S. market. By 2014, 75 percent of Americans lived within five miles of a Walgreens. The company was also facing threats to its core business model. Walgreens relies heavily on pharmacy sales, which generally are paid for by someone other than the patient, usually the government or an insurance company. As the government and insurers started to make a more sustained effort to cut costs, Walgreens's core profit center was at risk. To mitigate these threats, Walgreens looked to enter foreign markets.

Walgreens found an ideal international partner in Alliance Boots. Based in the UK, Alliance Boots had a global footprint with 3,300 stores across 10 countries. A partnership with Alliance Boots had several strategic advantages, allowing Walgreens to gain swift entry into foreign markets as well as complementary assets and expertise. First, it gave Walgreens access to new markets beyond the saturated United States for its retail pharmacies. Second, it provided Walgreens with a new revenue stream in wholesale drugs. Alliance Boots held a vast European distribution network for wholesale drug sales; Walgreens could leverage that network and expertise to build a similar model in the United States. Finally, a merger with Alliance Boots would strengthen Walgreens's existing business by increasing the company's market position and therefore bargaining power with drug companies. In light of

Jonathan Weiss/Shutterstock

these advantages, Walgreens moved quickly to partner with and later acquire Alliance Boots and merged both companies in 2014 to become Walgreens Boots Alliance. Walgreens Boots Alliance, Inc. is now one of the world's largest drug purchasers, with approximately 13,000 locations in the United States, Europe, and Latin America. The vast network of store locations enables Walgreens Boots Alliance to negotiate from a strong position with drug companies and other suppliers to realize economies of scale in its current businesses.

The market has thus far responded favorably to the merger. Walgreens Boots Alliance's stock has more than doubled in value since the first news of the partnership. However, the company is still struggling to integrate and faces new risks such as currency fluctuation in its new combined position. Yet as the pharmaceutical industry continues to consolidate, Walgreens is in an undoubtedly stronger position to continue to grow in the future thanks to its strategic international acquisition.

Note: Developed with Katherine Coster.

Sources: Company 10-K Form, 2015, **investor.walgreensbootsalliance.com/secfiling.cfm?filingID=1140361-15-38791&CIK=1618921;** L. Capron and W. Mitchell, "When to Change a Winning Strategy," *Harvard Business Review,* July 25, 2012, **hbr.org/2012/07/when-to-change-a-winning-strat;** T. Martin and R. Dezember, "Walgreen Spends $6.7 Billion on Alliance Boots Stake," *The Wall Street Journal,* June 20, 2012.

The Risks of Strategic Alliances with Foreign Partners Alliances and joint ventures with foreign partners have their pitfalls, however. Sometimes a local partner's knowledge and expertise turns out to be less valuable than expected (because its knowledge is rendered obsolete by fast-changing market conditions or because its operating practices are archaic). Cross-border allies typically must overcome language and cultural barriers and figure out how to deal with diverse (or conflicting) operating practices. The transaction costs of working out a mutually agreeable arrangement and monitoring partner compliance with the terms of the arrangement can be high. The communication, trust building, and coordination costs are not trivial in terms of management time.[10] Often, partners soon discover they have conflicting objectives and strategies, deep differences of opinion about how to proceed, or important differences in corporate values and ethical standards. Tensions build, working relationships cool, and the hoped-for benefits never materialize.[11] It is not unusual for there to be little personal chemistry among some of the key people on whom the success or failure of the alliance depends—the rapport such personnel need to work well together may never emerge. And even if allies are able to develop productive personal relationships, they can still have trouble reaching mutually agreeable ways to deal with key issues or launching new initiatives fast enough to stay abreast of rapid advances in technology or shifting market conditions.

One worrisome problem with alliances or joint ventures is that a firm may risk losing some of its competitive advantage if an alliance partner is given full access to its proprietary technological expertise or other competitively valuable capabilities. There is a natural tendency for allies to struggle to collaborate effectively in competitively sensitive areas, thus spawning suspicions on both sides about forthright exchanges of information and expertise. It requires many meetings of many people working in good faith over a period of time to iron out what is to be shared, what is to remain proprietary, and how the cooperative arrangements will work.

Even if the alliance proves to be a win–win proposition for both parties, there is the danger of becoming overly dependent on foreign partners for essential expertise and competitive capabilities. Companies aiming for global market leadership need to develop their own resources and capabilities in order to be masters of their destiny. Frequently, experienced international companies operating in 50 or more countries across the world find less need for entering into cross-border alliances than do companies in the early stages of globalizing their operations.[12] Companies with global operations make it a point to develop senior managers who understand how "the system" works in different countries, plus they can avail themselves of local managerial talent and know-how by simply hiring experienced local managers and thereby detouring the hazards of collaborative alliances with local companies. One of the lessons about cross-border partnerships is that they are more effective in helping a company establish a beachhead of new opportunity in world markets than they are in enabling a company to achieve and sustain global market leadership.

CORE CONCEPT

A **multinational enterprise** (MNE) is a company that produces goods or offers services in multiple countries.

CORE CONCEPT

An **international strategy** is a strategy for competing in two or more countries simultaneously.

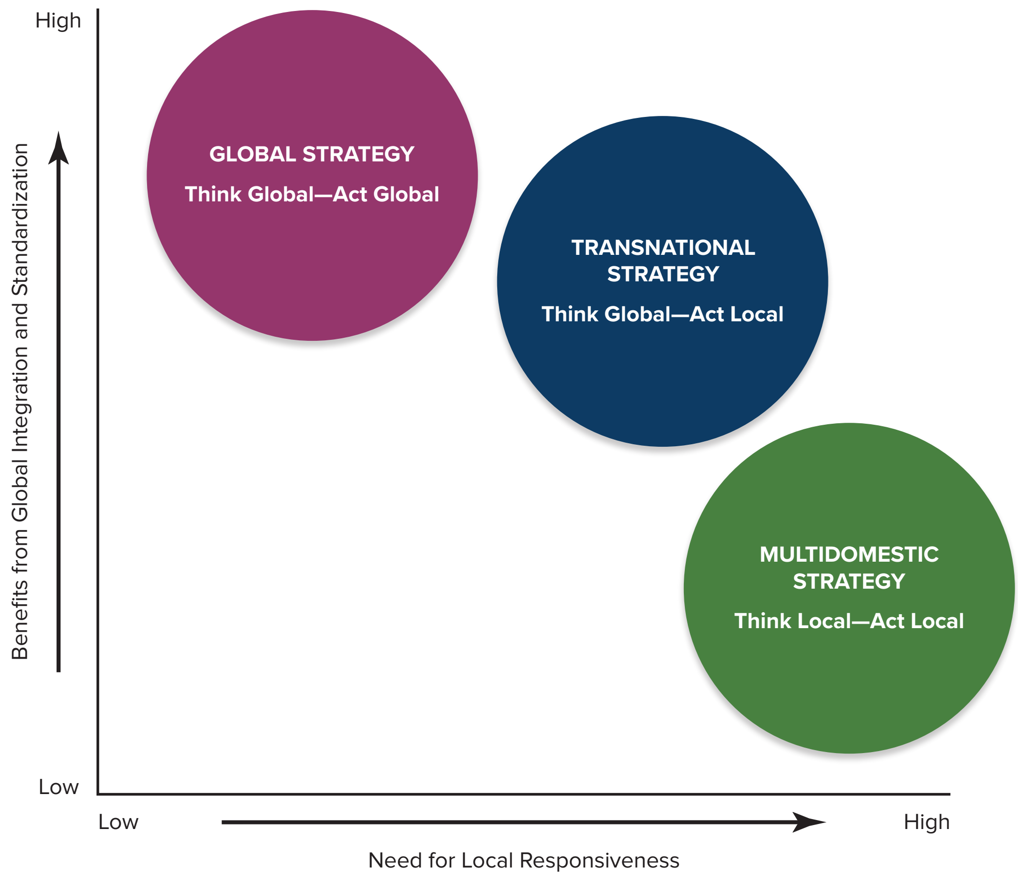
INTERNATIONAL STRATEGY: THE THREE MAIN APPROACHES

LO 7-4

Identify the three main strategic approaches for competing internationally.

Firms that produce goods or offer services in multiple countries are commonly referred to as **multinational enterprises (MNEs)** or multinational corporations (MNCs). Broadly speaking, an MNE's **international strategy** is simply its strategy for competing in two or more countries simultaneously. Typically, a company will start to compete internationally by entering one or perhaps a select few foreign markets—selling its products or services in countries where there is a ready market for them. But as it expands further internationally, it will have to confront head-on two conflicting pressures: the demand for responsiveness to local needs versus the prospect of efficiency gains from offering a standardized product globally. Deciding on the competitive approach to best

FIGURE 7.2 Three Approaches for Competing Internationally



address these competing pressures is perhaps the foremost strategic issue that must be addressed when a company is operating in two or more foreign markets.[13] Figure 7.2 shows a company's three options for resolving this issue: choosing a *multidomestic, global, or transnational* strategy.

Multidomestic Strategies—A "Think-Local, Act-Local" Approach

A **multidomestic strategy** is one in which a company varies its product offering and competitive approach from country to country in an effort to meet differing buyer needs and to address divergent local-market conditions. It involves having plants produce different product versions for different local markets and adapting marketing and distribution to fit local customs, cultures, regulations, and market requirements. In the food products industry, it is common for companies to vary the ingredients in their products and sell the localized versions under local brand names to cater to country-specific tastes and eating preferences. Government requirements for gasoline additives that help reduce carbon monoxide, smog, and other emissions are almost never the same from country to country. BP utilizes

CORE CONCEPT

A **multidomestic strategy** is one in which a company varies its product offering and competitive approach from country to country in an effort to be responsive to differing buyer preferences and market conditions. It is a **think-local, act-local** type of international strategy, facilitated by decision making decentralized to the local level.

localized strategies in its gasoline and service station business segment because of these cross-country formulation differences and because of customer familiarity with local brand names. For example, the company markets gasoline in the United States under its BP and Arco brands, but markets gasoline in Germany, Belgium, Poland, Hungary, and the Czech Republic under the Aral brand. Companies in the food products industry often vary the ingredients in their products and sell the localized versions under local brand names to cater to country-specific tastes and eating preferences.

In essence, a multidomestic strategy represents a **think-local, act-local** approach to international strategy. A think-local, act-local approach to strategy making is most appropriate when the need for local responsiveness is high due to significant cross-country differences in demographic, cultural, and market conditions and when the potential for efficiency gains from standardization is limited, as depicted in Figure 7.2. A think-local, act-local approach is possible only when decision making is decentralized, giving local managers considerable latitude for crafting and executing strategies for the country markets they are responsible for. Giving local managers decision-making authority allows them to address specific market needs and respond swiftly to local changes in demand. It also enables them to focus their competitive efforts, stake out attractive market positions vis-à-vis local competitors, react to rivals' moves in a timely fashion, and target new opportunities as they emerge.[14]

Despite their obvious benefits, think-local, act-local strategies have three big drawbacks:

1. They hinder transfer of a company's capabilities, knowledge, and other resources across country boundaries, since the company's efforts are not integrated or coordinated across country boundaries. This can make the company less innovative overall.
2. They raise production and distribution costs due to the greater variety of designs and components, shorter production runs for each product version, and complications of added inventory handling and distribution logistics.
3. They are not conducive to building a single, worldwide competitive advantage. When a company's competitive approach and product offering vary from country to country, the nature and size of any resulting competitive edge also tends to vary. At the most, multidomestic strategies are capable of producing a group of local competitive advantages of varying types and degrees of strength.

Global Strategies—A "Think-Global, Act-Global" Approach

A **global strategy** contrasts sharply with a multidomestic strategy in that it takes a standardized, globally integrated approach to producing, packaging, selling, and delivering the company's products and services worldwide. Companies employing a global strategy sell the same products under the same brand names everywhere, utilize much the same distribution channels in all countries, and compete on the basis of the same capabilities and marketing approaches worldwide. Although the company's strategy or product offering may be adapted in minor ways to accommodate specific situations in a few host countries, the company's fundamental competitive approach (low cost, differentiation, best cost, or focused) remains very much intact worldwide and local managers stick close to the global strategy.

CORE CONCEPT

A **global strategy** is one in which a company employs the same basic competitive approach in all countries where it operates, sells standardized products globally, strives to build global brands, and coordinates its actions worldwide with strong headquarters control. It represents a **think-global, act-global** approach.

A **think-global, act-global** approach prompts company managers to integrate and coordinate the company's strategic moves worldwide and to expand into most, if not all, nations where there is significant buyer demand. It puts considerable strategic emphasis on building a *global* brand name and aggressively pursuing opportunities to transfer ideas, new products, and capabilities from one country to another. Global strategies are characterized by relatively centralized value chain activities, such as production and distribution. While there may be more than one manufacturing plant and distribution center to minimize transportation costs, for example, they tend to be few in number. Achieving the efficiency potential of a global strategy requires that resources and best practices be shared, value chain activities be integrated, and capabilities be transferred from one location to another as they are developed. These objectives are best facilitated through centralized decision making and strong headquarters control.

Because a global strategy cannot accommodate varying local needs, it is an appropriate strategic choice when there are pronounced efficiency benefits from standardization and when buyer needs are relatively homogeneous across countries and regions. A globally standardized and integrated approach is especially beneficial when high volumes significantly lower costs due to economies of scale or added experience (moving the company further down a learning curve). It can also be advantageous if it allows the firm to replicate a successful business model on a global basis efficiently or engage in higher levels of R&D by spreading the fixed costs and risks over a higher-volume output. It is a fitting response to industry conditions marked by global competition.

Consumer electronics companies such as Apple, Nokia, and Motorola Mobility tend to employ global strategies. The development of universal standards in technology is one factor supporting the use of global strategies. So is the rise of global accounting and financial reporting standards. Whenever country-to-country differences are small enough to be accommodated within the framework of a global strategy, a global strategy is preferable because a company can more readily unify its operations and focus on establishing a brand image and reputation that are uniform from country to country. Moreover, with a global strategy a company is better able to focus its full resources on securing a sustainable low-cost or differentiation-based competitive advantage over both domestic rivals and global rivals.

There are, however, several drawbacks to global strategies: (1) They do not enable firms to address local needs as precisely as locally based rivals can; (2) they are less responsive to changes in local market conditions, in the form of either new opportunities or competitive threats; (3) they raise transportation costs and may involve higher tariffs; and (4) they involve higher coordination costs due to the more complex task of managing a globally integrated enterprise.

Transnational Strategies—A "Think-Global, Act-Local" Approach

A **transnational strategy** (sometimes called *glocalization*) incorporates elements of both a globalized and a localized approach to strategy making. This type of middle-ground strategy is called for when there are relatively high needs for local responsiveness as well as appreciable benefits to be realized from standardization, as Figure 7.2 suggests. A transnational strategy encourages a company to use a **think-global, act-local** approach to balance these competing objectives.

CORE CONCEPT

transnational strategy is a **think-global, act-local** approach that incorporates elements of both multidomestic and global strategies.

Often, companies implement a transnational strategy with mass-customization techniques that enable them to address local preferences in an efficient, semi-standardized manner. McDonald's, KFC, and Starbucks have discovered ways to customize their menu offerings in various countries without compromising costs, product quality, and operating effectiveness. Unilever is responsive to local market needs regarding its consumer products, while realizing global economies of scale in certain functions. Otis Elevator found that a transnational strategy delivers better results than a global strategy when it is competing in countries like China, where local needs are highly differentiated. By switching from its customary single-brand approach to a multi-brand strategy aimed at serving different segments of the market, Otis was able to double its market share in China and increased its revenues sixfold over a nine-year period.[15]

As a rule, most companies that operate internationally endeavor to employ as global a strategy as customer needs and market conditions permit. Electronic Arts (EA) has two major design studios—one in Vancouver, British Columbia, and one in Los Angeles—and smaller design studios in locations including San Francisco, Orlando, London, and Tokyo. This dispersion of design studios helps EA design games that are specific to different cultures—for example, the London studio took the lead in designing the popular FIFA Soccer game to suit European tastes and to replicate the stadiums, signage, and team rosters; the U.S. studio took the lead in designing games involving NFL football, NBA basketball, and NASCAR racing.

A transnational strategy is far more conducive than other strategies to transferring and leveraging subsidiary skills and capabilities. But, like other approaches to competing internationally, transnational strategies also have significant drawbacks:

1. They are the most difficult of all international strategies to implement due to the added complexity of varying the elements of the strategy to situational conditions.
2. They place large demands on the organization due to the need to pursue conflicting objectives simultaneously.
3. Implementing the strategy is likely to be a costly and time-consuming enterprise, with an uncertain outcome.

Illustration Capsule 7.2 explains how Four Seasons Hotels has been able to compete successfully on the basis of a transnational strategy.

Table 7.1 provides a summary of the pluses and minuses of the three approaches to competing internationally.

TABLE 7.1 Advantages and Disadvantages of Multidomestic, Global, and Transnational Strategies

	Advantages	Disadvantages
Multidomestic (think local, act local)	• Can meet the specific needs of each market more precisely • Can respond more swiftly to localized changes in demand • Can target reactions to the moves of local rivals • Can respond more quickly to local opportunities and threats	• Hinders resource and capability sharing or cross-market transfers • Has higher production and distribution costs • Is not conducive to a worldwide competitive advantage
Global (think global, act global)	• Has lower costs due to scale and scope economies • Can lead to greater efficiencies due to the ability to transfer best practices across markets • Increases innovation from knowledge sharing and capability transfer • Offers the benefit of a global brand and reputation	• Cannot address local needs precisely • Is less responsive to changes in local market conditions • Involves higher transportation costs and tariffs • Has higher coordination and integration costs
Transnational (think global, act local)	• Offers the benefits of both local responsiveness and global integration • Enables the transfer and sharing of resources and capabilities across borders • Provides the benefits of flexible coordination	• Is more complex and harder to implement • Entails conflicting goals, which may be difficult to reconcile and require trade-offs • Involves more costly and time-consuming implementation

ILLUSTRATION CAPSULE 7.2

Four Seasons Hotels: Local Character, Global Service

Four Seasons Hotels is a Toronto, Canada–based manager of luxury hotel properties. With more than 100 properties located in many of the world's most popular tourist destinations and business centers, Four Seasons commands a following of many of the world's most discerning travelers. In contrast to its key competitor, Ritz-Carlton, which strives to create one uniform experience globally, Four Seasons Hotels has gained market share by deftly combining local architectural and cultural experiences with globally consistent luxury service.

When moving into a new market, Four Seasons always seeks out a local capital partner. The understanding of local custom and business relationships this financier brings is critical to the process of developing a new Four Seasons hotel. Four Seasons also insists on hiring a local architect and design consultant for each property, as opposed to using architects or designers it's worked with in other locations. While this can be a challenge, particularly in emerging markets, Four Seasons has found it is worth it in the long run to have a truly local team.

The specific layout and programming of each hotel is also unique. For instance, when Four Seasons opened its hotel in Mumbai, India, it prioritized space for large banquet halls to target the Indian wedding market. In India, weddings often draw guests numbering in the thousands. When moving into the Middle East, Four Seasons designed its hotels with separate prayer rooms for men and women. In Bali, where destination weddings are common, the hotel employs a "weather shaman" who, for some guests, provides reassurance that the weather will cooperate for their special day. In all cases, the objective is to provide a truly local experience.

When staffing its hotels, Four Seasons seeks to strike a fine balance between employing locals who have an innate understanding of the local culture alongside expatriate staff or "culture carriers" who understand the DNA of Four Seasons. It also uses global systems to track customer preferences and employs globally consistent service standards. Four Seasons claims that its guests experience the same high level of service globally but that no two experiences are the same.

Chris Lawrence/Alamy Stock Photo

While it is much more expensive and time-consuming to design unique architectural and programming experiences, doing so is a strategic trade-off Four Seasons has made to achieve the local experience demanded by its high-level clientele. Likewise, it has recognized that maintaining globally consistent operation processes and service standards is important too. Four Seasons has struck the right balance between thinking globally and acting locally—the marker of a truly transnational strategy. As a result, the company has been rewarded with an international reputation for superior service and a leading market share in the luxury hospitality segment.

Note: Developed with Brian R. McKenzie.

Sources: Four Seasons annual report and corporate website; interview with Scott Woroch, executive vice president of development, Four Seasons Hotels, February 22, 2014.

INTERNATIONAL OPERATIONS AND THE QUEST FOR COMPETITIVE ADVANTAGE

LO 7-5

Explain how multinational enterprises (MNEs) are able to use international operations to improve overall competitiveness.

There are three important ways in which a firm can gain competitive advantage (or offset domestic disadvantages) by expanding outside its domestic market. First, it can use location to lower costs or achieve greater product differentiation. Second, it can transfer competitively valuable resources and capabilities from one country to another or share them across international borders to extend its competitive advantages. And third, it can benefit from cross-border coordination opportunities that are not open to domestic-only competitors.

Using Location to Build Competitive Advantage

To use location to build competitive advantage, a company must consider two issues: (1) whether or not to concentrate some of the activities it performs in only a few select countries of those in which they operate and if so (2) in which countries to locate particular activities.

Companies that compete internationally can pursue competitive advantage in world markets by locating their value chain activities in whatever nations prove most advantageous.

When to Concentrate Activities in a Few Locations It is advantageous for a company to concentrate its activities in a limited number of locations when

- *The costs of manufacturing or other activities are significantly lower in some geographic locations than in others.* For example, much of the world's athletic footwear is manufactured in Asia (China, Vietnam, India, and Indonesia) because of low labor costs; much of the production of circuit boards for PCs is located in Taiwan because of both low costs and the high-caliber technical skills of the Taiwanese labor force.
- *Significant scale economies exist in production or distribution.* The presence of significant economies of scale in components production or final assembly means that a company can gain major cost savings from operating a few super-efficient plants as opposed to a host of small plants scattered across the world. Samsung, for example, concentrates its OLED and QLED TV production in just three countries (South Korea, China, and the United States) to gain a low-cost advantage based on scale economies. Achieving low-cost leadership status often requires a company to have the largest worldwide manufacturing share (as distinct from brand share or market share), with production centralized in one or a few giant plants. Some companies even use such plants to manufacture units sold under the brand names of rivals to further boost production-related scale economies. Likewise, a company may be able to reduce its distribution costs by establishing large-scale distribution centers to serve major geographic regions of the world market (e.g., North America, Latin America, Europe and the Middle East, and the Asia-Pacific region).
- *Sizable learning and experience benefits are associated with performing an activity.* In some industries, learning-curve effects can allow a manufacturer to lower unit costs, boost quality, or master a new technology *more quickly* by concentrating production in a few locations. The key to riding down the learning curve is to concentrate production in a few locations to increase the cumulative volume at a plant (and thus the experience of the plant's workforce) as rapidly as possible.
- *Certain locations have superior resources, allow better coordination of related activities, or offer other valuable advantages.* Companies often locate a research unit or a sophisticated production facility in a particular country to take advantage of its pool

of technically trained personnel. Adidas located its first robotic "speedfactory" in Germany to benefit from its superior technological resources and to allow greater oversight from the company's headquarters (which are in Germany). Where just-in-time inventory practices yield big cost savings and/or where an assembly firm has long-term partnering arrangements with its key suppliers, parts manufacturing plants may be clustered around final-assembly plants. A customer service center or sales office may be opened in a particular country to help cultivate strong relationships with pivotal customers located nearby. Airbus established a major assembly site for their commercial aircraft in Alabama since the United States is a major market.

When to Disperse Activities across Many Locations In some instances, dispersing activities across locations is more advantageous than concentrating them. Buyer-related activities—such as distribution, marketing, and after-sale service—usually must take place close to buyers. This makes it necessary to physically locate the capability to perform such activities in every country or region where a firm has major customers. For example, firms that make mining and oil-drilling equipment maintain operations in many locations around the world to support customers' needs for speedy equipment repair and technical assistance. Large public accounting firms have offices in numerous countries to serve the foreign operations of their international corporate clients. Dispersing activities to many locations is also competitively important when high transportation costs, diseconomies of large size, and trade barriers make it too expensive to operate from a central location. Many companies distribute their products from multiple locations to shorten delivery times to customers. In addition, dispersing activities helps hedge against the risks of fluctuating exchange rates, supply interruptions (due to strikes, natural disasters, or transportation delays), and adverse political developments. Such risks are usually greater when activities are concentrated in a single location.

Even though global firms have strong reason to disperse buyer-related activities to many international locations, such activities as materials procurement, parts manufacture, finished-goods assembly, technology research, and new product development can frequently be decoupled from buyer locations and performed wherever advantage lies. Components can be made in Mexico; technology research done in Frankfurt; new products developed and tested in Phoenix; and assembly plants located in Spain, Brazil, Taiwan, or South Carolina, for example. Capital can be raised wherever it is available on the best terms.

Sharing and Transferring Resources and Capabilities across Borders to Build Competitive Advantage

When a company has competitively valuable resources and capabilities, it may be able to leverage them further by expanding internationally. If its resources retain their value in foreign contexts, then entering new foreign markets can extend the company's resource-based competitive advantage over a broader domain. For example, companies like Prada, Burberry, and Rolex have utilized their powerful brand names to extend their differentiation-based competitive advantages into markets far beyond their home-country origins. In each of these cases, the luxury brand name represents a valuable competitive asset that can readily be *shared* by all of the company's international stores, enabling them to attract buyers and gain a higher degree of market penetration over a wider geographic area than would otherwise be possible.

Another way for a company to extend its competitive advantage internationally is to *transfer* technological know-how or other important resources and capabilities from its operations in one country to its operations in other countries. For instance, if a company discovers ways to assemble a product faster and more cost-effectively at one plant, then that know-how can be transferred to its assembly plants in other countries. Whirlpool's efforts to link its product R&D and manufacturing operations in North America, Latin America, Europe, and Asia allowed it to accelerate the discovery of innovative appliance features, coordinate the introduction of these features in the appliance products marketed in different countries, and create a cost-efficient worldwide supply chain. Whirlpool's conscious efforts to integrate and coordinate its various operations around the world have helped it achieve operational excellence and speed product innovations to market. Walmart is expanding its international operations with a strategy that involves transferring its considerable resource capabilities in distribution and discount retailing to its retail units in 24 foreign countries.

Cross-border sharing or transferring resources and capabilities provides a cost-effective way for a company to leverage its core competencies more fully and extend its competitive advantages into a wider array of geographic markets. The cost of sharing or transferring already developed resources and capabilities across country borders is low in comparison to the time and considerable expense it takes to create them. Moreover, deploying them abroad spreads the fixed development costs over a greater volume of unit sales, thus contributing to low unit costs and a potential cost-based competitive advantage in recently entered geographic markets. Even if the shared or transferred resources or capabilities have to be adapted to local-market conditions, this can usually be done at low additional cost.

Consider the case of Walt Disney's theme parks as an example. The success of the theme parks in the United States derives in part from core resources such as the Disney brand name and characters like Mickey Mouse that have universal appeal and worldwide recognition. These resources can be freely shared with new theme parks as Disney expands internationally. Disney can also replicate its theme parks in new countries cost-effectively since it has already borne the costs of developing its core resources, park attractions, basic park design, and operating capabilities. The cost of replicating its theme parks abroad is relatively low, even if the parks need to be adapted to a variety of local country conditions. Thus, in establishing Disney parks in Tokyo, Paris, Hong Kong, and Shanghai, Disney has been able to leverage the differentiation advantage conferred by resources such as the Disney name and the park attractions. And by moving into new foreign markets, it has augmented its competitive advantage further through the efficiency gains that come from cross-border resource sharing and low-cost capability transfer and business model replication.

Sharing and transferring resources and capabilities across country borders may also contribute to the development of broader or deeper competencies and capabilities—helping a company achieve *dominating depth* in some competitively valuable area. For example, the reputation for quality that Honda established worldwide began in motorcycles but enabled the company to command a position in both automobiles and outdoor power equipment in multiple-country markets. A one-country customer base is often too small to support the resource buildup needed to achieve such depth; this is particularly true in a developing or protected market, where competitively powerful resources are not required. By deploying capabilities across a larger international domain, a company can gain the experience needed to upgrade them to a higher performance standard. And by facing a more challenging set of international competitors, a company may be spurred to develop a stronger set of competitive capabilities. Moreover, by entering international markets, firms may be able to augment their capability set by learning from international rivals, cooperative partners, or acquisition targets.

However, cross-border resource sharing and transfers of capabilities are not guaranteed recipes for competitive success. For example, whether a resource or capability can confer a competitive advantage abroad depends on the conditions of rivalry in each particular market. If the rivals in a foreign-country market have superior resources and capabilities, then an entering firm may find itself at a competitive disadvantage even if it has a resource-based advantage domestically and can transfer the resources at low cost. In addition, since lifestyles and buying habits differ internationally, resources and capabilities that are valuable in one country may not have value in another. Sometimes a popular or well-regarded brand in one country turns out to have little competitive clout against local brands in other countries.

Benefiting from Cross-Border Coordination

Multinational enterprises have another source of competitive advantage relative to their purely domestic rivals: They are able to benefit from coordinating activities across different countries' domains.[16] For example, an international manufacturer can shift production from a plant in one country to a plant in another to take advantage of exchange rate fluctuations, to cope with components shortages, or to profit from changing wage rates or energy costs. Production schedules can be coordinated worldwide; shipments can be diverted from one distribution center to another if sales rise unexpectedly in one place and fall in another. By coordinating their activities, international companies may also be able to enhance their leverage with host-country governments or respond adaptively to changes in tariffs and quotas. Efficiencies can also be achieved by shifting workloads from where they are unusually heavy to locations where personnel are underutilized.

CROSS-BORDER STRATEGIC MOVES

While international competitors can employ any of the offensive and defensive moves discussed in Chapter 6, there are two types of strategic moves that are particularly suited for companies competing internationally. The first is an offensive move that an international competitor is uniquely positioned to make, due to the fact that it may have a strong or protected market position in more than one country. The second type of move is a type of defensive action involving multiple markets.

Waging a Strategic Offensive

One advantage to being an international competitor is the possibility of having more than one significant and possibly protected source of profits. This may provide the company with the financial strength to engage in strategic offensives in selected country markets. The added financial capability afforded by multiple profit sources gives an international competitor the financial strength to wage an offensive campaign against a domestic competitor whose only source of profit is its home market. The international company has the flexibility of lowballing its prices or launching high-cost marketing campaigns in the domestic company's home market and grabbing market share at the domestic company's expense. Razor-thin margins or even losses in these markets can

CORE CONCEPT

Cross-market subsidization—supporting competitive offensives in one market with resources and profits diverted from operations in another market—can be a powerful competitive weapon.

A company is said to be *dumping* when it sells its goods in foreign markets at prices that are
1. well below the prices at which it normally sells them in its home market or
2. well below its full costs per unit.

be subsidized with the healthy profits earned in its markets abroad—a practice called **cross-market subsidization.** The international company can adjust the depth of its price cutting to move in and capture market share quickly, or it can shave prices slightly to make gradual market inroads (perhaps over a decade or more) so as not to threaten domestic firms precipitously and trigger protectionist government actions. If the domestic company retaliates with matching price cuts or increased marketing expenses, it thereby exposes its entire revenue stream and profit base to erosion; its profits can be squeezed substantially and its competitive strength sapped, even if it is the domestic market leader.

When taken to the extreme, cut-rate pricing attacks by international competitors may draw charges of unfair "dumping." A company is said to be *dumping* when it sells its goods in foreign markets at prices that are (1) well below the prices at which it normally sells them in its home market or (2) well below its full costs per unit. Almost all governments can be expected to retaliate against perceived dumping practices by imposing special tariffs on goods being imported from the countries of the guilty companies. Indeed, as the trade among nations has mushroomed over the past 20 years, most governments have joined the World Trade Organization (WTO), which promotes fair trade practices among nations and actively polices dumping. Companies deemed guilty of dumping frequently come under pressure from their own government to cease and desist, especially if the tariffs adversely affect innocent companies based in the same country or if the advent of special tariffs raises the specter of an international trade war.

Defending against International Rivals

Cross-border tactics involving multiple country markets can also be used as a means of defending against the strategic moves of rivals with multiple profitable markets of their own. If a company finds itself under competitive attack by an international rival in one country market, one way to respond is to conduct a counterattack against the rival in one of its key markets in a different country—preferably where the rival is least protected and has the most to lose. This is a possible option when rivals compete against one another in much the same markets around the world and engage in *multimarket competition.*

Multimarket competition refers to a situation where rivals compete against one another in many of the same markets.

For companies with at least one major market, having a presence in a rival's key markets can be enough to deter the rival from making aggressive attacks. The reason for this is that the combination of market presence in the rival's key markets and a highly profitable market elsewhere can send a signal to the rival that the company could quickly ramp up production (funded by the profit center) to mount a competitive counterattack if the rival attacks one of the company's key markets.

CORE CONCEPT

When the same companies compete against one another in multiple geographic markets, the threat of cross-border counterattacks may be enough to encourage **mutual restraint** among international rivals.

When international rivals compete against one another in multiple-country markets, this type of deterrence effect can restrain them from taking aggressive action against one another, due to the fear of a retaliatory response that might escalate the battle into a cross-border competitive war. **Mutual restraint** of this sort tends to stabilize the competitive position of multimarket rivals against one another. And while it may prevent each firm from making any major market share gains at the expense of its rival, it also protects against costly competitive battles that would be likely to erode the profitability of both companies without any compensating gain.

STRATEGIES FOR COMPETING IN THE MARKETS OF DEVELOPING COUNTRIES

LO 7-6

Recognize the unique characteristics of competing in developing-country markets.

Companies racing for global leadership have to consider competing in developing-economy markets like China, India, Brazil, Indonesia, Thailand, Poland, Mexico, and Vietnam—countries where the business risks are considerable but where the opportunities for growth are huge, especially as their economies develop and living standards climb toward levels in the industrialized world.[17] In today's world, a company that aspires to international market leadership (or to sustained rapid growth) cannot ignore the market opportunities or the base of technical and managerial talent such countries offer. For example, in 2023, China was the world's second-largest economy (behind the United States), based on the purchasing power of its population of over 1.4 billion people. China's growth in demand for consumer goods has made it the fifth-largest market for luxury goods, with sales greater than those in developed markets such as Germany, Spain, and the United Kingdom. Thus, no company that aspires to global market leadership can afford to ignore the strategic importance of establishing competitive market positions in China, India, other parts of the Asia-Pacific region, Latin America, and eastern Europe.

Tailoring products to fit market conditions in developing countries, however, often involves more than making minor product changes and becoming more familiar with local cultures. McDonald's has had to offer vegetable burgers in parts of Asia and to rethink its prices, which are often high by local standards and affordable only by the well-to-do. Kellogg has struggled to introduce its cereals successfully because consumers in many less-developed countries do not eat cereal for breakfast. Single-serving packages of detergents, shampoos, pickles, cough syrup, and cooking oils are very popular in India because they allow buyers to conserve cash by purchasing only what they need immediately. Thus, many companies find that trying to employ a strategy akin to that used in the markets of developed countries is hazardous.[18] Experimenting with some, perhaps many, local twists is usually necessary to find a strategy combination that works.

Strategy Options for Competing in Developing-Country Markets

There are several options for tailoring a company's strategy to fit the sometimes unusual or challenging circumstances presented in developing-country markets:

- *Prepare to compete on the basis of low price.* Consumers in developing markets are often highly focused on price, which can give low-cost local competitors the edge unless a company can find ways to attract buyers with bargain prices as well as better products. For example, in order to enter the market for laundry detergents in India, Unilever had to develop a low-cost detergent (named Wheel), construct new low-cost production facilities, package the detergent in single-use amounts so that it could be sold at a very low unit price, distribute the product to local merchants by handcarts, and craft an economical marketing campaign that included painted signs on buildings and demonstrations near stores. The new brand quickly captured $100 million in sales and was one of the top two brands of laundry detergent in India by 2021. Unilever replicated the strategy in India with low-priced packets of shampoos and deodorants and in South America with a detergent brand-named Ala.

- *Modify aspects of the company's business model to accommodate the unique local circumstances of developing countries.* For instance, Honeywell had sold industrial products and services for more than 100 years outside the United States and Europe using a foreign subsidiary model that focused international activities on sales only. When Honeywell entered China in 2004, it discovered that industrial customers in that country considered how many key jobs foreign companies created in China, in addition to the quality and price of the product or service when making purchasing decisions. Honeywell added about 150 engineers, strategists, and marketers in China in that year, to demonstrate its commitment to bolstering the Chinese economy and by 2021 was employing more than 13,000 people in 30 Chinese cities. As a result of this strategy, Honeywell's sales in China increased from $360 million in 2004 to more than $6 billion in 2021, accounting for one-sixth of its global revenue.
- *Try to change the local market to better match the way the company does business elsewhere.* An international company often has enough market clout to drive major changes in the way a local country market operates. When Japan's Suzuki entered India, it triggered a quality revolution among Indian auto parts manufacturers. Local component suppliers teamed up with Suzuki's vendors in Japan and worked with Japanese experts to produce higher-quality products. Over the next two decades, Indian companies became proficient in making top-notch components for vehicles, won more prizes for quality than companies in any country other than Japan, and broke into the global market as suppliers to many automakers in Asia and other parts of the world. Mahindra and Mahindra, one of India's premier automobile manufacturers, has been recognized by a number of organizations for its product quality. Among its most noteworthy awards was its number-one ranking by J.D. Power Asia Pacific for new-vehicle overall quality.
- *Stay away from developing markets where it is impractical or uneconomical to modify the company's business model to accommodate local circumstances.* Home Depot expanded successfully into Mexico, but it has avoided entry into other developing countries because its value proposition of good quality, low prices, and attentive customer service relies on (1) good highways and logistical systems to minimize store inventory costs, (2) employee stock ownership to help motivate store personnel to provide good customer service, and (3) high labor costs for housing construction and home repairs that encourage homeowners to engage in do-it-yourself projects. Relying on these factors in North American markets has worked spectacularly for Home Depot, but the company found that it could not count on these factors in China, from which it withdrew in 2012.

Company experiences in entering developing markets like Brazil, Indonesia, India, and China indicate that profitability seldom comes quickly or easily. Building a market for the company's products can often turn into a long-term process that involves reeducation of consumers, sizable investments in advertising to alter tastes and buying habits, and upgrades of the local infrastructure (transportation systems, distribution channels, etc.). In such cases, a company must be patient, work within the system to improve the infrastructure, and lay the foundation for generating sizable revenues and profits once conditions are ripe for market takeoff.

Profitability in developing markets rarely comes quickly or easily—new entrants have to adapt their business models to local conditions, which may not always be possible.

DEFENDING AGAINST GLOBAL GIANTS: STRATEGIES FOR LOCAL COMPANIES IN DEVELOPING COUNTRIES

If opportunity-seeking, resource-rich international companies are looking to enter developing-country markets, what strategy options can local companies use to survive? As it turns out, the prospects for local companies facing global giants are by no means grim. Studies of local companies in developing markets have disclosed five strategies that have proved themselves in defending against globally competitive companies:[19]

1. *Develop business models that exploit shortcomings in local distribution networks or infrastructure.* In many instances, the extensive collection of resources possessed by the global giants is of little help in building a presence in developing markets. The lack of well-established local wholesaler and distributor networks, telecommunication systems, consumer banking, or media necessary for advertising makes it difficult for large internationals to migrate business models proved in developed markets to emerging markets. Emerging markets sometimes favor local companies whose managers are familiar with the local language and culture and are skilled in selecting large numbers of conscientious employees to carry out labor-intensive tasks. Shanda, a Chinese producer of massively multiplayer online role-playing games (MMORPGs), overcame China's lack of an established credit card network by selling prepaid access cards through local merchants. The company's focus on online games also protects it from shortcomings in China's software piracy laws. An India-based electronics company carved out a market niche for itself by developing an all-in-one business machine, designed especially for India's millions of small shopkeepers, that tolerates the country's frequent power outages.
2. *Utilize keen understanding of local customer needs and preferences to create customized products or services.* When developing-country markets are largely made up of customers with strong local needs, a good strategy option is to concentrate on customers who prefer a local touch and to accept the loss of the customers attracted to global brands.[20] A local company may be able to astutely exploit its local orientation—its familiarity with local preferences, its expertise in traditional products, and its long-standing customer relationships. A small Middle Eastern cell phone manufacturer competes successfully against industry giants Samsung, Apple, Nokia, and Motorola by selling a model designed especially for Muslims—it is loaded with the Koran, alerts people at prayer times, and is equipped with a compass that points them toward Mecca. Shenzhen-based Tencent has become the leader in instant messaging in China through its unique understanding of Chinese behavior and culture.
3. *Take advantage of aspects of the local workforce with which large international companies may be unfamiliar.* Local companies that lack the technological capabilities of foreign entrants may be able to rely on their better understanding of the local labor force to offset any disadvantage. Focus Media is China's largest outdoor advertising firm and has relied on low-cost labor to update its more than 170,000 LCD displays and billboards in over 90 cities in a low-tech manner, while

international companies operating in China use electronically networked screens that allow messages to be changed remotely. Focus uses an army of employees who ride to each display by bicycle to change advertisements with programming contained on a USB flash drive or DVD. Indian information technology firms such as Infosys Technologies and Satyam Computer Services have been able to keep their personnel costs lower than those of international competitors EDS and Accenture because of their familiarity with local labor markets. While the large internationals have focused recruiting efforts in urban centers like Bangalore and Delhi, driving up engineering and computer science salaries in such cities, local companies have shifted recruiting efforts to second-tier cities that are unfamiliar to foreign firms.

4. *Use acquisition and rapid-growth strategies to better defend against expansion-minded internationals.* With the growth potential of developing markets such as China, Indonesia, and Brazil obvious to the world, local companies must attempt to develop scale and upgrade their competitive capabilities as quickly as possible to defend against the stronger international's arsenal of resources. Most successful companies in developing markets have pursued mergers and acquisitions at a rapid-fire pace to build first a nationwide and then an international presence. Hindalco, India's largest aluminum producer, has followed just such a path to achieve its ambitions for global dominance. By acquiring companies in India first, it gained enough experience and confidence to eventually acquire much larger foreign companies with world-class capabilities.[21] When China began to liberalize its foreign trade policies, Lenovo (the Chinese PC maker) realized that its long-held position of market dominance in China could not withstand the onslaught of new international entrants such as Dell and HP. Its acquisition of IBM's PC business allowed Lenovo to gain rapid access to IBM's globally recognized PC brand, its R&D capability, and its existing distribution in developed countries. This has allowed Lenovo not only to hold its own against the incursion of global giants into its home market but also to expand into new markets around the world.[22]
5. *Transfer company expertise to cross-border markets and initiate actions to contend on an international level.* When a company from a developing country has resources and capabilities suitable for competing in other country markets, launching initiatives to transfer its expertise to foreign markets becomes a viable strategic option. Televisa, Mexico's largest media company, used its expertise in Spanish culture and linguistics to become the world's most prolific producer of Spanish-language soap operas. By continuing to upgrade its capabilities and learn from its experience in foreign markets, a company can sometimes transform itself into one capable of competing on a worldwide basis, as an emerging global giant. Sundaram Fasteners of India began its foray into foreign markets as a supplier of radiator caps to General Motors—an opportunity it pursued when GM first decided to outsource the production of this part. As a participant in GM's supplier network, the company learned about emerging technical standards, built its capabilities, and became one of the first Indian companies to achieve QS 9000 quality certification. With the expertise it gained and its recognition for meeting quality standards, Sundaram was then able to pursue opportunities to supply automotive parts in Japan and Europe.

Illustration Capsule 7.3 discusses the strategy behind the success of WeChat (China's most popular messenger app), in keeping out international social media rivals.

ILLUSTRATION CAPSULE 7.3

WeChat's Strategy for Defending against International Social Media Giants in China

WeChat, a Chinese social media and messenger app similar to WhatsApp, allows users to chat, post photos, shop online, and share information as well as music. It has continued to add new features, such as WeChat Games and WePay, which allow users to send money electronically, much like Venmo. The company now serves more than a billion active users, a testament to the success of its strategy.

WeChat has also had incredible success keeping out international rivals. Due to censorship and regulations in China, Chinese social media companies have an inherent advantage over foreign competitors. However, this is not why WeChat has become an indispensable part of Chinese life.

WeChat has been able to surpass international rivals because, by better understanding Chinese customer needs, it can anticipate their desires. WeChat added features that allow users to check traffic cameras during rush hour, purchase tickets to movies, and book doctor appointments all on the app. Booking appointments with doctors is a feature that is wildly popular with the Chinese customer base due to common scheduling difficulties. Essentially, WeChat created its own distribution network for sought after information and goods in busy Chinese cities.

WeChat also has an understanding of local customs that international rivals can't match. In order to promote WePay, WeChat created a Chinese New Year lottery-like promotion in which users could win virtual "red envelopes" on the app. Red envelopes of money are traditionally given on Chinese New Year as presents. WePay was able to grow users from 30 to 100 million in the month following the promotion due to the popularity of the New Year's feature. By

BigTunaOnline/Shutterstock

2023, over 900 million of WeChat's nearly 1.3 billion active users were also using WePay. WeChat continues to allow users to send red envelopes and has continued New Year's promotions in subsequent years with success. Even Chinese companies have been bested by WeChat. Rival founder of Alibaba, Jack Ma, admitted the promotion put WeChat ahead of his company, saying it was a "pearl harbor attack" on his company. Chinese tech experts noted that the promotion was Ma's nightmare because it pushed WeChat to the forefront of Chinese person-to-person payments.

WeChat's strategy of continually developing new features also keeps the competition at bay. As China's "App for Everything," it now permeates all walks of life in China in a way that will likely continue to keep foreign competitors out.

Note: Developed with Meaghan I. Haugh.

Sources: **https://www.statista.com/statistics/255778/number-of-active-wechat-messenger-accounts/**, accessed 9/29/23; Guilford, Gwynn. "WeChat's Little Red Envelopes Are Brilliant Marketing for Mobile Payments." *Quartz,* January 29, 2014; Pasternack, Alex. "How Social Cash Made WeChat the App for Everything," *Fast Company,* January 3, 2017; "WeChat's World," *The Economist,* August 6, 2016; Stanciu, Tudor. "Why WeChat City Services Is a Game-Changing Move for Smartphone Adoption," *TechCrunch,* April 24, 2015.

KEY POINTS

1. Competing in international markets allows a company to (1) gain access to new customers; (2) achieve lower costs through greater economies of scale, learning, and increased purchasing power; (3) gain access to low-cost inputs of production; (4) further exploit its core competencies; and (5) gain access to resources and capabilities located outside the company's domestic market.
2. Strategy making is more complex for five reasons: (1) Different countries have *home-country advantages* in different industries; (2) there are location-based advantages to performing different value chain activities in different parts of the world; (3) varying political and economic risks make the business climate of some countries more favorable than others; (4) companies face the risk of adverse shifts in exchange rates when operating in foreign countries; and (5) differences in buyer tastes and preferences present a conundrum concerning the trade-off between customizing and standardizing products and services.
3. The strategies of multinational enterprises (MNEs) are usually grounded in home-country advantages concerning demand conditions; factor conditions; related and supporting industries; and firm strategy, structure, and rivalry, as described by the Diamond of National Competitive Advantage framework.
4. There are five strategic options for entering foreign markets. These include maintaining a home-country production base and *exporting* goods to foreign markets, *licensing* foreign firms to produce and distribute the company's products abroad, employing a *franchising* strategy, establishing a foreign *subsidiary via an acquisition or greenfield venture,* and using *strategic alliances or other collaborative partnerships.*
5. A company must choose among three alternative approaches for competing internationally: (1) a *multidomestic strategy*—a *think-local, act-local* approach to crafting international strategy; (2) a *global strategy*—a *think-global, act-global* approach; and (3) a combination *think-global, act-local* approach, known as a *transnational strategy.* A multidomestic strategy (think local, act local) is appropriate for companies that must vary their product offerings and competitive approaches from country to country in order to accommodate different buyer preferences and market conditions. The global strategy (think global, act global) works best when there are substantial cost benefits to be gained from taking a standardized, globally integrated approach and there is little need for local responsiveness. A transnational strategy (think global, act local) is called for when there is a high need for local responsiveness as well as substantial benefits from taking a globally integrated approach. In this approach, a company strives to employ the same basic competitive strategy in all markets but still customizes its product offering and some aspect of its operations to fit local market circumstances.
6. There are three general ways in which a firm can gain competitive advantage (or offset domestic disadvantages) in international markets. One way involves locating various value chain activities among nations in a manner that lowers costs or achieves greater product differentiation. A second way draws on an international competitor's ability to extend its competitive advantage by cost-effectively sharing, replicating, or transferring its most valuable resources and capabilities across borders. A third looks for benefits from cross-border coordination that are unavailable to domestic-only competitors.
7. Two types of strategic moves are particularly suited for multinational enterprises. The first involves waging strategic offenses in international markets through

cross-subsidization—a practice of supporting competitive offensives in one market with resources and profits diverted from operations in another market. The second is a defensive move used to encourage *mutual restraint* among competitors when there is international *multimarket competition* by signaling that each company has the financial capability for mounting a strong counterattack if threatened. For companies with at least one highly profitable or well-defended market, having a presence in a rival's key markets can be enough to deter the rival from making aggressive attacks.

8. Companies racing for global leadership have to consider competing in developing markets like the BRIC countries—Brazil, Russia, India, and China—where the business risks are considerable but the opportunities for growth are huge. To succeed in these markets, companies often have to (1) compete on the basis of low price, (2) modify aspects of the company's business model to accommodate local circumstances, and/or (3) try to change the local market to better match the way the company does business elsewhere. Profitability is unlikely to come quickly or easily in developing markets, typically because of the investments needed to alter buying habits and tastes, the increased political and economic risk, and/or the need for infrastructure upgrades. And there may be times when a company should simply stay away from certain developing markets until conditions for entry are better suited to its business model and strategy.
9. Local companies in developing-country markets can seek to compete against large international companies by (1) developing business models that exploit shortcomings in local distribution networks or infrastructure, (2) utilizing a superior understanding of local customer needs and preferences or local relationships, (3) taking advantage of competitively important qualities of the local workforce with which large international companies may be unfamiliar, (4) using acquisition strategies and rapid-growth strategies to better defend against expansion-minded international companies, or (5) transferring company expertise to cross-border markets and initiating actions to compete on an international level.

ASSURANCE OF LEARNING EXERCISES

1. L'Oràal markets over 500 brands of products in all sectors of the beauty business in 150 countries. The company's international strategy involves manufacturing these products in 45 plants located around the world. L'Oràal's international strategy is discussed in its operations section of the company's website (**https://www.loreal.com/en/articles/operations/**) and in its press releases, annual reports, and presentations. Why has the company chosen to pursue a foreign subsidiary strategy? Are there strategic advantages to global sourcing and production in the cosmetics, fragrances, and hair care products industry relative to an export strategy? **LO 7-1, LO 7-3**
2. Alliances, joint ventures, and mergers with foreign companies are widely used as a means of entering foreign markets. Such arrangements have many purposes, including learning about unfamiliar environments, and the opportunity to access the complementary resources and capabilities of a foreign partner. Illustration Capsule 7.1 provides an example of how Walgreens used a strategy of entering foreign markets via alliance, followed by a merger with the same entity. What was this entry strategy designed to achieve, and why would this make sense for a company like Walgreens? McGraw Hill connect **LO 7-1, LO 7-3**

LO 7-2, LO 7-4

3. Assume you are in charge of developing the strategy for an international company selling products in some 50 different countries around the world. One of the issues you face is whether to employ a multidomestic strategy, a global strategy, or a transnational strategy.
   a. If your company's product is mobile phones, which of these strategies do you think it would make better strategic sense to employ? Why?
   b. If your company's product is dry soup mixes and canned soups, would a multidomestic strategy seem to be more advisable than a global strategy or a transnational strategy? Why or why not?
   c. If your company's product is large home appliances such as washing machines, ranges, ovens, and refrigerators, would it seem to make more sense to pursue a multidomestic strategy, a global strategy, or a transnational strategy? Why?

LO 7-5, LO 7-6

4. Telsa was the second largest seller of electric vehicles in China in 2022, with the Model 3 and Model Y being the second and third most purchased electric vehicles in that year. The company's strategy for competing in international markets is discussed in its annual reports, press releases, and investor presentations. How does the company use international operations to improve competitiveness in China?

EXERCISES FOR SIMULATION PARTICIPANTS

The following questions are for simulation participants whose companies operate in an international market arena. If your company competes only in a single country, then skip the questions in this section.

LO 7-2

1. To what extent, if any, have you and your co-managers adapted your company's strategy to take shifting exchange rates into account? In other words, have you undertaken any actions to try to minimize the impact of adverse shifts in exchange rates?

LO 7-2

2. To what extent, if any, have you and your co-managers adapted your company's strategy to take geographic differences in import tariffs or import duties into account?
3. What are the attributes of each of the following approaches to competing in international markets?
   - Multidomestic or think-local, act-local approach.
   - Global or think-global, act-global approach.
   - Transnational or think-global, act-local approach.

   Explain your answer and indicate two or three chief elements of your company's strategy for competing in two or more different geographic regions.

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chapter 8

Corporate Strategy

Diversification and the Multibusiness Company

Learning Objectives

After reading this chapter, you should be able to

LO 8-1 Explain when and how business diversification can enhance shareholder value.

LO 8-2 Describe how related diversification strategies can produce cross-business strategic fit capable of delivering competitive advantage.

LO 8-3 Identify the merits and risks of unrelated diversification strategies.

LO 8-4 Use the analytic tools for evaluating a company's diversification strategy.

LO 8-5 Understand the four main corporate strategy options a diversified company can employ to improve company performance.

Richard Schneider/Getty Images

The question of diversification – where and how to expand into new businesses - is the heart of corporate strategy.

Ron Adner—*Professor, Author, and Consultant*

Corporate diversification that exploits existing resources and capabilities in new markets or builds new core competencies is likely be a source of competitive advantage.

Asli M. Arikan—*Professor and Consultant*

Fit between a parent and its businesses is a two-edged sword: A good fit can create value; a bad one can destroy it.

Andrew Campbell, Michael Goold, and Marcus Alexander—*Academics, authors, and consultants*

This chapter moves up one level in the strategy-making hierarchy, from strategy making in a single-business enterprise to strategy making in a diversified, multibusiness enterprise. Because a diversified company is a collection of individual businesses, the strategy-making task is more complicated. In a one-business company, managers have to come up with a plan for competing successfully in only a single industry environment—the result is what Chapter 2 labeled as *business strategy* (or *business-level strategy*). But in a diversified company, the strategy-making challenge involves assessing multiple industry environments and developing a *set of business strategies,* one for each industry arena in which the diversified company operates. And top executives at a diversified company must still go one step further and devise a companywide (or *corporate*) strategy for improving the performance of the company's overall business lineup and for making a rational whole out of its diversified collection of individual businesses.

In the first part of this chapter, we describe what crafting a diversification strategy entails, when and why diversification makes good strategic sense, the various approaches to diversifying a company's business lineup, and the pros and cons of related versus unrelated diversification strategies. The second part of the chapter looks at how to evaluate the attractiveness of a diversified company's business lineup, how to decide whether it has a good diversification strategy, and the strategic options for improving a diversified company's future performance.

WHAT DOES CRAFTING A DIVERSIFICATION STRATEGY ENTAIL?

The task of crafting a diversified company's overall *corporate strategy* falls squarely in the lap of top-level executives and involves three distinct facets:

1. *Picking new industries to enter and deciding on the means of entry.* Pursuing a diversification strategy requires that management decide which new industries to enter and then, for each new industry, whether to enter by starting a new business from the ground up, by acquiring a company already in the target industry, or by forming a joint venture or strategic alliance with another company. The choice of industries depends upon on the strategic rationale (or justification) for diversifying and the type of diversification being pursued—important issues that we discuss more fully in sections to follow.
2. *Pursuing opportunities to leverage cross-business value chain relationships, where there is strategic fit, into competitive advantage.* The task here is to determine whether there are opportunities to strengthen a diversified company's businesses by such means as transferring competitively valuable resources and capabilities from one business to another, combining the related value chain activities of different businesses to achieve lower costs, sharing resources, such as the use of a powerful and well-respected brand name or an R&D facility, across multiple businesses, and encouraging knowledge sharing and collaborative activity among the businesses.
3. *Initiating actions to boost the combined performance of the corporation's collection of businesses.* Strategic options for improving the corporation's overall performance include (1) sticking closely with the existing business lineup and pursuing opportunities presented by these businesses, (2) broadening the scope of diversification by entering additional industries, (3) retrenching to a narrower scope of diversification by divesting either poorly performing businesses or those that no longer fit into management's long-range plans, and (4) broadly restructuring the entire company by divesting some businesses, acquiring others, and reorganizing, to put a whole new face on the company's business lineup.

The demanding and time-consuming nature of these three tasks explains why corporate executives generally refrain from becoming immersed in the details of crafting and executing business-level strategies. Rather, the normal procedure is to delegate lead responsibility for business strategy to the heads of each business, giving them the latitude to develop strategies suited to the particular industry environment in which their business operates and holding them accountable for producing good financial and strategic results.

WHEN TO CONSIDER DIVERSIFYING

As long as a company has plentiful opportunities for profitable growth in its present industry, there is no urgency to pursue diversification. But growth opportunities are often limited in mature industries and markets where buyer demand is flat or declining. In addition, changing industry conditions—new technologies, inroads being made by substitute products, fast-shifting buyer preferences, or intensifying competition—can undermine a company's ability to deliver ongoing gains in revenues and profits. Consider, for example, what the Internet and smartphones have have done to the revenues of newspaper publishers such as The New York Times Company, Gannett, McClatchy, and News Corp. News Corp, as an example, has protected shareholder value from the decline in newspaper sales through diversification into subscription video services, digital real estate services, and financial research, risk management, and trading information.

The decision to diversify presents wide-ranging possibilities. A company can diversify into closely related businesses or into totally unrelated businesses. It can diversify its present revenue and earnings base to a small or major extent. It can move into one or two large new businesses or a greater number of small ones. It can achieve diversification by acquiring an existing company, starting up a new business from scratch, or forming a joint venture with one or more companies to enter new businesses. In every case, however, the decision to diversify must start with a strong economic justification for doing so.

BUILDING SHAREHOLDER VALUE: THE ULTIMATE JUSTIFICATION FOR DIVERSIFYING

LO 8-1

Explain when and how business diversification can enhance shareholder value.

Diversification must do more for a company than simply spread its business risk across various industries. In principle, diversification cannot be considered wise or justifiable unless it results in *added long-term economic value for shareholders*—value that shareholders cannot capture on their own by purchasing stock in companies in different industries or investing in mutual funds to spread their investments across several industries. A move to diversify into a new business stands little chance of building shareholder value without passing the following three **Tests of Corporate Advantage**:[1]

1. *The industry attractiveness test.* The industry to be entered through diversification must be structurally attractive (in terms of the five forces), have resource requirements that match those of the parent company, and offer good prospects for growth, profitability, and return on investment.
2. *The cost-of-entry test.* The cost of entering the target industry must not be so high as to exceed the potential for good profitability. A catch-22 can prevail here, however. The more attractive an industry's prospects are for growth and good long-term profitability, the more expensive it can be to enter. Entry barriers for startup companies are likely to be high in attractive industries—if barriers were low, a rush of new entrants would soon erode the potential for high profitability. And buying a well-positioned company in an appealing industry often entails a high acquisition cost that makes passing the cost-of-entry test less likely. Since the owners of a successful and growing company usually demand a price that reflects their business's profit prospects, it's easy for such an acquisition to fail the cost-of-entry test.
3. *The better-off test.* Diversifying into a new business must offer potential for the company's existing businesses and the new business to perform better together under a single corporate umbrella than they would perform operating as independent, stand-alone businesses—an effect known as **synergy.** For example, let's say that company A diversifies by purchasing company B in another industry. If A and B's consolidated profits in the years to come prove no greater than what each could have earned on its own, then A's diversification won't provide its

CORE CONCEPT

To add shareholder value, a move to diversify into a new business must pass the three **Tests of Corporate Advantage:**

1. The industry attractiveness test
2. The cost-of-entry test
3. The better-off test

CORE CONCEPT

Creating added value for shareholders via diversification requires building a multibusiness company in which the whole is greater than the sum of its parts; such 1 + 1 = 3 effects are called **synergy.**

shareholders with any added value. Company A's shareholders could have achieved the same $1 + 1 = 2$ result by merely purchasing stock in company B. Diversification does not result in added long-term value for shareholders unless it produces a $1 + 1 = 3$ effect, whereby the businesses *perform better together as part of the same firm than they could have performed as independent companies.*

Diversification moves must satisfy all three tests to grow shareholder value over the long term. Diversification moves that can pass only one or two tests are suspect.

APPROACHES TO DIVERSIFYING THE BUSINESS LINEUP

The means of entering new businesses can take any of three forms: acquisition, internal startup, or joint ventures with other companies.

Diversifying by Acquisition of an Existing Business

CORE CONCEPT

An **acquisition premium,** or control premium, is the amount by which the price offered exceeds the pre-acquisition market value or stock price of the target company.

Acquisition is a popular means of diversifying into another industry. Not only is it quicker than trying to launch a new operation, but it also offers an effective way to hurdle such entry barriers as acquiring technological know-how, establishing supplier relationships, achieving scale economies, building brand awareness, and securing adequate distribution. Acquisitions are also commonly employed to access resources and capabilities that are complementary to those of the acquiring firm and that cannot be developed readily internally. Buying an ongoing operation allows the acquirer to move directly to the task of building a strong market position in the target industry rather than getting bogged down in trying to develop the knowledge, experience, scale of operation, and market reputation necessary for a startup entrant to become an effective competitor.

However, acquiring an existing business can prove quite expensive. The costs of acquiring another business include not only the acquisition price but also the costs of performing the due diligence to ascertain the worth of the other company, the costs of negotiating the purchase transaction, and the costs of integrating the business into the diversified company's portfolio. If the company to be acquired is a successful company, the acquisition price will include a hefty *premium* over the preacquisition value of the company for the right to control the company. For example, the $1.2 billion that luxury fashion company Michael Kors paid to acquire luxury accessories brand Jimmy Choo included a 36.5 percent premium over Jimmy Choo's share price before being put up for sale. Premiums are paid in order to convince the shareholders and managers of the target company that it is in their financial interests to approve the deal. The average premium paid by U.S. companies over the last 25 years was more often in the 25 to 30 percent range.

While acquisitions offer an enticing means for entering a new business, many fail to deliver on their promise.[2] Realizing the potential gains from an acquisition requires a successful integration of the acquired company into the culture, systems, and structure of the acquiring firm. This can be a costly and time-consuming operation. Acquisitions can also fail to deliver long-term shareholder value if the acquirer overestimates the potential gains and pays a premium in excess of the realized gains. High integration costs and excessive price premiums are two reasons that an acquisition might fail the cost-of-entry test. Firms with significant experience in making acquisitions are better able to avoid these types of problems.[3]

Entering a New Line of Business through Internal Development

Achieving diversification through *internal development* involves starting a new business subsidiary from scratch. Internal development has become an increasingly important way for companies to diversify and is often referred to as **corporate venturing** or *new venture development.* Although building a new business from the ground up is generally a time-consuming and uncertain process, it avoids the pitfalls associated with entry via acquisition and may allow the firm to realize greater profits in the end. It may offer a viable means of entering a new or emerging industry where there are no good acquisition candidates.

CORE CONCEPT

Corporate venturing (or *new venture development*) is the process of developing new businesses as an outgrowth of a company's established business operations. It is also referred to as *corporate entrepreneurship* or *intrapreneurship* since it requires entrepreneurial-like qualities within a larger enterprise.

Entering a new business via internal development, however, poses some significant hurdles. An internal new venture not only has to overcome industry entry barriers but also must invest in new production capacity, develop sources of supply, hire and train employees, build channels of distribution, grow a customer base, and so on, unless the new business is quite similar to the company's existing business. The risks associated with internal startups can be substantial, and the likelihood of failure is often high. Moreover, the culture, structures, and organizational systems of some companies may impede innovation and make it difficult for corporate entrepreneurship to flourish.

Generally, internal development of a new business has appeal only when (1) the parent company already has in-house most of the resources and capabilities it needs to piece together a new business and compete effectively; (2) there is ample time to launch the business; (3) the internal cost of entry is lower than the cost of entry via acquisition; (4) adding new production capacity will not adversely impact the supply–demand balance in the industry; and (5) incumbent firms are likely to be slow or ineffective in responding to a new entrant's efforts to crack the market.

A good example of a successful corporate venture is Niantic Inc.—known for its augmented reality mobile games, such as Pokemon Go, Ingress, and Harry Potter: Wizards Unite. Niantic was founded in 2010 as an internal startup within Google and became an independent company (owned by Google) in 2015. By 2022, Niantic was employing around 800 people and earning over $700 million in annual revenue.

Using Joint Ventures to Achieve Diversification

Entering a new business via a joint venture can be useful in at least three types of situations.[4] First, a joint venture is a good vehicle for pursuing an opportunity that is too complex, uneconomical, or risky for one company to pursue alone. Second, joint ventures make sense when the opportunities in a new industry require a broader range of competencies and know-how than a company can marshal on its own. Many of the opportunities in satellite-based telecommunications, biotechnology, and network-based systems that blend hardware, software, and services call for the coordinated development of complementary innovations and the tackling of an intricate web of financial, technical, political, and regulatory factors simultaneously. In such cases, pooling the resources and competencies of two or more companies is a wiser and less risky way to proceed. Third, companies sometimes use joint ventures to diversify into a new industry when the diversification move entails having operations in a foreign country. However, as discussed in Chapters 6 and 7, partnering with another company can have significant drawbacks due to the potential for conflicting objectives, disagreements over how to best operate the venture, culture clashes, and so on. Joint ventures are generally the least durable of the entry options, usually lasting only until the partners decide to go their own ways.

Choosing a Mode of Entry

The choice of how best to enter a new business—whether through internal development, acquisition, or joint venture—depends on the answers to four important questions:

- Does the company have all of the resources and capabilities it requires to enter the business through internal development, or is it lacking some critical resources?
- Are there entry barriers to overcome?
- Is speed an important factor in the firm's chances for successful entry?
- Which is the least costly mode of entry, given the company's objectives?

The Question of Critical Resources and Capabilities If a firm has all the resources it needs to start up a new business or will be able to easily purchase or lease any missing resources, it may choose to enter the business via internal development. However, if missing critical resources cannot be easily purchased or leased, a firm wishing to enter a new business must obtain these missing resources through either acquisition or joint venture. Bank of America acquired Merrill Lynch to obtain critical investment banking resources and capabilities that it lacked. The acquisition of these additional capabilities complemented Bank of America's strengths in corporate banking and opened up new business opportunities for the company. Firms often acquire other companies as a way to enter foreign markets where they lack local marketing knowledge, distribution capabilities, and relationships with local suppliers or customers. McDonald's acquisition of Burghy, Italy's only national hamburger chain, offers an example.[5] If there are no good acquisition opportunities or if the firm wants to avoid the high cost of acquiring and integrating another firm, it may choose to enter via joint venture. This type of entry mode has the added advantage of spreading the risk of entering a new business, an advantage that is particularly attractive when uncertainty is high. De Beers's joint venture with the luxury goods company LVMH provided De Beers not only with the complementary marketing capabilities it needed to enter the diamond retailing business but also with a partner to share the risk.

The Question of Entry Barriers The second question to ask is whether entry barriers would prevent a new entrant from gaining a foothold and succeeding in the industry. If entry barriers are low and the industry is populated by small firms, internal development may be the preferred mode of entry. If entry barriers are high, the company may still be able to enter with ease if it has the requisite resources and capabilities for overcoming high barriers. For example, entry barriers due to reputational advantages may be surmounted by a diversified company with a widely known and trusted corporate name. But if the entry barriers cannot be overcome readily, then the only feasible entry route may be through acquisition of a well-established company. While entry barriers may also be overcome with a strong complementary joint venture, this mode is the more uncertain choice due to the lack of industry experience.

The Question of Speed Speed is another determining factor in deciding how to go about entering a new business. Acquisition is a favored mode of entry when speed is of the essence, as is the case in rapidly changing industries where fast movers can secure long-term positioning advantages. Speed is important in industries where early movers gain experience-based advantages that grow ever larger over time as they move down the learning curve. It is also important in technology-based industries where there is a race to establish an industry standard or leading technological platform. But, in other cases, it can be better to enter a market after the uncertainties about technology or consumer preferences have been resolved and learn from the missteps of early entrants. In these cases, when it is more advantageous to be a second-mover, joint venture or internal development may be preferred.

The Question of Comparative Cost The question of which mode of entry is most cost-effective is a critical one, given the need for a diversification strategy to pass the cost-of-entry test. Acquisition can be a high-cost mode of entry due to the need to pay a premium over the share price of the target company. When the premium is high, the price of the deal will exceed the worth of the acquired company as a stand-alone business by a substantial amount. Whether it is worth it to pay that high a price will depend on how much extra value will be created by the new combination of companies in the form of synergies. Moreover, the true cost of an acquisition must include the **transaction costs** of identifying and evaluating potential targets, negotiating a price, and completing other aspects of deal making. Often, companies pay hefty fees to investment banking firms, lawyers, and others to advise them and assist with the deal-making process. Finally, the true cost must take into account the costs of integrating the acquired company into the parent company's portfolio of businesses.

CORE CONCEPT

Transaction costs are the costs of completing a business agreement or deal, over and above the price of the deal. They can include the costs of searching for an attractive target, the costs of evaluating its worth, bargaining costs, and the costs of completing the transaction.

Joint ventures may provide a way to conserve on such entry costs. But even here, there are organizational coordination costs and transaction costs that must be considered, including settling on the terms of the arrangement. If the partnership doesn't proceed smoothly and is not founded on trust, these costs may be significant.

CHOOSING THE DIVERSIFICATION PATH: RELATED VERSUS UNRELATED BUSINESSES

Once a company decides to diversify, it faces the choice of whether to diversify into **related businesses, unrelated businesses,** or some mix of both. Businesses are said to be *related* when their value chains exhibit competitively important cross-business commonalities. By this we mean that there is a close correspondence between the businesses in terms of *how they perform* key value chain activities and *the resources and capabilities each needs* to perform those activities. The big appeal of related diversification is the opportunity to build shareholder value by leveraging these cross-business commonalities into competitive advantages for the individual businesses, thus allowing the company as a whole to perform better than just the sum of its businesses. Businesses are said to be *unrelated* when the resource requirements and key value chain activities are so dissimilar that no competitively important cross-business commonalities exist.

CORE CONCEPT

Related businesses possess competitively valuable cross-business value chain and resource commonalities. **Unrelated businesses** have dissimilar value chains and resource requirements, with no competitively important cross-business commonalities at the value chain level.

The next two sections explore the ins and outs of related and unrelated diversification.

DIVERSIFICATION INTO RELATED BUSINESSES

A related diversification strategy involves building the company around businesses where there is good *strategic fit across corresponding value chain activities.* **Strategic fit** exists whenever one or more activities constituting the value chains of different

LO 8-2

Describe how related diversification strategies can produce cross-business strategic fit capable of delivering competitive advantage.

CORE CONCEPT

Strategic fit exists whenever one or more activities constituting the value chains of different businesses are sufficiently similar to present opportunities for cross-business sharing or transferring of the resources and capabilities that enable these activities.

CORE CONCEPT

Related diversification involves sharing or transferring *specialized* resources and capabilities. **Specialized resources and capabilities** have very specific applications and their use is limited to a restricted range of industry and business types, in contrast to **general resources and capabilities,** which can be widely applied and can be deployed across a broad range of industry and business types.

businesses are sufficiently similar to present opportunities for cross-business sharing or transferring of the resources and capabilities that enable these activities.[6] That is to say, it implies the existence of competitively important cross-business commonalities. Prime examples of such opportunities include

- *Transferring specialized expertise, technological know-how, or other competitively valuable strategic assets from one business's value chain to another's.* Google's ability to transfer software developers and other information technology specialists from other business applications to the development of its Android mobile operating system and Chrome operating system for PCs aided considerably in the success of these new internal ventures.
    - *Sharing costs between businesses by combining their related value chain activities into a single operation.* For instance, it is often feasible to manufacture the products of different businesses in a single plant, use the same warehouses for shipping and distribution, or have a single sales force for the products of different businesses if they are marketed to the same types of customers.
    - *Exploiting the common use of a well-known brand name.* For example, Yamaha Motor's name in motorcycles gave the company instant credibility and recognition in entering the personal-watercraft business, allowing it to achieve a significant market share without spending large sums on advertising to establish a brand identity for the WaveRunner. Likewise, Apple's reputation for producing easy-to-operate computers was a competitive asset that facilitated the company's diversification into smartphones, tablet computers, and wearable technology.
- *Sharing other resources (besides brands) that support corresponding value chain activities across businesses.* After acquiring Marvel Comics and Lucasfilm, Walt Disney Company integrated Marvel's iconic characters such as Spider-Man and Iron Man and Lucasfilm's Star Wars and Indiana Jones franchises into other Disney businesses, including its theme parks, retail stores, motion picture division, and video game business. (Disney's characters, starting with Mickey Mouse, have always been among the most valuable of its resources.) Automobile companies like Ford share resources such as their relationships with suppliers and dealer networks across their lines of business.
- *Engaging in cross-business collaboration and knowledge sharing to create new competitively valuable resources and capabilities.* Businesses performing closely related value chain activities may seize opportunities to join forces, share knowledge and talents, and collaborate to create altogether new capabilities (such as virtually defect-free assembly methods or increased ability to speed new products to market) that will be mutually beneficial in improving their competitiveness and business performance.

Related diversification is based on value chain matchups with respect to *key* value chain activities—those that play a central role in each business's strategy and that link to its industry's key success factors. Such matchups facilitate the sharing or transfer of the resources and capabilities that enable the performance of these activities and underlie each business's quest for competitive advantage. By facilitating the sharing or transferring of such important competitive assets, related diversification can elevate each business's prospects for competitive success.

The resources and capabilities that are leveraged in related diversification are **specialized resources and capabilities.** By this we mean that they have very *specific* applications; their use is restricted to a limited range of business contexts in which these applications are competitively relevant. Because they are adapted for particular applications, specialized resources and capabilities must be utilized by particular types of businesses operating in specific kinds of industries to have value; they have limited utility outside this designated range of industry and business applications. This is in contrast to **general resources and capabilities** (such as general management capabilities, human resource management capabilities, and general accounting services), which can be applied usefully across a wide range of industry and business types.

L'Oréal is the world's largest beauty products company, with $37 billion in revenues and a successful strategy of related diversification built on leveraging a highly specialized set of resources and capabilities. These include 21 dermatologic and cosmetic research centers, R&D capabilities and scientific knowledge concerning skin and hair care, patents and secret formulas for hair and skin care products, and robotic applications developed specifically for testing the safety of hair and skin care products. These resources and capabilities are highly valuable for businesses focused on products for human skin and hair—they are *specialized* to such applications, and in consequence, they are of little or no value beyond this restricted range of applications. To leverage these resources in a way that maximizes their potential value, L'Oréal has diversified into cosmetics, hair care products, skin care products, and fragrances (but not food, transportation, industrial services, or any application area far from the narrow domain in which its specialized resources are competitively relevant). L'Oréal's businesses are related to one another on the basis of its value-generating specialized resources and capabilities and the cross-business linkages among the value chain activities that they enable.

Corning's most competitively valuable resources and capabilities are specialized to applications concerning fiber optics and specialty glass and ceramics. Over the course of its 173-year history, it has developed an unmatched understanding of fundamental glass science and related technologies in the field of optics. Its capabilities now span a variety of sophisticated technologies and include expertise in domains such as custom glass composition, specialty glass melting and forming, precision optics, high-end transmissive coatings, and optomechanical materials. Corning has leveraged these specialized capabilities into a position of global leadership in five related market segments: display technologies based on glass substrates; environmental technologies using ceramic substrates and filters; optical communications, providing optical fiber, cable and connectivity solutions; life sciences supporting research and drug discovery; and specialty materials employing advanced optics and specialty glass solutions. The market segments into which Corning has diversified are all related by their reliance on Corning's specialized capability set and by the many value chain activities that they have in common as a result.

General Mills has diversified into a closely related set of food businesses on the basis of its capabilities in the realm of "kitchen chemistry" and food production technologies. Its products include brands such as Old El Paso, Cascadian Farm, Cheerios, Cocoa Puffs, Haagen-Daz, Nature Valley, Annie's Organic, Pillsbury, Betty Crocker, and Yoplait yogurt. Earlier it had diversified into restaurant businesses on the mistaken notion that all food businesses were related. By exiting these businesses in the mid-1990s, the company was able to improve its overall profitability and strengthen its position in its remaining businesses. The lesson from its experience—and a takeaway for the managers of any diversified company—is that *it is not product relatedness that defines a well-crafted related diversification strategy.* Rather, *the businesses must be related in terms of their key value chain activities and the specialized resources and capabilities that enable these activities.*[7] An example is Citizen Watch Company, whose products appear to be different (watches, machine tools, and flat panel displays) but are related in terms of their common reliance on miniaturization know-how and advanced precision technologies.

While companies pursuing related diversification strategies may also have opportunities to share or transfer their *general* resources and capabilities (e.g., information systems; human resource management practices; accounting and tax services; budgeting, planning, and financial reporting systems; expertise in legal and regulatory affairs; and fringe-benefit management systems), *the most competitively valuable opportunities for resource sharing or transfer always come from leveraging their specialized resources and capabilities.* The reason for this is that specialized resources and capabilities drive the key value-creating activities that both connect the businesses (at points along their value chains where there is strategic fit) and link to the key success factors in the markets where they are competitively relevant. Figure 8.1 illustrates the range of opportunities to share and/or transfer specialized resources and capabilities among the value chain activities of related businesses. It is important to recognize that *even though general resources and capabilities may be also shared by multiple business units, such resource sharing alone cannot form the backbone of a strategy keyed to related diversification.* Illustration Capsule 8.1 provides examples of a few successful firms with related diversification strategies.

Identifying Cross-Business Strategic Fit along the Value Chain

Cross-business strategic fit can exist anywhere along the value chain—in R&D and technology activities, in supply chain activities and relationships with suppliers, in manufacturing, in sales and marketing, in distribution activities, or in customer service activities.[8]

FIGURE 8.1 Related Businesses Provide Opportunities to Benefit from Competitively Valuable Strategic Fit

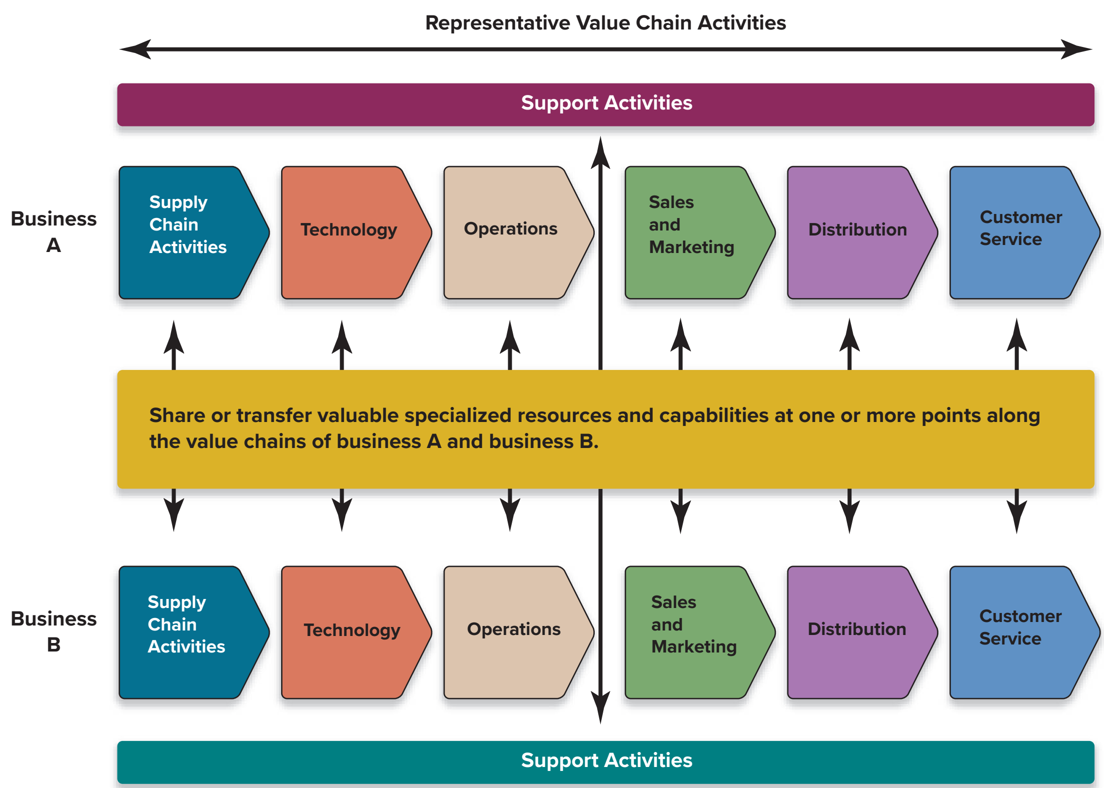


ILLUSTRATION CAPSULE 8.1 Examples of Companies Pursuing a Related Diversification Strategy

INDITEX

Inditex began as a small family business making women's clothing, but it has since evolved into one of the world's largest and most successful fashion retailers. The company is not just a retailer, however—it is involved with all aspects of producing fashion: design, manufacture, distribution, and retail. Its growth has been driven by acquisition as well as by internal growth and development. By 2020, Inditex included seven distinct brands or lines of business: Zara, Zara Home, Pull&Bear, Massimo Dutti, Berksha (which includes the BSK and Man brands), Stradivarius, and Oysho (women's lingerie, beachwear, and sport).

NEWS CORP

News Corp was created in 2013 when News Corporation was split into two independent companies: 21st Century Fox and News Corp. This move allowed News Corp to focus on the newspaper and publishing businesses, while 21st Century Fox retained the other parts of News Corporation (mainly television and film). News Corp characterizes itself today as a mass media company. The companies in its network include The New York Post, Harper Collins Publishers, News Corp Australia, News UK, News America Marketing, Storyful (a social media newswire), Dow Jones and Move (a provider of real estate information). News Corp Australia actually includes a broad portfolio of national, metropolitan, regional, and community newspapers; while News UK has similar breadth. Despite the general disruption in the newspaper industry due to Internet-related developments, News Corp recently announced record-setting subscriber performances at Dow Jones and the Wall Street Journal—two of their most important holdings.

KIMBERLY-CLARK CORPORATION

Kimberly-Clark is a Texas-based multinational in the personal care industry, producing mostly paper-based consumer products. Its products include iconic brands such as Kleenex, Huggies, Pull-Ups, Cottonelle, Scott, Viva, Kotex, and Depend. The company has organized its products into five related lines of business: Adult Care, Baby and Child Care, Family Care, Feminine Care, and K-C Professional. Its products are recognized and trusted around the world—distributed across more than 175 countries. With its sharp focus on the consumer and financial discipline, Kimberly-Clark has managed to sustain its record of solid performance and growth even during recessionary periods, since the types of products it offers are always in demand.

(top): TonyV3112/Shutterstock; (middle): Tetra Images/Getty Images; (bottom): Mark Steinmetz/McGraw Hill

Sources: Company websites, Wikipedia; **https://www.businesswire.com/news/home/20200207005506/en/News-Corp-Announces-Record-Setting-Subscriber-Performances-Dow**; **https://finance.yahoo.com/news/kimberly-clarks-impressive-momentum-continue-130001056.html**, accessed February 10, 2020.

Strategic Fit in Supply Chain Activities Businesses with strategic fit with respect to their supply chain activities can perform better together because of the potential for transferring skills in procuring materials, sharing resources and capabilities in logistics, collaborating with common supply chain partners, and/or increasing leverage with shippers in securing volume discounts on incoming parts and components. Dell's strategic partnerships with leading suppliers of microprocessors, circuit boards, disk drives, memory chips, flat-panel displays, wireless capabilities, long-life batteries, and other PC-related components have been an important element of the company's strategy to diversify into servers, data storage devices, networking components, plasma TVs, and printers—products that include many components common to PCs and that can be sourced from the same strategic partners that provide Dell with PC components.

Strategic Fit in R&D and Technology Activities Businesses with strategic fit in R&D or technology development perform better together than apart because of potential cost savings in R&D, shorter times in getting new products to market, and more innovative products or processes. Moreover, technological advances in one business can lead to increased sales for both. Technological innovations have been the driver behind the efforts of cable TV companies to diversify into high-speed Internet access (via the use of cable modems) and, further, to explore providing local and long-distance telephone service to residential and commercial customers either through a single wire or by means of Voice over Internet Protocol (VoIP) technology. These diversification efforts have resulted in companies such as DISH Network and Comcast (through its XFINITY subsidiary) offering TV, Internet, and phone bundles.

Manufacturing-Related Strategic Fit Cross-business strategic fit in manufacturing-related activities can be exploited when a diversifier's expertise in quality control and cost-efficient production methods can be transferred to another business. When Emerson Electric diversified into the chain-saw business, it transferred its expertise in low-cost manufacture to its newly acquired Beaird-Poulan business division. The transfer drove Beaird-Poulan's new strategy—to be the low-cost provider of chainsaw products—and fundamentally changed the way Beaird-Poulan chain saws were designed and manufactured. Another benefit of production-related value chain commonalities is the ability to consolidate production into a smaller number of plants and significantly reduce overall production costs. When snowmobile maker Bombardier diversified into motorcycles, it was able to set up motorcycle assembly lines in the manufacturing facility where it was assembling snowmobiles. When Smucker's acquired Procter & Gamble's Jif peanut butter business, it was able to combine the manufacture of the two brands of peanut butter products while gaining greater leverage with vendors in purchasing its peanut supplies.

Strategic Fit in Sales and Marketing Activities Various cost-saving opportunities spring from diversifying into businesses with closely related sales and marketing activities. When the products are sold directly to the same customers, sales costs can often be reduced by using a single sales force instead of having two different salespeople call on the same customer. The products of related businesses can be promoted at the same website and included in the same media ads and sales brochures. There may be opportunities to reduce costs by consolidating order processing and billing and by using common promotional tie-ins. When global power toolmaker Black & Decker acquired Vector Products, it was able to use its own global sales force to sell the newly acquired Vector power inverters, vehicle battery chargers, and rechargeable spotlights because the types of customers that carried its power tools (discounters like Kmart, home centers, and hardware stores) also stocked the types of products produced by Vector.

A second category of benefits arises when different businesses use similar sales and marketing approaches. In such cases, there may be competitively valuable opportunities to transfer selling, merchandising, advertising, and product differentiation skills from one business to another. Procter & Gamble's product lineup includes Pampers diapers, Olay beauty products, Tide laundry detergent, Crest toothpaste, Charmin toilet tissue, Gillette razors and blades, Cascade dishwasher detergent, Oral-B toothbrushes, and Head & Shoulders shampoo. All of these have different competitors and different supply chain and production requirements, but they all move through the same wholesale distribution systems, are sold in common retail settings to the same shoppers, and require the same marketing and merchandising skills.

Distribution-Related Strategic Fit Businesses with closely related distribution activities can perform better together than apart because of potential cost savings in sharing the same distribution facilities or using many of the same wholesale distributors and retail dealers. When Conair Corporation acquired Allegro Manufacturing's travel bag and travel accessory business, it was able to consolidate its own distribution centers for hair dryers and curling irons with those of Allegro, thereby generating cost savings for both businesses. Likewise, since Conair products and Allegro's neck rests, ear plugs, luggage tags, and toiletry kits were sold by the same types of retailers (discount stores, supermarket chains, and drugstore chains), Conair was able to convince many of the retailers not carrying Allegro products to take on the line.

Strategic Fit in Customer Service Activities Strategic fit with respect to customer service activities can enable cost savings or differentiation advantages, just as it does along other points of the value chain. For example, cost savings may come from consolidating after-sale service and repair organizations for the products of closely related businesses into a single operation. Likewise, different businesses can often use the same customer service infrastructure. For instance, an electric utility that diversifies into natural gas, water, appliance repair services, and home security services can use the same customer data network, the same call centers and local offices, the same billing and accounting systems, and the same customer service infrastructure to support all of its products and services. Through the transfer of best practices in customer service across a set of related businesses or through the sharing of resources such as proprietary information about customer preferences, a multibusiness company can also create a differentiation advantage through higher-quality customer service.

Strategic Fit, Economies of Scope, and Competitive Advantage

Strategic fit in the value chain activities of a diversified corporation's different businesses opens up opportunities for **economies of scope**—a concept distinct from *economies of scale.* Economies of *scale* are cost savings that accrue directly from a larger-sized operation—for example, unit costs may be lower in a large plant than in a small plant. In contrast, economies of scope are cost savings that flow from operating in multiple businesses (a larger *scope* of operation). *They stem directly from strategic fit along the value chains of related businesses,* which in turn enables the businesses to share resources or to transfer them from business to business at low cost. Significant scope economies are open only to firms engaged in related diversification, since they are the result of related businesses performing R&D together, transferring managers from one business to another, using common manufacturing or distribution facilities, sharing a common sales force or dealer network, using the same established brand name, and the like.

CORE CONCEPT

Economies of scope are cost reductions that flow from operating in multiple businesses (a larger scope of operation). This is in contrast to economies of scale, which accrue from a larger-sized operation.

The greater the cross-business economies associated with resource sharing and transfer, the greater the potential for a related diversification strategy to give the individual businesses of a multibusiness enterprise a cost advantage over rivals.

From Strategic Fit to Competitive Advantage, Added Profitability, and Gains in Shareholder Value The cost advantage from economies of scope is due to the fact that resource sharing allows a multibusiness firm to spread resource costs across its businesses and to avoid the expense of having to acquire and maintain duplicate sets of resources—one for each business. But related diversified companies can benefit from strategic fit in other ways as well.

Sharing or transferring valuable specialized assets among the company's businesses can help each business perform its value chain activities more proficiently. This translates into competitive advantage for the businesses in one or two basic ways: (1) The businesses can contribute to greater efficiency and lower costs relative to their competitors, and/or (2) they can provide a basis for differentiation so that customers are willing to pay relatively more for the businesses' goods and services. In either or both of these ways, a firm with a well-executed related diversification strategy can boost the chances of its businesses attaining a competitive advantage.

Diversifying into related businesses where competitively valuable strategic-fit benefits can be captured puts a company's businesses in position to perform better financially as part of the company than they could have performed as independent enterprises, thus providing a clear avenue for increasing shareholder value and satisfying the better-off test.

The greater the relatedness among a diversified company's businesses, the bigger a company's window for converting strategic fit into competitive advantage. The strategic and business logic is compelling: Capturing the benefits of strategic fit along the value chains of its related businesses gives a diversified company a clear path to achieving competitive advantage over undiversified competitors and competitors whose own diversification efforts don't offer equivalent strategic-fit benefits.[9] Such competitive advantage potential provides a company with a dependable basis for earning profits and a return on investment that exceeds what the company's businesses could earn as stand-alone enterprises. Converting the competitive advantage potential into greater profitability is what fuels $1 + 1 = 3$ gains in shareholder value—the necessary outcome for satisfying the *better-off test* and proving the business merit of a company's diversification effort.

There are five things to bear in mind here:

1. Capturing cross-business strategic-fit benefits via a strategy of related diversification builds shareholder value in ways that shareholders cannot undertake by simply owning a portfolio of stocks of companies in different industries.
2. The capture of cross-business strategic-fit benefits is possible only via a strategy of related diversification.
3. The greater the relatedness among a diversified company's businesses, the bigger the company's window for converting strategic fit into competitive advantage for its businesses.
4. The benefits of cross-business strategic fit come from the transferring or sharing of competitively valuable resources and capabilities among the businesses—resources and capabilities that are *specialized* to certain applications and have value only in specific types of industries and businesses.
5. The benefits of cross-business strategic fit are not automatically realized when a company diversifies into related businesses; *the benefits materialize only after management has successfully pursued internal actions to capture them.*

Illustration Capsule 8.2 describes the merger of Kraft Foods Group, Inc. with the H. J. Heinz Holding Corporation, and the managerial missteps that have limited the realization of strategic fit benefits and reduced shareholder value.

ILLUSTRATION CAPSULE 8.2 The Kraft–Heinz Merger: Managerial Missteps in Capturing Cross-Business Strategic Fit

The $62.6 billion merger between Kraft and Heinz that was finalized in the summer of 2015 created the third largest food and beverage company in North America and the fifth largest in the world. The architects of the merger envisioned 1 + 1 = 3 gains in shareholder value through the capture of strategic fit opportunities between these two companies. As a combined enterprise, Kraft Heinz would be able to exploit its cross-business value chain activities and resource similarities to more efficiently produce, distribute, and sell profitable processed food products.

Kraft and Heinz products share many of the same raw materials (milk, sugar, salt, wheat, etc.), which allows the new company to leverage its increased bargaining power as a larger business to get better deals with suppliers, using strategic fit in supply chain activities to achieve lower input costs and greater inbound efficiencies. Moreover, because both of these brands specialized in prepackaged foods, there is ample manufacturing-related strategic fit in production processes and packaging technologies that would allow the new company to trim and streamline manufacturing operations.

Their distribution-related strategic fit would allow for the complete integration of distribution channels and transportation networks, resulting in greater outbound efficiencies and a reduction in travel time for products moving from factories to stores. The Kraft Heinz Company also planned to leverage Heinz's global platform to expand Kraft's products internationally. By utilizing Heinz's already highly developed global distribution network and brand familiarity (key specialized resources), Kraft could more easily expand into the global market of prepackaged and processed food. Because these two brands are sold at similar types of retail stores (supermarket chains, wholesale retailers, and local grocery stores), they could claim even more shelf space with the increased bargaining power of the combined company.

Strategic fit in sales and marketing activities would permit the company to develop coordinated and more effective advertising campaigns. Toward this aim, the Kraft Heinz Company planned to consolidate its marketing capabilities under one marketing

Hayden Stirling/Shutterstock

firm. Also, by combining R&D teams, the Kraft Heinz Company could come out with innovative products that might appeal more to the growing number of on-the-go and health-conscious buyers in the market. Many of these potential and predicted synergies for the Kraft Heinz Company have yet to be realized, since merger integration activities always take time.

However, managerial missteps prevented most of the predicted synergies for the Kraft Heinz Company from being realized, and in 2022, the company's shares were trading at about one-half the 2015 merger share price. Key limitations in building share-holder value have been attributed to a top management team focused on cutting costs rather than implementation of changes needed to capture synergies. The extreme cost–cutting has also caused the company to lag the industry in the introduction of new products, especially those contributing to health and wellness. The company has also been plagued by poor morale and high turnover, with former employees citing a culture conflict between top management and the two companies' premerger values-based cultures. While strategic fit benefits offer the promise of dramatic increases in shareholder value, the benefits cannot materialize without careful planning and committed implementation efforts by management at all levels.

Note: Developed with Maria Hart.

Sources: The Kraft-Heinz company Form 10-K for the fiscal year ending December 31, 2022; "How Cost Cutting at Kraft Heinz Dampened Innovation", by Alex Bitter, *Business Insider,* September 21, 2021; **www.forbes.com/sites/paulmartyn/2015/03/31/heinz-and-kraft-merger-makes-supply-management-sense/**; **fortune.com/2015/03/25/kraft-mess-how-heinz-deal-helps/**; **www.nytimes.com/2015/03/26/business/dealbook/kraft-and-heinz-to-merge.html?_r=2**; company websites (accessed October 6, 2023.).

DIVERSIFICATION INTO UNRELATED BUSINESSES

LO 8-3

Identify the merits and risks of unrelated diversification strategies.

Achieving cross-business strategic fit is not a motivation for unrelated diversification. Companies that pursue a strategy of unrelated diversification often exhibit a willingness to diversify into *any industry* where senior managers see an opportunity to realize consistently good financial results. Such companies are frequently labeled *conglomerates* because their business interests range broadly across diverse industries. Companies engaged in unrelated diversification nearly always enter new businesses by acquiring an established company rather than by forming a startup subsidiary within their own corporate structures or participating in joint ventures.

A willingness to diversify into any business in any industry is unlikely to result in successful unrelated diversification. The key to success even for unrelated diversification is to create economic value for shareholders.

With a strategy of unrelated diversification, an acquisition is deemed to have potential if it passes the industry-attractiveness and cost-of-entry tests and if it has good prospects for attractive financial performance. Thus, with an unrelated diversification strategy, company managers spend much time and effort screening acquisition candidates and evaluating the pros and cons of keeping or divesting existing businesses, using such criteria as

- Whether the business can meet corporate targets for profitability and return on investment.
- Whether the business is in an industry with attractive growth potential.
- Whether the business is big enough to contribute *significantly* to the parent firm's bottom line.

But the key to successful unrelated diversification is to go beyond these considerations and *ensure that the strategy passes the better-off test as well.* This test requires more than just growth in revenues; it requires *growth in profits*—beyond what could be achieved by a mutual fund or a holding company that owns shares of the businesses without adding any value. Unless the combination of businesses is more profitable together under the corporate umbrella than they are apart as independent businesses, *the strategy cannot create economic value for shareholders.* And unless it does so, there is *no real justification for unrelated diversification,* since top executives have a fiduciary responsibility to maximize long-term shareholder value for the company's owners (its shareholders). Illustration Capsule 8.3 provides some examples of successful companies with unrelated diversification.

Building Shareholder Value via Unrelated Diversification

Given the absence of cross-business strategic fit with which to create competitive advantages, building shareholder value via unrelated diversification ultimately hinges on the ability of the parent company to improve its businesses (and make the combination *better off*) via other means. Critical to this endeavor is the role that the parent company plays as a *corporate parent.*[10] To the extent that a company has strong *corporate parenting capabilities*—capabilities that involve nurturing, guiding, grooming, and governing constituent businesses—a corporate parent can propel its businesses forward and help them gain ground over their market rivals. Corporate parents also contribute to the competitiveness of their unrelated businesses by sharing or transferring *general resources and capabilities* across the businesses—competitive assets that have utility in *any type* of industry and that can be leveraged across a wide range of business types as a result. Examples of the kinds of general resources that a corporate parent leverages

Corporate parenting capabilities involve nurturing, guiding, grooming, and governing a diversified company's constituent businesses.

ILLUSTRATION CAPSULE 8.3

Examples of Companies Pursuing an Unrelated Diversification Strategy

(top left): tassapon/123RF; (top right): Ranta Images/Shutterstock; (bottom): Getty Images

TATA

The Tata group is a global enterprise with total revenues exceeding $128 billion in 2020. It is organized into 10 "verticals," which are essentially industry domains. The verticals include Technology, Steel, Automotive, Consumer and Retail, Infrastructure, Financial Services, Aerospace and Defense, Tourism and Travel, Telecom and Media, and Trading and Investments. Within these 10 verticals are 29 publicly listed Tata enterprises. The most well-known of these include Tata Motors, Tata Steel, Tata Chemicals, Titan (jewelry and eyewear), Tata Power, Tata Communications, Tata Consumer Products, Tata Capital, Tata Consultancy Services, and Indian Hotels.

BERKSHIRE HATHAWAY

Berkshire Hathaway is an American conglomerate with a long and successful history, often attributed to the sage investment and acquisition strategy of its chairman and CEO, Warren Buffet. Its holdings include an insurance group, an energy group, a financial products group, and a diverse group covering manufacturing, service, and retailing. Companies that are wholly owned by Berkshire Hathaway include GEICO, Dairy Queen, Duracell, Fruit of the Loom, Burlington Northern Sante Fe Railway, and Helzberg Diamonds. It owns a significant share of a number of other companies, including Bank of America, Moody's Corporation, American Express, and Coca-Cola.

YAMAHA CORPORATION

The Yamaha Corporation no longer includes Yamaha Motor Co. (the motorcycle, snowmobile, boat, and motorized product maker), although it is still a major shareholder. But even without Yamaha Motor, the Yamaha Corporation still produces a wide array of products. It is the world's largest producer of all types of musical instruments, along with arguably related audio equipment and communication devices. But, in addition, it is involved in the production of industrial robots, home appliances, sporting goods, industrial machinery and components, specialty metals, golf products, resorts, and semiconductors.

Sources: Company websites, Wikipedia, accessed February 14, 2020.

in unrelated diversification include the corporation's reputation, credit rating, and access to financial markets; governance mechanisms; management training programs; a corporate ethics program; a central data and communications center; shared administrative resources such as public relations and legal services; and common systems for functions such as budgeting, financial reporting, and quality control.

The Benefits of Astute Corporate Parenting One of the most important ways that corporate parents contribute to the success of their businesses is by offering high-level oversight and guidance.[11] The top executives of a large diversified corporation have among them many years of accumulated experience in a variety of business settings and can often contribute expert problem-solving skills, creative strategy suggestions, and first-rate advice and guidance on how to improve competitiveness and financial performance to the heads of the company's various business subsidiaries. This is especially true in the case of newly acquired, smaller businesses. Particularly astute high-level guidance from corporate executives can help the subsidiaries perform better than they would otherwise be able to do through the efforts of the business unit heads alone. The outstanding leadership of Royal Little, the founder of Textron, was a major reason that the company became an exemplar of the unrelated diversification strategy while he was CEO. Little's bold moves transformed the company from its origins as a small textile manufacturer into a global powerhouse known for its Bell helicopters, Cessna aircraft, and a host of other strong brands in a wide array of industries. Norm Wesley, a former CEO of the conglomerate Fortune Brands, is similarly credited with driving the sharp rise in the company's stock price while he was at the helm. Under his leadership, Fortune Brands became the $7 billion maker of products ranging from spirits (e.g., Jim Beam bourbon and rye, Gilbey's gin and vodka, Courvoisier cognac) to golf products (e.g., Titleist golf balls and clubs, FootJoy golf shoes and apparel, Scotty Cameron putters) to hardware (e.g., Moen faucets, American Lock security devices). (Fortune Brands has since been converted into three separate entities, Beam Inc. Fortune Brands Innovation, and Masterbrand.)

CORE CONCEPT

Corporate parenting refers to the role that a diversified corporation plays in nurturing its component businesses through the provision of top management expertise, disciplined control, financial resources, and other types of general resources and capabilities such as long-term planning systems, business development skills, management development processes, and incentive systems.

An **umbrella brand** is a corporate brand name that can be applied to a wide assortment of business types. As such, it is a type of general resource that can be leveraged in unrelated diversification.

Corporate parents can also create added value for their businesses by providing them with other types of general resources that lower the operating costs of the individual businesses or that enhance their operating effectiveness. The administrative resources located at a company's corporate headquarters are a prime example. They typically include legal services, accounting expertise and tax services, and other elements of the administrative infrastructure, such as risk management capabilities, information technology resources, and public relations capabilities. Providing individual businesses with general support resources such as these creates value by *lowering companywide overhead costs,* since each business would otherwise have to duplicate the centralized activities.

Corporate brands that do not connote any specific type of product are another type of general corporate resource that can be shared among unrelated businesses. General Electric, for example, successfully applied its GE brand to such unrelated products and businesses as medical products and health care (GE Healthcare), jet engines (GE Aviation), and power and water technologies (GE Power and Water). Corporate brands that are applied in this fashion are sometimes called **umbrella brands.** Utilizing a well-known corporate name (GE) in a diversified company's individual businesses has the potential not only to lower costs (by spreading the fixed cost of developing and maintaining the brand over many businesses) but also to enhance each business's customer value proposition by linking its products to a name that consumers trust. In similar fashion, a corporation's reputation for well-crafted products, for product reliability, or for trustworthiness can lead to greater customer willingness to purchase the products of a wider range of a diversified company's businesses. Incentive systems, financial control systems, and a company's culture are other types of general corporate resources that may prove useful in enhancing the daily operations of a diverse set of businesses. The parenting activities of corporate executives may also include recruiting and hiring talented managers to run individual businesses.

We discuss two other commonly employed ways for corporate parents to add value to their unrelated businesses next.

Judicious Cross-Business Allocation of Financial Resources By reallocating surplus cash flows from some businesses to fund the capital requirements of other businesses—in essence, having the company serve as an *internal capital market*—corporate parents may also be able to create value. Such actions can be particularly important in times when credit is unusually tight (such as in the wake of the worldwide banking crisis that began in 2008) or in economies with less well-developed capital markets. Under these conditions, with strong financial resources a corporate parent can add value by shifting funds from business units generating excess cash (more than they need to fund their own operating requirements and new capital investment opportunities) to other, cash-short businesses with appealing growth prospects. A parent company's ability to function as its own internal capital market enhances overall corporate performance and increases shareholder value to the extent that (1) its top managers have better access to information about investment opportunities internal to the firm than do external financiers or (2) it can provide funds that would otherwise be unavailable due to poor financial market conditions.

Acquiring and Restructuring Undervalued Companies Another way for parent companies to add value to unrelated businesses is by acquiring weakly performing companies at a bargain price and then *restructuring* their operations in ways that produce sometimes dramatic increases in profitability. **Restructuring** refers to overhauling and streamlining the operations of a business—combining plants with excess capacity, selling off underutilized assets, reducing unnecessary expenses, revamping its product offerings, consolidating administrative functions to reduce overhead costs, and otherwise improving the operating efficiency and profitability of a company. Restructuring generally involves transferring seasoned managers to the newly acquired business, either to replace the top layers of management or to step in temporarily until the business is returned to profitability or is well on its way to becoming a major market contender.

CORE CONCEPT

Restructuring refers to overhauling and streamlining the activities of a business—combining plants with excess capacity, selling off underutilized assets, reducing unnecessary expenses, and otherwise improving the productivity and profitability of a company.

Restructuring is often undertaken when a diversified company acquires a new business that is performing well below levels that the corporate parent believes are achievable. Diversified companies that have proven *turnaround capabilities* in rejuvenating weakly performing companies can often apply these capabilities in a relatively wide range of unrelated industries. Newell Brands (whose diverse product line includes Rubbermaid food storage, Sharpie pens, Graco strollers and car seats, Coleman camping gear, Calphalon cookware, and Yankee Candle—all businesses with different value chain activities) developed such a strong set of turnaround capabilities that the company was said to "Newellize" the businesses it acquired.

Successful unrelated diversification strategies based on restructuring require the parent company to have considerable expertise in identifying underperforming target companies and in negotiating attractive acquisition prices so that each acquisition passes the cost-of-entry test. The capabilities in this regard of Lord James Hanson and Lord Gordon White, who headed up the storied British conglomerate Hanson Trust, played a large part in Hanson Trust's impressive record of profitability.

The Path to Greater Shareholder Value through Unrelated Diversification

For a strategy of unrelated diversification to produce companywide financial results above and beyond what the businesses could generate operating as standalone entities, corporate executives must do three things to pass the three Tests of Corporate Advantage:

1. Diversify into industries where the businesses can produce consistently good earnings and returns on investment (to satisfy the industry-attractiveness test).
2. Negotiate favorable acquisition prices (to satisfy the cost-of-entry test).
3. Do a superior job of corporate parenting via high-level managerial oversight and resource sharing, financial resource allocation and portfolio management, and/or the restructuring of underperforming businesses (to satisfy the better-off test).

CORE CONCEPT

A diversified company has a **parenting advantage** when it is more able than other companies to boost the combined performance of its individual businesses through high-level guidance, general oversight, and other corporate-level contributions.

The best corporate parents understand the nature and value of the kinds of resources at their command and know how to leverage them effectively across their businesses. Those that are able to create more value in their businesses than other diversified companies have what is called a **parenting advantage.** When a corporation has a parenting advantage, its top executives have the best chance of being able to craft and execute an unrelated diversification strategy that can satisfy all three Tests of Corporate Advantage and truly enhance long-term economic shareholder value.

The Drawbacks of Unrelated Diversification

Unrelated diversification strategies have two important negatives that undercut the pluses: very demanding managerial requirements and limited competitive advantage potential.

Demanding Managerial Requirements Successfully managing a set of fundamentally different businesses operating in fundamentally different industry and competitive environments is a challenging and exceptionally difficult proposition.[12] Consider, for example, that corporations like General Electric, ITT, Mitsubishi, and Bharti Enterprises have dozens of business subsidiaries making hundreds and sometimes thousands of products. While headquarters executives can glean information about an industry from third-party sources, ask lots of questions when making occasional visits to the operations of the different businesses, and do their best to learn about the company's different businesses, they still remain heavily dependent on briefings from business unit heads and on "managing by the numbers"—that is, keeping a close track on the financial and operating results of each subsidiary. Managing by the numbers works well enough when business conditions are normal and the heads of the various business units are capable of consistently meeting their numbers. But problems arise if things start to go awry in a business and corporate management has to get deeply involved in the problems of a business it does not know much about. Because every business tends to encounter rough sledding at some juncture, unrelated diversification is thus a somewhat risky strategy from a managerial perspective.[13] Just one or two unforeseen problems or big strategic mistakes—which are much more likely without close corporate oversight—can cause a precipitous drop in corporate earnings and crash the parent company's stock price.

Hence, competently overseeing a set of widely diverse businesses can turn out to be much harder than it sounds. In practice, comparatively few companies have proved that they have top-management capabilities that are up to the task. There are far more companies whose corporate executives have failed at delivering consistently good financial results with an unrelated diversification strategy than there are companies with corporate executives who have been successful.[14] Unless a company truly has a parenting advantage, the odds are that the result of unrelated diversification will be $1 + 1 = 2$ or even less.

Limited Competitive Advantage Potential The second big negative is that *unrelated diversification offers only a limited potential for competitive advantage beyond what each individual business can generate on its own.* Unlike a related diversification strategy, unrelated diversification provides no cross-business strategic-fit benefits that allow each business to perform its key value chain activities in a more efficient and effective manner. A cash-rich corporate parent pursuing unrelated diversification can provide its subsidiaries with much-needed capital, may achieve economies of scope in activities relying on general corporate resources, may extend an umbrella brand and may even offer some managerial know-how to help resolve problems in particular business units, but otherwise it has little to add in the way of enhancing the competitive strength of its individual business units. In comparison to the highly specialized resources that facilitate related diversification, the general resources that support unrelated diversification tend to be relatively low value, for the simple reason that they are more common. Unless they are of exceptionally high quality (such as GE's world-renowned general management capabilities and umbrella brand), resources and capabilities that are general in nature are less likely to provide a significant source of competitive advantage for the businesses of diversified companies. Without the competitive advantage potential of strategic fit in competitively important value chain activities, consolidated performance of an unrelated group of businesses may not be very much more than the sum of what the individual business units could achieve if they were independent, in most circumstances.

Relying solely on leveraging general resources and the expertise of corporate executives to wisely manage a set of unrelated businesses is a much weaker foundation for enhancing shareholder value than is a strategy of related diversification.

Misguided Reasons for Pursuing Unrelated Diversification

Companies sometimes pursue unrelated diversification for reasons that are entirely misguided. These include the following:

- *Risk reduction.* Spreading the company's investments over a set of diverse industries to spread risk cannot create long-term shareholder value since the company's shareholders can more flexibly (and more efficiently) reduce their exposure to risk by investing in a diversified portfolio of stocks and bonds.
- *Growth.* While unrelated diversification may enable a company to achieve rapid or continuous growth, firms that pursue growth for growth's sake are unlikely to maximize shareholder value. Only *profitable growth*—the kind that comes from creating added value for shareholders—can justify a strategy of unrelated diversification.
- *Stabilization.* Managers sometimes pursue broad diversification in the hope that market downtrends in some of the company's businesses will be partially offset by cyclical upswings in its other businesses, thus producing somewhat less earnings volatility. In actual practice, however, there's no convincing evidence that the consolidated profits of firms with unrelated diversification strategies are more stable or less subject to reversal in periods of recession and economic stress than the profits of firms with related diversification strategies.
- *Managerial motives.* Unrelated diversification can provide benefits to managers such as higher compensation (which tends to increase with firm size and degree of diversification) and reduced their unemployment risk. Pursuing diversification for these reasons will likely reduce shareholder value and violate managers' fiduciary responsibilities.

Only profitable growth—the kind that comes from creating added value for shareholders—can justify a strategy of unrelated diversification.

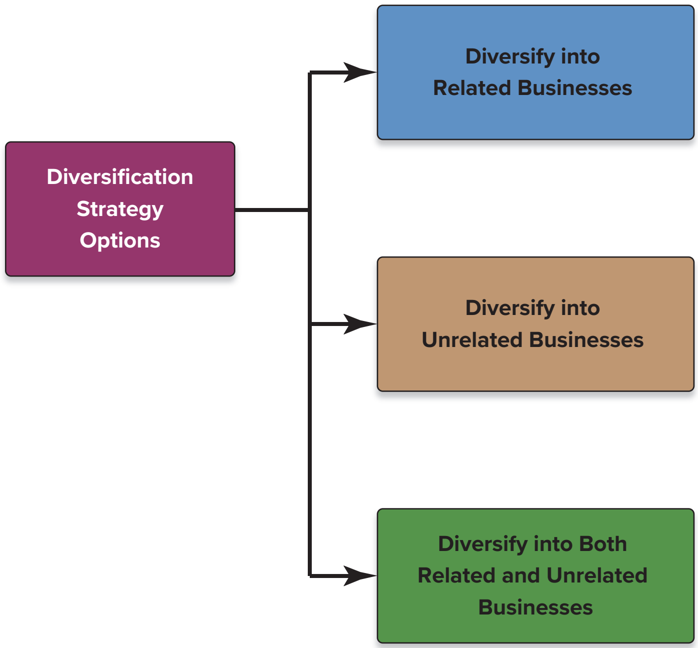
Because unrelated diversification strategies *at their best* have only a limited potential for creating long-term economic value for shareholders, it is essential that managers not compound this problem by taking a misguided approach toward unrelated diversification, in pursuit of objectives that are more likely to destroy shareholder value than create it.

COMBINATION RELATED–UNRELATED DIVERSIFICATION STRATEGIES

There's nothing to preclude a company from diversifying into both related and unrelated businesses. Indeed, in actual practice the business makeup of diversified companies varies considerably. Some diversified companies are really *dominant-business enterprises*—one major "core" business accounts for 50 to 80 percent of total revenues and a collection of small related or unrelated businesses accounts for the remainder. Some diversified companies are *narrowly diversified* around a few (two to five) related or unrelated businesses. Others are *broadly diversified* around a wide-ranging collection of related businesses, unrelated businesses, or a mixture of both. A number of multibusiness enterprises have diversified into unrelated areas but have a collection of related businesses within each area—thus giving them a business portfolio consisting of *several unrelated groups of related businesses.* There's ample room for companies to customize their diversification strategies to incorporate elements of both related and unrelated diversification, as may suit their own competitive asset profile and strategic vision. *Combination related–unrelated diversification strategies have particular appeal for companies with a mix of valuable competitive assets, covering the spectrum from general to specialized resources and capabilities.*

Figure 8.2 shows the range of alternatives for companies pursuing diversification.

FIGURE 8.2 Three Strategy Options for Pursuing Diversification



EVALUATING THE STRATEGY OF A DIVERSIFIED COMPANY

LO 8-4

Use the analytic tools for evaluating a company's diversification strategy.

Strategic analysis of diversified companies builds on the concepts and methods used for single-business companies. But there are some additional aspects to consider and a couple of new analytic tools to master. The procedure for evaluating the pluses and minuses of a diversified company's strategy and deciding what actions to take to improve the company's performance involves six steps:

1. Assessing the attractiveness of the industries the company has diversified into, both individually and as a group.
2. Assessing the competitive strength of the company's business units and drawing a nine-cell matrix to simultaneously portray industry attractiveness and business unit competitive strength.
3. Evaluating the extent of cross-business strategic fit along the value chains of the company's various business units.
4. Checking whether the firm's resources fit the requirements of its present business lineup.
5. Ranking the performance prospects of the businesses from best to worst and determining what the corporate parent's priorities should be in allocating resources to its various businesses.
6. Crafting new strategic moves to improve overall corporate performance.

The core concepts and analytic techniques underlying each of these steps merit further discussion.

Step 1: Evaluating Industry Attractiveness

A principal consideration in evaluating the caliber of a diversified company's strategy is the attractiveness of the industries in which it has business operations. Several questions arise:

1. Does each industry the company has diversified into represent a good market for the company to be in—does it pass the industry-attractiveness test?
2. Which of the company's industries are most attractive, and which are least attractive?
3. How appealing is the whole group of industries in which the company has invested?

The more attractive the industries (both individually and as a group) that a diversified company is in, the better its prospects for good long-term performance.

Calculating Industry-Attractiveness Scores A simple and reliable analytic tool for gauging industry attractiveness involves calculating quantitative industry-attractiveness scores based on the following measures:

- *Market size and projected growth rate.* Big industries are more attractive than small industries, and fast-growing industries tend to be more attractive than slow-growing industries, other things being equal.
- *The intensity of competition.* Industries where competitive pressures are relatively weak are more attractive than industries where competitive pressures are strong.
- *Emerging opportunities and threats.* Industries with promising opportunities and minimal threats on the near horizon are more attractive than industries with modest opportunities and imposing threats.
- *The presence of cross-industry strategic fit.* The more one industry's value chain and resource requirements match up well with the value chain activities of other industries in which the company has operations, the more attractive the industry is to a firm pursuing related diversification. However, cross-industry strategic fit is not something that a company committed to a strategy of unrelated diversification considers when it is evaluating industry attractiveness.
- *Resource requirements.* Industries in which resource requirements are within the company's reach are more attractive than industries in which capital and other resource requirements could strain corporate financial resources and organizational capabilities.
- *Social, political, regulatory, and environmental factors.* Industries that have significant problems in such areas as consumer health, safety, or environmental pollution or those subject to intense regulation are less attractive than industries that do not have such problems.
- *Industry profitability.* Industries with healthy profit margins and high rates of return on investment are generally more attractive than industries with historically low or unstable profits.

Each attractiveness measure is then assigned a weight reflecting its relative importance in determining an industry's attractiveness, since not all attractiveness measures are equally important. The intensity of competition in an industry should nearly always carry a high weight (say, 0.20 to 0.30). Strategic-fit considerations should be assigned a high weight in the case of companies with related diversification strategies; but for companies with an unrelated diversification strategy, strategic fit with other industries may be dropped from the list of attractiveness measures altogether. The importance weights must add up to 1.

TABLE 8.1 Calculating Weighted Industry-Attractiveness Scores

		Industry-Attractiveness Assessments					
		Industry A		Industry B		Industry C	
Industry-Attractiveness Measure	Importance Weight	Attractiveness Rating*	Weighted Score	Attractiveness Rating*	Weighted Score	Attractiveness Rating*	Weighted Score
Market size and projected growth rate	0.10	8	0.80	3	0.30	5	0.50
Intensity of competition	0.25	8	2.00	2	0.50	5	1.25
Emerging opportunities and threats	0.10	6	0.60	5	0.50	4	0.40
Cross-industry strategic fit	0.30	8	2.40	2	0.60	3	0.90
Resource requirements	0.10	5	0.50	5	0.50	4	0.40
Social, political, regulatory, and environmental factors	0.05	8	0.40	3	0.15	7	1.05
Industry profitability	0.10	5	0.50	4	0.40	6	0.60
Sum of importance weights	**1.00**						
Weighted overall industry-attractiveness scores			**7.20**		**2.95**		**5.10**

**Rating scale:* 1 = very unattractive to company; 10 = very attractive to company.

Finally, each industry is rated on each of the chosen industry-attractiveness measures, using a rating scale of 1 to 10 (where a *high* rating signifies *high* attractiveness, and a *low* rating signifies *low* attractiveness). *Keep in mind here that the more intensely competitive an industry is, the lower the attractiveness rating for that industry.* Likewise, the more the resource requirements associated with being in a particular industry are beyond the parent company's reach, the lower the attractiveness rating. On the other hand, the presence of good cross-industry strategic fit should be given a very high attractiveness rating, since there is good potential for competitive advantage and added shareholder value. Weighted attractiveness scores are then calculated by multiplying the industry's rating on each measure by the corresponding weight. For example, a rating of 8 times a weight of 0.25 gives a weighted attractiveness score of 2. The sum of the weighted scores for all the attractiveness measures provides an overall industry-attractiveness score. This procedure is illustrated in Table 8.1.

Interpreting the Industry-Attractiveness Scores Industries with a score much below 5 probably do not pass the attractiveness test. If a company's industry-attractiveness scores are all above 5, it is probably fair to conclude that the group of industries the company operates in is attractive as a whole. But the group of industries takes on a decidedly lower degree of attractiveness as the number of industries with scores below 5 increases, especially if industries with low scores account for a sizable fraction of the company's revenues.

For a diversified company to be a strong performer, a substantial portion of its revenues and profits must come from business units with relatively high attractiveness scores. It is particularly important that a diversified company's principal businesses be in industries with a good outlook for growth and above-average profitability. Having a big fraction of the company's revenues and profits come from industries with slow growth, low profitability, intense competition, or other troubling conditions tends to drag overall company performance down. Business units in the least attractive industries are potential candidates for divestiture, unless they are positioned strongly enough to overcome the unattractive aspects of their industry environments or they are a strategically important component of the company's business makeup.

Step 2: Evaluating Business Unit Competitive Strength

The second step in evaluating a diversified company is to appraise the competitive strength of each business unit in its respective industry. Doing an appraisal of each business unit's strength and competitive position in its industry not only reveals its chances for success in its industry but also provides a basis for ranking the units from competitively strongest to competitively weakest and sizing up the competitive strength of all the business units as a group.

Calculating Competitive-Strength Scores for Each Business Unit Quantitative measures of each business unit's competitive strength can be calculated using a procedure similar to that for measuring industry attractiveness. The following factors are used in quantifying the competitive strengths of a diversified company's business subsidiaries:

- *Relative market share.* A business unit's *relative market share* is defined as the ratio of its market share to the market share held by the largest rival firm in the industry, with market share measured in unit volume, not dollars. For instance, if business A has a market-leading share of 40 percent and its largest rival has 30 percent, A's relative market share is 1.33. (Note that only business units that are market share leaders in their respective industries can have relative market shares greater than 1.) If business B has a 15 percent market share and B's largest rival has 30 percent, B's relative market share is 0.5. *The further below 1 a business unit's relative market share is, the weaker its competitive strength and market position vis-à-vis rivals.*
- *Costs relative to competitors' costs.* Business units that have low costs relative to those of key competitors tend to be more strongly positioned in their industries than business units struggling to maintain cost parity with major rivals. The only time a business unit's competitive strength may not be undermined by having higher costs than rivals is when it has incurred the higher costs to strongly differentiate its product offering and its customers are willing to pay premium prices for the differentiating features.
- *Ability to match or beat rivals on key product attributes.* A company's competitiveness depends in part on being able to satisfy buyer expectations with regard to features, product performance, reliability, service, and other important attributes.

- *Brand image and reputation.* A widely known and respected brand name is a valuable competitive asset in most industries.
- *Other competitively valuable resources and capabilities.* Valuable resources and capabilities, including those accessed through collaborative partnerships, enhance a company's ability to compete successfully and perhaps contend for industry leadership.
- *Ability to benefit from strategic fit with other business units.* Strategic fit with other businesses within the company enhances a business unit's competitive strength and may provide a competitive edge.
- *Ability to exercise bargaining leverage with key suppliers or customers.* Having bargaining leverage signals competitive strength and can be a source of competitive advantage.
- *Profitability relative to competitors.* Above-average profitability on a consistent basis is a signal of competitive advantage, whereas consistently below-average profitability usually denotes competitive disadvantage.

After settling on a set of competitive-strength measures that are well matched to the circumstances of the various business units, the company needs to assign weights indicating each measure's importance. As in the assignment of weights to industry-attractiveness measures, the importance weights must add up to 1. Each business unit is then rated on each of the chosen strength measures, using a rating scale of 1 to 10 (where a *high* rating signifies competitive *strength,* and a *low* rating signifies competitive *weakness*). In the event that the available information is too limited to confidently assign a rating value to a business unit on a particular strength measure, it is usually best to use a score of 5—this avoids biasing the overall score either up or down. Weighted strength ratings are calculated by multiplying the business unit's rating on each strength measure by the assigned weight. For example, a strength score of 6 times a weight of 0.15 gives a weighted strength rating of 0.90. The sum of the weighted ratings across all the strength measures provides a quantitative measure of a business unit's overall competitive strength. Table 8.2 provides sample calculations of competitive-strength ratings for three businesses.

Interpreting the Competitive-Strength Scores Business units with competitive-strength ratings above 6.7 (on a scale of 1 to 10) are strong market contenders in their industries. Businesses with ratings in the 3.3-to-6.7 range have moderate competitive strength vis-à-vis rivals. Businesses with ratings below 3.3 have a competitively weak standing in the marketplace. If a diversified company's business units all have competitive-strength scores above 5, it is fair to conclude that its business units are all fairly strong market contenders in their respective industries. But as the number of business units with scores below 5 increases, there's reason to question whether the company can perform well with so many businesses in relatively weak competitive positions. This concern takes on even more importance when business units with low scores account for a sizable fraction of the company's revenues.

Using a Nine-Cell Matrix to Simultaneously Portray Industry Attractiveness and Competitive Strength The industry-attractiveness and business-strength scores can be used to portray the strategic positions of each business in a diversified company. Industry attractiveness is plotted on the vertical axis and competitive strength on the horizontal axis. A nine-cell grid emerges from dividing the vertical axis into three regions (high, medium, and low attractiveness) and the horizontal axis into three regions (strong, average, and weak competitive strength). As shown in Figure 8.3, scores of 6.7 or greater on a rating scale of 1 to 10 denote high industry attractiveness,

TABLE 8.2 Calculating Weighted Competitive-Strength Scores for a Diversified Company's Business Units

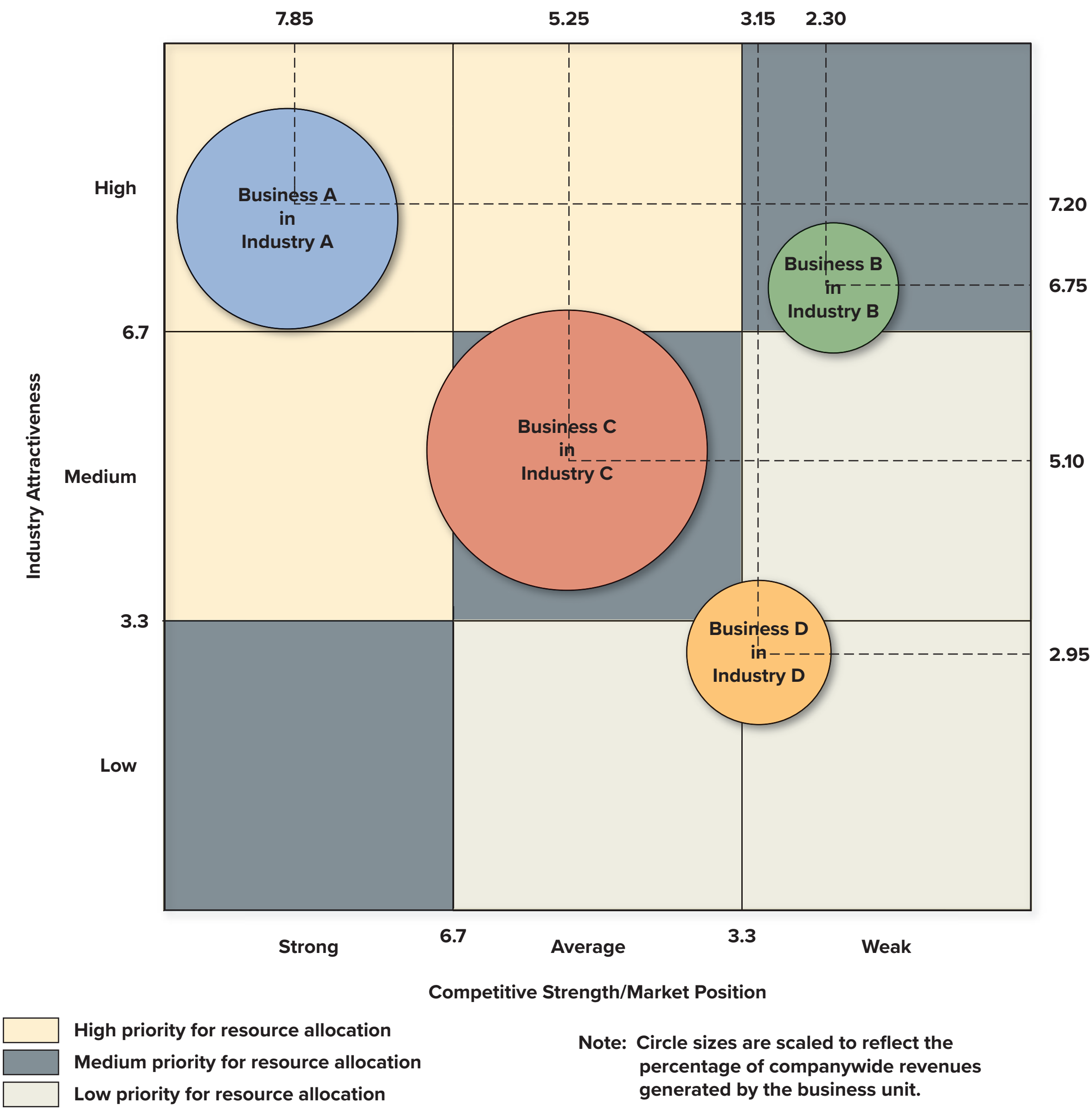
		Competitive-Strength Assessments					
		Business A in Industry A		Business B in Industry B		Business C in Industry C	
Competitive-Strength Measures	**Importance Weight**	**Strength Rating***	**Weighted Score**	**Strength Rating***	**Weighted Score**	**Strength Rating***	**Weighted Score**
Relative market share	0.15	10	1.50	2	0.30	6	0.90
Costs relative to competitors' costs	0.20	7	1.40	4	0.80	5	1.00
Ability to match or beat rivals on key product attributes	0.05	9	0.45	5	0.25	8	0.40
Ability to benefit from strategic fit with sister businesses	0.20	8	1.60	4	0.80	8	0.80
Bargaining leverage with suppliers/customers	0.05	9	0.45	2	0.10	6	0.30
Brand image and reputation	0.10	9	0.90	4	0.40	7	0.70
Other valuable resources/ capabilities	0.15	7	1.05	2	0.30	5	0.75
Profitability relative to competitors	0.10	5	0.50	2	0.20	4	0.40
Sum of importance weights	**1.00**						
Weighted overall competitive strength scores			**7.85**		**3.15**		**5.25**

**Rating scale:* 1 = very weak; 10 = very strong.

scores of 3.3 to 6.7 denote medium attractiveness, and scores below 3.3 signal low attractiveness. Likewise, high competitive strength is defined as scores greater than 6.7, average strength as scores of 3.3 to 6.7, and low strength as scores below 3.3. *Each business unit is plotted on the nine-cell matrix according to its overall attractiveness score and strength score, and then it is shown as a "bubble."* The size of each bubble is scaled to the percentage of revenues the business generates relative to total corporate revenues. The bubbles in Figure 8.3 were located on the grid using the three industry-attractiveness scores from Table 8.1 and the strength scores for the three business units in Table 8.2.

The locations of the business units on the attractiveness–strength matrix provide valuable guidance in deploying corporate resources. In general, *a diversified company's best prospects for good overall performance involve concentrating corporate resources on business units having the greatest competitive strength and industry attractiveness.* Businesses positioned in the three cells in the upper left portion of the attractiveness–strength matrix (like business A) have both favorable industry attractiveness and competitive strength and should receive a high investment priority. Business units plotted in these

FIGURE 8.3 A Nine-Cell Industry Attractiveness–Competitive Strength Matrix



three cells (such as business A in Figure 8.3) are referred to as *grow and build* businesses because of their capability to drive future increases in shareholder value.

Next in priority come businesses positioned in the three diagonal cells stretching from the lower left to the upper right (businesses B and C in Figure 8.3). Such businesses usually merit intermediate priority in the parent's resource allocation ranking. However, some businesses in the medium-priority diagonal cells may have brighter or dimmer prospects than others. For example, a small business in the upper right cell of the matrix, (like business B), despite being in a highly attractive industry, may occupy too weak a competitive position in its industry to justify the investment and resources needed to turn it into a strong market contender.

Businesses in the three cells in the lower right corner of the matrix (business D in Figure 8.3) have comparatively low industry attractiveness and minimal competitive strength, making them weak performers with little potential for improvement. At best, they have the lowest claim on corporate resources and may be good candidates for being divested (sold to other companies). However, there are occasions when a business located in the three lower-right cells generates sizable positive cash flows. It may make sense to retain such businesses and divert their cash flows to finance expansion of business units with greater potential for profit growth.

The nine-cell attractiveness–strength matrix provides clear, strong logic for why a diversified company needs to consider both industry attractiveness and business strength in allocating resources and investment capital to its different businesses. A good case can be made for concentrating resources in those businesses that enjoy higher degrees of attractiveness and competitive strength, being very selective in making investments in businesses with intermediate positions on the grid, and withdrawing resources from businesses that are lower in attractiveness and strength unless they offer exceptional profit or cash flow potential.

Step 3: Determining the Competitive Value of Strategic Fit in Diversified Companies

While this step can be bypassed for diversified companies whose businesses are all unrelated (since, by design, strategic fit is lacking), assessing the degree of strategic fit across a company's businesses is central to evaluating its related diversification strategy. But more than just checking for the presence of strategic fit is required here. *The real question is how much competitive value can be generated from whatever strategic fit exists.* Are the cost savings associated with economies of scope likely to give one or more individual businesses a cost-based advantage over rivals? How much competitive value will come from the cross-business transfer of skills, technology, or intellectual capital or the sharing of competitive assets? Can leveraging a potent umbrella brand or corporate image strengthen the businesses and increase sales significantly? Could cross-business collaboration to create new competitive capabilities lead to significant gains in performance? Without significant cross-business strategic fit and dedicated company efforts to capture the benefits, one has to be skeptical about the potential for a diversified company's businesses to perform better together than apart.

The greater the value of cross-business strategic fit in enhancing the performance of a diversified company's businesses, the more competitively powerful is the company's related diversification strategy.

Figure 8.4 illustrates the process of comparing the value chains of a company's businesses and identifying opportunities to exploit competitively valuable cross-business strategic fit.

CORE CONCEPT

A company pursuing related diversification exhibits **resource fit** when its businesses have matching specialized resource requirements along their value chains. A company pursuing unrelated diversification has resource fit when the parent company has adequate corporate resources (parenting and general resources) to support its businesses' needs and add value.

Step 4: Checking for Good Resource Fit

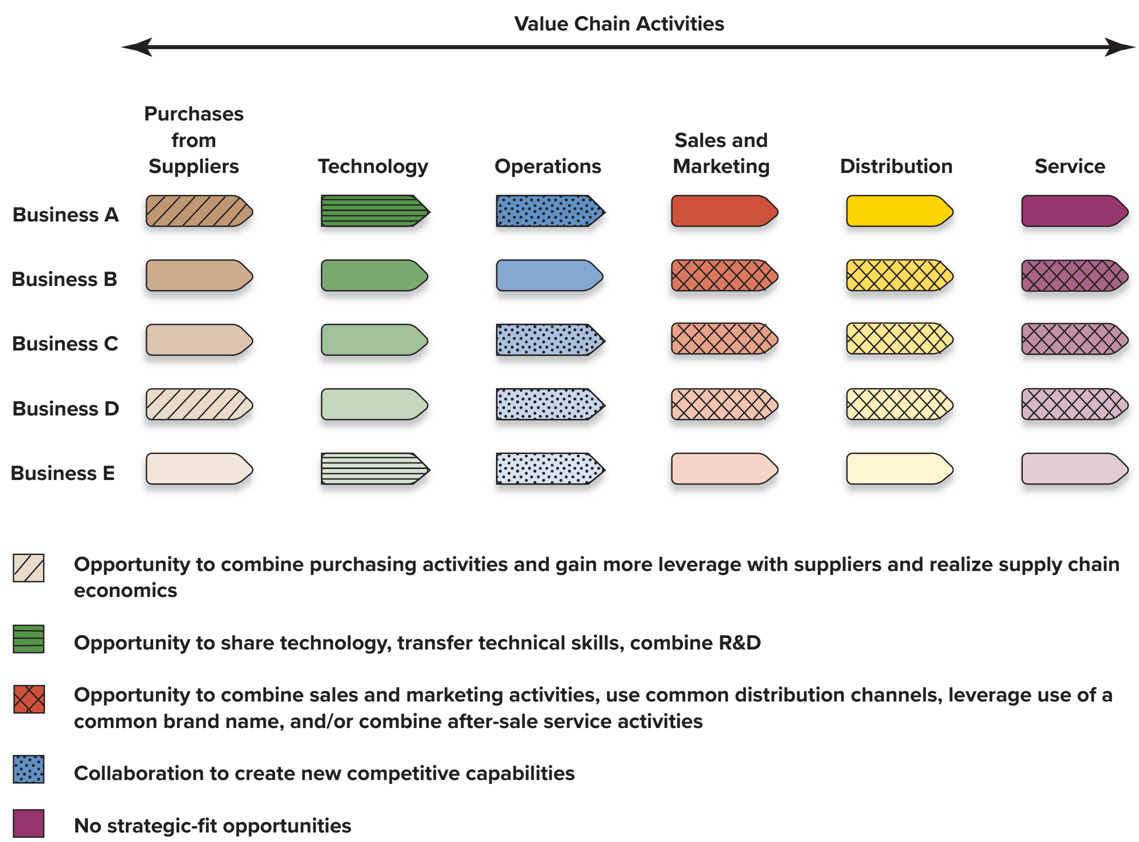
The businesses in a diversified company's lineup need to exhibit good **resource fit.** In firms with a related diversification strategy, good resource fit exists *when the firm's businesses have well-matched specialized resource requirements at points along their value chains* that are critical for the businesses' market success. Matching resource requirements is important in related diversification because they facilitate resource sharing and low-cost resource transfer. In companies pursuing unrelated diversification, resource fit exists when the company has solid *parenting capabilities or resources of a general nature that it can share or transfer to its component businesses.* Firms pursuing related diversification and firms with combination related– unrelated diversification strategies can also benefit from leveraging corporate parenting capabilities and other general resources. Another dimension of resource fit that concerns all types of multibusiness firms is whether they have resources sufficient to support their group of businesses without being spread too thin.

Financial Resource Fit The most important dimension of financial resource fit concerns whether a diversified company can generate the internal cash flows sufficient to fund the capital requirements of its businesses, pay its dividends, meet its debt obligations, and otherwise remain financially healthy. (Financial resources, including the firm's ability to borrow or otherwise raise funds, are a type of general resource.) While additional capital can usually be raised in financial markets, it is important for a diversified firm to have a healthy **internal capital market** that can support the financial requirements of its business lineup. The greater the extent to which a diversified company is able to fund investment in its businesses through internally generated cash flows rather than from equity issues or borrowing, the more powerful its financial resource fit and the less dependent the firm is on external financial resources. This can provide a competitive advantage over single business rivals when credit market conditions are tight, as they have been in the United States and abroad in recent years.

CORE CONCEPT

A strong **internal capital market** allows a diversified company to add value by shifting capital from business units generating free cash flow to those needing additional capital to expand and realize their growth potential.

FIGURE 8.4 Identifying the Competitive Advantage Potential of Cross-Business Strategic Fit



CORE CONCEPT

A **portfolio approach** to ensuring financial fit among a firm's businesses is based on the fact that different businesses have different cash flow and investment characteristics.

CORE CONCEPT

A **cash hog** business generates cash flows that are too small to fully fund its growth; it thereby requires cash infusions to provide additional working capital and finance new capital investment.

CORE CONCEPT

A **cash cow** business generates cash flows over and above its internal requirements, thus providing a corporate parent with funds for investing in cash hog businesses, financing new acquisitions, or paying dividends.

A **portfolio approach** to ensuring financial fit among a firm's businesses is based on the fact that different businesses have different cash flow and investment characteristics. For example, business units in rapidly growing industries are often **cash hogs**—so labeled because the cash flows they are able to generate from internal operations aren't big enough to fund their operations and capital requirements for growth. To keep pace with rising buyer demand, rapid-growth businesses frequently need sizable annual capital investments—for new facilities and equipment, for new product development or technology improvements, and for additional working capital to support inventory expansion and a larger base of operations. Because a cash hog's financial resources must be provided by the corporate parent, corporate managers have to decide whether it makes good financial and strategic sense to keep pouring new money into a cash hog business.

In contrast, business units with leading market positions in mature industries may be **cash cows** in the sense that they generate substantial cash surpluses over what is needed to adequately fund their operations. Market leaders in slow-growth industries often generate sizable positive cash flows *over and above what is needed for growth and reinvestment* because their industry-leading positions tend to generate attractive earnings and because the slow-growth nature of their industry often entails relatively modest annual investment requirements. Cash cows, although not attractive from a growth standpoint, are valuable businesses from a financial resource perspective. The surplus cash flows they generate can be used to pay corporate dividends, finance acquisitions, and provide funds for investing in the company's promising cash hogs. It makes good financial and strategic sense for diversified companies to keep cash cows in a healthy condition, fortifying and defending their market position so as to preserve their cash-generating capability and have an ongoing source of financial resources to deploy elsewhere. General Electric considers its advanced materials, equipment services, and appliance and lighting businesses to be cash cow businesses.

Viewing a diversified group of businesses as a collection of cash flows and cash requirements (present and future flows) can be helpful in understanding what the financial ramifications of diversification are and why having businesses with good financial resource fit can be important. For instance, *a diversified company's businesses exhibit good financial resource fit when the excess cash generated by its cash cow businesses is sufficient to fund the investment requirements of promising cash hog businesses.* Ideally, investing in promising cash hog businesses over time results in growing the hogs into self-supporting *star businesses* that have strong or market-leading competitive positions in attractive, high-growth markets and high levels of profitability. Star businesses are often the cash cows of the future. When the markets of star businesses begin to mature and their growth slows, their competitive strength should produce self-generated cash flows that are more than sufficient to cover their investment needs. The "success sequence" is thus cash hog to young star (but perhaps still a cash hog) to self-supporting star to cash cow. While the practice of viewing a diversified company in terms of cash cows and cash hogs has declined in popularity, it illustrates one approach to analyzing financial resource fit and allocating financial resources across a portfolio of different businesses.

Aside from cash flow considerations, there are two other factors to consider in assessing whether a diversified company's businesses exhibit good financial fit:

1. *Do any of the company's individual businesses present financial challenges with respect to contributing adequately to achieving companywide performance targets?* A business exhibits poor financial fit if it soaks up a disproportionate share of the company's

financial resources, while making subpar or insignificant contributions to the bottom line. Too many underperforming businesses reduce the company's overall performance and ultimately limit growth in shareholder value.

2. *Does the corporation have adequate financial strength to fund its different businesses and maintain a healthy credit rating?* A diversified company's strategy fails the resource-fit test when the resource needs of its portfolio unduly stretch the company's financial health and threaten to impair its credit rating. Many of the world's largest banks, including Royal Bank of Scotland, Citigroup, and HSBC, recently found themselves so undercapitalized and financially overextended that they were forced to sell off some of their business assets to meet regulatory requirements and restore public confidence in their solvency.

Nonfinancial Resource Fit Just as a diversified company must have adequate financial resources to support its various individual businesses, it must also have a big enough and deep enough pool of managerial, administrative, and other parenting capabilities to support all of its different businesses. The following two questions help reveal whether a diversified company has sufficient nonfinancial resources:

1. *Does the parent company have (or can it develop) the specific resources and capabilities needed to be successful in each of its businesses?* Sometimes the resources a company has accumulated in its core business prove to be a poor match with the competitive capabilities needed to succeed in the businesses into which it has diversified. For instance, BTR, a multibusiness company in Great Britain, discovered that the company's resources and managerial skills were quite well suited for parenting its industrial manufacturing businesses but not for parenting its distribution businesses (National Tyre Services and Texas-based Summers Group). As a result, BTR decided to divest its distribution businesses and focus exclusively on diversifying around small industrial manufacturing. For companies pursuing related diversification strategies, a mismatch between the company's competitive assets and the key success factors of an industry can be serious enough to warrant divesting businesses in that industry or not acquiring a new business. In contrast, when a company's resources and capabilities are a good match with the key success factors of industries it is not presently in, it makes sense to take a hard look at acquiring companies in these industries and expanding the company's business lineup.
2. *Are the parent company's resources being stretched too thin by the resource requirements of one or more of its businesses?* A diversified company must guard against overtaxing its resources and capabilities, a condition that can arise when (1) it goes on an acquisition spree and management is called on to assimilate and oversee many new businesses very quickly or (2) it lacks sufficient resource depth to do a creditable job of transferring skills and competencies from one of its businesses to another. The broader the diversification, the greater the concern about whether corporate executives are overburdened by the demands of competently parenting so many different businesses. Plus, the more a company's diversification strategy is tied to transferring know-how or technologies from existing businesses to newly acquired businesses, the more time and money that has to be put into developing a deep-enough resource pool to supply these businesses with the resources and capabilities they need to be successful.[15] Otherwise, its resource pool ends up being spread too thinly across many businesses, and the opportunity for achieving 1 + 1 = 3 outcomes slips through the cracks.

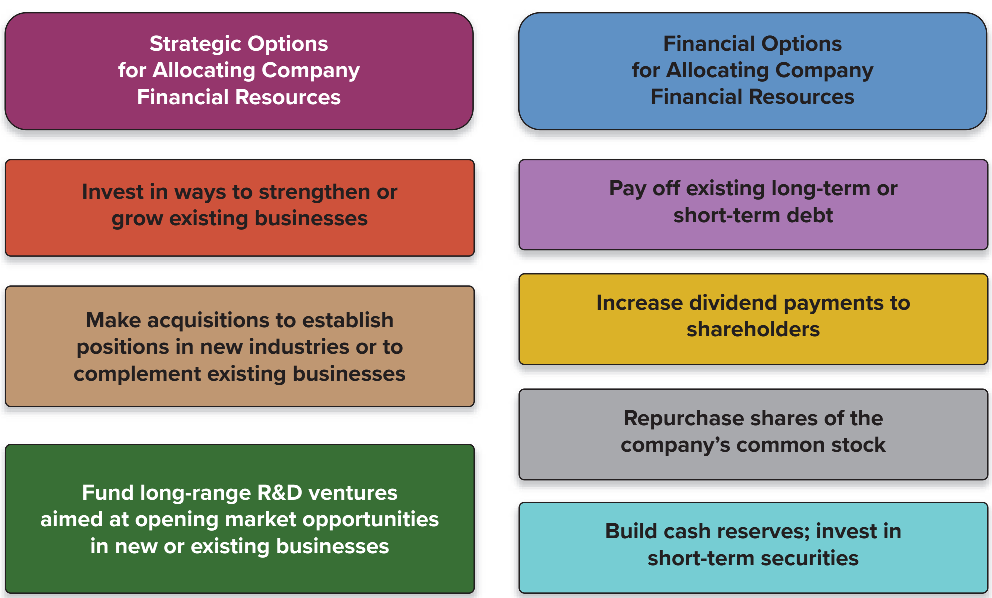
Step 5: Ranking Business Units and Assigning a Priority for Resource Allocation

Once a diversified company's strategy has been evaluated from the perspective of industry attractiveness, competitive strength, strategic fit, and resource fit, the next step is to use this information to rank the performance prospects of the businesses from best to worst. Such ranking helps top-level executives assign each business a priority for resource support and capital investment.

The locations of the different businesses in the nine-cell industry-attractiveness–competitive-strength matrix provide a solid basis for identifying high-opportunity businesses and low-opportunity businesses. Normally, competitively strong businesses in attractive industries have significantly better performance prospects than competitively weak businesses in unattractive industries. Also, the revenue and earnings outlook for businesses in fast-growing industries is normally better than for businesses in slow growing industries. As a rule, *business subsidiaries with the brightest profit and growth prospects, attractive positions in the nine-cell matrix, and solid strategic and resource fit should receive top priority for allocation of corporate resources.* However, in ranking the prospects of the different businesses from best to worst, it is usually wise to also take into account each business's past performance in regard to sales growth, profit growth, contribution to company earnings, return on capital invested in the business, and cash flow from operations. While past performance is not always a reliable predictor of future performance, it does signal whether a business is already performing well or has problems to overcome.

Allocating Financial Resources Figure 8.5 shows the chief strategic and financial options for allocating a diversified company's financial resources. Divesting businesses

FIGURE 8.5 The Chief Strategic and Financial Options for Allocating a Diversified Company's Financial Resources



with the weakest future prospects and businesses that lack adequate strategic fit and/or resource fit is one of the best ways of generating additional funds for redeployment to businesses with better opportunities and better strategic and resource fit. Free cash flows from cash cow businesses also add to the pool of funds that can be usefully redeployed. *Ideally,* a diversified company will have sufficient financial resources to strengthen or grow its existing businesses, make any new acquisitions that are desirable, fund other promising business opportunities, pay off existing debt, and periodically increase dividend payments to shareholders and/or repurchase shares of stock. But, as a practical matter, a company's financial resources are limited. Thus, to make the best use of the available funds, top executives must steer resources to those businesses with the best prospects and either divest or allocate minimal resources to businesses with marginal prospects—this is why ranking the performance prospects of the various businesses from best to worst is so crucial. *Strategic* uses of corporate financial resources should usually take precedence over strictly financial considerations (see Figure 8.5) unless there is a compelling reason to strengthen the firm's balance sheet or better reward shareholders.

Step 6: Crafting New Strategic Moves to Improve Overall Corporate Performance

LO 8-5

Understand the four main corporate strategy options a diversified company can employ to improve company performance.

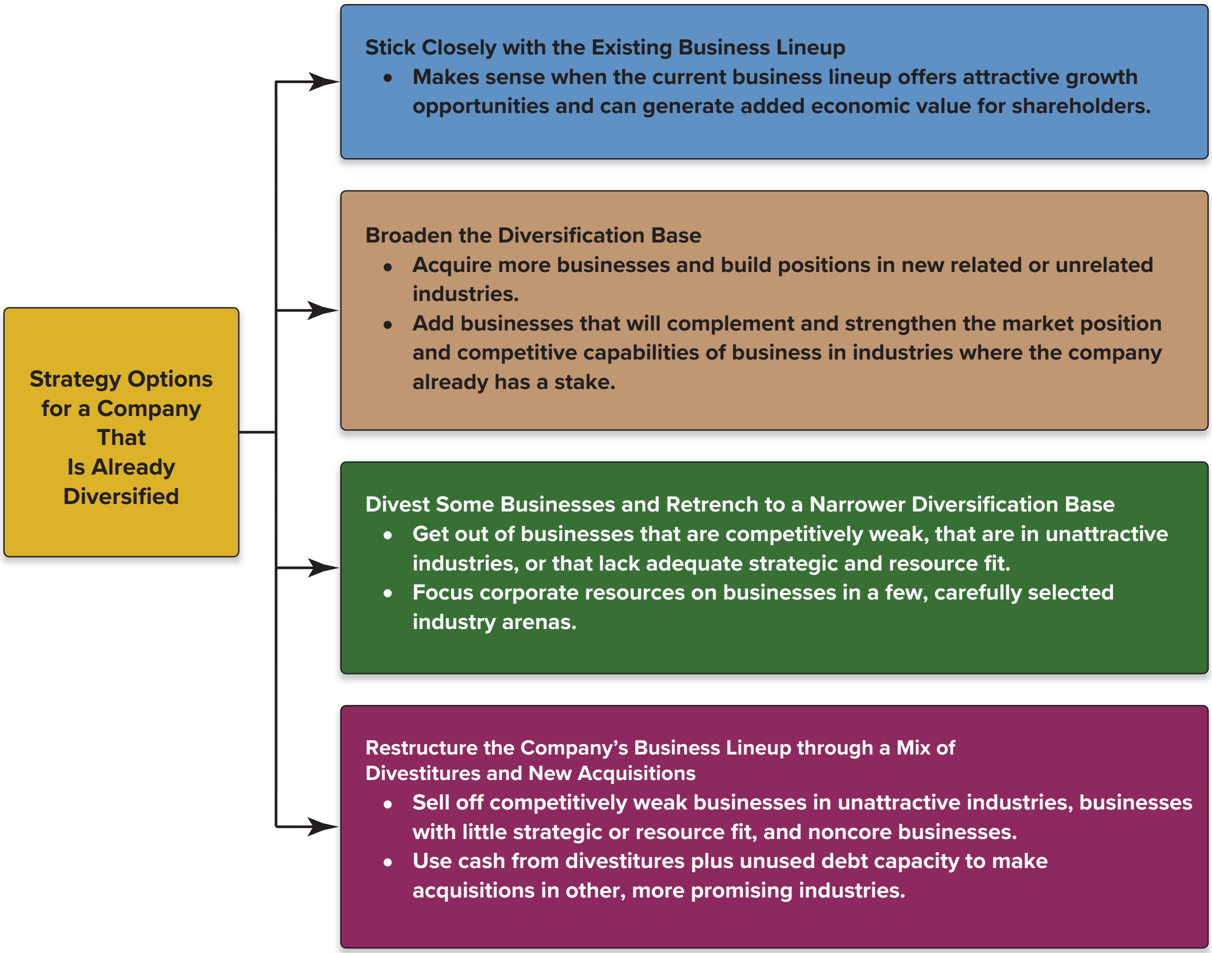
The conclusions flowing from the five preceding analytic steps set the agenda for crafting strategic moves to improve a diversified company's overall performance. The strategic options boil down to four broad categories of actions (see Figure 8.6):

1. Sticking closely with the existing business lineup and pursuing the opportunities these businesses present.
2. Broadening the company's business scope by making new acquisitions in new industries.
3. Divesting certain businesses and retrenching to a narrower base of business operations.
4. Restructuring the company's business lineup and putting a whole new face on the company's business makeup.

Sticking Closely with the Present Business Lineup The option of sticking with the current business lineup makes sense when the company's existing businesses offer attractive growth opportunities and can be counted on to create economic value for shareholders. As long as the company's set of existing businesses have good prospects and are in alignment with the company's diversification strategy, then major changes in the company's business mix are unnecessary. Corporate executives can concentrate their attention on getting the best performance from each of the businesses, steering corporate resources into the areas of greatest potential and profitability. The specifics of "what to do" to wring better performance from the present business lineup have to be dictated by each business's circumstances and the preceding analysis of the corporate parent's diversification strategy.

Broadening a Diversified Company's Business Base Diversified companies sometimes find it desirable to build positions in new industries, whether related or unrelated. Several motivating factors are in play. One is sluggish growth that makes the potential revenue and profit boost of a newly acquired business look attractive. A second is the potential for transferring resources and capabilities to other related or complementary

FIGURE 8.6 A Company's Four Main Strategic Alternatives after It Diversifies



businesses. A third is rapidly changing conditions in one or more of a company's core businesses, brought on by technological, legislative, or demographic changes. For instance, the passage of legislation in the United States allowing banks, insurance companies, and stock brokerages to enter each other's businesses spurred a raft of acquisitions and mergers to create full-service financial enterprises capable of meeting the multiple financial needs of customers. A fourth, and very important, motivating factor for adding new businesses is to complement and strengthen the market position and competitive capabilities of one or more of the company's present businesses. Procter & Gamble's acquisition of Gillette strengthened and extended P&G's reach into personal care and household products—Gillette's businesses included Oral-B toothbrushes, Gillette razors and razor blades, Duracell batteries, Braun shavers, small appliances (coffeemakers, mixers, hair dryers, and electric toothbrushes), and toiletries (Right Guard, Foamy, Soft & Dry, White Rain, and Dry Idea). Johnson & Johnson has used acquisitions to diversify far beyond its well-known Band-Aid and baby care businesses and become a major player in pharmaceuticals, medical devices, and medical diagnostics.

Another important avenue for expanding the scope of a diversified company is to grow by extending the operations of existing businesses into additional country markets, as discussed in Chapter 7. Expanding a company's geographic scope may offer an exceptional competitive advantage potential by facilitating the full capture of economies of scale and learning- and experience-curve effects. In some businesses, the volume of sales needed to realize full economies of scale and/or benefit fully from experience-curve effects exceeds the volume that can be achieved by operating within the boundaries of just one or several country markets, especially small ones.

Retrenching to a Narrower Diversification Base A number of diversified firms have had difficulty managing a diverse group of businesses and have elected to exit some of them. Selling a business outright to another company is far and away the most frequently used option for divesting a business. In 2022, Newell Brands sold its Connected Home & Security business to Resideo Technologies, where the strategic fit was much better. Nike chose to divest its Cole Haan brand to focus on Jordan and Converse brands that are more complementary to the Nike brand. But sometimes a business selected for divestiture has ample resources and capabilities to compete successfully on its own. In such cases, a corporate parent may elect to *spin off* the unwanted business as a financially and managerially independent company, either by selling shares to the public via an initial public offering or by distributing shares in the new company to shareholders of the corporate parent. A newly independent company created in such a manner is referred to as a **spin-off.** eBay spun off PayPal in 2015 at a valuation of $45 billion—a value 30 times more than what eBay paid for the company in a 2002 acquisition. In 2018, pesticide maker FMC Corp. spun off its lithium business to boost profitability by focusing on its core business.

A **spin-off** is an independent company created when a corporate parent divests a business either by selling shares to the public via an initial public offering or by distributing shares in the new company to shareholders of the corporate parent.

Retrenching to a narrower diversification base is usually undertaken when top management concludes that its diversification has ranged too far afield and that the company can improve long-term performance by concentrating on a smaller number of businesses. But there are other important reasons for divesting one or more of a company's present businesses. Sometimes divesting a business has to be considered because market conditions in a once-attractive industry have badly deteriorated. A business can become a prime candidate for divestiture because it lacks adequate strategic or resource fit, because it is a cash hog with questionable long-term potential, or because remedying its competitive weaknesses is too expensive relative to the likely gains in profitability. Sometimes a company acquires businesses that, down the road, just do not work out as expected even though management has tried its best. Subpar performance by some business units is bound to occur, thereby raising questions of whether to divest them or keep them and attempt a turnaround. Other business units, despite adequate financial performance, may not mesh as well with the rest of the firm as was originally thought. For instance, PepsiCo divested its group of fast-food restaurant businesses (Kentucky Fried Chicken, Pizza Hut, and Taco Bell) to focus on its core soft-drink and snack-food businesses, where their specialized resources and capabilities could add more value.

On occasion, a diversification move that seems sensible from a strategic-fit standpoint turns out to be a poor *cultural fit.*[16] When several pharmaceutical companies diversified into cosmetics and perfume, they discovered their personnel had little respect for the "frivolous" nature of such products compared to the far nobler task of developing miracle drugs to cure the ill. The absence of shared values and cultural compatibility between the medical research and chemical-compounding expertise of the pharmaceutical companies and the fashion and marketing orientation of the

Diversified companies need to divest low-performing businesses or businesses that don't fit in order to concentrate on expanding existing businesses and entering new ones where opportunities are more promising.

cosmetics business was the undoing of what otherwise was diversification into businesses with technology-sharing potential, product development fit, and some overlap in distribution channels.

A useful guide to determine whether or when to divest a business subsidiary is to ask, "If we were not in this business today, would we want to get into it now?" When the answer is no or probably not, divestiture should be considered. Another signal that a business should be divested occurs when it is worth more to another company than to the present parent; in such cases, shareholders would be well served if the company sells the business and collects a premium price from the buyer for whom the business is a valuable fit.

CORE CONCEPT

Corporate restructuring involves making major changes in a diversified company by divesting some businesses and/or acquiring others, so as to put a whole new face on the company's business lineup.

Restructuring a Diversified Company's Business Lineup Restructuring a diversified company on a companywide basis, called **corporate restructuring,** involves divesting some businesses and/or acquiring others, so as to put a whole new face on the company's business lineup.[17] Performing radical surgery on a company's business lineup is appealing when its financial performance is being squeezed or eroded by

- A serious mismatch between the company's resources and capabilities and the type of diversification that it has pursued.
- Too many businesses in slow-growth, declining, low-margin, or otherwise unattractive industries.
- Too many competitively weak businesses.
- The emergence of new technologies that threaten the survival of one or more important businesses.
- Ongoing declines in the market shares of one or more major business units that are falling prey to more market-savvy competitors.
- An excessive debt burden with interest costs that eat deeply into profitability.
- Ill-chosen acquisitions that haven't lived up to expectations.

On occasion, corporate restructuring can be prompted by special circumstances—such as when a firm has a unique opportunity to make an acquisition so big and important that it has to sell several existing business units to finance the new acquisition or when a company needs to sell off some businesses in order to raise the cash for entering a potentially big industry with wave-of-the-future technologies or products. As businesses are divested, corporate restructuring generally involves aligning the remaining business units into groups with the best strategic fit and then redeploying the cash flows from the divested businesses to either pay down debt or make new acquisitions to strengthen the parent company's business position in the industries it has chosen to emphasize.

Over the past decade, corporate restructuring has become a popular strategy at many diversified companies, especially those that had diversified broadly into many different industries and lines of business. Google is a prime example, having acquired over 200 businesses of varying types within the past 20 years. This rapid expansion led to a corporate restructuring in 2015 that created a new holding company called Alphabet, Inc. into which businesses other than Internet services were moved, each to be managed by its own CEO. Google remained the umbrella company for its core Internet service businesses, such as YouTube, Waze, the Android mobile operating system, and Google Search. Ultimately, Google was also folded into Alphabet and became its largest subsidiary. This restructuring allowed Google to slim down a bit

ILLUSTRATION CAPSULE 8.4 Restructuring Strategically at VF Corporation

Over its 125-year history, VF Corporation has become one of the world's largest apparel, footwear, and accessories companies through an aggressive acquisition strategy. Brands that they have acquired include North Face, Timberland, Wrangler, Lee, Jan Sport, Nautica, Eagle Creek, Smart Wool, and Altra Footwear. In recent years, however, the company's top managers began to notice that different segments of their business had diverging management requirements, due to differing distribution channels, customer needs, and growth patterns. The solution was to restructure the company, which was characterized as very much a strategic move, since there was an absence of good strategic fit among these two different types of businesses.

In 2019, the company split itself into two separate organizations, moving VF's Jeanswear organization into an independent, publicly traded company (a type of move known as a *spin-off*). The new company was named Kontoor Brands, Inc., and included the Wrangler, Lee, and Rock & Republic brands, along with the VF Outlet business. VF Corporation, also known as VFC, would retain the more dynamic, faster-moving active-lifestyle brands. The split was hoped to enable the faster growing segments retained within VFC to pursue opportunities that are less relevant to the concerns of the more staid sister business of Kontoor. It would also enable the brands within VFC to respond in a more nimble way to the rapid changes that tend to characterize the world of fashion. VF acquired the Supreme streetwear brand in 2020 and divested its workwear division in 2021 to tighten its focus on outdoor and lifestyle brands. By 2022, it was regarded as a $11.8 billion powerhouse in the apparel industry.

SOPA Images/Getty Images

Sources: "The 10 Largest Clothing Companies in America and the World", by Amanda Covaleski, April 16, 2023, **Zipia.com**; Company website; **https://www.thestreet.com/investing/stocks/v-f-corp-ceo-why-we-just-made-one-of-the-biggest-decisions-in-our-company-history-14681383**, accessed February 4, 2020.

and focus more on its core businesses, while allowing the more unrelated companies greater independence under Alphabet. The restructuring has purportedly accomplished much of its aims, reaching $1.26 trillion market value by January 2023. Other seemingly successful restructuring efforts include Disney's reorganization into four business units to help it capitalize on growth opportunities, Hulu's steps to streamline while accommodating further growth, and the Wall Street Journal's efforts to shift toward a more digital strategy.

Illustration Capsule 8.4 discusses how VF Corporation, maker of North Face and other popular "lifestyle" apparel brands, has used a restructuring strategy to rationalize its management of different types of companies.

KEY POINTS

1. The purpose of diversification is to build shareholder value. Diversification builds shareholder value only when a diversified group of businesses can perform better under the auspices of a single corporate parent than they would as independent, standalone businesses. The goal is to achieve not just a $1 + 1 = 2$ result but rather to realize important $1 + 1 = 3$ performance benefits—an effect known as *synergy.* For a move to diversify into a new business to have a reasonable prospect of adding shareholder value, it must be capable of passing the three Tests of Corporate Advantage: the industry attractiveness test, the cost-of-entry test, and the better-off test.
2. Entry into new businesses can take any of three forms: acquisition, internal startup, or joint venture. The choice of which is best depends on the firm's resources and capabilities, the industry's entry barriers, the importance of speed, and relative costs.
3. There are two fundamental approaches to diversification—into related businesses and into unrelated businesses. The rationale for *related* diversification is to benefit from *strategic fit:* diversify into businesses with commonalities across their respective value chains, and then capitalize on the strategic fit by sharing or transferring the resources and capabilities across matching value chain activities to gain competitive advantages.
4. *Unrelated* diversification strategies surrender the competitive advantage potential of strategic fit at the value chain level in return for the potential that can be realized from superior corporate parenting or the sharing and transfer of general resources and capabilities. An outstanding corporate parent can benefit its businesses through (1) providing high-level oversight and making available other corporate resources, (2) allocating financial resources across the business portfolio (under certain circumstances), and (3) restructuring underperforming acquisitions.
5. Related diversification provides a stronger foundation for creating shareholder value than does unrelated diversification, since the *specialized resources and capabilities* that are leveraged in related diversification tend to be more valuable competitive assets than the *general resources and capabilities* underlying unrelated diversification, which in most cases are relatively common and easier to imitate.
6. Analyzing how good a company's diversification strategy is consists of a six-step process:

   Step 1: *Evaluate the long-term attractiveness of the industries into which the firm has diversified.* Determining industry attractiveness involves developing a list of industry-attractiveness measures, each of which might have a different importance weight.

   Step 2: *Evaluate the relative competitive strength of each of the company's business units.* The purpose of rating the competitive strength of each business is to gain a clear understanding of which businesses are strong contenders in their industries, which are weak contenders, and what the underlying reasons are for their strength or weakness. The conclusions about industry attractiveness can be joined with the conclusions about competitive strength by drawing a nine-cell industry-attractiveness–competitive-strength matrix that helps identify the prospects of each business and the level of priority each business should be given in allocating corporate resources and investment capital.

   Step 3: *Check for the competitive value of cross-business strategic fit.* A business is more attractive strategically when it has value chain relationships with the other business units that offer the potential to (1) combine operations to realize economies of scope, (2) transfer technology, skills, know-how, or other resource capabilities from one business to another, (3) leverage the use of a trusted brand name or other resources that enhance differentiation, (4) share other competitively valuable resources among the company's businesses, and (5) build new resources and competitive capabilities via cross-business collaboration. Cross-business strategic fit represents a significant avenue for producing competitive advantage beyond what any one business can achieve on its own.

Step 4: *Check whether the firm's resources fit the resource requirements of its present business lineup.* In firms with a related diversification strategy, resource fit exists when the firm's businesses have matching resource requirements at points along their value chains that are critical for the businesses' market success. In companies pursuing unrelated diversification, resource fit exists when the company has solid parenting capabilities or resources of a general nature that it can share or transfer to its component businesses. When there is financial resource fit among the businesses of any type of diversified company, the company can generate internal cash flows sufficient to fund the capital requirements of its businesses, pay its dividends, meet its debt obligations, and otherwise remain financially healthy.

Step 5: *Rank the performance prospects of the businesses from best to worst, and determine what the corporate parent's priority should be in allocating resources to its various businesses.* The most important considerations in judging business unit performance are sales growth, profit growth, contribution to company earnings, and the return on capital invested in the business. Normally, strong business units in attractive industries should head the list for corporate resource support.

Step 6: *Craft new strategic moves to improve overall corporate performance.* This step draws on the results of the preceding steps as the basis for selecting one of four different strategic paths for improving a diversified company's performance: (1) Stick closely with the existing business lineup and pursue opportunities presented by these businesses, (2) broaden the scope of diversification by entering additional industries, (3) retrench to a narrower scope of diversification by divesting poorly performing businesses, or (4) broadly restructure the business lineup with multiple divestitures and/or acquisitions.

ASSURANCE OF LEARNING EXERCISES

connect

LO 8-1, LO 8-2, LO 8-3, LO 8-4

1. See if you can identify the value chain relationships that make the businesses of the following companies related in competitively relevant ways. In particular, you should consider whether there are cross-business opportunities for (1) transferring skills and technology, (2) combining related value chain activities to achieve economies of scope, and/or (3) leveraging the use of a well-respected brand name or other resources that enhance differentiation.

Bloomin' Brands

- Outback Steakhouse
- Carrabba's Italian Grill
- Bonefish Grill (market-fresh fine seafood)
- Fleming's Prime Steakhouse & Wine Bar

L'Oréal

- Maybelline, Lancôme, Helena Rubinstein, essie, Kiehl's and Shu Uemura cosmetics
- L'Oréal and Soft Sheen/Carson hair care products

- Redken, Matrix, L'Oréal Professional, and Kerastase Paris professional hair care and skin care products
- Ralph Lauren and Giorgio Armani fragrances
- Biotherm skin care products
- La Roche–Posay and Vichy Laboratories dermo-cosmetics

Johnson & Johnson

- Baby products (powder, shampoo, oil, lotion)
- Band-Aids and other first-aid products
- Women's health and personal care products (Stayfree, Carefree, Sure & Natural)
- Neutrogena, and Aveeno skin care products
- Nonprescription drugs (Tylenol, Motrin, Pepcid AC, Mylanta, Monistat)
- Prescription drugs
- Prosthetic and other medical devices
- Surgical and hospital products
- Acuvue contact lenses

LO 8-1, LO 8-2, LO 8-3, LO 8-4

2. Peruse the business group listings for 3M Company shown as follows and listed on its website. How would you characterize the company's corporate strategy—related diversification, unrelated diversification, or a combination related–unrelated diversification strategy? Explain your answer.
    - Consumer products—for the home and office including Post-it® and Scotch®
    - Transportation and Electronics—automotive and aerospace films and tapes; electronics assembly solutions
    - Health Care—filtration systems, wound care products, dentistry products, health care software solutions
    - Safety and Industrial—abrasives, adhesives, specialty materials, and filtration systems, safety and security products

connect

LO 8-1, LO 8-2, LO 8-3, LO 8-4, LO 8-5

3. ITT is a technology-oriented engineering and manufacturing company with the following business divisions and products:
    - Industrial Process Division—industrial pumps, valves, and monitoring and control systems; aftermarket services for the chemical, oil and gas, mining, pulp and paper, power, and biopharmaceutical markets
    - Motion Technologies Division—durable brake pads, shock absorbers, and damping technologies for the automotive and rail markets
    - Interconnect Solutions—connectors and fittings for the production of automobiles, aircraft, railcars and locomotives, oil field equipment, medical equipment, and industrial equipment
    - Control Technologies—energy absorption and vibration dampening equipment, transducers and regulators, and motion controls used in the production of robotics, medical equipment, automobiles, subsea equipment, industrial equipment, aircraft, and military vehicles

    Based on the previous listing, would you say that ITT's business lineup reflects a strategy of related diversification, unrelated diversification, or a combination of related and unrelated diversification? What benefits are generated from any strategic fit existing between ITT's businesses? Also, what types of companies should ITT consider acquiring that might improve shareholder value? Justify your answer.

EXERCISES FOR SIMULATION PARTICIPANTS

1. In the event that your company has the opportunity to diversify into other products or businesses of your choosing, what would be the advantages of opting to pursue related diversification, unrelated diversification, or a combination of both? Explain why. **LO 8-1, LO 8-2, LO 8-3**
2. What strategic-fit benefits might be captured by transferring resources and competitive capabilities to newly acquired related businesses.
3. If your company opted to pursue a strategy of related diversification, what industries or product categories could it diversify into that would allow it to achieve economies of scope? Name at least two or three such industries or product categories, and indicate the specific kinds of cost savings that might accrue from entry into each. **LO 8-1, LO 8-2**
4. If your company opted to pursue a strategy of unrelated diversification, what industries or product categories could it diversify into that would allow it to capitalize on using its present brand name and corporate image to good advantage in the newly entered businesses or product categories? Name at least two or three such industries or product categories, and indicate the *specific benefits* that might be captured by transferring your company's umbrella brand name to each. **LO 8-1, LO 8-3**

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chapter 9

Ethics, Corporate Social Responsibility, Environmental Sustainability, and Strategy

Learning Objectives

After reading this chapter, you should be able to

LO 9-1 Understand why the standards of ethical behavior in business are no different from ethical standards in general.

LO 9-2 Recognize conditions that give rise to unethical business strategies and behavior.

LO 9-3 Identify the costs of business ethics failures.

LO 9-4 Understand the concepts of corporate social responsibility and sustainability and how companies balance economic responsibilities to shareholders with environmental and social responsibilities.

Richard Schneider/Getty Images

A well-run business must have high and consistent standards of ethics.

Richard Branson—*Founder of Virgin Atlantic Airlines and Virgin Group*

When sustainability is viewed as being a matter of survival for your business, I believe you can create massive change.

Cameron Sinclair—*Head of social innovation at Airbnb*

The choice between a healthy planet and good business strategy has always been a false one, and we've proved that, with a company that runs on 100% clean energy and a supply chain transitioning to do the same

Lisa Jackson—*Vice President of Environment, Policy, and Social Initiatives, Apple Inc.*

Clearly, in capitalistic or market economies, a company has a responsibility to make a profit and grow the business. Managers of public companies have a fiduciary duty to operate the enterprise in a manner that creates value for the company's shareholders—a legal obligation. Just as clearly, a company and its personnel are duty-bound to obey the law otherwise and comply with governmental regulations. But does a company also have a duty to go beyond legal requirements and hold all company personnel responsible for conforming to high ethical standards? Does it have an obligation to contribute to the betterment of society, independent of the needs and preferences of the customers it serves? Should a company display a social conscience by devoting a portion of its resources to bettering society? Should its strategic initiatives be screened for possible negative effects on future generations of the world's population?

This chapter focuses on whether a company, in the course of trying to craft and execute a strategy that delivers value to both customers and shareholders, also has a duty to benefit, or at least do no harm to, its stakeholders (which extends to society at large). That is to say, is there a duty to (1) act in an ethical manner; (2) be a committed corporate citizen and allocate some of its resources to improving the well-being of employees, the communities in which it operates, and society as a whole; and (3) adopt business practices that conserve natural resources, protect the interests of future generations, and preserve the well-being of the planet?

WHAT DO WE MEAN BY *BUSINESS ETHICS?*

CORE CONCEPT

Business ethics involves the application of general ethical principles to the actions and decisions of businesses and the conduct of their personnel.

LO 9-1

Understand why the standards of ethical behavior in business are no different from ethical standards in general.

Ethics concerns principles of right or wrong conduct. **Business ethics** is the application of ethical principles and standards to the actions and decisions of business organizations and the conduct of their personnel.[1] *Ethical principles in business are not materially different from ethical principles in general.* Why? Because business actions have to be judged in the context of society's standards of right and wrong, not with respect to a special set of ethical standards applicable only to business situations. If dishonesty is considered unethical and immoral, then dishonest behavior in business—whether it relates to customers, suppliers, employees, shareholders, competitors, or government—qualifies as equally unethical and immoral. If being ethical entails not deliberately harming others, then businesses are ethically obliged to recall a defective or unsafe product swiftly, regardless of the cost. If society deems bribery unethical, then it is unethical for company personnel to make payoffs to government officials to win government contracts or bestow favors to customers to win or retain their business. In short, ethical behavior in business situations requires adhering to generally accepted norms about right or wrong conduct. As a consequence, company managers have an obligation—indeed, a duty—to observe ethical norms when crafting and executing strategy.

WHERE DO ETHICAL STANDARDS COME FROM—ARE THEY UNIVERSAL OR DEPENDENT ON LOCAL NORMS?

Notions of right and wrong, fair and unfair, moral and immoral are present in all societies and cultures. But there are three distinct schools of thought about the extent to which ethical standards travel across cultures and whether multinational companies can apply the same set of ethical standards in any and all locations where they operate.

The School of Ethical Universalism

CORE CONCEPT

The school of **ethical universalism** holds that the most fundamental conceptions of right and wrong are *universal* and apply to members of all societies, all companies, and all businesspeople.

According to the school of **ethical universalism,** the most fundamental conceptions of right and wrong are *universal* and transcend culture, society, and religion.[2] For instance, being truthful (not lying and not being deliberately deceitful) strikes a chord of what's right in the peoples of all nations. Likewise, demonstrating integrity of character, not cheating or harming people, and treating others with decency are concepts that resonate with people of virtually all cultures and religions.

Common moral agreement about right and wrong actions and behaviors across multiple cultures and countries gives rise to universal ethical standards that apply to members of all societies, all companies, and all businesspeople. These universal ethical principles set forth the traits and behaviors that are considered virtuous and that a good person is supposed to believe in and to display. Thus, adherents of the school of ethical universalism maintain that it is entirely appropriate to expect all members of society (including all personnel of all companies worldwide) to conform to these universal ethical standards.[3] For example, people in most societies would concur that it is unethical for companies to knowingly expose workers to toxic chemicals and hazardous materials or to sell products known to be unsafe or harmful to the users.

The strength of ethical universalism is that it draws on the collective views of multiple societies and cultures to put some clear boundaries on what constitutes ethical and unethical business behavior, regardless of the country or culture in which a company's personnel are conducting activities. This means that with respect to basic moral standards that do not vary significantly according to local cultural beliefs, traditions, or religious convictions, a multinational company can develop a code of ethics that it applies more or less evenly across its worldwide operations. It can avoid the slippery slope that comes from having different ethical standards for different company personnel depending on where in the world they are working.

The School of Ethical Relativism

While undoubtedly there are some universal moral prescriptions (like being truthful and trustworthy), there are also observable variations from one society to another as to what constitutes ethical or unethical behavior. Indeed, differing religious beliefs, social customs, traditions, core values, and behavioral norms frequently give rise to different standards about what is fair or unfair, moral or immoral, and ethically right or wrong. For instance, European and American managers often establish standards of business conduct that protect human rights such as freedom of movement and residence, freedom of speech and political opinion, and the right to privacy. In China, where societal commitment to basic human rights is weak, human rights considerations play a small role in determining what is ethically right or wrong in conducting business activities. In Japan, managers believe that showing respect for the collective good of society is a more important ethical consideration. In Muslim-majority countries, managers typically apply ethical standards compatible with the teachings of Muhammad. Consequently, the school of **ethical relativism** holds that a "one-size-fits-all" template for judging the ethical appropriateness of business actions and the behaviors of company personnel is totally inappropriate. Rather, the underlying thesis of ethical relativism is that whether certain actions or behaviors are ethically right or wrong depends on the ethical norms of the country or culture in which they take place. For businesses, this implies that when there are cross-country or cross-cultural differences in ethical standards, it is appropriate for *local ethical standards to take precedence over what the ethical standards may be in a company's home market.*[4] In a world of ethical relativism, there are few absolutes when it comes to business ethics, and thus few ethical absolutes for consistently judging the ethical correctness of a company's conduct in various countries and markets.

CORE CONCEPT

The school of **ethical relativism** holds that differing religious beliefs, customs, and behavioral norms across countries and cultures give rise to *differing of standards concerning what is ethically right or wrong.* These differing standards mean that whether business-related actions are right or wrong depends on the prevailing local ethical standards.

This needs to contour local ethical standards to fit local customs, local notions of fair and proper individual treatment, and local business practices gives rise to multiple sets of ethical standards. It also poses some challenging ethical dilemmas. Consider the following two examples.

The Use of Underage Labor In industrialized nations, the use of underage workers is considered taboo. Social activists are adamant that child labor is unethical and that companies should neither employ children under the age of 18 as full-time employees nor source any products from foreign suppliers that employ underage workers. Many countries have passed legislation forbidding the use of underage labor or, at a minimum, regulating the employment of people under the age of 18. However, in Eretria Chad, Syria, Somalia, Mozambique, Guinea-Bissau, South Sudan, North Korea, and more than 50 other countries, it is customary to view children as potential, even necessary, workers. In other countries, like China, India, Russia, Venezuela, and

Under ethical relativism, there can be no one-size-fits-all set of authentic ethical norms against which to gauge the conduct of company personnel.

Brazil, child labor laws are often poorly enforced.[5] As of 2020, the International Labor Organization estimated that there were about 160 million child laborers age 5 to 17 and that some 70 million of them were engaged in hazardous work.[6]

While exposing children to hazardous work and long work hours is unquestionably deplorable, the fact remains that poverty-stricken families in many developing nations cannot subsist without the work efforts of young family members; sending their children to school instead of having them work is not a realistic option. If such children are not permitted to work (especially those in the 12 to 17 age group)—due to pressures imposed by activist groups in industrialized nations—they may be forced to go out on the streets begging or to seek work in parts of the "underground" economy such as drug trafficking and prostitution.[7] So, if all businesses in countries where employing underage workers is common succumb to the pressures to stop employing underage labor, then have they served the best interests of the underage workers, their families, and society in general? In recognition of this issue, organizations opposing child labor are targeting certain forms of child labor such as enslaved child labor and hazardous work. IKEA is an example of a company that has worked hard to prevent any form of child labor by its suppliers. Its practices go well beyond standards and safeguards to include measures designed to address the underlying social problems of the communities in which their suppliers operate. Other companies that have formally pledged to work toward the elimination of child labor include Amazon, VF Corporation, ALDI, Varner, Colosseum, Arena S.P.A., Mekong Timber Plantations, Morrisons, and REWE Group.

The Payment of Bribes and Kickbacks A particularly thorny area facing multinational companies is the degree of cross–country variability in paying bribes.[8] In many countries in eastern Europe, Africa, Latin America, and Asia, it is customary to pay bribes to government officials in order to win a government contract, obtain a license or permit, or facilitate an administrative ruling.[9] In some developing nations, it is difficult for any company, foreign or domestic, to move goods through customs without paying off low-level officials. Senior managers in China and Russia often use their power to obtain kickbacks when they purchase materials or other products for their companies.[10] Likewise, in many countries it is normal to make payments to prospective customers in order to win or retain their business. Some people stretch to justify the payment of bribes and kickbacks on grounds that bribing government officials to get goods through customs or giving kickbacks to customers to retain their business or win new orders is simply a payment for services rendered, in the same way that people tip for service at restaurants.[11] However, while this is a clever rationalization, it rests on moral quicksand.

Companies that forbid the payment of bribes and kickbacks in their codes of ethical conduct and that are serious about enforcing this prohibition face a particularly vexing problem in countries where bribery and kickback payments are an entrenched local custom. Complying with the company's code of ethical conduct in these countries is very often tantamount to losing business to competitors that have no such scruples—an outcome that penalizes ethical companies and ethical company personnel (who may suffer lost sales commissions or bonuses). On the other hand, the payment of bribes or kickbacks not only undercuts the company's code of ethics but also risks breaking the law. The Foreign Corrupt Practices Act (FCPA) prohibits U.S. companies from paying bribes to government officials, political parties, political candidates, or others in all countries where they do business. The Organization for Economic Cooperation and Development (OECD) has antibribery standards that criminalize the bribery of foreign public officials in international business transactions—all 35 OECD member countries and seven nonmember countries have adopted these standards.

Despite laws forbidding bribery to secure sales and contracts, the practice persists. As of January 2022, 687 individuals and 264 entities were convicted or sanctioned under criminal proceedings for foreign bribery by the OECD. In 2020, in the midst of a national opioid drug crisis, the executive chairperson of Insys Therapeutics was sentenced to 66 months in prison for bribing doctors to overprescribe the company's opioid products. Four of the company's top executives were sentenced as well. In 2022, ABB, a leading global technology company was ordered to pay more than $147 million by the SEC for having violated the anti bribery, books and records, and internal accounting controls provisions of the FCPA in connection with a bribery scheme in South Africa. The SEC has made enforcement of the FCPA a priority and secured similar judgments recently against a number of other high-profile companies, including Oracle Corporation, Deutsche Bank, Goldman Sachs, KPMG, and Novartis.

Why Ethical Relativism Is Problematic for Multinational Companies

Relying on the principle of ethical relativism to determine what is right or wrong poses major problems for multinational companies trying to decide which ethical standards to enforce companywide. It is a slippery slope indeed to resolve conflicting ethical standards for operating in different countries without any kind of higher-order moral compass. Consider, for example, the ethical inconsistency of a multinational company that, in the name of ethical relativism, declares it impermissible to engage in kickbacks unless such payments are customary and generally overlooked by legal authorities. It is likewise problematic for a multinational company to declare it ethically acceptable to use underage labor at its plants in those countries where child labor is allowed but ethically inappropriate to employ underage labor at its plants elsewhere. If a country's culture is accepting of environmental degradation or practices that expose workers to dangerous conditions (toxic chemicals or bodily harm), should a multinational company lower its ethical bar in that country but rule the very same actions to be ethically wrong in other countries?

Codes of conduct based on ethical relativism can be *ethically problematic* for multinational companies by creating a maze of conflicting ethical standards.

Business leaders who rely on the principle of ethical relativism to justify conflicting ethical standards for operating in different countries have little moral basis for establishing or enforcing ethical standards companywide. Rather, when a company's ethical standards vary from country to country, the clear message being sent to employees is that the company has no ethical standards or convictions of its own and prefers to let its standards of ethical right and wrong be governed by the customs and practices of the countries in which it operates. Applying multiple sets of ethical standards without some kind of higher-order moral compass is scarcely a basis for holding company personnel to high standards of ethical behavior. And it can lead to prosecutions of both companies and individuals alike when there are conflicting sets of laws.

Ethics and Integrative Social Contracts Theory

Integrative social contracts theory provides a middle position between the opposing views of ethical universalism and ethical relativism.[12] According to this theory, the ethical standards a company should try to uphold are governed by both (1) a limited number of universal ethical principles that are widely recognized as putting legitimate ethical boundaries on behaviors in *all* situations and (2) the circumstances of local cultures, traditions, and values that further prescribe what constitutes ethically permissible behavior. The universal ethical principles are based on the collective views of multiple cultures and societies and combine to form a "social contract" that all individuals, groups, organizations, and businesses in all situations have a duty to observe. *Within the*

CORE CONCEPT

According to **integrated social contracts theory,** universal ethical principles based on the collective views of multiple societies form a "social contract" that all individuals and organizations have a duty to observe in all situations. *Within the boundaries of this social contract,* local cultures or groups can specify what *additional* actions may or may not be ethically permissible.

boundaries of this social contract, local cultures or groups can specify what *other* actions may or may not be ethically permissible. While this system leaves some "moral free space" for the people in a particular country (or local culture, or profession, or even a company) to make specific interpretations of what other actions may or may not be permissible, *universal ethical norms always take precedence.* Thus, local ethical standards can be *more* stringent than the universal ethical standards but *never less so.* For example, both the legal and medical professions have standards regarding what kinds of advertising are ethically permissible that extend beyond the universal norm that advertising not be false or misleading.

The strength of integrated social contracts theory is that it accommodates the best parts of ethical universalism and ethical relativism. Moreover, integrative social contracts theory offers managers in multinational companies clear guidance in resolving cross-country ethical differences: Those parts of the company's code of ethics that involve universal ethical norms must be enforced worldwide, but within these boundaries, there is room for ethical diversity and the opportunity for host-country cultures to exert *some* influence over the moral and ethical standards of business units operating in that country.

According to integrated social contracts theory, adherence to universal or "first-order" ethical norms should always take precedence over local or "second-order" norms.

A good example of the application of integrative social contracts theory to business involves the payment of bribes and kickbacks. Yes, bribes and kickbacks are common in some countries. However, the fact that bribery flourishes in a country does not mean it is an authentic or legitimate ethical norm. Virtually all of the world's major religions (e.g., Buddhism, Christianity, Confucianism, Hinduism, Islam, Judaism, Sikhism, and Taoism) and all moral schools of thought condemn bribery and corruption. Therefore, a multinational company might reasonably conclude that there is a universal ethical principle to be observed here—one of refusing to condone bribery and kickbacks on the part of company personnel no matter what the local custom is and no matter what the sales consequences are.

In instances involving *universally applicable* ethical norms (like paying bribes), there can be *no compromise* on what is ethically permissible and what is not.

HOW AND WHY ETHICAL STANDARDS IMPACT THE TASKS OF CRAFTING AND EXECUTING STRATEGY

Many companies have acknowledged their ethical obligations in official codes of ethical conduct. In the United States, for example, the Sarbanes–Oxley Act, passed in 2002, requires that companies whose stock is publicly traded have a code of ethics or else explain in writing to the SEC why they do not. But the senior executives of ethically principled companies understand that there's a big difference between having a code of ethics because it is mandated and having ethical standards that truly provide guidance for a company's strategy and business conduct.[13] They know that *the litmus test of whether a company's code of ethics is cosmetic is the extent to which it is embraced in crafting strategy and in operating the business day to day.* Executives committed to high standards make a point of considering three sets of questions whenever a new strategic initiative or policy or operating practice is under review:

1. Is what we are proposing to do fully compliant with our code of ethical conduct? Are there any areas of ambiguity that may be of concern?
2. Is there any aspect of the strategy (or policy or operating practice) that gives the appearance of being ethically questionable?
3. Is there anything in the proposed action that customers, employees, suppliers, stockholders, competitors, community activists, regulators, or the media might consider ethically objectionable?

Unless questions of this nature are posed—either in open discussion or by force of habit in the minds of company managers—there's a risk that strategic initiatives and/or the way daily operations are conducted will become disconnected from the company's code of ethics. If a company's executives believe strongly in living up to the company's ethical standards, they will unhesitatingly reject strategic initiatives and operating approaches that don't measure up. However, in companies with a cosmetic approach to ethics, any linkage of the professed standards to its strategy and operating practices stems mainly from a desire to avoid the risk of embarrassment and possible disciplinary action for approving actions that are later deemed unethical and perhaps illegal.

While most company managers are careful to ensure that a company's strategy is within the bounds of what is *legal,* evidence indicates they are not always so careful to ensure that all elements of their strategies and operating activities are within the bounds of what is considered *ethical.* In recent years, there have been revelations of ethical misconduct on the part of managers at such organizations as Bed, Bath, and Beyond; FIFA; Ericsson; Kobe Steel; several leading investment banking firms such as Credit Suisse; and a host of mortgage lenders. Sexual harassment allegations plagued many companies, including film company Weinstein Company LLC and entertainment giant 21st Century Fox. Google agreed to a $310 million sexual misconduct settlement. Other large companies that have been charged with workplace harassment include Ford Motor, Kroger/Ralphs Grocery, and McDonald's. The consequences of crafting strategies that cannot pass the test of moral scrutiny are manifested in sizable fines, devastating public relations hits, sharp drops in stock prices that cost shareholders billions of dollars, criminal indictments, and convictions of company executives. The fallout from all these scandals has resulted in heightened management attention to legal and ethical considerations in crafting strategy.

LO 9-2

Recognize conditions that give rise to unethical business strategies and behavior.

DRIVERS OF UNETHICAL BUSINESS STRATEGIES AND BEHAVIOR

Apart from the "business of business is business, not ethics" kind of thinking apparent in recent high-profile business scandals, three other main drivers of unethical business behavior also stand out:[14]

1. Faulty oversight, enabling the unscrupulous pursuit of personal gain and self-interest.
2. Heavy pressures on company managers to meet or beat short-term performance targets.
3. A company culture that puts profitability and business performance ahead of ethical behavior.

Faulty Oversight, Enabling the Unscrupulous Pursuit of Personal Gain and Self-Interest People who are obsessed with wealth accumulation, power, status, and their own self-interest often push aside ethical principles in their quest for personal gain. Driven by greed and ambition, they exhibit few qualms in skirting the rules or doing whatever is necessary to achieve their goals. A general disregard for business ethics can prompt all kinds of unethical strategic maneuvers and behaviors at companies. The scandal that brought down cryptocurrency company FTX and forced the resignation of its CEO is a case in point, as described in Illustration Capsule 9.1.

Responsible corporate governance and oversight by the company's corporate board is necessary to guard against self-dealing and the manipulation of information to disguise

ILLUSTRATION CAPSULE 9.1 Ethical Violations and Their Consequences at Cryptocurrency Exchange FTX

In 2023, the cryptocurrency industry was largely unregulated, which left its investors unprotected from losses. While crypto's allure of potentially high returns drew many to the market, some investors suffered when crypto companies were hacked or went bankrupt, while others were defrauded in Ponzi-like schemes, such as those perpetrated by PlusToken, WoToken, Onecoin, and Bitconnect. For those investors more worried about risk, one company seemed a safer choice: FTX, one of the largest cryptocurrencies in the world. FTX was commonly regarded as one of the industry's "blue chip" companies—one that was well-capitalized, well-managed, and capable of weathering the volatility that sometimes roiled the industry. Its firm economic standing seemed evident in that it often bailed out other troubled crypto firms and made significant contributions to charity. Paid endorsements by celebrities such as Tom Brady, Shaquille O'Neal, and Jimmy Fallon helped boost investor confidence in the company.

What was unknown to investors was that the founder and CEO of FTX, Sam Bankman-Fried (commonly called SBF) was allegedly using their money in a highly unethical and fraudulent manner. SBF was accused of funneling FTX user funds into his private hedge fund, Alameda Research, which was run by his ex-girlfriend. Through Alameda, he allegedly used FTX customer money to buy real estate in the Bahamas, purchase the naming rights to the Miami Heat basketball arena, place risky bets, and contribute to political campaigns.

In early November 2022, the cryptocurrency market suffered a downturn in response to macroeconomic factors and investors began closing accounts. When the company had insufficient liquidity to return more than $8 billion to customers who had closed their accounts, FTX filed for bankruptcy and Sam Bankman-Fried resigned as CEO. Evidence of gross financial misconduct soon came to light and SBF was arrested and extradited from the Bahamas to the United States. Two members of Bankman-Fried's inner circle pleaded guilty to criminal charges and agreed to cooperate with prosecutors in their investigation of FTX's collapse. SBF was charged with eight felony counts, including wire fraud, money laundering, campaign finance law violations, and conspiracy. Other charges include lying to investors and taking billions of dollars of their money for his personal use. He is facing up to 115 years in prison over these charges and, if convicted, could spend the rest of his life in prison.

Chinnapong/Shutterstock

Sources: **https://www.nytimes.com/2022/11/09/technology/cryptocurrency-binance-ftx.html**; **https://www.politico.com/news/2022/12/28**; **https://www.analyticsinsight.net/10-crypto-ponzi-schemes-that-ravaged-the-digital-asset-market-in-2022/**; **https://www.npr.org/2023/01/03/1146653595**.

CORE CONCEPT

Self-dealing occurs when managers take advantage of their position to further their own private interests rather than those of the firm.

such actions by a company's managers. **Self-dealing** occurs when managers take advantage of their position to further their own private interests rather than those of the firm. As discussed in Chapter 2, the duty of the corporate board (and its compensation and audit committees in particular) is to guard against such actions. A strong, independent board is necessary to have proper oversight of the company's financial practices and to hold top managers accountable for their actions.

A particularly egregious example of the lack of proper oversight is the scandal over mortgage lending and banking practices that resulted in a crisis for the U.S. residential real estate market and heartrending consequences for many home buyers. This scandal stemmed from consciously unethical strategies at many banks and mortgage companies to boost the fees they earned on home mortgages by deliberately lowering lending standards to approve so-called subprime loans for home buyers whose incomes were insufficient to make their monthly mortgage payments. Once these lenders earned their fees on these loans, they repackaged the loans to hide their true nature and auctioned them off to unsuspecting investors, who later suffered huge losses when the high-risk borrowers began to default on their loan payments. (Government authorities later forced some of the firms that auctioned off these packaged loans to repurchase them at the auction price and bear the losses themselves.) A lawsuit by the attorneys general of 49 states charging widespread and systematic fraud ultimately resulted in a $26 billion settlement by the five largest U.S. banks (Bank of America, Citigroup, JPMorgan Chase, Wells Fargo, and Ally Financial). Included in the settlement were new rules designed to increase oversight and reform policies and practices among the mortgage companies. The settlement also established a set of what are believed to be robust monitoring and enforcement mechanisms that should help prevent such abuses in the future.[15]

Heavy Pressures on Company Managers to Meet Short-Term Performance Targets When key personnel find themselves scrambling to meet the quarterly and annual sales and profit expectations of investors and financial analysts, they often feel enormous pressure to *do whatever it takes* to protect their reputation for delivering good results. Executives at high-performing companies know that investors will see the slightest sign of a slowdown in earnings growth as a red flag and drive down the company's stock price. In addition, slowing growth or declining profits could lead to a downgrade of the company's credit rating if it has used lots of debt to finance its growth. The pressure to "never miss a quarter"—to not upset the expectations of analysts, investors, and creditors—prompts nearsighted managers to engage in short-term maneuvers to make the numbers, regardless of whether these moves are really in the best long-term interests of the company. Sometimes the pressure induces company personnel to continue to stretch the rules until the limits of ethical conduct are overlooked.[16] Once ethical boundaries are crossed in efforts to "meet or beat their numbers," the threshold for making more extreme ethical compromises becomes lower.

To meet its demanding profit target, Wells Fargo put such pressure on its employees to hit sales quotas that many employees responded by fraudulently opening customer accounts. After the practices came to light, the bank was forced to return $2.6 million to customers and pay $186 million in fines to the government. Wells Fargo's reputation took a big hit, its stock price plummeted, and its CEO lost his job. Despite these consequences, the pressure for profits continued in what the Consumer Financial Protection Bureau (CFPB) characterized as a "rinse and repeat cycle." In 2022, Wells Fargo was ordered to pay $3.7 billion for widespread mismanagement of auto loans, mortgages, and deposit accounts.

Company executives often feel pressured to hit financial performance targets because their compensation depends heavily on the company's performance. Over the last two decades, it has become fashionable for boards of directors to grant lavish bonuses, stock option awards, and other compensation benefits to executives for meeting specified performance targets. So outlandishly large were these rewards that executives had strong personal incentives to bend the rules and engage in behaviors that allowed the targets to be met. Much of the accounting manipulation at the root of recent corporate scandals has entailed situations in which executives benefited enormously from misleading accounting or other shady activities that allowed them to hit the numbers and

CORE CONCEPT

Short-termism is the tendency for managers to focus excessively on short-term performance objectives at the expense of longer-term strategic objectives. It has negative implications for the likelihood of ethical lapses as well as company performance in the longer run.

receive incentive awards ranging from $10 million to more than $1 billion for hedge fund managers.

The fundamental problem with **short-termism**—the tendency for managers to focus excessive attention on short-term performance objectives—is that it doesn't create value for customers or improve the firm's competitiveness in the marketplace; that is, it sacrifices the activities that are the most reliable drivers of higher profits and added shareholder value in the long run. Cutting ethical corners in the name of profits carries exceptionally high risk for shareholders—the steep stock price decline and tarnished brand image that accompany the discovery of scurrilous behavior leave shareholders with a company worth much less than before—and the rebuilding task can be arduous, taking both considerable time and resources.

A Company Culture That Puts Profitability and Business Performance Ahead of Ethical Behavior When a company's culture spawns an ethically corrupt or amoral work climate, people have a company-approved license to ignore "what's right" and engage in any behavior or strategy they think they can get away with. Such cultural norms as "Everyone else does it" and "It is okay to bend the rules to get the job done" permeate the work environment. At such companies, ethically immoral people are certain to play down observance of ethical strategic actions and business conduct. Moreover, cultural pressures to utilize unethical means if circumstances become challenging can prompt otherwise honorable people to behave unethically. A perfect example of a company culture gone awry on ethics is Enron, a now-defunct but infamous company found guilty of one of the most sprawling business frauds in U.S. history.[17]

Enron's leaders pressured company personnel to be innovative and aggressive in figuring out how to grow current earnings— *regardless of the methods.* Enron's annual "rank and yank" performance evaluation process, in which the lowest-ranking 15 to 20 percent of employees were let go, made it abundantly clear that bottom-line results were what mattered most. The name of the game at Enron became devising clever ways to boost revenues and earnings, even if this sometimes meant operating outside established policies (and legal limits). In fact, outside-the-lines behavior was celebrated if it generated profitable new business.

A high-performance-high-rewards climate came to pervade the Enron culture, as the best workers (determined by who produced the best bottom-line results) received impressively large incentives and bonuses. On Car Day at Enron, an array of luxury sports cars arrived for presentation to the most successful employees. Understandably, employees wanted to be seen as part of Enron's star team and partake in the benefits granted to Enron's best and brightest employees. The high monetary rewards, the ambitious and hard-driving people whom the company hired and promoted, and the competitive, results-oriented culture combined to give Enron a reputation not only for trampling competitors but also for internal ruthlessness. The company's win-at-all-costs mindset nurtured a culture that gradually and then more rapidly fostered the erosion of ethical standards, eventually making a mockery of the company's stated values of integrity and respect. When it became evident that Enron was a house of cards propped up by deceitful accounting and myriad unsavory practices, the company imploded in a matter of weeks—one of the biggest bankruptcies of all time, costing investors $64 billion in losses.

In contrast, when high ethical principles are deeply ingrained in the corporate culture of a company, culture can function as a powerful mechanism for communicating ethical behavioral norms and gaining employee buy-in to the company's moral standards, business principles, and corporate values. In such cases, the ethical principles embraced in the company's code of ethics and/or in its statement of corporate values are seen as integral to the company's identity, self-image, and ways of operating. The message that ethics matters—and matters a lot—resounds loudly and clearly throughout the organization and in its strategy and decisions.

WHY SHOULD COMPANY STRATEGIES BE ETHICAL?

There are two reasons why a company's strategy should be ethical: (1) because a strategy that is unethical is morally wrong and reflects badly on the character of the company and its personnel, and (2) because an ethical strategy can be good business and serve the self-interest of shareholders.

The Moral Case for an Ethical Strategy

LO 9-3

Identify the costs of business ethics failures.

Managers do not dispassionately assess what strategic course to steer—how strongly committed they are to observing ethical principles and standards definitely comes into play in making strategic choices. Ethical strategy making is generally the product of managers who are of strong moral character (i.e., who are trustworthy, have integrity, and truly care about conducting the company's business honorably). Managers with high ethical principles are usually advocates of a corporate code of ethics and strong ethics compliance, and they are genuinely committed to upholding corporate values and ethical business principles. They demonstrate their commitment by displaying the company's stated values and living up to its business principles and ethical standards. They understand the difference between merely adopting value statements and codes of ethics and ensuring that they are followed strictly in a company's actual strategy and business conduct. As a consequence, ethically strong managers consciously opt for strategic actions that can pass the strictest moral scrutiny—they display no tolerance for strategies with ethically controversial components.

The Business Case for Ethical Strategies

In addition to the moral reasons for adopting ethical strategies, there may be solid business reasons. Pursuing unethical strategies and tolerating unethical conduct not only damages a company's reputation but also may result in a wide-ranging set of other costly consequences. Figure 9.1 shows the kinds of costs a company can incur when unethical behavior on its part is discovered, the wrongdoings of company personnel are headlined in the media, and it is forced to make amends for its behavior. The more egregious are a company's ethical violations, the higher the costs and the bigger the damage to its reputation (and to the reputations of the company personnel involved). In high-profile instances, the costs of ethical misconduct can easily run into the hundreds of millions and even billions of dollars, especially if they provoke widespread public outrage and many people were harmed. The penalties levied on executives caught in wrongdoing can skyrocket as well, as the 150-year prison term sentence of infamous financier and Ponzi scheme perpetrator Bernie Madoff illustrates.

The fallout of a company's ethical misconduct goes well beyond the costs of making amends for the misdeeds. Customers shun companies caught up in highly publicized ethical scandals. Rehabilitating a company's shattered reputation is time-consuming and costly. Companies with tarnished reputations have difficulty in recruiting and retaining talented employees. Most ethically upstanding people are repulsed by a work

FIGURE 9.1 The Costs Companies Incur When Ethical Wrongdoing Is Discovered

Visible Costs	Internal Administrative Costs	Intangible or Less Visible Costs
• Government fines and penalties • Civil penalties arising from class-action lawsuits and other litigation aimed at punishing the company for its offense and the harm done to others • The costs to shareholders in the form of a lower stock price (and possibly lower dividends)	• Legal and investigative costs incurred by the company • The costs of providing remedial education and ethics training to company personnel • The costs of taking corrective actions • Administrative costs associated with ensuring future compliance	• Customer defections • Loss of reputation • Lost employee morale and higher degrees of employee cynicism • Higher employee turnover • Higher recruiting costs and difficulty in attracting talented employees • Adverse effects on employee productivity • The costs of complying with often harsher government regulations

Source: Adapted from Terry Thomas, John R. Schermerhorn, and John W. Dienhart, "Strategic Leadership of Ethical Behavior," *Academy of Management Executive* 18, no. 2 (May 2004), p. 58.

environment where unethical behavior is condoned; they don't want to get entrapped in a compromising situation, nor do they want their personal reputations tarnished by the actions of an unsavory employer. Creditors are unnerved by the unethical actions of a borrower because of the potential business fallout and subsequent higher risk of default on loans.

Shareholders suffer major damage when a company's unethical behavior is discovered. Making amends for unethical business conduct is costly, and it takes years to rehabilitate a tarnished company reputation.

All told, a company's unethical behavior can do considerable damage to shareholders in the form of lost revenues, higher costs, lower profits, lower stock prices, and a diminished business reputation. To a significant degree, therefore, ethical strategies and ethical conduct are *good business.* Most companies understand the value of operating in a manner that wins the approval of suppliers, employees, investors, and society at large. Most businesspeople recognize the risks and adverse fallout attached to the discovery of unethical behavior. Hence, companies have an incentive to employ strategies that can pass the test of being ethical. Even if a company's managers are not personally committed to high ethical standards, they have good reason to operate within ethical bounds, if only to (1) avoid the risk of embarrassment, scandal, disciplinary action, fines, and possible jail time for unethical conduct on their part; and (2) escape being held accountable for lax enforcement of ethical standards and unethical behavior by personnel under their supervision. Illustration Capsule 9.2 discusses PepsiCo's commitment to high ethical standards and their approach to putting their ethical principles into practice.

ILLUSTRATION CAPSULE 9.2 How PepsiCo Put Its Ethical Principles into Practice

PepsiCo is one of the world's leading food and beverage companies with over $86 billion in net revenue, coming from iconic brands such as Lays and Ruffles potato chips, Quaker Oatmeal, Tropicana juice, Mountain Dew, and Diet Pepsi. The company is also known for its dedication to ethical business practices, having ranked consistently as among the World's Most Ethical Companies by business ethics think tank *Ethicsphere* ever since the award program was initiated. PepsiCo's Global Code of Conduct plays a pivotal role in ensuring that PepsiCo's employees, managers, and directors around the world are complying with the company's high ethical standards. It provides specific guidance concerning how to make decisions, how to treat others, and how to conduct business globally, organized around four key operating principles: (1) respect in the workplace, (2) integrity in the marketplace, (3) ethics in business activities, and (4) responsibility to shareholders. Essentially, the Code of Conduct lays out a set of behavioral norms that have come to define the company's culture.

Even with a strong ethical culture, implementing a code of conduct across a global organization of over 309,000 employees is challenging. To assist, PepsiCo set up a Global Compliance & Ethics Department with primary responsibility for promoting, monitoring, and enforcing the code. Employees at all levels are required to participate in annual Code of Conduct training, through online courses as well as in-person, manager-led workshops. Compliance training also takes place in a more targeted fashion, based on role and geography, concerning such issues as bribery. Other types of communications throughout the year, such as internal newsletter articles and messaging from the leadership, reinforce the annual training.

monticello/Shutterstock

Employees are encouraged to seek guidance when faced with an ethical dilemma. They are also encouraged to raise concerns and are obligated to report any Code violations. A variety of channels have been set up for them to do this, including a hotline operated by an independent third party. All reports of suspected violations are reviewed in accordance with company policies designed to foster consistency of the investigative process and corrective actions (which may include termination of employment). PepsiCo has also established an annual peer-nominated Ethical Leadership Award designed to recognize instances of exceptional ethical conduct by employees.

The leadership at PepsiCo believes that their commitment to ethical principles has helped the company in attracting and retaining the best people. Indeed, PepsiCo has been listed as among the Top Attractors of talent globally. In addition, the company has regularly been listed as among the World's Most Respected Companies (Barron) and the World's Most Admired Companies (Fortune).

Sources: Company website; **https://ethisphere.com/pepsico-performance-purpose/**.

STRATEGY, CORPORATE SOCIAL RESPONSIBILITY, AND ENVIRONMENTAL SUSTAINABILITY

The notion that corporate executives should balance the interests of all stakeholders—shareholders, employees, customers, suppliers, the communities in which they operate, and society at large—began to take hold in the 1960s. Over time, this idea took root and expanded to include the environmental impact of business activities. Companies today commonly embrace the notion that acting responsibly toward the environment

• **LO 9-4**

Understand the concepts of corporate social responsibility and sustainability and how companies balance economic responsibilities to shareholders with environmental and social responsibilities.

and society at large is not only the right thing to do but good for the present and future of their businesses. Concepts such as corporate citizenship, corporate social responsibility, and sustainability now inform business practice in enlightened companies all over the world.

Today, corporate social responsibility is a concept that resonates within enlightened companies all over the world.

The Concepts of Corporate Social Responsibility and Good Corporate Citizenship

CORE CONCEPT

Corporate social responsibility (CSR) refers to a company's *duty* to operate in an ethical manner, provide good working conditions for employees, encourage workforce diversity, be a good steward of the environment, and actively work to better the quality of life in the local communities where it operates and in society at large.

The essence of socially responsible business behavior is that a company should balance strategic actions to benefit shareholders against the *duty* to be a good corporate citizen. The underlying thesis is that company managers should display a *social conscience* in operating the business and specifically take into account how management decisions and company actions affect the well-being of employees, local communities, the environment, and society at large.[18] Acting in a socially responsible manner thus encompasses more than just participating in community service projects and donating money to charities and other worthy causes. Demonstrating **corporate social responsibility (CSR)** also entails undertaking actions that earn trust and respect from all stakeholders—operating in an honorable and ethical manner, striving to make the company a great place to work, demonstrating genuine respect for the environment, and trying to make a difference in bettering society. As depicted in Figure 9.2, corporate social responsibility programs commonly include the following elements:

- *Striving to employ an ethical strategy and observe ethical principles in operating the business.* A sincere commitment to observing ethical principles is a necessary component of a CSR strategy simply because unethical conduct is incompatible with the concept of good corporate citizenship and socially responsible business behavior.
- *Taking actions to protect the environment and, in particular, to minimize or eliminate any adverse impact on the environment stemming from the company's own business activities.* Corporate social responsibility as it applies to environmental protection entails actively striving to be a good steward of the environment. This means using the best available science and technology to reduce environmentally harmful aspects of the company's operations *below the levels required by prevailing environmental regulations.* It also means putting time and money into improving the environment in ways that extend beyond a company's own industry boundaries—such as participating in recycling projects, adopting energy conservation practices, and supporting efforts to clean up local water supplies. Honeywell has committed to become carbon neutral by 2035 and to continue to assess carbon emissions throughout their supply chain, mitigating them wherever practicable. Since 2004, the company has cut its greenhouse gas emissions by more than 90 percent. The Walt Disney Company is similarly committed to a science-based reduction goal in emissions from its products, service manufacturing, and delivery.
- *Creating a work environment that enhances the quality of life for employees.* Numerous companies exert extra effort to enhance the quality of life for their employees at work and at home. This can include onsite day care, flexible work schedules, workplace exercise facilities, special leaves for employees to care for sick family members, work-at-home opportunities, career development programs and education opportunities,

FIGURE 9.2 The Five Components of a Corporate Social Responsibility Strategy

Source: Adapted from material in Ronald Paul Hill, Debra Stephens, and Iain Smith, "Corporate Social Responsibility: An Examination of Individual Firm Behavior," *Business and Society Review* 108, no. 3 (September 2003), p. 348.

showcase plants and offices, special safety programs, and the like. Tech companies Microsoft, Adobe, and HubSpot are among the highest-rated large employers for perks and benefits.

- *Building a diverse workforce with respect to gender, race, national origin, and other aspects that different people bring to the workplace.* Most large companies in the United States have established **diversity, equity, and inclusion (DEI) programs** to ensure that their workplaces are attractive to all groups and perspectives. As employees with lower socioeconomic backgrounds are 32 percent less likely to become a manager in the United States, companies have revised hiring, retention, and development practices to build more diverse workforces and leadership teams. Citi has implemented a broad approach to DEI that includes 10 different employee affinity groups, a commitment to LGBTQ+ equality and rights, disability inclusion programs that allow all employees to meet their full potential, targeted recruiting, and internal promotion policies to build diverse representation at senior levels of the company.

CORE CONCEPT

Diversity, equity, and inclusion (DEI) programs are designed to ensure that company workplaces are attractive to all groups and perspectives.

- *Making charitable contributions, supporting community service endeavors, engaging in broader philanthropic initiatives, and reaching out to make a difference in the lives of the disadvantaged.* Some companies fulfill their philanthropic obligations by spreading their efforts over a multitude of charitable and community activities—for instance, Free People, Patagonia, Nike, BLQK Coffee, and Cotopaxi support a broad variety of community, art, and social welfare programs. Others prefer to focus their energies more narrowly. Two Blind Brothers donates 100% of their profits back to research for eye disease through their Foundation Fighting Blindness. They also hire blind workers through organizations like Industries for the Blind. Genentech and many pharmaceutical companies run prescription assistance programs to provide expensive medications at little or no cost to patients with lower incomes. Companies frequently reinforce their philanthropic efforts by encouraging employees to support charitable causes and participate in community affairs, often through programs that match employee contributions.

CORE CONCEPT

A company's **CSR strategy** is defined by the specific combination of socially beneficial activities the company opts to support with its contributions of time, money, and other resources.

The particular combination of socially responsible endeavors a company elects to pursue defines its **corporate social responsibility (CSR) strategy.** The specific components emphasized in a CSR strategy vary from company to company and are typically linked to a company's core values. Few companies have managed to integrate CSR as fully and seamlessly throughout their organization as Burt's Bees; there a special committee is dedicated to leading the organization to attain its CSR goals with respect to three primary areas: natural well-being, humanitarian responsibility, and environmental sustainability. General Mills centers its CSR strategy around four themes: putting people first (via ensuring an equitable workplace environment and fighting against racial and social injustice), nourishing lives (via healthier and easier-to-prepare foods), strengthening communities (via charitable donations to community causes and volunteerism for community service projects), and regenerating the planet (via efforts to conserve natural resources, reduce energy and water usage, promote recycling, and otherwise support environmental sustainability).[19] Johnson & Johnson is widely admired for their CSR policies and practices. It is based on their Vision for Good, which encompasses Good for Communities, Good for Talent, and Good for the Planet. Illustration Capsule 9.3 describes Warby Parker's approach to corporate social responsibility—an approach that ensures that social responsibility is reflected in all of the company's actions and endeavors.

Although there is wide variation in how companies devise and implement a CSR strategy, communities of companies concerned with corporate social responsibility (such as CSR Europe) have emerged to help companies share best CSR practices. Moreover, a number of reporting standards have been developed, including ISO 26000—a new internationally recognized standard for social responsibility set by the International Standards Organization (ISO).[20] Companies that exhibit a strong commitment to corporate social responsibility are often recognized by being included on lists such as *Corporate Responsibility* magazine's "100 Best Corporate Citizens" or *Corporate Knights* magazine's "Global 100 Most Sustainable Corporations."

Corporate Social Responsibility and the Triple Bottom Line CSR initiatives undertaken by companies are frequently directed at improving the company's *triple bottom line (TBL)*—a reference to three types of performance metrics: *economic, social,* and *environmental.* The goal is for a company to succeed simultaneously in all three dimensions, as illustrated in Figure 9.3.[21] The three dimensions of performance are often referred to in terms of the "three pillars" of "people, planet, and profit." The term *people* refers to the various social initiatives that make up CSR strategies, such as corporate giving, community involvement, and company efforts to improve the lives of its internal and external stakeholders. *Planet* refers to a firm's ecological impact and

ILLUSTRATION CAPSULE 9.3

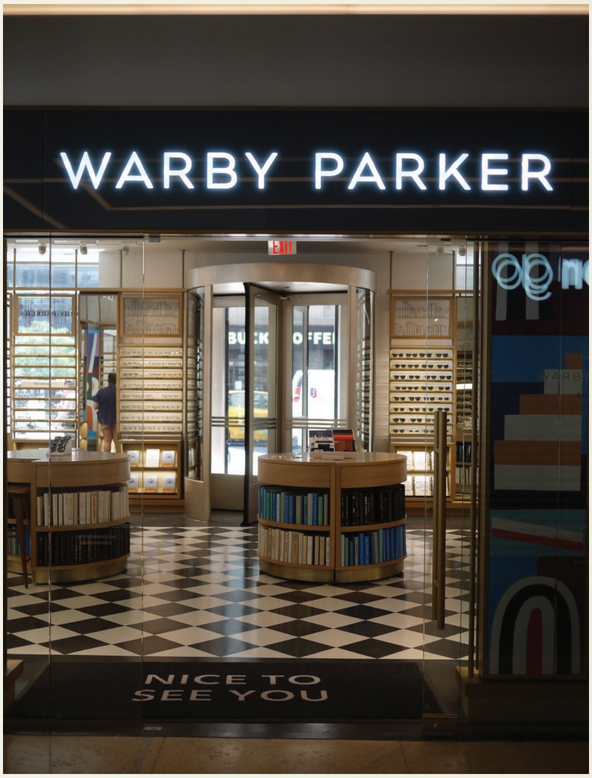
Warby Parker: Combining Corporate Social Responsibility with Affordable Fashion

Since its founding in 2010, Warby Parker has succeeded in selling over one million pairs of high-fashion glasses at a discounted price of $95–roughly 80 percent below the average $500 price tag on a comparable pair of eyeglasses from another producer. With more than 70 stores in the United States, the company has built a brand recognized universally as one of the strongest in the world; it consistently posts a net promoter score (a measure of how likely someone would be to recommend the product) of close to 90–higher than companies like Zappos and Apple.

Corporate responsibility is at Warby Parker's core. For each pair of glasses sold, the company provides international nonprofit partners like VisionSpring with a monthly donation of glasses. With Warby Parker's support, these partners provide basic eye exams and teach community members how to manufacture and sell glasses at very low prices, thereby providing vocational training and improving the standard of living in these communities. The average impact on a recipient of a pair of donated glasses was a 20 percent increase in personal income and a 35 percent increase in productivity.

Efforts to be a responsible company expand beyond Warby Parker's international partnerships. The company voluntarily evaluates itself against benchmarks in the fields of "environment," "workers," "customers," "community," and "governance," demonstrating a nearly unparalleled dedication to outcomes outside of profit. The company is widely seen as an employer of choice and regularly attracts top talent for all roles across the organization. It holds to an extremely high environmental standard, running an entirely carbon neutral operation.

While socially impactful actions matter at Warby Parker, the company is mindful of the critical role of its suppliers as well. Both founders spent countless hours coordinating partnerships with dedicated suppliers to ensure quality, invested deeply in building a lean manufacturing operation to minimize cost, and sought to build an organization that would keep buyers happy. The net effect is a very economically healthy company–they post around $3,000 in sales per square foot, in line with Tiffany & Co.—with financial stability to pursue responsibilities outside of customer satisfaction.



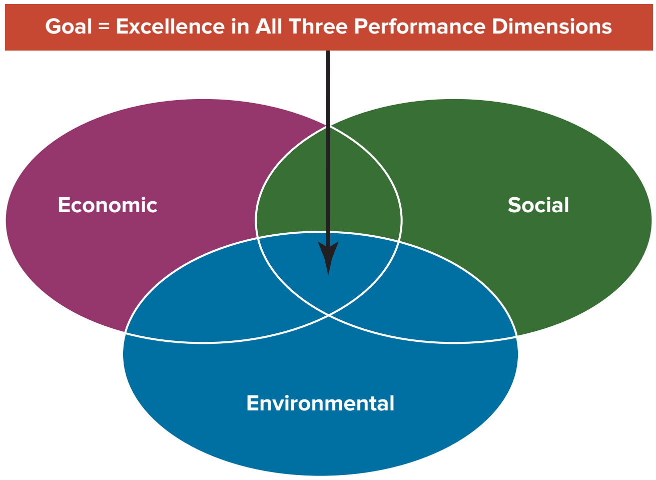
Interim Archives/Contributor/Getty Images

The strong fundamentals put in place by the firm's founders blend responsibility into its DNA and attach each piece of commercial success to positive outcomes in the world. The company was recently recognized as number one on *Fast Company*'s "Most Innovative Companies" list and continues to build loyal followers–both of its products and its CSR efforts–as it expands.

Note: Developed with Jeremy P. Reich.

Sources: Warby Parker and "B Corp" websites; Max Chafkin, "Warby Parker Sees the Future of Retail," *Fast Company,* February 17, 2015 (accessed February 22, 2016); Jenni Avins, "Warby Parker Proves Customers Don't Have to Care about Your Social Mission," *Quartz,* December 29, 2014 (accessed February 14, 2016).

FIGURE 9.3 The Triple Bottom Line: Excelling on Three Measures of Company Performance



Source: Developed with help from Amy E. Florentino.

environmental practices. The term *profit* has a broader meaning with respect to the triple bottom line than it does otherwise. It encompasses not only the profit a firm earns for its shareholders but also the economic impact that the company has on society more generally, in terms of the overall value that it creates and the overall costs that it imposes on society. For example, Procter & Gamble's Swiffer cleaning system, one of the company's best-selling products, not only offers an earth-friendly design but also outperforms less ecologically friendly alternatives in terms of its broader economic impact: It reduces demands on municipal water sources, saves electricity that would be needed to heat mop water, and doesn't add to the amount of detergent making its way into waterways and waste treatment facilities. Nike sees itself as bringing people, planet, and profits into balance by producing innovative new products in a more sustainable way, recognizing that sustainability is key to its future profitability. Nvidia is a technology company known, in part, for making graphic cars used in gaming consoles. It is also known for its high scores on Triple Bottom Line metrics.

Many companies now make a point of citing the beneficial outcomes of their CSR strategies in press releases and issue special reports for consumers and investors to review. Southwest Airlines makes reporting an important part of its commitment to corporate responsibility; the company posts its annual Southwest Airlines One Report on its website that describes its initiatives and accomplishments with respect to each of the three pillars of triple bottom line performance—people, planet, and profit. Triple-bottom-line reporting is an effective way for companies to make the results of their CSR strategies apparent to stakeholders and for stakeholders to hold companies accountable for their impact on society. Attention to the triple bottom line of companies has led to the development of a number of different reporting initiatives, such as Full Cost Accounting, and the Global Reporting Initiative. The use of standard reporting frameworks such as these promotes greater transparency and facilitates benchmarking CSR efforts across firms and industries.

What Do We Mean by *Sustainability* and *Sustainable Business Practices?*

The term *sustainability* is used in a variety of ways. In many firms, it is synonymous with corporate social responsibility; it is seen by some as a term that is gradually replacing *CSR* in the business lexicon. The term is also used as shorthand for environmental sustainability, a narrower concept concerned only with protecting and conserving environmental resources for the future. But much of this confusion can be avoided by distinguishing between **corporate sustainability** and **environmental sustainability.** We discuss corporate sustainability here and elaborate on environmental sustainability in the paragraphs below.

CORE CONCEPT

Corporate sustainability differs from Corporate Social Responsibility in that it takes into account explicitly the impact of a company's activities on its profits and growth goals. Its three pillars coincide with those of the TBL: People, Planet, and Profit.

Corporate sustainability differs from corporate social responsibility in that it considers explicitly the impact of a company's activities on its profits and growth goals. That is to say, it includes the sustainability of the company itself. CSR is often seen as shining a spotlight on the activities of a company in the present, while corporate sustainability addresses the impact of those activities on the company's future as well. While the triple bottom line has long been associated with CRS reporting, the list of the elements included in CRS programs does not include any that are directly related to economic outcomes. In contrast, the three performance dimensions of the TBL (people, planet, profit) coincide with the concerns of corporate sustainability—a concept based on the same three pillars of people, planet, and profit.

A metric more often associated with the corporate sustainability of companies is the **Environmental, Social, and Governance (ESG)** set of standards. Its usage has been growing exponentially since institutional investors increasingly use ESG scores to screen investments. ESG investing is also called sustainable investing, impact investing, or socially responsible investing. Companies with high ESG scores can leverage these for marketing and benchmarking, as well as for raising capital. The Dow Jones Sustainability World Index is made up of the top 10 percent of the 2,500 companies listed in the Dow Jones World Index in terms of environmental performance, social performance, and governance performance (ESG). Companies are evaluated in these three ESG performance areas, using indicators such as climate change mitigation, risk management, board composition, executive compensation, supply chain standards, product safety, accounting transparency, and labor practices. Table 9.1 shows a sampling of the companies with the highest ESG scores according to the Dow Jones Sustainability World Index in 2023.

CORE CONCEPT

Environmental, Social, and Governance (ESG) scores are used by Institutional investors and others to screen their investment choices.

The term environmental sustainability has a more focused meaning than corporate sustainability. It is concerned with the impact of a company on its *environment* and its use of *natural resources,* including land, water, air, plants, animals, minerals, fossil fuels, and biodiversity. It is widely recognized that the world's natural resources are finite and are being consumed and degraded at rates that threaten their capacity for renewal. Since corporations are the biggest users of natural resources, managing and maintaining these resources is critical for the long-term economic interests of corporations.

For some companies, this issue has direct and obvious implications for the continued viability of their business model and strategy. Pacific Gas and Electric has begun measuring the full carbon footprint of its supply chain to become not only a "greener" company but a more efficient energy producer.[22] Beverage companies such as Coca-Cola and PepsiCo are having to rethink their business models because of the prospect of future worldwide

CORE CONCEPT

Sustainable business practices are those that meet the needs of the present without compromising the ability to meet the needs of the future.

TABLE 9.1 A Selection of Companies Recognized for ESG Performance in 2023

Name	Market Sector	Region
Bridgestone Corp.	Automobile Components	Asia / Pacific
Electronic Arts Inc	Software & Services	North America
Acer, Inc.	Technology Hardware	Asia / Pacific
Crown Holdings, Inc.	Containers & Packaging	North America
Firmenich SA	Chemicals	Europe
Hasbro, Inc.	Consumer Durables	North America
Grupo de Inversiones Suramericana S.A.	Diversified Financials	Latin America and Caribbean
Fox Corp.	Media	North America
Burberry Group PLC	Textiles & Apparel	Europe
Columbia Sportswear Co.	Retailing	North America
Freehold Royalties Ltd.	Oil & Gas Producers	North America
Dubai Aerospace Enterprise (DAE) Ltd.	Traders & Distributors	Africa / Middle East
Sony Group Corp.	Consumer Durables	Asia / Pacific
Deterra Royalties Ltd.	Steel	Asia / Pacific
News Corp	Media	North America
Danaher Corp.	Pharmaceuticals, Biotechnology & Life Sciences	North America
Fibra Uno Administración SA de CV	Real Estate	Latin America and Caribbean
CarMax, Inc.	Retailing	North America
Mondi PLC	Paper & Forestry	Europe
Adobe, Inc.	Software & Services	North America
Cisco Systems, Inc.	Technology Hardware & Equipment	North America
Accenture Plc	Software & Services	Europe
DP World Ltd.	Transportation Infrastructure	Africa / Middle East
Grenergy Renovables SA	Utilities	Europe

Source: **https://www.sustainalytics.com/corporate-solutions/esg-solutions/top-rated-companies** (accessed 2/6/2023).

CORE CONCEPT

A company's **environmental sustainability strategy** consists of its deliberate actions to protect the environment, provide for the longevity of natural resources, maintain ecological support systems for future generations, and guard against ultimate endangerment of the planet.

water shortages. For other companies, the connection is less direct, but all companies are part of a business ecosystem whose economic health depends on the availability of natural resources. In response, most major companies have begun to change *how* they do business, emphasizing the use of **sustainable business practices,** defined as those capable of meeting the needs of the present without compromising the ability to meet the needs of the future. Many have also begun to incorporate a consideration of environmental sustainability into their strategy-making activities.

Environmental sustainability strategies entail deliberate and concerted actions to operate businesses in a manner that protects natural resources and ecological support systems, guards against outcomes that will ultimately endanger the planet, and is therefore sustainable for centuries.[23] One aspect of environmental sustainability is keeping use of the Earth's natural resources within levels that can be replenished via the use of sustainable business practices. In the case of some resources (like crude oil, freshwater, and edible fish from the oceans), scientists say that use levels either are already unsustainable or will be soon, given the world's growing population and propensity to consume additional resources as incomes and living standards rise. Another aspect of sustainability concerns containing the adverse effects of greenhouse gases and other forms of air pollution to reduce their impact on undesirable climate and atmospheric changes. Other aspects of sustainability include greater reliance on sustainable energy sources; greater use of recyclable materials; the use of sustainable methods of growing foods (to reduce topsoil depletion and the use of pesticides, herbicides, fertilizers, and other chemicals that may be harmful to human health or ecological systems); habitat protection; environmentally sound waste management practices; and increased attempts to decouple environmental degradation and economic growth. (According to scientists, economic growth has historically been accompanied by declines in the well-being of the environment.)

Examples of environmental sustainability initiatives include Amazon's plans to purchase 100,000 electric vehicles by 2040 and Ingersoll Rand's plans to reduce the carbon footprint of customers purchasing its heating and air conditioning systems by 1 gigaton. Unilever, a diversified producer of processed foods, personal care, and home cleaning products, is among the most committed corporations pursuing sustainable business practices. The company tracks 11 sustainable agricultural indicators in its processed-foods business and has launched a variety of programs to improve the environmental performance of its suppliers. Examples of such programs include special low-rate financing for tomato suppliers choosing to switch to water-conserving irrigation systems and training programs in India that have allowed contract cucumber growers to reduce pesticide use by 90 percent while improving yields by 78 percent. Unilever has also reengineered many internal processes to improve the company's overall performance on sustainability measures. For example, the company's factories have reduced water usage by 50 percent and manufacturing waste by 14 percent through the implementation of sustainability initiatives. Unilever has also redesigned packaging for many of its products to conserve natural resources and reduce the volume of consumer waste. The company's Suave shampoo bottles were reshaped to save almost 150 tons of plastic resin per year, which is the equivalent of 15 million fewer empty bottles making it to landfills annually. As the producer of Lipton Tea, Unilever is the world's largest purchaser of tea leaves; the company committed to sourcing all of its tea from Rainforest Alliance Certified farms, due to its comprehensive approach toward environmentally sustainable farm management. Illustration Capsule 9.4 sheds more light on Unilever's focus on environmental sustainability.

Crafting Corporate Social Responsibility and Sustainability Strategies

While CSR, corporate sustainability, and environmental sustainability strategies take many forms, those that both provide valuable social benefits *and* fulfill customer needs in a superior fashion may also contribute to a company's competitive advantage.[24] For example, while carbon emissions may be a generic social concern for financial institutions such as Wells Fargo, Toyota's environmental sustainability strategy for reducing carbon emissions has produced both competitive advantage and environmental benefits. Its Toyota Prius hybrid is widely recognized as having the lowest lifetime carbon footprint. On its debut, the newly introduced Toyota Crown captured the Green Car

ILLUSTRATION CAPSULE 9.4 Unilever's Focus on Environmental Sustainability

With over 60.1 billion euros in revenue in 2022, Unilever is one of the world's largest companies. The global consumer goods giant has products that are used by over 2.5 billion people on any given day. It manufactures iconic global brands like Dove, Vaseline, Axe, Hellman's, Ben & Jerry's, and many others. What it is also known for, however, is its commitment to environmental sustainability. It is consistently listed on the A list of the environmental nonprofit CDP, which is considered the gold-standard for environmental reporting.

Unilever's environmental strategy is guided by its Climate Transition Action Plan, which is updated every year. Its focus is on emissions reduction, with a goal of reaching zero emissions from its global operations by 2030 and net zero emissions across the company's value chain by 2039. Their plan is a comprehensive one, involving their suppliers and partners, aimed at reducing emissions across the entire life cycle of their products, from the raw materials and packaging used to their distribution, use, and disposal. The plan is updated each year with targets and goals, as well as an annual progress report.

The company has created new business practices to reach their ambitious targets. They set up a central corporate team dedicated to spreading the best sustainability practices from one factory or business unit to the rest of the company—a major change from the siloed manner in which the company had operated previously. Moreover, the company set up a "small actions, big differences" fund to invest in innovative ideas that help the company achieve its environmental sustainability goals. One such initiative resulted in a $15 million fund to help recycle an estimated 60,000 metric tons of plastic packaging waste annually.

GeoPic/Alamy Stock Photo

The company's focus on sustainability isn't just charity, but is really an act of self-interest. Multiple polls show that a majority of consumers want companies to be environmentally responsible and seek out brands from such companies. As a recent Unilever annual report states "growth and sustainability are not in conflict." And as their website proclaims, Unilever is "determined to prove that their future-fit business model delivers superior performance.

Sources: https://advertising.amazon.com/blog/sustainable-strategy; https://advertising.amazon.com/blog/sustainable-strategy; https://www.cdp.net/en/companies/companies-scores; *company website (accessed February 11, 2023).*

of the Year award from Green Car reports. The development of hybrid models like the Prius and the Crown have helped Toyota gain the loyalty of fuel-conscious buyers and given the company a new green image. Keurig Green Mountain (now part of Keurig Dr. Pepper) is committed to caring for the environment while also improving the livelihoods in coffee-growing communities. Their focus is on three primary solutions: (1) helping farmer improve their farming techniques; (2) addressing local water scarcity and planning for climate change; and (3) strengthening farmers' organizations. Its consumers are aware of these efforts and purchase Green Mountain coffee, in part, to encourage such practices.

CSR, corporate responsibility, and environmental sustainability strategies are more likely to contribute to a company's competitive advantage if they are linked to a company's competitively important resources and capabilities or value chain activities. Thus, it is common for companies engaged in natural resource extraction, electric power production, forestry and paper products manufacture, motor vehicles production, and chemical production to place more emphasis on addressing environmental concerns than, say, software and electronics firms or apparel manufacturers. Companies whose business success is heavily dependent on maintaining high employee morale or attracting and retaining the best and brightest employees are somewhat more prone to stress the well-being of their employees and foster a positive, high-energy workplace environment that elicits the dedication and enthusiastic commitment of employees, thus putting real meaning behind the claim "Our people are our greatest asset." But given the emphasis investors put on the ESG ratings of all types of companies, even firms with no obvious connection to environmental concerns are making environmental sustainability a priority. Zurich Insurance, for example, has decreased its energy and water consumption and is aiming to make its global offices carbon neutral in the near term.

CSR strategies and environmental sustainability strategies that both provide valuable social benefits *and* fulfill customer needs in a superior fashion can lead to competitive advantage. Corporate social agendas that address only social issues may help boost a company's reputation for corporate citizenship but are unlikely to improve its competitive strength in the marketplace.

At Whole Foods Market, a $16 billion supermarket chain specializing in organic and natural foods, its environmental sustainability strategy is evident in almost every segment of its company value chain and is a big part of its differentiation strategy. The company's procurement policies encourage stores to purchase fresh fruits and vegetables from local farmers and screen processed-food items for more than 400 common ingredients that the company considers unhealthy or environmentally unsound. Spoiled food items are sent to regional composting centers rather than landfills, and all cleaning products used in its stores are biodegradable. The company also has created the Animal Compassion Foundation to develop natural and humane ways of raising farm animals and has converted all of its vehicles to run on biofuels.

Not all companies choose to link their corporate environmental or social agendas to their value chain, their business model, or their industry. However, unless a company's social responsibility initiatives become part of the way it operates its business every day, the initiatives are unlikely to catch fire and be fully effective. As an executive at Royal Dutch/Shell put it, corporate social responsibility "is not a cosmetic; it must be rooted in our values. It must make a difference to the way we do business."[25] The same is true for environmental sustainability initiatives.

The Moral Case for Corporate Social Responsibility and Environmentally Sustainable Business Practices

The moral case for why businesses should act in a manner that benefits all of the company's stakeholders—not just shareholders—boils down to "It's the right thing to do." Ordinary decency, civic-mindedness, and contributions to society's well-being should be expected of any business.[26] In today's social and political climate, most business leaders can be expected to acknowledge that socially responsible actions are important and that businesses have a duty to be good corporate citizens. But there is a complementary school of thought that business operates on the basis of an implied social contract with the members of society. According to this contract, society grants a business the right to conduct its business affairs and agrees not to unreasonably restrain its pursuit of a fair profit for the goods or services it sells. In return for this "license to operate," a business is obligated to act as a responsible citizen, do its fair share to promote the general welfare, and avoid doing any harm. Such a view clearly puts a moral burden on a company to operate honorably, provide good working conditions to employees, be a good environmental steward, and display good corporate citizenship.

Every action a company takes can be interpreted as a statement of what it stands for.

The Business Case for Corporate Social Responsibility and Environmentally Sustainable Business Practices

Whatever the moral arguments for socially responsible business behavior and environmentally sustainable business practices, there are definitely good business reasons why companies should be public-spirited and devote time and resources to social responsibility initiatives, environmental sustainability, and good corporate citizenship:

- *Such actions can lead to increased buyer patronage.* A strong visible social responsibility or environmental sustainability strategy gives a company an edge in appealing to consumers who prefer to do business with companies that are good corporate citizens. Ben & Jerry's, Dr. Bronner's, Stonyfield Farm, Bombas, Klean Kanteen, and Patagonia have definitely expanded their customer bases because of their visible and well-publicized activities as socially conscious companies. More and more companies are also recognizing the cash register payoff of social responsibility strategies that reach out to people of all cultures and demographics (women, retirees, and members of ethnic minority groups).
- *A strong commitment to socially responsible behavior reduces the risk of reputation-damaging incidents.* Companies that place little importance on operating in a socially responsible manner are more prone to scandal and embarrassment. Consumer, environmental, and human rights activist groups are quick to criticize businesses whose behavior they consider to be out of line, and they are adept at getting their message into the media and onto the Internet. Pressure groups can generate widespread adverse publicity, promote boycotts, and influence like-minded or sympathetic buyers to avoid an offender's products.

  Research has shown that product boycott announcements are associated with a decline in a company's stock price.[27] When a major oil company suffered damage to its reputation on environmental and social grounds, the CEO repeatedly said that the most negative impact the company suffered—and the one that made him fear for the future of the company—was that bright young graduates were no longer attracted to working for the company. For many years, Nike received stinging criticism for not policing sweatshop conditions in the Asian factories that produced Nike footwear, a situation that caused Nike cofounder and chair Phil Knight to observe that "Nike has become synonymous with slave wages, forced overtime, and arbitrary abuse."[28] In response, Nike began an extensive effort to monitor conditions in the 800 factories of the contract manufacturers that produced Nike shoes. As Knight said, "Good shoes come from good factories and good factories have good labor relations." Nonetheless, Nike has continually been plagued by complaints from human rights activists that its monitoring procedures are flawed and that it is not doing enough to correct the plight of factory workers. As this suggests, a damaged reputation is not easily repaired.

> The higher the public profile of a company or its brand, the greater the scrutiny of its activities and the higher the potential for it to become a target for pressure group action.

- *Socially responsible actions and sustainable business practices can lower costs and enhance employee recruiting and workforce retention.* Companies with deservedly good reputations for social responsibility and sustainable business practices are better able to attract and retain employees, compared to companies with tarnished reputations. Some employees just feel better about working for a company committed to improving society. This can contribute to lower turnover and better worker productivity. Other direct and indirect economic benefits include lower costs for staff recruitment and training. For example, Starbucks is said to enjoy much lower rates of employee turnover because of its full-benefits package for both full-time and part-time employees, management efforts to make Starbucks a great place to work, and the company's socially responsible practices. Sustainable business practices are often concomitant with greater operational efficiencies. For example, when a U.S. manufacturer of recycled paper, taking eco-efficiency to heart, discovered how to increase its fiber recovery rate, it saved the equivalent of 20,000 tons of waste paper—a factor that helped the company become the industry's lowest-cost producer. By helping two-thirds of its employees to stop smoking and by investing in a number of wellness programs for employees, Johnson & Johnson saved $250 million on its health care costs over a 10-year period.[29]

- *Opportunities for revenue enhancement may also come from CSR and environmental sustainability strategies.* The drive for sustainability and social responsibility can spur innovative efforts that in turn lead to new products and opportunities for revenue enhancement. Electric cars such as the Chevy Bolt and the Nissan Leaf are one example. In many cases, the revenue opportunities are tied to a company's core products. PepsiCo and Coca-Cola, for example, have expanded into the juice business to offer a healthier alternative to their carbonated beverages. General Electric has created a profitable new business in wind turbines. In other cases, revenue enhancement opportunities come from innovative ways to reduce waste and use the by-products of a company's production. Tyson Foods now produces jet fuel for B-52 bombers from the vast amount of animal waste resulting from its meat product business. Staples has become one of the largest nonutility corporate producers of renewable energy in the United States due to its installation of solar power panels in all of its outlets (and the sale of what it does not consume in renewable energy credit markets). More surprising is the fact that the banking firm, JP Morgan, is now engaged in preserving timberland, since money can be made from carbon sequestration.
- *Well-conceived CSR strategies and sustainable business practices are in the best long-term interest of shareholders.* When CSR and sustainability strategies increase buyer patronage, offer revenue-enhancing opportunities, lower costs, increase productivity, and reduce the risk of reputation-damaging incidents, they contribute to the economic value created by a company and improve its profitability. A two-year study of leading companies found that improving environmental compliance and developing environmentally friendly products can enhance earnings per share, profitability, and the likelihood of winning contracts. The stock prices of companies that rate high on social and environmental performance criteria have been found to perform 35 to 45 percent better than the average of the 2,500 companies that constitute the Dow Jones Global Index.[30] A review of 135 studies indicated there is a positive, but small, correlation between good corporate behavior and good financial performance; only two percent of the studies showed that dedicating corporate resources to social responsibility harmed the interests of shareholders.[31] Furthermore, socially responsible business behavior helps avoid or preempt legal and regulatory actions that could prove costly and otherwise burdensome. In some cases, it is possible to craft corporate social responsibility strategies that contribute to competitive advantage and, at the same time, deliver greater value to society. For instance, Walmart, by working with its suppliers to reduce the use of packaging materials and revamping the routes of its delivery trucks to cut out 100 million miles of travel, saved $200 million in costs (which enhanced its cost-competitiveness vis-à-vis rivals) and lowered carbon emissions.[32] Thus, a social responsibility strategy that packs some punch and is more than rhetorical flourish can produce outcomes that are in the best interest of shareholders.

Socially responsible strategies that create value for customers and lower costs can improve company profits and shareholder value at the same time that they address other stakeholder interests.

There's little hard evidence indicating shareholders are disadvantaged in any meaningful way by a company's actions to be socially responsible.

In sum, companies that take social responsibility and environmental sustainability seriously can improve their business reputations and operational efficiency while also reducing their risk exposure and encouraging loyalty and innovation. Overall, companies that take special pains to protect the environment (beyond what is required by law) are active in community affairs and are generous supporters of charitable causes and projects that benefit society are more likely to be seen as good investments and as good companies to work for or do business with. Shareholders are likely to view the business case for sustainability as a strong one, particularly when it results in the creation of more customer value, greater productivity, lower operating costs, and lower business risk—all of which should increase firm profitability and enhance shareholder value even as the company's actions address broader stakeholder interests.

Companies are, of course, sometimes rewarded for bad behavior—a company that is able to shift environmental and other social costs associated with its activities onto society as a whole can reap large short-term profits. The major cigarette producers for many years were able to earn greatly inflated profits by shifting the health-related costs of smoking onto others and escaping any responsibility for the harm their products caused to consumers and the general public. Only recently have they been facing the prospect of having to pay high punitive damages for their actions. Unfortunately, the cigarette makers are not alone in trying to evade paying for the social harms of their operations for as long as they can. Calling a halt to such actions usually hinges on (1) the effectiveness of activist social groups in publicizing the adverse consequences of a company's social irresponsibility and marshaling public opinion for something to be done, (2) the enactment of legislation or regulations to correct the inequity, and (3) decisions on the part of socially conscious buyers to take their business elsewhere.

KEY POINTS

1. Ethics concerns standards of right and wrong. Business ethics concerns the application of ethical principles to the actions and decisions of business organizations and the conduct of their personnel. Ethical principles in business are not materially different from ethical principles in general.
2. There are three schools of thought about ethical standards for companies with international operations:
   - According to the *school of ethical universalism,* common understandings across multiple cultures and countries about what constitutes right and wrong behaviors give rise to universal ethical standards that apply to members of all societies, all companies, and all businesspeople.
   - According to the *school of ethical relativism,* different societal cultures and customs have divergent values and standards of right and wrong. Thus, what is ethical or unethical must be judged in the light of local customs and social mores and can vary from one culture or nation to another.
   - According to the *integrated social contracts theory,* universal ethical principles based on the collective views of multiple cultures and societies combine to form

a "social contract" that all individuals in all situations have a duty to observe. Within the boundaries of this social contract, local cultures or groups can specify what additional actions are not ethically permissible. However, universal norms always take precedence over local ethical norms.

3. Apart from the "business of business is business, not ethics" kind of thinking, three other factors contribute to unethical business behavior: (1) faulty oversight that enables the unscrupulous pursuit of personal gain, (2) heavy pressures on company managers to meet or beat short-term earnings targets, and (3) a company culture that puts profitability and good business performance ahead of ethical behavior. In contrast, culture can function as a powerful mechanism for promoting ethical business conduct when high ethical principles are deeply ingrained in the corporate culture of a company.

4. Business ethics failures can result in three types of costs: (1) visible costs, such as fines, penalties, and lower stock prices; (2) internal administrative costs, such as legal costs and costs of taking corrective action; and (3) intangible costs or less visible costs, such as customer defections and damage to the company's reputation.

5. The term *corporate social responsibility* concerns a company's *duty* to operate in an honorable manner, provide good working conditions for employees, encourage workforce diversity, be a good steward of the environment, and support philanthropic endeavors in local communities where it operates and in society at large. The particular combination of socially responsible endeavors a company elects to pursue defines its corporate social responsibility (CSR) strategy.

6. The *triple bottom line* refers to company performance in three realms: economic, social, and environmental, often referred to as profit, people, and planet. Increasingly, companies are reporting their performance with respect to all three performance dimensions.

7. *Corporate sustainability* involves the adoption and implementation of a broad range of practices across the *environmental, social, and governance* (ESG) interfaces of an organization. Sustainable business practices are those capable of meeting the needs of the present without compromising the world's ability to meet future needs.

8. A company's *environmental sustainability strategy* consists of its deliberate actions to protect the environment, provide for the longevity of natural resources, maintain ecological support systems for future generations, and guard against ultimate endangerment of the planet.

9. CSR, corporate sustainability, and environmental sustainability strategies that provide valuable social benefits *and* fulfill customer needs in a superior fashion can lead to competitive advantage.

10. The moral case for corporate social responsibility and environmental sustainability boils down to a simple concept: It's the right thing to do. There are also solid reasons why CSR and environmental sustainability strategies may be good business—they can be conducive to greater buyer patronage, reduce the risk of reputation-damaging incidents, provide opportunities for revenue enhancement, and lower costs. Well-crafted CSR and environmental sustainability strategies are in the best long-term interest of shareholders, for the reasons just mentioned and because they can avoid or preempt costly legal or regulatory actions.

ASSURANCE OF LEARNING EXERCISES

LO 9-1

1. Dell Technologies has been recognized as one of the World's Most Ethical Companies. Dell conducts its business according to a strict Code of Conduct that articulates its ethical principles and provides guidance for putting these principles into action throughout the firm. Skim sections 1.2 (Dell Technologies' Ethical Principles) and 1.3 (Additional Responsibilities for Leaders) in the PDF document titled "How We Win," which can be found on your browser by Googling "Dell Technologies: Our Code of Conduct – Media Corporate IR Net." Why are these guidelines for conduct not only good, but good for business?

LO 9-2, LO 9-3

2. Prepare a one- to two-page analysis of a recent ethics scandal using your university library's resources. Your report should (1) discuss the conditions that gave rise to unethical business strategies and behavior and (2) provide an overview of the costs to the company resulting from the company's business ethics failure.

connect LO 9-4

3. Based on the information provided in Illustration Capsule 9.3, explain how Warby Parker's CSR strategy has contributed to its success in the marketplace. How are the company's various stakeholder groups affected by its commitment to social responsibility? How would you evaluate its triple-bottom-line performance?

connect LO 9-4

4. The U.S. Drug Enforcement Agency (DEA) issued a warning in 2021 concerning the sale of fake prescription drugs such as Xanax and Adderall to unsuspecting teenagers and young adults via social media platforms. These counterfeit drugs are made using fentanyl, with about 40 percent containing a lethal dose. Between 2020 and 2021, almost 79,000 Americans aged 18 to 45 died from fentanyl overdoses, making fentanyl poisoning the leading cause of death for those in that age bracket. Social media companies have aggressively limited communications they deem to be harmful but have done little to prevent the sale of lethal drugs on their platforms. Prepare a one-page analysis about whether social media companies have the responsibility to do more in preventing the sale of counterfeit drugs using their apps.

EXERCISES FOR SIMULATION PARTICIPANTS

connect

LO 9-1

1. What factors build the business case for operating your company in an ethical manner?

LO 9-4

2. In what ways, if any, is your company exercising corporate social responsibility? What are the elements of your company's CSR strategy? Are there any changes to this strategy that you would suggest?

LO 9-3, LO 9-4

3. If some shareholders complained that you and your co-managers have been spending too little or too much on corporate social responsibility, what would you tell them?

LO 9-4

4. Is your company striving to conduct its business in an environmentally sustainable manner? What specific *additional* actions could your company take that would make an even greater contribution to environmental sustainability?

LO 9-4

5. In what ways do a company's environmental sustainability strategy in the best long-term interest of shareholders? Does it contribute to your company's competitive advantage or profitability?

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chapter **10**

Building an Organization Capable of Good Strategy Execution

People, Capabilities, and Structure

Learning Objectives

After reading this chapter, you should be able to

LO 10-1 Understand what managers must do to execute strategy successfully.

LO 10-2 Explain why hiring, training, and retaining the right people constitute a key component of the strategy execution process.

LO 10-3 Recognize that good strategy execution requires continuously building and upgrading the organization's resources and organizational capabilities.

LO 10-4 Identify and establish a strategy-supportive organizational structure and organize the work effort.

LO 10-5 Comprehend the pros and cons of centralized and decentralized decision making in implementing the chosen strategy.

Richard *Schneider/Getty Images*

Crafting a good strategy is half of the job; the other half is to build an organization to roll it out.

J. Ramon Lecuona—*Professor and Thought Leader*

I try to motivate people and align our individual incentives with organizational incentives. And then let people do their best.

John D. Liu—*CEO, Essex Equity Management*

Leadership is really about seeing the potential in other people and accelerating that potential by pushing them out of their comfort zone.

Sydney Finkelstein—*Professor and consultant*

Once managers have decided on a strategy, the emphasis turns to converting it into actions and good results. Putting the strategy into place and getting the organization to execute it will call for different sets of managerial skills rather than crafting strategy. Whereas crafting strategy is largely an analysis-driven activity focused on market conditions and the company's resources and capabilities, executing strategy is primarily operations-driven, revolving around the management of people, resources, business processes, and organizational structure. Successful strategy execution depends on doing a good job of working with and through others; building and strengthening competitive capabilities; creating an appropriate organizational structure; allocating resources; instituting strategy-supportive policies, processes, and systems; and instilling a discipline of getting things done. Executing strategy is an action-oriented task that tests a manager's ability to direct organizational change, achieve improvements in day-to-day operations, create and nurture a culture that supports good strategy execution, and meet or beat performance targets.

Experienced managers are well aware that it is much easier to develop a sound strategic plan than it is to execute the plan and achieve targeted outcomes. A study of 400 CEOs in the United States, Europe, and Asia found that executional excellence was the number-one challenge facing their companies.[1] According to one executive, "It's been rather easy for us to decide where we wanted to go. The hard part is to get the organization to act on the new priorities."[2] It takes adept managerial leadership to convincingly communicate the reasons for a new strategy and overcome pockets of doubt, secure the commitment of key personnel, build consensus for how to implement the strategy, and move forward to get all the pieces into place and deliver results. *Just because senior managers announce a new strategy doesn't mean that organization members will embrace it and move forward enthusiastically to implement it.* Company personnel must understand—in their heads and hearts—why a new strategic direction is necessary and where the new strategy is taking them.[3] Instituting change is, of course, easier when the problems with the old strategy have become obvious and/or the company has spiraled into a financial crisis.

But the challenge of successfully implementing new strategic initiatives goes well beyond managerial adeptness in overcoming resistance to change. What really make executing strategy a tougher, more time-consuming management challenge than crafting strategy are the wide array of managerial activities that must be attended to, the many ways to put new strategic initiatives in place and keep things moving, and the number of bedeviling issues that always crop up and have to be resolved. It takes first-rate "managerial smarts" to zero in on what exactly needs to be done and how to get good results in a timely manner. Excellent people-management skills and perseverance are needed to get a variety of initiatives underway and to integrate the efforts of many different work groups into a smoothly functioning whole. Depending on how much consensus building and organizational change is involved, the process of implementing strategy changes can take several months to several years. And executing the strategy with *real proficiency* takes even longer.

Like crafting strategy, *executing strategy is a job for a company's whole management team—not just a few senior managers.* While the chief executive officer and the heads of major units (business divisions, functional departments, and key operating units) are ultimately responsible for seeing that strategy is executed successfully, the process typically affects every part of the firm—all value chain activities and all work groups. Top-level managers must rely on the active support of middle and lower managers to institute whatever new operating practices are needed in the various operating units to achieve proficient strategy execution. Middle- and lower-level managers must ensure that frontline employees perform strategy-critical value chain activities proficiently enough to allow companywide performance targets to be met. Consequently, *all company personnel are actively involved in the strategy execution process in one way or another.*

A FRAMEWORK FOR EXECUTING STRATEGY

CORE CONCEPT

Good strategy execution requires a *team effort*. All managers have strategy-executing responsibility in their areas of authority, and all employees are active participants in the strategy execution process.

LO 10-1

Understand what managers must do to execute strategy successfully.

Executing strategy entails figuring out the specific techniques, actions, and behaviors that are needed to get things done and deliver results. The exact items that need to be placed on management's action agenda always have to be customized to fit the particulars of a company's situation. The techniques for successfully executing a low-cost leader strategy are different from those for executing a high-end differentiation strategy. Making minor changes in an existing strategy differs from implementing radical strategy changes. Implementing a new strategy for a struggling company in the midst of a financial crisis is a different job from improving strategy execution in a company that is doing relatively well. Moreover, some managers are more adept than others at using particular approaches to achieving certain kinds of organizational changes. Hence, there's no definitive managerial recipe for successful strategy execution that cuts across all company situations and strategies or that works for all managers. Rather, the specific actions required to execute a strategy–the "to-do list" that constitutes management's action agenda–always represent management's judgment about how best to proceed in light of prevailing circumstances.

The Principal Components of the Strategy Execution Process

Despite the need to tailor a company's strategy-executing approaches to the situation at hand, certain managerial bases must be covered no matter what the circumstances. These include 10 basic managerial tasks (see Figure 10.1):

1. Staffing the organization with managers and employees capable of executing the strategy well.
2. Developing the resources and organizational capabilities required for successful strategy execution.
3. Creating a strategy-supportive organizational structure.

4. Allocating sufficient resources (budgetary and otherwise) to the strategy execution effort.
5. Instituting policies and procedures that facilitate strategy execution.
6. Adopting business management processes that drive continuous improvement in how value chain activities are performed.
7. Installing information and operating systems that enable company personnel to perform essential activities.
8. Tying rewards directly to the achievement of performance objectives.
9. Fostering a corporate culture that promotes good strategy execution.
10. Exerting the leadership needed to propel strategy execution forward.

When strategies fail, it is often because of poor execution. Strategy execution is therefore a critical managerial endeavor.

The two best signs of good strategy execution are whether a company is meeting its performance targets and whether it has attained real proficiency in performing strategy-critical value chain activities.

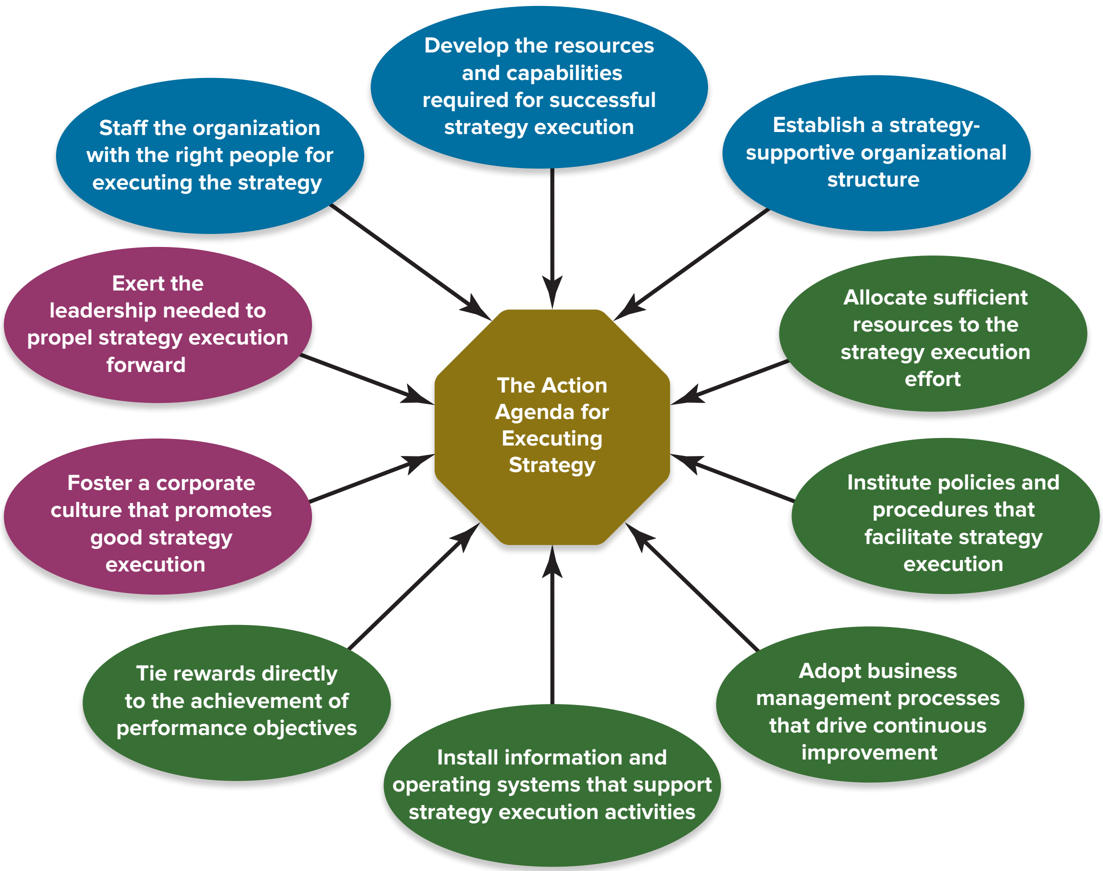
How well managers perform these 10 tasks has a decisive impact on whether the outcome of the strategy execution effort is a spectacular success, a colossal failure, or something in between.

In devising an action agenda for executing strategy, managers should start by conducting *a probing assessment of what the organization must do differently to carry out the strategy successfully.* Each manager needs to ask the question "What needs to be done in my area of responsibility to implement our part of the company's strategy, and what should I do to get these things accomplished *effectively and efficiently?*" It is then incumbent on every manager to determine *precisely how to make the necessary internal changes.* Strong managers have a knack for diagnosing what their organizations need to do to execute the chosen strategy well and figuring out how to get these things done in a timely fashion. They are masters in promoting results-oriented behaviors on the part of company personnel and following through on making the right things happen to achieve the target outcomes.[4]

When strategies fail, it is often because of poor execution. Strategy execution is therefore a critical managerial endeavor. The two best signs of good strategy execution are whether a company is meeting its performance targets and whether it has attained real proficiency in performing strategy-critical value chain activities. In big organizations with geographically scattered operating units, senior executives' action agenda mostly involves communicating the case for change, building consensus for how to proceed, installing strong managers to move the process forward in key organizational units, directing resources to the right places, establishing deadlines and measures of progress, rewarding those who achieve implementation milestones, and personally leading the strategic change process. Thus, the bigger the organization, the more that successful strategy execution depends on the cooperation and implementation skills of operating managers who can promote needed changes at the lowest organizational levels and deliver results. In small organizations, top managers can deal directly with frontline managers and employees, personally orchestrating the action steps and implementation sequence, observing firsthand how implementation is progressing, and deciding how hard and how fast to push the process along. Whether the organization is large or small and whether strategy implementation involves sweeping or minor changes, effective leadership requires a keen grasp of what to do and how to do it in light of the organization's circumstances. Then it remains for company personnel in strategy-critical areas to step up to the plate and produce the desired results.

What's Covered in Chapters 10, 11, and 12 In the remainder of this chapter and in the next two chapters, we discuss what is involved in performing the 10 key managerial tasks that shape the process of executing strategy. This chapter explores the first three of these tasks (highlighted in blue in Figure 10.1): (1) staffing the organization with people

FIGURE 10.1 The 10 Basic Tasks of the Strategy Execution Process

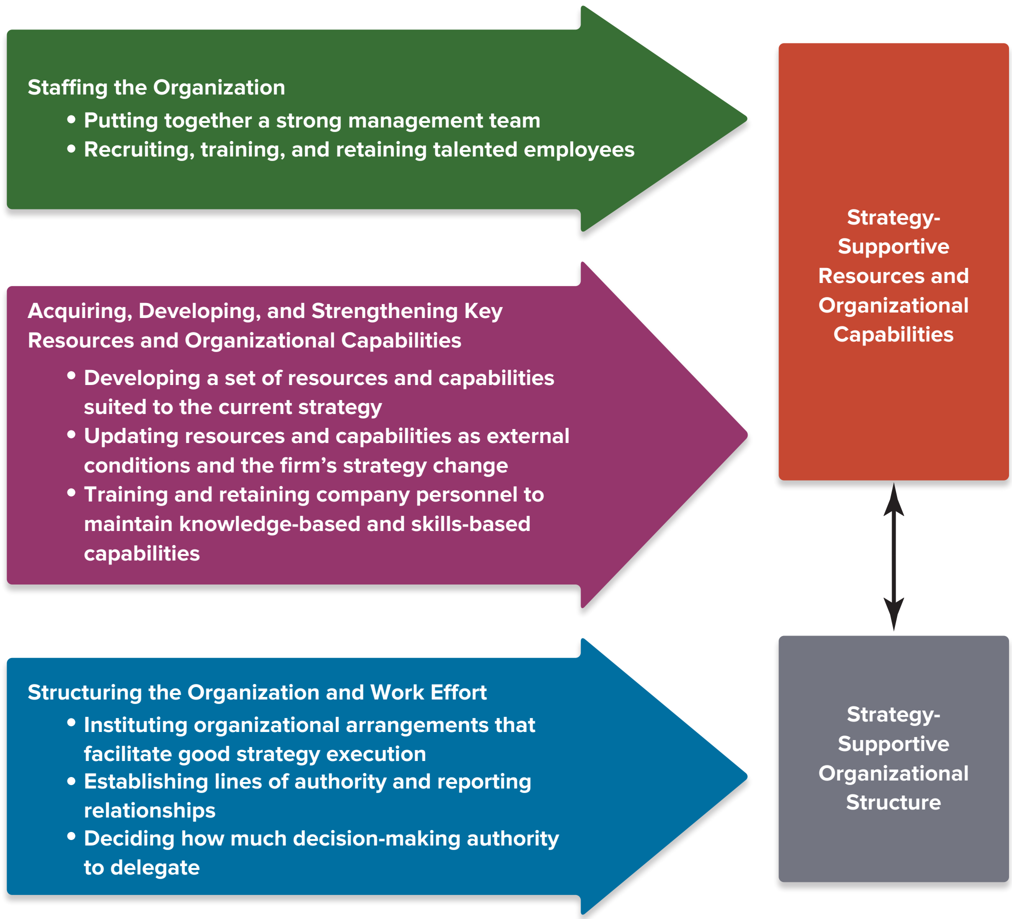


capable of executing the strategy well, (2) developing the resources and organizational capabilities needed for successful strategy execution, and (3) creating an organizational structure supportive of the strategy execution process. Chapter 11 concerns the tasks of allocating resources (budgetary and otherwise), instituting strategy-facilitating policies and procedures, employing business process management tools, installing operating and information systems, and tying rewards to the achievement of good results (highlighted in green in Figure 10.1). Chapter 12 deals with the two remaining tasks: instilling a corporate culture conducive to good strategy execution, and exerting the leadership needed to drive the execution process forward (highlighted in purple).

BUILDING AN ORGANIZATION CAPABLE OF GOOD STRATEGY EXECUTION: THREE KEY ACTIONS

Proficient strategy execution depends foremost on having in place an organization capable of the tasks demanded of it. Building an execution-capable organization is thus always a top priority. As shown in Figure 10.2, three types of organization-building actions are paramount:

FIGURE 10.2 Building an Organization Capable of Proficient Strategy Execution: Three Key Actions



1. *Staffing the organization*–putting together a strong management team, and recruiting, training, and retaining employees with the needed experience, technical skills, and intellectual capital (the human resources).
2. *Acquiring, developing, and strengthening the other resources and organizational capabilities required for good strategy execution*–accumulating the required resources, developing proficiencies in performing strategy-critical value chain activities, and updating the company's capabilities to match changing market conditions and customer expectations.
3. *Structuring the organization and work effort*–organizing value chain activities and business processes, establishing lines of authority and reporting relationships, and deciding how much decision-making authority to delegate to lower-level managers and frontline employees.

Implementing a strategy depends critically on ensuring that strategy-supportive resources and organizational capabilities are in place, ready to be deployed. These include the skills, talents, experience, and knowledge of the company's human resources (managerial and otherwise). Proficient strategy execution depends heavily on competent personnel of all types, but because of the many managerial tasks involved and the role of leadership in strategy execution, assembling a strong management team is especially important.

If the strategy being implemented is a new strategy, the company may need to add to its resource and capability mix in other respects as well. But renewing, upgrading, and revising the organization's resources and capabilities is a part of the strategy execution process even if the strategy is fundamentally the same, since strategic assets depreciate and conditions are always changing. Thus, augmenting and strengthening the firm's core competencies and seeing that they are suited to the current strategy are also top priorities.

Structuring the organization and work effort is another critical aspect of building an organization capable of good strategy execution. An organization structure that is well matched to the strategy can help facilitate its implementation; one that is not well suited can lead to higher bureaucratic costs and communication or coordination breakdowns.

STAFFING THE ORGANIZATION

LO 10-2

Explain why hiring, training, and retaining the right people constitute a key component of the strategy execution process.

No company can hope to perform the activities required for successful strategy execution without attracting and retaining talented managers and employees with suitable skills and *intellectual capital.*

Putting Together a Strong Management Team

Assembling a capable management team is a cornerstone of the organization-building task.[5] While different strategies and company circumstances often call for different mixes of backgrounds, experiences, management styles, and know-how, *the most important consideration is to fill key managerial slots with smart people who are clear thinkers, good at figuring out what needs to be done, skilled in managing people, and accomplished in getting the job done and delivering good results.*[6] The task of implementing challenging strategic initiatives must be assigned to executives who have the skills and talents to handle them and who can be counted on to rise to the challenge and do what is needed. Without a capable, results-oriented management team, the implementation process is likely to be hampered by missed deadlines, misdirected or wasteful efforts, and managerial ineptness. Weak executives are serious impediments to getting optimal results–the caliber of work done under their supervision suffers.[7] In contrast, managers with strong strategy implementation capabilities understand how to drive organizational change, and know how to motivate and lead the company down the path for first-rate strategy execution. They have a talent for asking tough, incisive questions and know enough about the details of the business to ensure the soundness of the decisions of the people around them–they can discern whether the resources people are asking for to put the strategy in place make sense. They are good at getting things done through others, partly by making sure they have the right people under them, assigned to the right jobs and partly because they know how to motivate and inspire people. They have strong social skills and high emotional intelligence. They consistently follow through on issues, monitor progress carefully, make adjustments when needed, and keep important details from slipping through the cracks.

Sometimes a company's existing management team is up to the task. At other times it may need to be strengthened by promoting qualified people from within or by bringing in outsiders whose experiences, talents, and leadership styles better suit the situation. In turnaround and rapid-growth situations, and in instances when company managers lack the requisite know-how, filling key management slots from the outside is a standard organization-building approach. In all situations, it is important to identify and replace managers who are incapable, for whatever reason, of making the required changes in a timely and cost-effective manner. For a management team to be truly effective at strategy execution, it must be composed of managers who recognize that organizational changes are needed and who are both capable and ready to get on with the process.

The overriding aim in building a management team should be to assemble a *critical mass* of talented managers who can function as agents of change and spearhead excellent strategy execution. Every manager's success is enhanced (or limited) by the quality of their managerial colleagues and the degree to which they freely exchange ideas, debate ways to make operating improvements, and join forces to tackle issues and solve problems. When a first-rate manager enjoys the help and support of other first-rate managers, it's possible to create a managerial whole that is greater than the sum of individual efforts–talented managers who work well together as a team can produce organizational results that are dramatically better than what one- or two-star managers acting individually can achieve.[8]

Putting together a talented management team with the right mix of experiences, skills, and abilities to get things done is one of the first steps to take in launching the strategy-executing process.

Increasingly, companies are also recognizing the importance and the benefits of having a more diverse top management team that includes, for example, women, people of color, and other under-represented groups. Illustration Capsule 10.1 provides examples.

Recruiting, Training, and Retaining Capable Employees

Assembling a capable management team is not enough. Staffing the organization with the right kinds of people must go much deeper than managerial jobs in order for value chain activities to be performed competently. *The quality of an organization's employees is always an essential ingredient of successful strategy execution.* Companies like Mercedes-Benz, Alphabet, SAS, Boston Consulting Group, Edward Jones, Quicken Loans, Genentech, Intuit, Salesforce.com, and Goldman Sachs make a concerted effort to recruit the best and brightest people they can find and then retain them with excellent compensation packages, opportunities for rapid advancement and professional growth, and interesting assignments. Having a pool of "A players" with strong skill sets and lots of brainpower is essential to their business.

In many industries, adding to a company's talent base and building intellectual capital are more important to good strategy execution than are additional investments in capital projects.

Meta Platforms, the parent company of Facebook, Instagram, and WhatsApp, makes a point of hiring the very brightest and most talented programmers it can find and motivating them with both good monetary incentives and the challenge of working on cutting-edge technology projects. McKinsey & Company, one of the world's premier management consulting firms, recruits only cream-of-the-crop MBAs at the nation's top-10 business schools; such talent is essential to McKinsey's strategy of performing high-level consulting for the world's top corporations. The leading global accounting firms screen candidates not only on the basis of their accounting expertise but also on whether they possess the people skills needed to relate

ILLUSTRATION CAPSULE 10.1 Diversity and Inclusion at the Top Levels of Management

Companies are recognizing the benefits of having a diverse team and are making a conscious effort to create inclusive environments and provide equal opportunities for all. This shift has led to greater representation and visibility of underrepresented groups in the C-suite and a more diverse group of decision-makers at the highest levels of corporate leadership. For example, Beth Ford, CEO of Land O'Lakes is openly gay, while Marc Benioff, Chairman and CEO of Salesforce is a person of color, along with John Chen, CEO and Executive Chairman of BlackBerry. The number of women, people of color, and members of the LGBTQ+ community who hold top leadership positions at major U.S. companies is still relatively small compared to their representation in the overall population; however, their numbers are steadily increasing. And the impact of these changes is being felt throughout organizational life.


Beth Ford, CEO of Land O'Lakes
Richard Tsong-Taatarii/Star Tribune/Getty Images


Marc Benioff, Chairman and CEO of Salesforce
Bloomberg/Getty Images

Rosalind Brewer, CEO of Walgreens Boots Alliance
Paul Morigi/Getty Images


Kenneth Chenault, Former CEO of American Express
Jemal Countess/Getty Images


Mary Barra, CEO of GM
Stephen Olker/Getty Images


Satya Nadella, CEO of Microsoft
Justin Sullivan/Getty Images


Thasunda Duckett, CEO of TIAA
Bloomberg/Getty Images


Kenneth Frazier, Former CEO of Merck
Bloomberg/Getty Images

well with clients and colleagues. Southwest Airlines goes to considerable lengths to hire people who can have fun and be fun on the job. It uses special interviewing and screening methods to gauge whether applicants for customer-contact jobs have outgoing personality traits that match its strategy of creating a high-spirited, fun-loving, in-flight atmosphere for passengers. Southwest Airlines is so selective that only about 3 percent of the people who apply are offered jobs.

In high-tech companies, the challenge is to staff work groups with gifted, imaginative, and energetic people who can bring life to new ideas quickly and inject into the organization what one Dell executive calls "hum."[9] The saying "People are our most important asset" may seem trite, but it fits high-technology companies precisely. Besides checking closely for functional and technical skills, Dell tests applicants for their tolerance of ambiguity and change, their capacity to work in teams, and their ability to learn on the fly. Companies like LinkedIn, Credit Suisse, IDEO, Amazon.com, and Cisco Systems have broken new ground in recruiting, hiring, cultivating, developing, and retaining talented employees–almost all of whom are in their 20s and 30s.

ILLUSTRATION CAPSULE 10.2 Management Development at Deloitte Touche Tohmatsu Limited

Kent *Johansson/Shutterstock*

Hiring, retaining, and cultivating talent are critical activities at Deloitte, the world's largest professional services firm. By offering robust learning and development programs, Deloitte has been able to create a strong talent pipeline to the firm's partnership. Deloitte's emphasis on learning and development, across all stages of the employee life cycle, has led to recognitions such as being ranked number-one on *Chief Executives*' list of "Best Private Companies for Leaders" and being listed among *Fortune*'s "100 Best Companies to Work For." The following programs contribute to Deloitte's successful execution of its talent strategy:

- *Clear path to partnership.* During the initial recruiting phase and then throughout an employee's tenure at the firm, Deloitte lays out a clear career path. The path indicates the expected timeline for promotion to each of the firm's hierarchy levels, along with the competencies and experience required. Deloitte's transparency on career paths, coupled with its in-depth performance management process, helps employees clearly understand their performance. This serves as a motivational tool for top performers, often leading to career acceleration.
- *Formal training programs.* Like other leading organizations, Deloitte has a program to ensure that recent college graduates are equipped with the necessary training and tools for succeeding on the job. Yet Deloitte's commitment to formal training is evident at all levels within the organization. Once promoted, an employee attends the Deloitte "milestone" school, a weeklong simulation that replicates true business situations employees would face as they transition to new stages of career development. In addition, Deloitte institutes mandatory training hours for all of its employees to ensure that individuals continue to further their professional development.
- *Special programs for high performers.* Deloitte also offers fellowships and programs to help employees acquire new skills and enhance their leadership development. For example, the Global Fellows program helps top performers work with senior leaders in the organization to focus on the realities of delivering client service across borders. Deloitte has also established the Emerging Leaders Development program, which utilizes skill building, 360-degree feedback, and one-on-one executive coaching to help top-performing managers and senior managers prepare for partnership.
- *Sponsorship, not mentorship.* To train the next generation of leaders, Deloitte has implemented formal mentorship programs to provide leadership development support. Deloitte, however, uses the term *sponsorship* to describe this initiative. A sponsor is tasked with helping rising leaders navigate the firm, develop new competencies, expand their network, and hone the skills needed to accelerate their career.

Note: Developed with Heather Levy.

Sources: Company websites; **www.accountingweb.com/article/leadership-development-community-service-integral-deloitte-university/220845** (accessed February 2014).

Cisco goes after the top 10 percent, raiding other companies and endeavoring to retain key people at the companies it acquires. Cisco executives believe that a cadre of star engineers, programmers, managers, salespeople, and support personnel is the backbone of the company's efforts to execute its strategy and remain the world's leading provider of Internet infrastructure products and technology. Deloitte is similarly known for its ability to recruit, train, and retain high performers, creating a pipeline for partnership in the company. Illustration Capsule 10.2 describes Deloitte's highly effective approach.

> The best companies make a point of recruiting and retaining talented employees—the objective is to make the company's entire workforce (managers and rank-and-file employees) a genuine competitive asset.

The practices listed here are common among companies dedicated to staffing jobs with the best people they can find:

1. Putting forth considerable effort on screening and evaluating job applicants–selecting only those with suitable skill sets, energy, initiative, judgment, aptitude for learning, and personality traits that mesh well with the company's work environment and culture.
2. Providing employees with training programs that continue throughout their careers.
3. Offering promising employees challenging, interesting, and skill-stretching assignments.
4. Rotating people through jobs that span functional and geographic boundaries. In multinational companies, an essential part of career development involves providing people with opportunities to gain experience in a variety of international settings.
5. Making the work environment stimulating and engaging so that employees will consider the company a great place to work.
6. Encouraging employees to challenge existing ways of doing things, to be creative in proposing better ways of operating, and to push their ideas for new products or businesses. Progressive companies work hard at creating an environment in which employees are made to feel that their views and suggestions count.
7. Striving to retain talented, high-performing employees via promotions, salary increases, performance bonuses, stock options and equity ownership, benefit packages including health insurance and retirement packages, and other perks, such as flexible work hours and onsite day care.
8. Coaching average performers to improve their skills and capabilities, while weeding out underperformers.

DEVELOPING AND BUILDING CRITICAL RESOURCES AND ORGANIZATIONAL CAPABILITIES

LO 10-3

Recognize that good strategy execution requires continuously building and upgrading the organization's resources and organizational capabilities.

High among the organization-building priorities in the strategy execution process is the need to build and strengthen the company's portfolio of resources and capabilities. As explained in Chapter 4, a company's chances of gaining a sustainable advantage over its market rivals depends on the caliber of its resource and capability portfolio. In the course of crafting strategy, managers may well have well have identified the resources and organizational capabilities that will enable the firm's strategy to succeed, but getting the strategy execution process underway requires acquiring or developing these resources and capabilities, putting them into place, refreshing and strengthening them as needed, and then modifying them as market conditions evolve.

If the strategy being implemented has important new elements, company managers may have to acquire new resources, significantly broaden or deepen certain capabilities, or even add entirely new competencies in order to put the strategic initiatives in place and execute them proficiently. But even when a company's strategy has not changed materially, good strategy execution still involves continually upgrading the firm's resources and organizational capabilities to keep them in top form and perform value chain activities ever more proficiently.

Three Approaches to Building and Strengthening Organizational Capabilities

Building the right kinds of organizational capabilities and keeping them finely honed is a time-consuming, managerially challenging exercise. While some assistance can be gotten from discovering how best-in-industry or best-in-world companies perform a particular activity, trying to replicate and then improve on the capabilities of other companies is easier said than done–for the same reasons that one is unlikely to ever become a world-class halfpipe snowboarder just by studying legendary Olympic gold medalist Shaun White.

> Building new organizational capabilities is a multistage process that occurs over a period of months and years. It is not something that is accomplished overnight.

With deliberate effort, well-orchestrated organizational actions, and continued practice, however, it is possible for a firm to become proficient at capability building despite the difficulty. Indeed, by making capability-building activities a *routine* part of their strategy execution endeavors, some firms are able to develop *dynamic capabilities* that assist them in managing resource and capability change, as discussed in Chapter 4. The most common approaches to capability building include (1) developing and strengthening capabilities internally, (2) acquiring capabilities through mergers and acquisitions, and (3) developing new organizational capabilities via collaborative partnerships.

Developing Organizational Capabilities Internally Organizational capabilities develop incrementally along an evolutionary path that entails a series of deliberate and well-orchestrated steps as organizations search for solutions to their problems. The process is a complex one, since capabilities are the product of *bundles of skills and know-how that are integrated into organizational routines and deployed within activity systems* through the combined efforts of teams that are often cross-functional in nature, spanning a variety of departments and locations. For instance, the capability of speeding new products to market involves the *collaborative efforts* of personnel in R&D, engineering and design, purchasing, production, marketing, and distribution. Similarly, the capability to provide superior customer service is a team effort among people in customer call centers (where orders are taken and inquiries are answered), shipping and delivery, billing and accounts receivable, and after-sale support. The process of building an organizational capability begins when managers set an objective of developing a particular capability and organize activity around that objective.[10]

Because the process is incremental, the first step is to develop the *ability* to do something, however imperfectly or inefficiently. This entails selecting people with the requisite skills and experience, enabling them to upgrade their abilities as needed, and then molding the efforts of individuals into a joint effort to create an organizational ability. At this stage, progress can be fitful since it depends on experimenting, actively searching for alternative solutions, and learning through trial and error.[11]

> A company's capabilities must be continually refreshed to remain aligned with changing customer expectations, altered competitive conditions, and new strategic initiatives.

As experience grows and company personnel learn how to perform the activities consistently well and at an acceptable cost, the ability *evolves* into a tried-and-true competence. Getting to this point requires a *continual investment* of resources and *systematic efforts* to improve processes and solve problems creatively as they arise. Improvements in the functioning of an organizational capability come from task repetition and the resulting *learning by doing* of individuals and teams. But the process can be accelerated by making learning a more deliberate endeavor and providing the incentives that will motivate company personnel to achieve the desired ends.[12] This can be critical to successful strategy execution when market conditions are changing rapidly.

It is generally much easier and less time-consuming to update and remodel a company's existing capabilities as external conditions and company strategy change than it is to create them from scratch. Maintaining organizational capabilities in top form may simply require exercising them continually and fine-tuning them as necessary. Similarly, augmenting a capability may require less effort if it involves the recombination of well-established company capabilities and draws on existing company resources. For example, Williams-Sonoma first developed the capability to expand sales beyond its brick-and-mortar location in 1970, when it launched a catalog that was sent to customers throughout the United States. The company extended its mail-order business with the acquisitions of Hold Everything, a garden products catalog, and Pottery Barn, and entered online retailing in 2000 when it launched e-commerce sites for Pottery Barn and Williams-Sonoma. The ongoing renewal of these capabilities allowed Williams-Sonoma to be named to the Fortune 500 list of largest U.S. companies for the first time in 2019 and to generate revenues of $8.7 billion in 2022. Toyota beat out General Motors to become the global leader in motor vehicles by aggressively upgrading its capabilities in fuel-efficient hybrid engine technology and constantly fine-tuning its famed Toyota Production System to enhance its already proficient capabilities in manufacturing top-quality vehicles at relatively low costs.

Managerial actions to develop competitive capabilities generally take one of two forms: either strengthening the company's base of skills, knowledge, and experience or coordinating and integrating the efforts of the various work groups and departments. Actions of the first sort can be undertaken at all managerial levels, but actions of the second sort are best orchestrated by senior managers who not only appreciate the strategy-executing significance of strong organizational capabilities but also have the clout to enforce the necessary cooperation and coordination among individuals, groups, and departments.[13]

Acquiring Capabilities through Mergers and Acquisitions Sometimes the best way for a company to upgrade its portfolio of capabilities is by acquiring (or merging with) another company with attractive resources and capabilities.[14] An acquisition aimed at building a stronger portfolio of resources and capabilities can be every bit as valuable as an acquisition aimed at adding new products or services to the company's lineup of offerings. The advantage of this mode of acquiring new capabilities is primarily one of speed, since developing new capabilities internally can, at best, take many years of effort and, at worst, come to naught. Capabilities-motivated acquisitions are essential (1) when the company does not have the ability to create the needed capability internally (perhaps because it is too far afield from its existing capabilities) and (2) when industry conditions, technology, or competitors are moving at such a rapid clip that time is of the essence.

At the same time, acquiring capabilities in this way is not without difficulty. Capabilities involve tacit knowledge and complex routines that cannot be transferred readily from one organizational unit to another. This may limit the extent to which the new capability can be utilized. For example, Meta Platforms (formerly Facebook) has spent more than $25 billion over the years to acquire producers of augmented reality, voice recognition, image filters, language translation, face recognition, and other technologies to add capabilities that might enhance the social media experience. Transferring and integrating these capabilities to other parts of the Meta organization may prove easier said than done, however, as many technology acquisitions fail to yield the hoped-for benefits. Integrating the capabilities of two companies is particularly problematic when there are underlying incompatibilities in their supporting systems or processes. Moreover, since internal fit is important, there is always the risk that under new management the acquired capabilities may not be as productive as they had been. In a worst-case scenario, the acquisition process may end up damaging or destroying the very capabilities that were the object of the acquisition in the first place.

Accessing Capabilities through Collaborative Partnerships Another method of acquiring capabilities from an external source is to access them via collaborative partnerships with suppliers, competitors, or other companies having the cutting-edge expertise. There are three basic ways to pursue this course of action:

1. *Outsource the function in which the company's capabilities are deficient to a key supplier or another provider.* As discussed in Chapter 6, outsourcing has the advantage of conserving resources so the firm can focus its energies on those activities most central to its strategy. It may be a good choice for firms that are too small and resource-constrained to execute all the parts of their strategy internally.
2. *Collaborate with a firm that has complementary resources and capabilities in a joint venture, strategic alliance, or other type of partnership established for the purpose of achieving a shared strategic objective.* This requires launching initiatives to identify the most attractive potential partners and to establish collaborative working relationships. Since the success of the venture will depend on how well the partners work together, potential partners should be selected as much for their management style, culture, and goals as for their resources and capabilities. Close collaboration with suppliers to achieve mutually beneficial outcomes has become a common approach to building supply chain capabilities.
3. *Engage in a collaborative partnership for the purpose of learning how the partner does things, internalizing its methods and thereby acquiring its capabilities.* This may be a viable method when each partner has something to learn from the other and can achieve an outcome *beneficial to both partners.* For example, firms sometimes enter into collaborative marketing arrangements whereby each partner is granted access to the other's dealer network for the purpose of expanding sales in geographic areas where the firms lack dealers. But if the intended gains are only one-sided, the arrangement more likely involves an abuse of trust. In consequence, it not only puts the cooperative venture at risk but also encourages the firm's partner to treat the firm similarly or refuse further dealings with the firm.

Collaborative arrangements tend to be less risky when the partnership involves companies from different industries. In racing to develop motor vehicles with self-driving capability, most all vehicle manufacturers are supplementing their own internal efforts with collaborative partnerships with one or more of the growing number of hardware and software firms operating in the driverless vehicle space. These include those developing self-driving software (Alphabet's Waymo, Aurora Innovation, Tesla, Oxbotica, Zoox), makers of the two competing radar systems to spot road obstacles and read traffic signs and signals (RADAR, LiDAR), computing platforms (Nvidia, Qualcomm, Intel), and driverless car technology systems (Mobileye, Bosch, Aptiv).

Nike entered into a strategic partnership with Swiss company Bluesign Technologies for the purpose of making two innovative Bluesign tools available to the hundreds of textile manufacturers supplying the contract factories making Nike products. The tools enable the textile manufacturers to access more than 30,000 materials produced with chemicals that have undergone rigorous assessment for safe use in apparel products. In these types of cases, working together to achieve a capability-related outcome can be beneficial to all the partners.

The Strategic Role of Employee Training

Training and retraining are important when a company shifts to a strategy requiring different skills, competitive capabilities, and operating methods. Training is also strategically important in organizational efforts to build skill-based competencies. And it is a key activity in businesses where technical know-how is changing so rapidly that a company loses its ability to compete unless its employees have cutting-edge knowledge and expertise. Successful strategy implementation requires that the training function is both adequately funded and effective. If better execution of the chosen strategy calls for new skills, deeper technological capability, or the building and deploying of new capabilities, training efforts need to be placed near the top of the action agenda.

The strategic importance of training has not gone unnoticed. Over 4,000 companies around the world have established internal "universities" to lead the training effort, facilitate continuous organizational learning, and upgrade their company's knowledge resources. General Electric has long been known for the excellence of its management training program at Crotonville, outside of New York City. McDonald's maintains a 130,000-square-foot training facility that they call Hamburger University.

Many companies conduct orientation sessions for new employees, fund an assortment of competence-building training programs, and reimburse employees for tuition and other expenses associated with obtaining additional college education, attending professional development courses, and earning professional certification of one kind or another. A number of companies offer online training courses that are available to employees around the clock. Increasingly, companies are expecting employees at all levels are expected to take an active role in their own professional development and assume responsibility for keeping their skills up to date and in sync with the company's needs.

Strategy Execution Capabilities and Competitive Advantage

As firms get better at executing their strategies, they develop capabilities in the domain of strategy execution much as they build other organizational capabilities. Superior strategy execution capabilities allow companies to get the most from their other organizational resources and competitive capabilities. In this way they contribute to the success of a firm's business model. But excellence in strategy execution can also be a more direct source of competitive advantage, since more efficient and effective strategy execution can lower costs and permit firms to deliver more value to customers. Superior strategy execution capabilities may also enable a company to react more quickly to market changes and beat other firms to the market with new products and services. This can allow a company to profit from a period of uncontested market dominance. See Illustration Capsule 10.3 for an example of Zara's route to competitive advantage.

Because strategy execution capabilities are socially complex capabilities that develop with experience over long periods of time, they are hard to imitate. And there is no substitute for good strategy execution. (Recall the four tests of resource advantage from Chapter 4.) As such, they may be as important a source of sustained competitive advantage as the core competencies that drive a firm's strategy. Indeed, they may be a far more important avenue for securing a competitive edge over rivals in situations where it is relatively easy for rivals to copy promising strategies. In such cases, the only way for firms to achieve lasting competitive advantage is to *out-execute* their competitors.

Superior strategy execution capabilities are the only source of sustainable competitive advantage when strategies are easy for rivals to copy.

ILLUSTRATION CAPSULE 10.3 Zara's Strategy Execution Capabilities

monticello/Shutterstock

Zara is the world's largest "fast fashion" retailer and the flagship brand of Inditex. As soon as designs are seen in high-end fashion houses such as Prada, Zara's design team sets to work altering the clothing designs so that it can produce high fashion at mass-retailing prices. Zara's strategy is clever, but by no means unique. The company's competitive advantage is in strategy execution. Every step of Zara's value chain execution is geared toward putting fashionable clothes in stores quickly, realizing high turnover, and strategically driving traffic.

The first key lever is a quick production process. Manufacturing largely occurs in factories close to headquarters which allows for more flexibility and greater responsiveness to market needs, The entire production process, from design to arrival at stores, takes only four weeks, while other retailers take six months. The flexibility of their system allows Zara to offer customers an unparalleled degree of choice, offering 12,000 new styles annually versus an industry average of 3,000. Zara purposefully manufactures in small lot sizes to avoid discounting later on and also to encourage impulse shopping, as a particular item could be gone in a few days. Their vertically integrated supply chain eliminates the need for warehouses, thereby reducing their costs and preventing the kind of pandemic related supply chain problems that plagued other producers. From start to finish, Zara has engineered its production process to maximize turnover and turnaround time, creating a true advantage in this step of strategy execution.

Zara also excels at driving traffic to stores. First, the small lot sizes and frequent shipments (up to twice a week per store) drive customers to visit often and purchase quickly. Zara shoppers average 17 visits per year, versus 2 visits per year for competitors. On average, items stay in a Zara store only 11 days. Zara tracks items that are not selling well with RDIF (Radio Frequency Identification Technology) and pulls them after three to four weeks. Second, Zara spends no money on advertising, but it occupies some of the most expensive retail space in town, always near the high-fashion houses it imitates. Proximity reinforces the high-fashion association, while the busy street drives significant foot traffic. Over time, Zara has managed to create competitive advantage in every level of strategy execution by tightly aligning design, production, advertising, and real estate with the overall strategy of fast fashion: extremely fast and extremely flexible.

The challenge for Zara is to maintain their advantage, since fast fashion competitors like H&M, Uniqlo, and Shein are busy refining their business models to chip away at Zara's competitive edge. And the shift to online buying presents another reason that Zara's strategy will have to evolve for the company to stay ahead.

Note: Developed with Sara Paccamonti.

Sources: Seth Stevenson, "Polka Dots Are In? Polka Dots It Is!" *Slate,* June 21, 2012, **www.slate.com/articles/arts/operations/2012/06/zara_s_fast_fashion_how_the_company_gets_new_styles_to_stores_so_quickly.html** (accessed February 5, 2014). Martin Roll, "The Secret of Zara's Success: A Culture of Customer Co-creation, *Business & Brand Leadership,* November 2021, **https://martinroll.com/resources/articles/strategy/the-secret-of-zaras-success-a-culture-of-customer-co-creation/**

MATCHING ORGANIZATIONAL STRUCTURE TO THE STRATEGY

While there are few hard-and-fast rules for organizing the work effort to support good strategy execution, there is one: A firm's organizational structure should be *matched* to the particular requirements of implementing the firm's strategy. Every company's strategy is grounded in its own set of organizational capabilities and value chain activities.

FIGURE 10.3 Structuring the Work Effort to Promote Successful Strategy Execution

LO 10-4

Identify and establish a strategy-supportive organizational structure and organize the work effort.

Moreover, every firm's organizational chart is partly a product of its particular situation, reflecting prior organizational patterns, varying internal circumstances, and executive judgments about how to best structure reporting relationships. Thus, the determinants of the fine details of each firm's organizational structure are unique. But some considerations in organizing the work effort are common to all companies. These are summarized in Figure 10.3 and discussed in the following sections.

Deciding Which Value Chain Activities to Perform Internally and Which to Outsource

A company's organizational structure should be matched to the particular requirements of implementing the firm's strategy.

Aside from the fact that an outsider, because of its expertise and specialized know-how, may be able to perform certain value chain activities better or cheaper than a company can perform them internally (as discussed in Chapter 6), outsourcing can also sometimes contribute to better strategy execution. Outsourcing the performance of selected activities to outside vendors enables a company to heighten its strategic focus and *concentrate its full energies on performing those value chain activities that are at the core of its strategy, where it can create unique value.* For example, 83 percent of the top 10 pharmaceutical companies outsource tactical roles such as clinical data management and trial monitoring; they are much less likely to outsource more strategic functions, such as new product planning. Broadcom Inc., a diversified global technology company, outsources the manufacture of its semiconductor chips, thus freeing company personnel to focus their full energies on R&D, new chip design, and marketing. Nike concentrates on design, marketing, and distribution to retailers, while outsourcing virtually all production of its shoes and sporting apparel. Interestingly,

ILLUSTRATION CAPSULE 10.4 Which Value Chain Activities Does Apple Outsource and Why?

DAVID CHANG/EPA-EFE/Shutterstock

Innovation and design are core competencies for Apple and the drivers behind the creation of winning products such as the iPhone, Apple Watch, MacBook Pro, Apple TV, and iPad. In consequence, all activities directly related to new product development and product design are performed internally. For example, Apple's Industrial Design Group is responsible for creating the look and feel of all Apple products—from the Mac mini to the latest iPhone, and beyond to future products.

Producing a continuing stream of great new products and product versions is key to the success of Apple's strategy. But executing this strategy takes more than innovation and design capabilities. Manufacturing flexibility and speed are imperative in the production of Apple products to ensure that the latest ideas are reflected in the products and that the company meets the high demand for its products—especially around launch.

For these capabilities, Apple turns to outsourcing, as do the majority of its competitors in the consumer electronics space. Apple outsources the manufacturing of products like its iPhone to Asia, where contract manufacturing organizations (CMOs) create value through their vast scale, high flexibility, and low cost. Perhaps no company better epitomizes the Asian CMO value proposition than Foxconn, a company that manufactures not only for Apple but for Hewlett-Packard, Motorola Mobility, Lenovo, Nintendo, Sega, Vizio, and IBM as well. Foxconn's scale is incredible, with 1.3 million people on its payroll as of 2023. Such a scale offers companies a significant degree of flexibility, as Foxconn has the ability to hire 3,000 employees on practically a moment's notice. Apple, more so than its competitors, is able to capture CMO value creation by leveraging its immense sales volume and strong cash position to receive preferred treatment. While outsourcing has allowed Apple to reap the benefits of lower cost and more flexible manufacturing, the lack of direct control has proven to be a challenge. Working conditions at Foxconn were at one time appalling and even now occasional protests by employees over Foxconn policies or wages threaten to disrupt production. In response, Apple has tightened its supplier standards and increased its efforts at monitoring conditions and enforcing its standards. Apple has also begun to consider moving more of its manufacturing to other partners outside of China. But its strategy of outsourcing this function remains a given and an important aspect of how it structures its activities.

Note: Developed with Margaret W. Macauley.

Sources: Company website; **https://biz.crast.net/where-is-the-iphone-made-journey-from-components-to-final-assembly/** (accessed 2/16/23).

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e-commerce powerhouse Alibaba got its start by outsourcing web development (a key function) to a U.S. firm; but this was due to the fact that China lacked sufficient development talent at the time. Illustration Capsule 10.4 describes Apple's decisions about which activities to outsource and which to perform in-house.

Such heightened focus on performing strategy-critical activities can yield three important execution-related benefits:

- *The company improves its chances for outclassing rivals in the performance of strategy-critical activities and turning a competence into a distinctive competence.* At the very least, the heightened focus on performing a select few value chain activities should promote more effective performance of those activities. This could

> Wisely choosing which activities to perform internally and which to outsource can lead to several strategy-executing advantages—lower costs, heightened strategic focus, less internal bureaucracy, speedier decision making, and a better arsenal of organizational capabilities.

materially enhance competitive capabilities by either lowering costs or improving product or service quality. Businesses that get a lot of inquiries from customers or that have to provide 24/7 technical support to users of their products around the world often find that it is considerably less expensive to outsource these functions to specialists (often located in foreign countries where skilled personnel are readily available and worker compensation costs are much lower) than to operate their own call centers. Many businesses also outsource IT functions such as desktop support, disaster recovery, help desk, and data center operations, which often results in cost savings due to the economies of scale available to service providers.

- *By streamlining internal operations, outsourcing can decrease internal bureaucracies, flatten the organizational structure, speed internal decision making, and shorten the time it takes to respond to changing market conditions.* In consumer electronics, where advancing technology drives new product innovation, organizing the work effort in a manner that expedites getting next-generation products to market ahead of rivals is a critical competitive capability. The world's motor vehicle manufacturers have found that they can shorten the cycle time for new models by outsourcing the production of many parts and components to independent suppliers. They then work closely with the suppliers to swiftly incorporate new technology and to better integrate individual parts and components to form engine cooling systems, transmission systems, electrical systems, and so on.
- *Partnerships with outside vendors that add to a company's arsenal of capabilities can contribute to better strategy execution.* Outsourcing activities to vendors with first-rate capabilities can enable a firm to concentrate on strengthening its own complementary capabilities internally; the result will be a more powerful package of organizational capabilities that the firm can draw upon to deliver more value to customers and attain competitive success. Soft-drink and beer manufacturers cultivate their relationships with their bottlers and distributors to strengthen access to local markets and build loyalty, support, and commitment for corporate marketing programs, without which their own sales and growth would be weakened. Similarly, fast-food enterprises like Wendy's and Burger King find it essential to work hand in hand with franchisees on outlet cleanliness, consistency of product quality, in-store ambience, courtesy and friendliness of store personnel, and other aspects of store operations. Unless franchisees continuously deliver sufficient customer satisfaction to attract repeat business, a fast-food chain's reputation, sales, and competitive standing will quickly suffer. Companies like Boeing, Dell, and Apple have learned that their central R&D groups cannot begin to match the innovative capabilities of a well-managed network of supply chain partners.

However, as emphasized in Chapter 6, a company must guard against going overboard on outsourcing and becoming overly dependent on outside suppliers. A company cannot be the master of its own destiny unless it maintains expertise and resource depth in performing those value chain activities that underpin its long-term competitive success.[15]

CORE CONCEPT

A firm's **organizational structure** comprises the formal and informal arrangement of tasks, responsibilities, lines of authority, and reporting relationships by which the firm is administered.

Aligning the Firm's Organizational Structure with Its Strategy

The design of the firm's **organizational structure** is a critical aspect of the strategy execution process. The organizational structure comprises the formal and informal arrangement of tasks, responsibilities, and lines of authority and communication by which the firm is administered.[16] It specifies the linkages among parts of the organization, the reporting relationships, the direction of information flows, and the decision-making processes. It is a key factor in strategy implementation since it exerts a strong influence on how well managers can coordinate and control the complex set of activities involved.[17]

A well-designed organizational structure is one in which the various parts (e.g., decision-making rights, communication patterns) are aligned with one another and also matched to the requirements of the strategy. With the right structure in place, managers can orchestrate the various aspects of the implementation process with an even hand and a light touch. Without a supportive structure, strategy execution is more likely to become bogged down by administrative confusion, political maneuvering, and bureaucratic waste.

Good organizational design may even contribute to the firm's ability to create value for customers and realize a profit. By enabling lower bureaucratic costs and facilitating operational efficiency, it can lower a firm's operating costs. By facilitating the coordination of activities within the firm, it can improve the capability-building process, leading to greater differentiation and/or lower costs. Moreover, by improving the speed with which information is communicated and activities are coordinated, it can enable the firm to beat rivals to the market and profit from a period of unrivaled advantage.

Making Strategy-Critical Activities the Main Building Blocks of the Organizational Structure In any business, some activities in the value chain are always more critical to successful strategy execution than others. For instance, ski apparel companies like Obermeyer, Arc'teryx, and Spyder must be good at styling and design, low-cost manufacturing, distribution (convincing an attractively large number of dealers to stock and promote the company's brand), and marketing and advertising (building a brand image that generates buzz among ski enthusiasts). For brokerage firms like Charles Schwab Corporation and TD Ameritrade, the strategy-critical activities are fast access to information, accurate order execution, efficient record keeping and transaction processing, and full-featured customer service. With respect to such core value chain activities, it is important for management to build its organizational structure around proficient performance of these activities, making them the centerpieces or main building blocks in the enterprise's organizational structure.

The rationale is compelling: If activities crucial to strategic success are to have the resources, decision-making influence, and organizational impact they need, they must be centerpieces in the enterprise's organizational scheme. Making them the focus of structuring efforts will also facilitate their coordination and promote good internal fit–an essential attribute of a winning strategy, as elaborated in Chapter 4. To the extent that implementing a new strategy entails new or altered key activities or capabilities, different organizational arrangements may be required.

Matching Type of Organizational Structure to Strategy Execution Requirements Organizational structures can be classified into a limited number of standard types. Which type makes the most sense for a given firm depends largely on the firm's size and business makeup, but not so much on the specifics of its strategy. As firms grow and their needs for structure evolve, their structural form is likely to evolve from one type to another. The four basic types are the *simple structure,* the *functional structure,* the *multidivisional structure,* and the *matrix structure,* as described next.

CORE CONCEPT

A **simple structure** consists of a central executive (often the owner-manager) who handles all major decisions and oversees all operations with the help of a small staff. Simple structures are also called *line-and-staff structures* or *flat structures*.

1. Simple Structure A **simple structure** is one in which a central executive (often the owner-manager) handles all major decisions and oversees the operations of the organization with the help of a small staff.[18] Simple structures are also known as *line-and-staff structures,* since a central administrative staff supervises line employees who conduct the operations of the firm, or *flat structures,* since there are few levels of hierarchy. The simple structure is characterized by limited task specialization; few rules; informal relationships; minimal use of training, planning, and liaison devices; and a lack of sophisticated support systems. It has all the advantages of simplicity, including low administrative costs, ease of coordination, flexibility, quick decision making, adaptability, and responsiveness to change. Its informality and lack of rules may foster creativity and heightened individual responsibility.

Simple organizational structures are typically employed by small firms and entrepreneurial startups. The simple structure is the most common type of organizational structure since small firms are the most prevalent type of business. As an organization grows, however, this structural form becomes inadequate to the demands that come with size and complexity. In response, growing firms tend to alter their organizational structure from a simple structure to a *functional structure.*

CORE CONCEPT

A **functional structure** is organized into functional departments, with departmental managers who report to the CEO and small corporate staff. Functional structures are also called *departmental structures* and *unitary structures* or *U-forms.*

2. Functional Structure A **functional structure** is one that is organized along functional lines, where a function represents a major component of the firm's value chain, such as R&D, engineering and design, manufacturing, sales and marketing, logistics, and customer service. Each functional unit is supervised by functional line managers who report to the chief executive officer and a corporate staff. This arrangement allows functional managers to focus on their area of responsibility, leaving it to the CEO and headquarters to provide direction and ensure that the activities of the functional managers are coordinated and integrated. Functional structures are also known as *departmental structures,* since the functional units are commonly called departments, and *unitary structures* or *U-forms,* since a single unit is responsible for each function.

In large organizations, functional structures lighten the load on top management, in comparison to simple structures, and enable more efficient use of managerial resources. Their primary advantage, however, is greater *task specialization,* which promotes learning, enables the realization of scale economies, and offers productivity advantages not otherwise available. Their chief disadvantage is that the departmental boundaries can inhibit the flow of information and limit the opportunities for cross-functional cooperation and coordination.

The primary advantage of a functional structure is greater task specialization, which promotes learning, enables the realization of scale economies, and offers productivity advantages not otherwise available.

It is generally agreed that a functional structure is the best organizational arrangement when a company is in just one particular business (irrespective of which of the five generic competitive strategies it opts to pursue). For instance, a technical instruments manufacturer may be organized around research and development, engineering, supply chain management, assembly, quality control, marketing, and technical services. A discount retailer, such as Dollar General or Family Dollar, may organize around such functional units as purchasing, warehousing, distribution logistics, store operations, advertising, merchandising and promotion, and customer service. Functional structures can also be appropriate for firms with high-volume production, products that are closely related, and a limited degree of vertical integration. For example, General Motors now manages all of its brands (Cadillac, GMC, Chevrolet, Buick, etc.) under a common functional structure designed to promote technical transfer and capture economies of scale.

As firms continue to grow, they often become more diversified and complex, placing a greater burden on top management. At some point, the centralized control that characterizes the functional structure becomes a liability, and the advantages of functional specialization begin to break down. To resolve these problems and address a growing need for coordination across functions, firms generally turn to the *multidivisional structure.*

3. Multidivisional Structure A **multidivisional structure** is a decentralized structure consisting of a set of operating divisions organized along market, customer, product, or geographic lines, along with a central corporate headquarters, which monitors divisional activities, allocates resources, performs assorted support functions, and exercises overall control. Since each division is essentially a business (often called a *single business unit* or *SBU*), the divisions typically operate as independent profit centers (i.e., with profit and loss responsibility) and are organized internally along functional lines. Division managers oversee day-to-day operations and the development of business-level strategy, while corporate executives attend to overall performance and corporate strategy, the elements of which were described in Chapter 8. Multidivisional structures are also called *divisional structures* or *M-forms,* in contrast with U-form (functional) structures.

CORE CONCEPT

A **multidivisional structure** is a decentralized structure consisting of a set of operating divisions organized along business, product, customer group, or geographic lines and a central corporate headquarters that allocates resources, provides support functions, and monitors divisional activities. Multidivisional structures are also called *divisional structures* or *M-forms.*

Multidivisional structures are common among companies pursuing some form of diversification strategy or international strategy, with operations in a number of businesses or countries. When the strategy is one of unrelated diversification, as in a conglomerate, the divisions generally represent businesses in separate industries. When the strategy is based on related diversification, the divisions may be organized according to industries, customer groups, product lines, geographic regions, or technologies. In this arrangement, the decision about where to draw the divisional lines depends foremost on the nature of the relatedness and the strategy-critical building blocks, in terms of which businesses have key value chain activities in common. For example, a company selling closely related products to business customers as well as two types of end consumers–online buyers and in-store buyers–may organize its divisions according to customer groups since the value chains involved in serving the three groups differ. Another company may organize by product line due to commonalities in product development and production within each product line. Multidivisional structures are also common among vertically integrated firms. There the major building blocks are often divisional units performing one or more of the major processing steps along the value chain (e.g., raw-material production, components manufacture, assembly, wholesale distribution, retail store operations).

Multidivisional structures offer significant advantages over functional structures in terms of facilitating the management of a complex and diverse set of operations.[19] Putting business-level strategy in the hands of division managers while leaving corporate strategy to top executives reduces the potential for information overload and improves the quality of decision making in each domain. This also minimizes the costs of coordinating division-wide activities while enhancing top management's ability to control a diverse and complex operation. Moreover, multidivisional structures can help align individual incentives with the goals of the corporation and spur productivity by encouraging competition for resources among the different divisions.

But a multidivisional structure can also present some problems to a company pursuing related diversification, because having independent business units–each running its own business in its own way–inhibits cross-business collaboration and the capture of cross-business synergies, which are critical for the success of a related diversification strategy, as Chapter 8 explains. To solve this type of problem, firms turn to more complex structures, such as the matrix structure.

CORE CONCEPT

A **matrix structure** is a combination structure that overlays one type of structure onto another type, with multiple reporting relationships. It is used to foster cross-unit collaboration. Matrix structures are also called *composite structures* or *combination structures.*

4. Matrix Structure A **matrix structure** is a combination structure in which the organization is organized along two or more dimensions at once (e.g., business, geographic area, value chain function) for the purpose of enhancing cross-unit communication, collaboration, and coordination. In essence, it overlays one type of structure onto another type. Matrix structures are managed through multiple reporting relationships, so a middle manager may report to several bosses. For instance, in a matrix structure based on product line, region, and function, a sales manager for plastic containers in Georgia might report to the manager of the plastics division, the head of the southeast sales region, and the head of marketing.

Matrix organizational structures have evolved from the complex, over-formalized structures that were popular in the late 20th century but often produced inefficient, unwieldy bureaucracies. The modern incarnation of the matrix structure is generally a more flexible arrangement, with a single primary reporting relationship that can be overlaid with a temporary secondary reporting relationship as need arises. For example, a software company that is organized into functional departments (software design, quality control, customer relations) may assign employees from those departments to different projects on a temporary basis, so an employee reports to a project manager as well as to their primary boss (the functional department head) for the duration of a project. Texas Instruments, Caterpillar Inc., and Philips are examples of companies that use the matrix structure organizational form successfully.

Matrix structures are also called *composite structures* or *combination structures.* They are often used for project-based, process-based, or team-based management. Such approaches are common in businesses involving projects of limited duration, such as consulting, architecture, and engineering services. The type of close cross-unit collaboration that a flexible matrix structure supports is also needed to build competitive capabilities in strategically important activities, such as speeding new products to market, that involve employees scattered across several organizational units.[20] Capabilities-based matrix structures that combine process departments (like new product development) with more traditional functional departments provide a solution.

An advantage of matrix structures is that they facilitate the sharing of plant and equipment, specialized knowledge, and other key resources. Thus, they lower costs by enabling the realization of economies of scope. They also have the advantage of flexibility in form and may allow for better oversight since supervision is provided from more than one perspective. A disadvantage is that they add another layer of management, thereby increasing bureaucratic costs and possibly decreasing response time to new situations.[21] In addition, there is a potential for confusion among employees due to dual reporting relationships and divided loyalties. While there is some controversy over the utility of matrix structures, the modern approach to matrix structures does much to minimize their disadvantages.[22]

Determining How Much Authority to Delegate

LO 10-5

Comprehend the pros and cons of centralized and decentralized decision making in implementing the chosen strategy.

Under any organizational structure, there is room for considerable variation in how much authority top-level executives retain and how much is delegated to down-the-line managers and employees. In executing strategy and conducting daily operations, companies must decide how much authority to delegate to the managers of each organizational unit–especially the heads of divisions, functional departments, plants, and other operating units–and how much decision-making latitude to give individual employees in performing their jobs. The two extremes are to *centralize decision making* at the top or to *decentralize decision making* by giving managers and employees at all levels considerable decision-making latitude in their areas of responsibility. As shown in

TABLE 10.1 Advantages and Disadvantages of Centralized versus Decentralized Decision Making

Centralized Organizational Structures	Decentralized Organizational Structures
Basic tenets	**Basic tenets**
• Decisions on most matters of importance should be in the hands of top-level managers who have the experience, expertise, and judgment to decide what is the best course of action. • Lower-level personnel have neither the knowledge, time, nor inclination to properly manage the tasks they are performing. • Strong control from the top is a more effective means for coordinating company actions.	• Decision-making authority should be put in the hands of the people closest to, and most familiar with, the situation. • Those with decision-making authority should be trained to exercise good judgment. • A company that draws on the combined intellectual capital of all its employees can outperform a command-and-control company.
Chief advantages	**Chief advantages**
• Fixes accountability through tight control from the top. • Eliminates potential for conflicting goals and actions on the part of lower-level managers. • Facilitates quick decision making and strong leadership under crisis situations.	• Encourages company employees to exercise initiative and act responsibly. • Promotes greater motivation and involvement in the business on the part of more company personnel. • Spurs new ideas and creative thinking. • Allows for fast response to market change. • Entails fewer layers of management.
Primary disadvantages	**Primary disadvantages**
• Lengthens response times by those closest to the market conditions because they must seek approval for their actions. • Does not encourage responsibility among lower-level managers and rank-and-file employees. • Discourages lower-level managers and rank-and-file employees from exercising any initiative.	• May result in higher-level managers being unaware of actions taken by empowered personnel under their supervision. • Can lead to inconsistent or conflicting approaches by different managers and employees. • Can impair cross-unit collaboration.

Table 10.1, the two approaches are based on sharply different underlying principles and beliefs, with each having its pros and cons.

Centralized Decision Making: Pros and Cons In a highly centralized organizational structure, *top executives retain authority for most strategic and operating decisions* and keep a tight rein on business unit heads, department heads, and the managers of key operating units. Comparatively little discretionary authority is granted to frontline supervisors and rank-and-file employees. The command-and-control paradigm of centralized decision making is based on the underlying assumptions that frontline personnel have neither the time nor the inclination to direct and properly control the work they are performing and that they lack the knowledge and judgment to make wise decisions about how best to do it–hence the need for prescribed policies and procedures for a wide range of activities, close supervision, and tight control by top executives. The thesis underlying centralized structures is that strict enforcement of detailed procedures backed by rigorous managerial oversight is the most reliable way to keep the daily execution of strategy on track.

One advantage of a centralized structure, with tight control by the manager in charge, is that it is easy to know who is accountable when things do not go well.

This structure can also reduce the potential for conflicting decisions and actions among lower-level managers who may have differing perspectives and ideas about how to tackle certain tasks or resolve particular issues. For example, a manager in charge of an engineering department may be more interested in pursuing a new technology than a marketing manager who doubts that customers will value the technology highly. Another advantage of a command-and-control structure is that it can facilitate strong leadership from the top in a crisis situation that affects the organization as a whole and can enable a more uniform and swift response.

But there are some serious disadvantages as well. Hierarchical command-and-control structures do not encourage responsibility and initiative on the part of lower-level managers and employees. They can make a large organization with a complex structure sluggish in responding to changing market conditions because of the time it takes for the review-and-approval process to run up all the layers of the management bureaucracy. Furthermore, to work well, centralized decision making requires top-level managers to gather and process whatever information is relevant to the decision. When the relevant knowledge resides at lower organizational levels (or is technical, detailed, or hard to express in words), it is difficult and time-consuming to get all the facts in front of a high-level executive located far from the scene of the action–full understanding of the situation cannot be readily copied from one mind to another. Hence, centralized decision making is often impractical–the larger the company and the more scattered its operations, the more that decision-making authority must be delegated to managers closer to the scene of the action.

The ultimate goal of decentralized decision making is to put authority in the hands of those people closest to and most knowledgeable about the situation.

Decentralized Decision Making: Pros and Cons In a highly decentralized organization, *decision-making authority is pushed down to the lowest organizational level capable of making timely, informed, competent decisions.* The objective is to put adequate decision-making authority in the hands of the people closest to and most familiar with the situation and train them to weigh all the factors and exercise good judgment. At Starbucks, for example, employees are encouraged to exercise initiative in promoting customer satisfaction–there's the oft-repeated story of a store employee who, when the computerized cash register system went offline, offered free coffee to waiting customers, thereby avoiding customer displeasure and damage to Starbucks's reputation.[23]

The case for empowering down-the-line managers and employees to make decisions related to daily operations and strategy execution is based on the belief that a company that draws on the combined intellectual capital of all its employees can outperform a command-and-control company.[24] The challenge in a decentralized system is maintaining adequate control. With decentralized decision making, top management maintains control by placing limits on the authority granted to company personnel, installing companywide strategic control systems, holding people accountable for their decisions, instituting compensation incentives that reward people for doing their jobs well, and creating a corporate culture where there's strong peer pressure on individuals to act responsibly.[25]

Decentralized organizational structures have much to recommend them. Delegating authority to subordinate managers and rank-and-file employees encourages them to take responsibility and exercise initiative. It shortens organizational response times to market changes and spurs new ideas, creative thinking, innovation, and greater involvement on the part of all company personnel. At TJX Companies Inc., parent company of T.J.Maxx, Marshalls, and five other fashion and home decor retail store chains, buyers are encouraged to be intelligent risk takers in deciding what items to purchase for TJX stores–there's the story of a buyer for a seasonal product category who cut their own budget to have dollars allocated to other categories where sales were expected to be stronger. In worker-empowered structures, jobs can be defined more broadly, several tasks can be integrated into a single job, and people can direct their own work. Fewer managers are needed because deciding how to do things becomes part of each person's or team's job. Further, today's online communication systems and smartphones make it easy and relatively inexpensive for people at all organizational levels to have direct access to data, other employees, managers, suppliers, and customers. They can access information quickly (via the Internet or company network), readily check with superiors or whomever else as needed, and take responsible action. Typically, there are genuine gains in morale and productivity when people are provided with the tools and information they need to operate in a self-directed way.

But decentralization also has some disadvantages. Top managers lose an element of control over what goes on and may thus be unaware of actions being taken by personnel under their supervision. Such lack of control can be problematic in the event that empowered employees make decisions that conflict with those of others or that serve their unit's interests at the expense of other parts of the company. Moreover, because decentralization gives organizational units the authority to act independently, there is risk of too little collaboration and coordination between different units.

Many companies have concluded that the advantages of decentralization outweigh the disadvantages. Over the past several decades, there's been a decided shift from centralized, hierarchical structures to flatter, more decentralized structures that stress employee empowerment. This shift reflects a strong and growing consensus that authoritarian, hierarchical organizational structures are not well suited to implementing and executing strategies in an era when extensive information and instant communication are the norm and when a big fraction of the organization's most valuable assets consists of intellectual capital that resides in its employees' capabilities.

Capturing Cross-Business Strategic Fit in a Decentralized Structure Diversified companies striving to capture the benefits of synergy between separate businesses must beware of giving business unit heads full rein to operate independently. Cross-business strategic fit typically must be captured either by enforcing close cross-business collaboration or by centralizing the performance of functions requiring close coordination at the corporate level.[26] For example, if businesses with overlapping process and product technologies have their own independent R&D departments–each pursuing its own priorities, projects, and strategic agendas–it's hard for the corporate parent to prevent duplication of effort, capture either economies of scale or economies of scope, or encourage more collaborative R&D efforts. Where cross-business strategic fit with respect to R&D is important, one solution is to centralize the R&D function and have a coordinated corporate R&D effort that serves the interests of both the individual businesses and the company as a whole. Likewise, centralizing the related activities of separate businesses makes sense when there are opportunities to share a common sales force, use common distribution channels, rely on a common field service organization, use common e-commerce systems, and so on. Another structural solution to realizing the benefits of strategic fit is to create business groups consisting of those business units with common strategic-fit opportunities.

> Efforts to decentralize decision making and give company personnel some leeway in conducting operations must be tempered with the need to maintain adequate control and cross-unit coordination.

Providing for Internal Cross-Unit Coordination

Close cross-unit collaboration is usually needed to build capabilities in such strategically important activities as speeding new products to market and providing superior customer service. This is because these activities involve collaboration among the efforts of company personnel who work in different departments or organizational units (and perhaps the employees of outside strategic partners or specialty vendors). For example, being first-to-market with new products involves coordinating the efforts of personnel in R&D (to develop a stream of new products with appealing attributes), design and engineering (to prepare a cost-efficient design and set of specifications), purchasing (to obtain the needed parts and components), manufacturing (to carry out all the production activities), and sales and marketing (to secure orders, arrange for introductory advertising and the distribution of product information, and get the products on retailers' shelves). Achieving the simple strategic objective of filling customer orders accurately and promptly involves personnel from sales (to win the order); finance (to check credit terms or approve special financing); production (to produce the goods and replenish warehouse inventories as needed); and warehousing and shipping (to verify whether the items are in stock, pick the order from the warehouse, package it for shipping, and choose the best carrier to deliver the goods).

To achieve tight coordination when pieces of execution-critical tasks are performed in multiple organizational units, company executives typically emphasize the necessity of cross-unit teamwork and cooperation and the importance of frequent back-and-forth communication among key people in the various related organizational units to resolve problems, avoid delays, and keep things moving along. The executives supervising the units performing parts of the execution-critical task typically make it clear that the relevant department heads and key personnel are all *expected to work closely together and coordinate their actions.* There are meetings to discuss schedules and set deadlines, often ending with the verbal commitments of everyone involved to stick close to the agreed-upon schedule, coordinate their activities, and meet the established deadlines. Gaining such commitments is almost always imperative, along with ensuring that everyone lives up to their commitments.

Normally, the supervising executives follow up, check on progress, and, in many cases, visit the different units to personally determine how well things are going and solicit the views of numerous people about what problems exist and what they think should be done to resolve them. They seldom hesitate to intervene to make corrective adjustments and to reiterate their expectations of teamwork, close communication, effective collaboration, and cooperation to resolve issues, avoid delays, and achieve the needed degree of cross-unit coordination. Such executive interventions, together with added executive pressure on the managers of units where close collaboration and coordinated action is lacking, may suffice. If it does, then all is well and good. But if such efforts fail, execution suffers and it becomes the responsibility of executives to determine the causes and take corrective action.

In many instances, the chief cause of ineffective cross-unit coordination in building capabilities rests with departmental-level managers and other key operating personnel who, for assorted reasons, don't or won't spend the time and effort needed to partner with other organizational units in the capability-building process. But it also has to be recognized that top-executive urging that departmental managers and their staff *voluntarily* place high priority on coordinating their respective activities *poses significant challenges* in achieving effective cross-unit coordination. This is especially true in decentralized organizational structures where department heads are delegated a high degree of decision-making authority in running their respective units and, thus, have a natural tendency to place a lower priority on cooperating closely with other organizational units than on ensuring that the activities under their direct supervision are done well. The weakness of heavily depending on the largely voluntary efforts of personnel for the development of critical cross-unit capabilities has prompted many companies to supplement such efforts by forming cross-functional committees, project management teams, and centralized project management offices to forge better cross-unit working relationships and improve coordination across multiple organizational units. While these arrangements have proved helpful in a number of organizations, more effective solutions involve creating incentive compensation systems where the payouts are tied to effective group performance of cross-unit tasks.

Facilitating Collaboration with External Partners and Strategic Allies

Getting managers of execution-critical activities to live up to their commitments to coordinate closely with sister organizational unit is a *key* factor in achieving good internal cross-unit coordination.

Organizational mechanisms–whether formal or informal–are also required to ensure effective working relationships with each major outside constituency involved in strategy execution. Strategic alliances, outsourcing arrangements, joint ventures, and cooperative partnerships can contribute little of value without active management of the relationship. Unless top management sees that constructive organizational bridge building with external partners occurs and that productive working relationships emerge, the potential value of cooperative relationships is lost and the company's power to execute its strategy is weakened. For example, if close working relationships with suppliers are crucial, then supply chain management must enter into considerations of how to create an effective organizational structure. If distributor, dealer, or franchisee relationships are important, then someone must be assigned the task of nurturing the relationships with such forward-channel allies.

Building organizational bridges with external partners and strategic allies can be accomplished by appointing "relationship managers" with responsibility for making particular strategic partnerships generate the intended benefits. Relationship managers have many roles and functions: getting the right people together, promoting good rapport, facilitating the flow of information, nurturing interpersonal communication and cooperation, and ensuring effective coordination.[27] Multiple cross-organization ties have to be established and kept open to ensure proper communication and coordination. There has to be enough information sharing to make the relationship work and periodic frank discussions of conflicts, trouble spots, and changing situations.

Organizing and managing a network or an ecosystem provides a mechanism for encouraging more effective collaboration and cooperation among external partners. A **network** is a configuration based on a set of contractual agreements linking a group of independent organizations involved in some common undertaking organized by a central firm. Networks are typically supply networks or distribution networks that serve the needs of the central, organizing firm. In a well-managed network structure, the central firm assumes the responsibility of ensuring that the right partners are included and the activities across the network are coordinated. The high-end Italian motorcycle company Ducati operates in this manner, assembling its motorcycles from parts obtained from a handpicked integrated network of parts suppliers.

CORE CONCEPT

A **network** is a configuration linking a group of independent organizations engaged in some common undertaking organized by a central firm.

An **ecosystem** is a looser configuration of different types of organizations involved in some noncontractual mutual purpose. Business ecosystems might include venture capitalists, suppliers, manufacturers, distributors, competitors, customers, and regulatory agencies—all involved in creating a specific type of product. Silicon Valley in California is known for the productivity of its innovation and entrepreneurship ecosystems.

CORE CONCEPT

An **ecosystem** is a loose configuration of different types of organizations involved in some noncontractual mutual purpose.

Further Perspectives on Structuring the Work Effort

All organizational designs have their strategy-related strengths and weaknesses. To do a good job of matching structure to strategy, strategy implementers first have to pick a basic organizational design and modify it as needed to fit the company's particular business lineup. They must then (1) supplement the design with appropriate coordinating mechanisms (cross-functional task forces, special project teams, self-contained work teams, etc.) and (2) institute whatever networking and communications arrangements are necessary to support effective execution of the firm's strategy. Some companies may avoid setting up "ideal" organizational arrangements because they do not want to disturb existing reporting relationships or because they need to accommodate other situational idiosyncrasies, yet they must still work toward the goal of building a competitively capable organization.

What can be said unequivocally is that building a capable organization entails a process of consciously knitting together the efforts of individuals and groups. Organizational capabilities emerge from establishing and nurturing cooperative working relationships among people and groups to perform activities in a more efficient, value-creating fashion. While an appropriate organizational structure can facilitate this, organization building is a task in which senior management must be deeply involved. Indeed, effectively managing both internal organizational processes and external collaboration to create and develop competitively valuable organizational capabilities remains a top challenge for senior executives in today's companies.

KEY POINTS

1. Executing strategy is an action-oriented, operations-driven activity revolving around the management of people, business processes, and organizational structure. In devising an action agenda for executing strategy, managers should start by conducting a probing assessment of what the organization must do to carry out the strategy successfully. They should then consider precisely *how* to go about this.
2. Good strategy execution requires a *team effort.* All managers have strategy-executing responsibility in their areas of authority, and all employees are active participants in the strategy execution process.
3. Ten managerial tasks are part of every company effort to execute strategy: (1) staffing the organization with the right people, (2) developing and augmenting the necessary resources and organizational capabilities, (3) creating a supportive organizational structure, (4) allocating sufficient resources (budgetary and otherwise), (5) instituting supportive policies and procedures, (6) adopting processes for continuous improvement, (7) installing systems that enable proficient company operations, (8) tying incentives to the achievement of desired targets, (9) instilling the right corporate culture, and (10) exerting the leadership needed to propel strategy execution forward.
4. The two best signs of good strategy execution are that a company is meeting or beating its performance targets and is performing value chain activities in a manner that is conducive to companywide operating excellence. *Shortfalls in performance signal weak strategy, weak execution, or both.*

5. Building an organization capable of good strategy execution entails three types of actions: (1) *staffing the organization*–assembling a talented management team and recruiting and retaining employees with the needed experience, technical skills, and intellectual capital; (2) *acquiring, developing, and strengthening strategy-supportive resources and capabilities*–accumulating the required resources, developing proficiencies in performing strategy-critical value chain activities, and updating the company's capabilities to match changing market conditions and customer expectations; and (3) *structuring the organization and work effort*–instituting organizational arrangements that facilitate good strategy execution, deciding how much decision-making authority to delegate, facilitating cross-unit coordination, and managing external relationships.
6. Building competitive capabilities is a time-consuming, managerially challenging exercise that can be approached in three ways: (1) developing capabilities internally, (2) acquiring capabilities through mergers and acquisitions, and (3) accessing capabilities via collaborative partnerships.
7. In building capabilities internally, the first step is to develop the *ability* to do something, through experimenting, actively searching for alternative solutions, and learning by trial and error. As experience grows and company personnel learn how to perform the activities consistently well and at an acceptable cost, the ability evolves into a tried-and-true capability. The process can be accelerated by making learning a more deliberate endeavor and providing the incentives that will motivate company personnel to achieve the desired ends.
8. As firms get better at executing their strategies, they develop capabilities in the domain of strategy execution. Superior strategy execution capabilities allow companies to get the most from their resources and capabilities. But excellence in strategy execution can also be a more direct source of competitive advantage, since more efficient and effective strategy execution can lower costs and permit firms to deliver more value to customers. Because they are socially complex capabilities, superior strategy execution capabilities are hard to imitate and have no good substitutes. As such, they can be an important source of *sustainable* competitive advantage. Anytime rivals can readily duplicate successful strategies, making it impossible to *out-strategize* rivals, the chief way to achieve lasting competitive advantage is to *out-execute* them.
9. Structuring the organization and organizing the work effort in a strategy-supportive fashion has five aspects: (1) deciding which value chain activities to perform internally and which ones to outsource; (2) aligning the firm's organizational structure with its strategy; (3) deciding how much authority to centralize at the top and how much to delegate to down-the-line managers and employees; (4) providing for the internal cross-unit coordination needed to build and strengthen capabilities; and (5) facilitating the necessary collaboration and coordination with external partners and strategic allies.
10. To align the firm's organizational structure with its strategy, it is important to make strategy-critical activities the main building blocks. There are four basic types of organizational structures: the simple structure, the functional structure, the multidivisional structure, and the matrix structure. Which is most appropriate depends on the firm's size, complexity, and strategy.

ASSURANCE OF LEARNING EXERCISES

connect

LO 10-1

1. The heart of Zara's strategy in the apparel industry is to outcompete rivals by putting fashionable clothes in stores quickly and maximizing the frequency of customer visits. Illustration Capsule 10.3 discusses the capabilities that the company has developed in the execution of its strategy. How do its capabilities lead to a quick production process and new apparel introductions? How do these capabilities encourage customers to visit its stores every few weeks? Does the execution of the company's site selection capability also contribute to its competitive advantage? Explain.

LO 10-2, 10-3

2. Review Meta's Careers page (**www.metacareers.com**). The page emphasizes Meta's core values and explains how potential employees could fit that mold. Bold and decisive thinking and a commitment to transparency and social connectivity drive the page and the company as a whole. Then research Meta's internal management training programs, called "employee boot camps," using a search engine like Google or Bing. How do these programs integrate the traits and stated goals on the Careers page into specific and tangible construction of employee capabilities? Boot camps are open to all Meta employees, not just engineers. How does this internal training prepare Meta employees of all types to "move fast and break things"?

LO 10-4

3. Review Valve Corporation's company handbook online: **www.valvesoftware.com/company/Valve_Handbook_LowRes.pdf.** Specifically, focus on Valve's corporate structure. Valve has hundreds of employees but no managers or bosses at all. Valve's gaming success hinges on innovative and completely original experiences like Portal and Half-Life. Does it seem that Valve's corporate structure uniquely promotes this type of gaming innovation? Why or why not? How would you characterize Valve's organizational structure? Is it completely unique, or could it be characterized as a multidivisional, matrix, or functional structure? Explain your answer.

LO 10-5

4. Johnson & Johnson, a multinational health care company responsible for manufacturing medical, pharmaceutical, and consumer goods, has been a leader in promoting a decentralized management structure. Perform an Internet search to gain some background information on the company's products, value chain activities, and leadership. How does Johnson & Johnson exemplify (or not exemplify) a decentralized management strategy? Describe the advantages and disadvantages of a decentralized system of management in the case of Johnson & Johnson. Why was it established in the first place? Has it been an effective means of decision making for the company?

EXERCISES FOR SIMULATION PARTICIPANTS

connect

LO 10-5

1. How would you describe the organization of your company's top-management team? Is some decision making decentralized and delegated to individual managers? If so, explain how the decentralization works. Or are decisions made more by consensus, with all co-managers having input? What do you see as the advantages and disadvantages of the decision-making approach your company is employing?

LO 10-3

2. What specific actions have you and your co-managers taken to develop core competencies or competitive capabilities that can contribute to good strategy execution and potential competitive advantage? If no actions have been taken, explain your rationale for doing nothing.

LO 10-1

3. What value chain activities are most crucial to good execution of your company's strategy? Does your company have the ability to outsource any value chain activities? If so, have you and your co-managers opted to engage in outsourcing? Why or why not?

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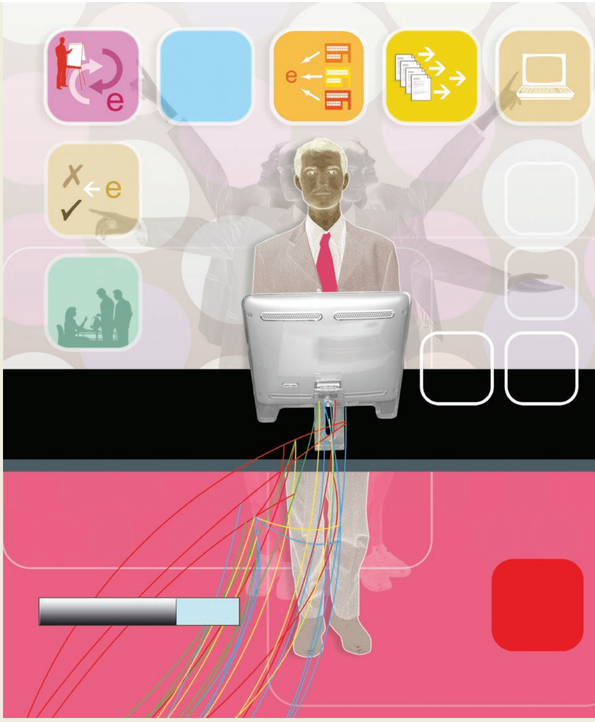
chapter 11

Managing Internal Operations

Actions That Promote Good Strategy Execution



Andrea Pemberton/Media Bakery

Learning Objectives

After reading this chapter, you should be able to

LO 11-1 Explain why resource allocation should always be based on strategic priorities.

LO 11-2 Comprehend how well-designed policies and procedures can facilitate good strategy execution.

LO 11-3 Understand how process management tools drive continuous improvement in executing value chain activities.

LO 11-4 Recognize the role of information systems and operating systems in enabling company personnel to carry out their strategic roles proficiently.

LO 11-5 Explain how and why the use of well-designed incentives can be management's single most powerful tool for promoting operating excellence.

Processes underpin business capabilities, and capabilities underpin strategy execution.

Pearl Zhu—*Author and Digital Visionary*

Pay your people the least possible and you'll get the same from them.

Malcolm Forbes—*late Publisher of Forbes Magazine*

Great companies without great business processes won't stay great companies long–they are depending on luck.

Alva H. Taylor—*Professor and Consultant*

In Chapter 10, we emphasized that proficient strategy execution begins with three types of managerial actions: staffing the organization with the right people; acquiring, developing, and strengthening the firm's resources and capabilities; and structuring the organization in a manner supportive of the strategy execution effort.

In this chapter, we discuss five additional managerial actions that promote good strategy execution:

1. Allocating ample resources to the strategy execution effort.
2. Instituting policies and procedures that facilitate good strategy execution.
3. Employing process management tools to drive continuous improvement in how value chain activities are performed.
4. Installing information and operating systems that support strategy implementation activities.
5. Tying rewards and incentives to the achievement of performance objectives.

ALLOCATING RESOURCES TO THE STRATEGY EXECUTION EFFORT

LO 11-1

Explain why resource allocation should always be based on strategic priorities.

A company's strategic priorities must drive how capital allocations are made and the size of each unit's operating budgets.

Early in the strategy implementation process, managers must determine what resources (in terms of funding, people, and so on) will be required and how they should be distributed across the company's various organizational units. This includes carefully screening requests for more people and new facilities and equipment, approving those that will contribute to the strategy execution effort, and turning down those that don't. Should internal cash flows prove insufficient to fund the planned strategic initiatives, then management must raise additional funds through borrowing or selling additional shares of stock to investors.

A company's ability to marshal the resources needed to support new strategic initiatives has a major impact on the strategy execution process. Too little funding and an insufficiency of other types of resources slow progress and impede the efforts of organizational units to execute their pieces of the strategic plan competently. Too much funding of particular organizational units and value chain activities wastes organizational resources and reduces financial performance. Both of these scenarios argue for managers to become deeply involved in reviewing budget proposals and directing the proper kinds and amounts of resources to strategy-critical organizational units.

A change in strategy nearly always calls for budget reallocations and resource shifting. Previously important units with a lesser role in the new strategy may need downsizing. Units that now have a bigger strategic role may need more people, new equipment, additional facilities, and above-average increases in their operating budgets. Implementing new strategy initiatives requires managers to take an active and sometimes forceful role in shifting resources, not only to better support activities now having a higher priority but also to capture opportunities to operate more cost-effectively. This requires putting enough resources behind new strategic initiatives to fuel their success and making the tough decisions to kill projects and activities that are no longer justified.

Visible actions to reallocate operating funds and move people into new organizational units signal a determined commitment to strategic change. Such actions can catalyze the implementation process and give it credibility. Microsoft has made a practice of regularly shifting hundreds of programmers to new high-priority programming initiatives within a matter of weeks or even days. Fast-moving developments in many markets are prompting companies to abandon traditional annual budgeting and resource allocation cycles in favor of resource allocation processes supportive of more rapid adjustments in strategy. In response to rapid technological change in the communications industry, AT&T has prioritized investments and acquisitions that have allowed it to offer its enterprise customers faster, more flexible networks and accelerate the introduction of its new 5G-centric product offerings.

Alphabet's (formerly Google) strong support of R&D activities helped it to grow to a $282.8 billion giant by 2022. In 2013, however, Google decided to drop its 20 percent time policy, which allowed its staff to work on side projects of their choice one day a week. While this side project program gave rise to many innovations, such as Gmail and AdSense (a big contributor to Google's revenues), it also meant that fewer resources were available to projects that were deemed closer to the core of Google's mission. In the years since Google killed the 20 percent policy, the company has consistently topped Fortune, Forbes, and Fast Company magazines' "most innovative companies" list for ideas such as Google Pixel smartphones and its Waymo self-driving automobile subsidiary.

Merely fine-tuning the execution of a company's existing strategy seldom requires big shifts of resources from one area to another. In contrast, new strategic initiatives generally require not only big shifts in resources but a larger allocation of resources to the effort as well. However, there are times when strategy changes or new execution initiatives need to be made without adding to total company expenses. In such circumstances, managers have to work their way through the existing budget line by line and activity by activity, looking for ways to trim costs and shift resources to activities that are higher priority in the strategy execution effort. In the event that a company needs to make significant cost cuts during the course of launching new strategic initiatives, managers must be especially creative in finding ways to do more with less. Indeed, it is common for strategy changes and the drive for good strategy execution to be aimed at achieving considerably higher levels of operating efficiency and, at the same time, making sure the most important value chain activities are performed as effectively as possible.

INSTITUTING POLICIES AND PROCEDURES THAT FACILITATE STRATEGY EXECUTION

LO 11-2

Comprehend how well-designed policies and procedures can facilitate good strategy execution.

A company's policies and procedures can either support or hinder good strategy execution. Anytime a company attempts to put new strategy elements in place or improve its strategy execution capabilities, some changes in work practices are usually needed. Managers are thus well advised to carefully consider whether existing policies and procedures fully support such changes and to revise or discard those that do not.

As shown in Figure 11.1, well-conceived policies and operating procedures facilitate strategy execution in two significant ways:

1. *By providing top-down guidance regarding how things need to be done.* Policies and procedures provide company personnel with a set of guidelines for how to perform organizational activities, conduct various aspects of operations, solve problems as they arise, and accomplish particular tasks. They clarify uncertainty about how to proceed in executing strategy and align the actions and behavior of company personnel with the requirements for good strategy execution. Moreover, they place limits on ineffective independent action. When they are well matched with the requirements of the strategy implementation plan, they channel the efforts of individuals along a path that supports the plan. When existing ways of doing things pose a barrier to strategy execution initiatives, actions and behaviors have to be changed. Under these conditions, the managerial role is to establish and enforce new policies and operating practices that are more conducive to executing the strategy appropriately. Policies are a particularly useful way to counteract tendencies for some people to resist change. People generally refrain from violating company policy or going against recommended practices and procedures without gaining clearance or having strong justification.
2. *By helping ensure consistency in how execution-critical activities are performed.* Policies and procedures serve to standardize the way that activities are performed. In essence, they represent a store of organizational or managerial knowledge about efficient and effective ways of doing things—a set of

A company's policies and procedures provide a set of well-honed *routines* for running the company and executing the strategy.

FIGURE 11.1 How Policies and Procedures Facilitate Good Strategy Execution

well-honed *routines* for running the company. This can be important for ensuring the quality and reliability of the strategy execution process. It helps align and coordinate the strategy execution efforts of individuals and groups throughout the organization—a feature that is particularly beneficial when there are geographically scattered operating units. For example, eliminating significant differences in the operating practices of different plants, sales regions, or customer service centers or in the individual outlets in a chain operation helps a company deliver consistent product quality and service to customers. Good strategy execution nearly always entails an ability to replicate product quality and the caliber of customer service at every location where the company does business—anything less blurs the company's image and lowers customer satisfaction.

To ensure consistency in product quality and service behavior patterns, McDonald's policy manual spells out detailed procedures that personnel in each McDonald's unit are expected to observe. For example, "Cooks must turn, never flip, hamburgers. If they haven't been purchased, Big Macs must be discarded in 10 minutes after being cooked and French fries in 7 minutes. Cashiers must make eye contact with and smile at every customer." Retail chain stores and other organizational chains (e.g., hotels, hospitals, child care centers) similarly rely on detailed policies and procedures to ensure consistency in their operations and reliable service to their customers. Video game developer Valve Corporation prides itself on a lack of rigid policies and procedures; its 37-page handbook for new employees' details how things get done in such an environment—an ironic tribute to the fact that all types of companies need policies.

One of the big policy-making issues concerns what activities need to be strictly prescribed and what activities ought to allow room for independent action on the part of personnel. Few companies need thick policy manuals to prescribe exactly how daily operations are to be conducted. Too much policy can be as obstructive as wrong policy and as confusing as no policy. There is wisdom in a middle approach*: Prescribe enough policies to give organization members clear direction and to place reasonable boundaries on their actions; then empower them to act within these boundaries in pursuit of company goals.* Allowing company personnel to act with some degree of freedom is especially appropriate when individual creativity and initiative are more essential to good strategy execution than are standardization and strict conformity.

There is wisdom in a middle-ground approach: Prescribe enough policies to give organization members clear direction and to place reasonable boundaries on their actions; then empower them to act within these boundaries in pursuit of company goals.

EMPLOYING BUSINESS PROCESS MANAGEMENT TOOLS

Company managers can significantly advance the cause of competent strategy execution by using business process management tools to drive continuous improvement in how internal operations are conducted. Process management tools are used to model, control, measure, and optimize a variety of organizational activities that may span departments, functions, value chain systems, employees, customers, suppliers, and other partners in support of company goals. They also provide corrective feedback, allowing managers to change and improve company operations in an ongoing manner.

LO 11-3

Understand how process management tools drive continuous improvement in executing value chain activities.

Promoting Operating Excellence: Three Powerful Business Process Management Tools

Three of the most powerful management tools for promoting operating excellence and better strategy execution are business process reengineering, total quality management (TQM) programs, and Six Sigma quality control programs. Each of these merits discussion since many companies around the world use these tools to help execute strategies tied to cost reduction, defect-free manufacture, superior product quality, superior customer service, and total customer satisfaction.

Business Process Reengineering Companies searching for ways to improve their operations have sometimes discovered that the execution of strategy-critical activities is hampered by a disconnected organizational arrangement whereby pieces of an activity are performed in several different functional departments, with no one manager or group being accountable for optimal performance of the entire activity. This can easily occur in such inherently cross-functional activities as customer service (which can involve personnel in order filling, warehousing and shipping, invoicing, accounts receivable, after-sale repair, and technical support), particularly for companies with a functional organizational structure.

CORE CONCEPT

Business process reengineering involves radically redesigning and streamlining how an activity is performed, with the intent of achieving quantum improvements in performance.

To address the suboptimal performance problems that can arise from this type of situation, a company can *reengineer the work effort,* pulling the pieces of an activity out of different departments and creating a cross-functional work group or single department (often called a *process department*) to take charge of the whole process. The use of cross-functional teams has been popularized by the practice of

business process reengineering, which involves radically redesigning and streamlining the workflow (typically enabled by cutting-edge use of online technology and information systems), with the goal of achieving quantum gains in performance of the activity.[1]

The reengineering of value chain activities has been undertaken at many companies in many industries all over the world, with excellent results being achieved at some firms.[2] Hallmark reengineered its process for developing new greeting cards, creating teams of mixed-occupation personnel (artists, writers, lithographers, merchandisers, and administrators) to work on a single holiday or greeting card theme. The reengineered process speeded development times for new lines of greeting cards by up to 24 months, reduced costs, and increased customer satisfaction.[3] In the order-processing section of General Electric's circuit breaker division, elapsed time from order receipt to delivery was cut from three weeks to three days by consolidating six production units into one, reducing a variety of former inventory and handling steps, automating the design system to replace a human custom-design process, and cutting the organizational layers between managers and workers from three to one. Productivity rose 20 percent in one year, and unit manufacturing costs dropped 30 percent. In the health care industry, business process reengineering is being used to lower health care costs and improve patient outcomes in a variety of ways. South Africa is attempting to reengineer its primary health care system, which is in need of significant reform. Similar initiatives are ongoing in India. In the United States, exemplary health care providers, such as Mayo Clinic, are using reengineering tools on a continuous basis to achieve outcomes such as fewer hospitalizations, improved patient–physician interactions, and the delivery of lower cost health care.

While business process reengineering has on occasion been criticized as an excuse for downsizing, it has nonetheless proved itself a useful tool for streamlining a company's work effort and moving closer to operational excellence. It has also inspired more technologically based approaches to integrating and streamlining business processes, such as *enterprise resource planning,* a software-based system implemented with the help of consulting companies such as SAP (the leading provider of business software).

CORE CONCEPT

Total quality management (TQM) entails creating a total quality culture, involving managers and employees at all levels, bent on continuously improving the performance of every value chain activity.

Total Quality Management Programs

Total quality management (TQM) is a management approach that strives for continuous improvement in all phases of operations, 100 percent accuracy in performing tasks, involvement and empowerment of employees at all levels, team-based work design, benchmarking, and total customer satisfaction.[4] It involves an ongoing process of detecting errors and working to eliminate them. While TQM concentrates on producing quality goods and fully satisfying customer expectations, it achieves its biggest successes when it is extended to employee efforts in *all departments*—human resources, billing, accounting, and information systems—that may lack pressing, customer-driven incentives to improve. It involves reforming the corporate culture and shifting to a continuous-improvement business philosophy that permeates every facet of the organization.[5] TQM aims at instilling enthusiasm and commitment to doing things right from the top to the bottom of the organization. Management's job is to kindle an organization-wide search for ways to improve that involves all company personnel exercising initiative and using their ingenuity. TQM doctrine preaches that there's no such thing as "good enough" and that everyone has a responsibility to participate in continuous improvement. TQM is thus a race without a finish. Success comes from making little steps forward each day, a process that the Japanese call *kaizen.*

TQM takes a fairly long time to show significant results—very little benefit emerges within the first six months. The long-term payoff of TQM, if it comes, depends heavily on management's success in implanting a culture within which the TQM philosophy and practices can thrive. But it is a management tool that has attracted numerous users and advocates over several decades, and it can deliver good results when used properly.

CORE CONCEPT

Six Sigma programs utilize advanced statistical methods to improve quality by reducing defects and variability in the performance of business processes.

Six Sigma Quality Control Programs

Six Sigma programs offer another way to drive continuous improvement in quality and strategy execution. This approach entails the use of advanced statistical methods to identify and remove the causes of defects (errors) and undesirable variability in performing an activity or business process. When performance of an activity or process reaches "Six Sigma quality," there are *no more than 3.4 defects per million iterations* (equal to 99.9997 percent accuracy).[6]

There are two important types of Six Sigma programs. The Six Sigma process of define, measure, analyze, improve, and control (DMAIC, pronounced "dee-may-ic") is an improvement system for existing processes falling below specification. The Six Sigma process of define, measure, analyze, design, and verify (DMADV, pronounced "dee-mad-vee") is used to develop *new* processes or products at Six Sigma quality levels. DMADV is sometimes referred to as Design for Six Sigma, or DFSS. Both Six Sigma programs are overseen by personnel who have completed Six Sigma "master black belt" training, and they are executed by personnel who have earned Six Sigma "green belts" and Six Sigma "black belts." Renfro Corporation, a North Carolina sock manufacturer, managed to save as much as $1.2 million by providing Green Belt training to just seven employees.[7]

The statistical thinking underlying Six Sigma is based on the following three principles: (1) All work is a process, (2) all processes have variability, and (3) all processes create data that explain variability.[8] Six Sigma's DMAIC process is a particularly good vehicle for improving performance when there are *wide variations* in how well an activity is performed. For instance, airlines striving to improve the on-time performance of their flights have more to gain from actions to curtail the number of flights that are late by more than 30 minutes than from actions to reduce the number of flights that are late by less than five minutes. Six Sigma quality control programs are of particular interest for large companies, which are better able to shoulder the cost of the large investment required in employee training, organizational infrastructure, and consulting services. For example, to realize a cost savings of $4.4 billion from rolling out its Six Sigma program, GE had to invest $1.6 billion and suffer losses from the program during its first year.[9]

Since the programs were first introduced, thousands of companies and nonprofit organizations around the world have used Six Sigma to promote operating excellence. For companies at the forefront of this movement, such as Motorola, General Electric (GE), Ford, and Honeywell (Allied Signal), the cost savings as a percentage of revenue varied from 1.2 to 4.5 percent, according to data analysis conducted by iSixSigma (an organization that provides free articles, tools, and resources concerning Six Sigma). More recently, there has been a resurgence of interest in Six Sigma practices, with companies such as Siemens, Coca-Cola, Ocean Spray, GEICO, and Merrill Lynch turning to Six Sigma as a vehicle to improve their bottom lines. In the first five years of its adoption, Six Sigma at Bank of America helped the bank reap about $2 billion in revenue gains and cost savings; the bank holds an annual "Best of Six Sigma Expo" to celebrate the teams and the projects with the greatest contribution to the company's bottom line. GE, one of the most successful companies implementing Six Sigma training and pursuing Six Sigma perfection across the company's entire operations, estimated benefits of some $10 billion during the first five years of implementation—its Lighting division, for example, cut invoice defects and disputes by 98 percent.[10]

Six Sigma has also been used to improve processes in health care. Froedtert Hospital in Milwaukee, Wisconsin, used Six Sigma to improve the accuracy of administering the proper drug doses to patients. DMAIC analysis of the three-stage process by which prescriptions were written by doctors, filled by the hospital pharmacy, and then administered to patients by nurses revealed that most mistakes came from misreading the doctors' handwriting. The hospital implemented a program requiring doctors to enter the prescription on the hospital's computers, which slashed the number of errors dramatically. In recent years, Pfizer embarked on 85 Six Sigma projects to streamline its R&D process and lower the cost of delivering medicines to patients in its pharmaceutical sciences division.

Illustration Capsule 11.1 describes Charleston Area Medical Center's use of Six Sigma as a health care provider coping with the current challenges facing this industry.

Despite its potential benefits, Six Sigma is not without its problems. There is evidence, for example, that Six Sigma techniques can stifle innovation and creativity. The essence of Six Sigma is to reduce variability in processes, but creative processes, by nature, include quite a bit of variability. In many instances, breakthrough innovations occur only after thousands of ideas have been abandoned and promising ideas have gone through multiple iterations and extensive prototyping. Alphabet Executive Chairman of the Board Eric Schmidt has declared that applying Six Sigma measurement and control principles to creative activities at Google would choke off innovation altogether.[11]

CORE CONCEPT

Ambidextrous organizations are adept at employing continuous improvement in operating processes while allowing R&D and other areas engaged in development of new ideas freer rein.

A blended approach to Six Sigma implementation that is gaining in popularity pursues incremental improvements in operating efficiency, while R&D and other processes that allow the company to develop new ways of offering value to customers are given freer rein. Managers of these **ambidextrous organizations** are adept at employing continuous improvement in operating processes but allowing R&D to operate under a set of rules that allows for exploration and the development of breakthrough innovations. However, the two distinctly different approaches to managing employees must be carried out by tightly integrated senior managers to ensure that the separate and diversely oriented units operate with a common purpose. Ciba Vision, now part of eye care multinational Alcon, dramatically reduced operating expenses through the use of continuous improvement programs, while simultaneously and harmoniously developing a new series of contact lens products that have allowed its revenues to increase by 300 percent over a 10-year period.[12] An enterprise that systematically and wisely applies Six Sigma methods to its value chain, activity by activity, can make major strides in improving the proficiency with which its strategy is executed without sacrificing innovation. As is the case with TQM, obtaining managerial commitment, establishing a quality culture, and fully involving employees are all of critical importance to the successful implementation of Six Sigma quality programs.[13]

Business process reengineering aims at one-time quantum improvement, while continuous-improvement programs like TQM and Six Sigma aim at ongoing incremental improvements.

The Difference between Business Process Reengineering and Continuous-Improvement Programs Like Six Sigma and TQM Business process reengineering and continuous improvement efforts such as TQM and Six Sigma both aim at improved efficiency, better product quality, and greater customer satisfaction. The essential difference between business process reengineering and continuous improvement programs business process reengineering aims at *quantum gains* on the order of 30 to 50 percent or more, whereas total quality programs like TQM and

ILLUSTRATION CAPSULE 11.1 Charleston Area Medical Center's Six Sigma Program

Caiaimage/Robert Daly/Getty Images

Charleston Area Medical Center (CAMC) is West Virginia's largest health care provider in terms of beds, admissions, and revenues. Performance improvement is important to CAMC's management for a variety of strategic reasons, including competitive positioning and cost control. To drive performance improvement, CAMC management implemented a Six Sigma program in order to examine quality problems and standardize care processes.

The United States has been evolving toward a pay-for-performance structure, which rewards hospitals for providing quality care. CAMC has utilized its Six Sigma program to take advantage of these changes in the health care environment. For example, to improve its performance in acute myocardial infarction (AMI), CAMC applied a Six Sigma DMAIC (define–measure–analyze–improve–control) approach. Nursing staff members were educated on AMI care processes, performance targets were posted in nursing units, and adherence to the eight Hospital Quality Alliance (HQA) indicators of quality care for AMI patients was tracked. As a result of the program, CAMC improved its compliance with HQA-recommended treatment for AMI from 50 to 95 percent. Harvard researchers identified CAMC as one of the top-performing hospitals reporting comparable data.

Controlling cost has also been an important aspect of CAMC's performance improvement initiatives due to local regulations. West Virginia is one of two states where medical services rates are set by state regulators. This forces CAMC to limit expenditures because the hospital cannot raise prices. CAMC first applied Six Sigma in an effort to control costs by managing the supply chain more effectively. The effort created a one-time $150,000 savings by working with vendors to remove outdated inventory. As a result of continuous improvement, CAMC managed to achieve supply chain management savings of $12 million in just four years.

Since CAMC introduced Six Sigma, over 100 quality improvement projects have been initiated. A key to CAMC's success has been instilling a continuous improvement mindset into the organization's culture. Dale Wood, chief quality officer at CAMC, stated: "If you have people at the top who completely support and want these changes to occur, you can still fall flat on your face. . . . You need a group of networkers who can carry change across an organization." Due to CAMC's performance improvement culture, the hospital ranks high nationally in ratings for quality of care and patient safety, as reported on the Centers for Medicare and Medicaid Services (CMS) website.

Note: Developed with Robin A. Daley.

Sources: CAMC website; Martha Hostetter, "Case Study: Improving Performance at Charleston Area Medical Center," *The Commonwealth Fund,* November–December 2007, **www.commonwealthfund.org/publications/newsletters/quality-matters/2007/november-december/case-study-improving-performance-at-charleston-area-medical-center** (accessed January 2016); J. C. Simmons, "Using Six Sigma to Make a Difference in Health Care Quality," *The Quality Letter,* April 2002.

Six Sigma stress *ongoing incremental progress,* striving for inch-by-inch gains again and again in a never-ending stream. The two approaches to improved performance of value chain activities and operating excellence are not mutually exclusive; it makes sense to use them in tandem. Reengineering can be used first to produce a good basic design that yields quick, dramatic improvements in performing a business process. TQM or Six Sigma programs can then be used as a follow-on to deliver incremental improvements over a longer period of time.

Capturing the Benefits of Initiatives to Improve Operations

The biggest beneficiaries of process improvement initiatives, reengineering, TQM, and Six Sigma are companies that view such programs not as ends in themselves but as tools for executing company strategy more effectively. The least rewarding payoffs occur when company managers seize on the programs as novel ideas that might be worth a try. In most such instances, they result in strategy-blind efforts to simply manage better.

There's an important lesson here. Business process management tools all need to be linked to a company's strategic priorities to contribute effectively to improving the strategy's execution. Only strategy can point to which value chain activities matter and what performance targets make the most sense. Without a strategic framework, managers lack the context in which to fix things that really matter to business unit performance and competitive success.

To get the most from initiatives to execute strategy more proficiently, managers must have a clear idea of what specific outcomes really matter. Is it high on-time delivery, lower overall costs, fewer customer complaints, shorter cycle times, a higher percentage of revenues coming from recently introduced products, or something else? Benchmarking best-in-industry and best-in-world performance of targeted value chain activities provides a realistic basis for setting internal performance milestones and longer-range targets. Once initiatives to improve operations are linked to the company's strategic priorities, then comes the managerial task of building a total quality culture that is genuinely committed to achieving the performance outcomes that strategic success requires.[14]

Managers can take the following action steps to realize full value from TQM, reengineering, or Six Sigma initiatives and promote a culture of operating excellence:[15]

1. Demonstrating visible, unequivocal, and unyielding commitment to total quality and continuous improvement, including specifying measurable objectives for increasing quality and making continual progress.
2. Nudging people toward quality-supportive behaviors by
   a. Screening job applicants rigorously and hiring only those with attitudes and aptitudes that are right for quality-based performance.
   b. Providing quality training for employees.
   c. Using teams and team-building exercises to reinforce and nurture individual effort. (The creation of a quality culture is facilitated when teams become more cross-functional, multitask-oriented, and increasingly self-managed.)
   d. Recognizing and rewarding individual and team efforts to improve quality regularly and systematically.
   e. Stressing prevention (doing it right the first time), not correction (instituting ways to undo or overcome mistakes).
3. Empowering employees so that authority for delivering great service or improving products is in the hands of those who do the job rather than their managers: *improving quality has to be seen as part of everyone's job.*
4. Using online systems to provide all relevant parties with the latest best practices, thereby speeding the diffusion and adoption of best practices throughout the organization. Online systems can also allow company personnel to exchange data and opinions about how to upgrade the prevailing best-in-company practices.
5. Emphasizing that performance can and must be improved, because competitors are not resting on their laurels and customers are always looking for something better.

In sum, initiatives to improve operations, like business process reengineering, TQM, and Six Sigma techniques all need to be seen and used as part of a bigger-picture effort to execute strategy proficiently. Used properly, all of these tools are capable of improving the proficiency with which an organization performs its value chain activities. Not only do improvements from such initiatives add up over time and strengthen organizational capabilities, but they also help build a culture of operating excellence. All this lays the groundwork for gaining a competitive advantage.[16] While it is relatively easy for rivals to also implement process management tools, it is much more difficult and time-consuming for them to instill a deeply ingrained culture of operating excellence (as occurs when such techniques are religiously employed and top management exhibits lasting commitment to operational excellence throughout the organization).

The purpose of using business process management tools, such as business process reengineering, TQM, and Six Sigma programs is to improve the performance of strategy-critical activities and thereby enhance strategy execution.

INSTALLING INFORMATION AND OPERATING SYSTEMS

LO 11-4

Recognize the role of information systems and operating systems in enabling company personnel to carry out their strategic roles proficiently.

Company strategies and value-creating internal processes can't be executed well without a number of internal systems for business operations. American Airlines, Delta, Ryanair, Lufthansa, and other successful airlines cannot hope to provide passenger-pleasing service without a user-friendly online reservation system, an accurate and speedy baggage-handling system, and a strict aircraft maintenance program that minimizes problems requiring at-the-gate service that delays departures. FedEx has internal communication systems that allow it to coordinate its over 86,000 vehicles in handling a daily average of 16.5 million shipments to more than 220 countries and territories. Its leading-edge flight operations systems allow a single controller to direct as many as 200 of FedEx's 659 aircraft simultaneously, overriding their flight plans should weather problems or other special circumstances arise. FedEx also has created a series of e-business tools for customers that allow them to ship and track packages online, create address books, review shipping history, generate custom reports, simplify customer billing, reduce internal warehousing and inventory management costs, purchase goods and services from suppliers, and respond to their own quickly changing customer demands. All of FedEx's systems support the company's strategy of providing businesses and individuals with a broad array of package delivery services and enhancing its competitiveness against United Parcel Service, DHL, and the U.S. Postal Service.

Amazon ships customer orders from a global network of 185 technologically sophisticated order fulfillment centers. Using complex picking algorithms, computers initiate the order-picking process by sending signals to workers' wireless receivers, telling them which items to pick off the shelves in which order. Computers also generate data on mix-boxed items, chute backup times, line speed, worker productivity, and shipping weights on orders. Systems are upgraded regularly, and productivity improvements are aggressively pursued. Amazon has been experimenting with drone delivery in order to lower costs and speed package delivery; more recently it began marketing a program called "Seller Flex" that allows sellers who join to improve their inventory management and control.

Otis Elevator, the world's largest manufacturer of elevators, with more than 2 million elevators and escalators installed worldwide, has a 24/7 remote electronic monitoring system that can detect when an elevator or escalator installed on a customer's site has any of 325 problems. If the monitoring system detects a problem, it analyzes and diagnoses the cause and location, then makes the service call to an Otis mechanic at the nearest location, and helps the mechanic (who is equipped with a web-enabled cell phone) identify the component causing the problem. The company's maintenance system helps keep outage times to 2.5 hours on average—the elevators are often back in service before people even realize there was a problem. All trouble-call data are relayed to design and manufacturing personnel, allowing them to quickly alter design specifications or manufacturing procedures when needed to correct recurring problems. All customers have online access to performance data on each of their Otis elevators and escalators.

Well-conceived state-of-the-art operating systems not only enable better strategy execution but also strengthen organizational capabilities—enough at times to provide a competitive edge over rivals. For example, a company with a differentiation strategy based on superior quality has added capability if it has systems for training personnel in quality techniques, tracking product quality at each production step, and ensuring that all goods shipped meet quality standards. If these quality control systems are better than those employed by rivals, they provide the company with a competitive advantage. Similarly, a company striving to be a low-cost provider is competitively stronger if it has an unrivaled benchmarking system that identifies opportunities to implement best-in-the-world practices and drive costs out of the business faster than rivals. Fast-growing companies get an important assist from having capabilities in place to recruit and train new employees in large numbers and from investing in infrastructure that gives them the capability to handle rapid growth as it occurs, rather than having to scramble to catch up to customer demand.

Instituting Adequate Information Systems, Performance Tracking, and Controls

Accurate and timely information about daily operations is essential if managers are to gauge how well the strategy execution process is proceeding. Companies everywhere are capitalizing on today's technology to install real-time data-generating capability. Most retail companies now have automated online systems that generate daily sales reports for each store and maintain up-to-the-minute inventory and sales records on each item. Manufacturing plants typically generate daily production reports and track labor productivity on every shift. Transportation companies have elaborate information systems to provide real-time arrival information for buses and trains that is automatically sent to digital message signs and platform audio address systems.

Siemens Healthcare, one of the largest suppliers to the health care industry, uses a cloud-based business activity monitoring (BAM) system to continuously monitor and improve the company's processes across more than 190 countries. Customer satisfaction is one of Siemens's most important business objectives, so the reliability of its order management and services is crucial. It also offers a cloud-based portfolio of enterprise-class technology to its clients that provides secure remote monitoring of a client's various buildings and equipment.

Caesars Entertainment, owner of casinos and hotels, uses a sophisticated customer relationship database that records detailed information about its customers' gambling habits. When a member of Caesars's Total Rewards program calls to make a reservation, the representative can review previous spending, including average bet size, to offer an upgrade or complimentary stay at Caesars Palace or one of the company's other properties.

Walmart has implemented blockchain technology to provide more accurate and timely payments to third-party freight carriers, which are essential to keeping its stores stocked with inventory. With more than 200 supply chain data points such as stop locations, gallons of fuel, and temperature updates affecting a billing invoice, approximately

70 percent of invoices were disputed when calculated manually. The implementation of a shared blockchain network between shippers and Walmart has allowed disputed invoices to fall to just 1 percent and has sped payment to Walmart's shipping partners.

Information systems need to cover five broad areas: (1) customer data, (2) operations data, (3) employee data, (4) supplier and/or strategic partner data, and (5) financial performance data. All key strategic performance indicators must be tracked and reported in real time whenever possible. Real-time information systems permit company managers to stay on top of implementation initiatives and daily operations and to intervene if things seem to be drifting off course. Tracking key performance indicators, gathering information from operating personnel, quickly identifying and diagnosing problems, and taking corrective actions are all integral pieces of the process of managing strategy execution and overseeing operations.

Statistical information gives managers a feel for the numbers, briefings and meetings provide a feel for the latest developments and emerging issues, and personal contacts add a feel for the people dimension. All are good barometers of how well things are going and what operating aspects need management attention. Managers must identify problem areas and deviations from plans before they can take action to get the organization back on course by either improving the approaches to strategy execution or fine-tuning the strategy. Jeff Bezos, the founder and executive chairman of Amazon, is an ardent proponent of managing by the numbers. As he puts it, "Math-based decisions always trump opinion and judgment. The trouble with most corporations is that they make judgment-based decisions when data-based decisions could be made."[17]

> Having state-of-the-art operating systems, information systems, and real-time data is integral to superior strategy execution and operating excellence.

Monitoring Employee Performance Information systems also provide managers with a means for monitoring the performance of empowered workers to see that they are acting within the specified limits.[18] Leaving empowered employees to their own devices in meeting performance standards without appropriate checks and balances can expose an organization to excessive risk.[19] Instances abound of employees' decisions or behavior going awry, sometimes costing a company huge sums or producing lawsuits and reputation-damaging publicity.

Scrutinizing daily and weekly operating statistics is one of the ways in which managers can monitor the results that flow from the actions of subordinates without resorting to constant over-the-shoulder supervision; if the operating results look good, then it is reasonable to assume that empowerment is working. But close monitoring of operating performance is only one of the control tools at management's disposal. Another valuable lever of control in companies that rely on empowered employees, especially in those that use self-managed work groups or other such teams, is peer-based control. Because peer evaluation is such a powerful control device, companies organized into teams can remove some layers of the management hierarchy and rely on strong peer pressure to keep team members operating between the white lines. This is especially true when a company has the information systems capability to monitor team performance daily or in real time.

USING REWARDS AND INCENTIVES TO PROMOTE BETTER STRATEGY EXECUTION

It is essential that company personnel be committed to executing strategy successfully and achieving performance targets. Enlisting such commitment typically requires use of an assortment of motivational techniques and rewards. Indeed, *an effectively*

LO 11-5

Explain how and why the use of well-designed incentives can be management's single most powerful tool for promoting adept operating excellence.

designed incentive and reward structure is the single most powerful tool management has for mobilizing employee commitment to successful strategy execution. But incentives and rewards do more than just strengthen the resolve of company personnel to succeed—they also focus employees' attention on the accomplishment of specific strategy execution objectives. Not only do they spur the efforts of individuals to achieve those aims, but they also help coordinate the activities of individuals throughout the organization by aligning their personal motives with the goals of the organization. In this manner, reward systems serve as an indirect type of control mechanism that conserves on the more costly control mechanism of supervisory oversight.

To win employees' sustained, energetic commitment to the strategy execution process, management must be resourceful in designing and using motivational incentives—*both monetary and nonmonetary.* The more a manager understands what motivates subordinates and the more they rely on motivational incentives as a tool for achieving the targeted strategic and financial results, the greater will be employees' commitment to good day-in, day-out strategy execution and the achievement of performance targets.[20]

A properly designed incentive and reward structure is management's single most powerful tool for gaining employee commitment to successful strategy execution and excellent operating results.

Incentives and Motivational Practices That Facilitate Good Strategy Execution

CORE CONCEPT

Financial rewards provide **high-powered incentives** when rewards are tied to specific outcome objectives.

Financial incentives generally head the list of motivating tools for gaining wholehearted employee commitment to good strategy execution and focusing attention on strategic priorities. Generous financial rewards always catch employees' attention and produce *high-powered incentives* for individuals to exert their best efforts. A company's package of monetary rewards typically includes some combination of base-pay increases, performance bonuses, profit-sharing plans, stock awards, company contributions to employee 401(k) or retirement plans, and piecework incentives based on the amount a worker produces (in the case of production workers). But most successful companies and managers also make extensive use of nonmonetary incentives. Some of the most important nonmonetary approaches companies can use to enhance employee motivation include the following:[21]

- *Providing attractive perks and fringe benefits.* The various options include coverage of health insurance premiums, wellness programs, college tuition reimbursement, generous paid vacation time, onsite child care, onsite fitness centers and massage services, opportunities for getaways at company-owned recreational facilities, personal concierge services, subsidized cafeterias and free lunches, casual dress every day, personal travel services, paid sabbaticals, maternity and paternity leaves, paid leaves to care for ill family members, telecommuting, compressed workweeks (four 10-hour days instead of five 8-hour days), flextime (variable work schedules that accommodate individual needs), college scholarships for children, and relocation services.
- *Giving awards and public recognition to high performers and showcasing company successes.* Many companies hold award ceremonies to honor top-performing individuals, teams, and organizational units and to celebrate important company milestones and achievements. Others make a special point of recognizing the outstanding accomplishments of individuals, teams, and organizational units at informal company gatherings or in the company newsletter. Such actions foster a positive *esprit de corps* within the organization and may also act to spur healthy competition among units and teams within the company.

- *Relying on promotion from within whenever possible.* This practice helps bind workers to their employer, and employers to their workers. Moreover, it provides strong incentives for good performance. Promoting from within also helps ensure that people in positions of responsibility have knowledge specific to the business, technology, and operations they are managing.
- *Inviting and acting on suggestions from employees.* Many companies find that their best ideas for nuts-and-bolts operating improvements come from the suggestions of employees. Moreover, research indicates that giving decision-making power to down-the-line employees increases their motivation and satisfaction as well as their productivity. The use of self-managed teams has much the same effect.
- *Creating a work atmosphere in which there is genuine caring and mutual respect among workers and between management and employees.* A "family" work environment where people are on a first-name basis and there is strong camaraderie promotes teamwork and cross-unit collaboration.
- *Stating the strategic vision in inspirational terms that make employees feel they are a part of something worthwhile in a larger social sense.* There's strong motivating power associated with giving people a chance to be part of something exciting and personally satisfying. Jobs with a noble purpose tend to inspire employees to give their all. As described in Chapter 2, this not only increases productivity but reduces turnover and lowers costs for staff recruitment and training as well.
- *Sharing information with employees about financial performance, strategy, operational measures, market conditions, and competitors' actions.* Broad disclosure and prompt communication send the message that managers trust their workers and regard them as valued partners in the enterprise. Keeping employees in the dark denies them information useful to performing their jobs, prevents them from being intellectually engaged, saps their motivation, and detracts from performance.
- *Providing an appealing working environment.* An appealing workplace environment can have decidedly positive effects on employee morale and productivity. Providing a comfortable work environment, designed with ergonomics in mind, is particularly important when workers are expected to spend long hours at work. But some companies go beyond the mundane to design exceptionally attractive work settings. The workspaces and surrounding parklands of Apple's multibillion dollar campus headquarters were designed to inspire Apple's people, foster innovative collaboration, while also benefiting the environment. Employees have access to a 100,000-square-foot fitness center, two miles of walking and running paths, an orchard, meadow, and pond as well as community bicycles, electric golf carts, and commuter shuttles for getting around. Defense contractor Oshkosh Corporation has also opened dramatic new global headquarters recently.

For a specific example of the motivational tactics employed by one of the best companies to work for in America, see Illustration Capsule 11.2 on the supermarket chain Wegmans.

Striking the Right Balance between Rewards and Punishment

While most approaches to motivation, compensation, and people management accentuate the positive, companies also make it clear that lackadaisical or indifferent effort and subpar performance can result in negative consequences. At General Electric,

ILLUSTRATION CAPSULE 11.2 How Wegmans Rewards and Motivates Its Employees

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Companies use a variety of tools and strategies designed to motivate employees and engender superior strategy execution. In this respect, Wegmans Food Markets, Inc. serves as an exemplar. With approximately 53,000 employees spread across more than 100 stores across the Northeast and Mid-Atlantic, Wegmans stands out as an organization that delivers above-average results in an industry known for its low margins, low wages, and challenging employee relationships. Guided by a philosophy of *employees first,* Wegmans employs an array of programs that enables the company to attract and retain the best people.

Since the creation of its broad benefits program for full-time employees in the 1950s, Wegmans has had a strong benefits philosophy. Today, flexible or compressed schedules are common, and policies extend to same-sex partners. Regarding financial compensation, wages are above average for the grocery retail industry, which also has an added benefit of keeping its workforce nonunionized.

In addition to the traditional elements of compensation and benefits, Wegmans invests considerably in the training and education of its employees. Known for its strength in employee development, upwards of $50 million annually is spent on employee learning. Since 1984, the company has awarded over $135 million in scholarships to more than 44,000 Wegmans employees.

Another crucial aspect of employee motivation is feeling heard. Employees see their ideas put into action through a series of programs designed to capture and implement their ideas. Wegmans deploys a series of programs, including open-door days, team huddles, focus groups, and two-way Q&As with senior management.

With the recognition that employees are critical to delivering a great customer experience, Wegmans directs a considerable amount of resources to its biggest asset, its people. Its suite of programs and benefits, along with a policy of filling at least half of its open opportunities internally, lead to one of the lowest turnover rates in its industry. They have also resulted in Wegmans placing among the top five firms on Fortune's list of *The 100 Best Companies to Work For* year after year.

Note: Developed with Sadé M. Lawrence.

Sources: Company website accessed 10/17/23; Boyle, M., *The Wegmans Way,* January 24, 2005, **http://archive.fortune.com/magazines/fortune/fortune_archive/2005/01/24/8234048/index.htm**; "Great Place to Work," *Wegmans Food Markets, Inc.—Great Place to Work Reviews,* February 14, 2018, **http://reviews.greatplacetowork.com/wegmans-food-markets-inc**.

McKinsey & Company, several global public accounting firms, and other companies that look for and expect top-notch individual performance, there's an "up-or-out" policy—managers and professionals whose performance is not good enough to warrant promotion are first denied bonuses and stock awards and eventually weeded out. At most companies, senior executives and key personnel in underperforming units are pressured to raise performance to acceptable levels and keep it there or risk being replaced.

As a general rule, it is unwise to take off the pressure for good performance or play down the adverse consequences of shortfalls in performance. There is scant evidence that a no-pressure, no-adverse-consequences work environment leads to superior strategy execution or operating excellence. As the CEO of a major bank put it, "There's a deliberate policy here to create a level of anxiety. Winners usually play like they're one touchdown behind."[22] A number of companies deliberately give employees heavy workloads and tight deadlines to test their mettle—personnel are pushed hard to achieve "stretch" objectives and are expected to put in long hours (nights and weekends if need be). High-performing organizations nearly always have a cadre of ambitious people who relish the opportunity to climb the ladder of success, love a challenge, thrive in a performance-oriented environment, and find some competition and pressure useful to satisfy their own drives for personal recognition, accomplishment, and self-satisfaction.

However, if an organization's motivational approaches and reward structure induce too much stress, internal competitiveness, job insecurity, and fear of unpleasant consequences, the impact on workforce morale and strategy execution can be counterproductive. Evidence shows that managerial initiatives to improve strategy execution should incorporate more positive than negative motivational elements because when cooperation is positively enlisted and rewarded, rather than coerced by orders and threats (implicit or explicit), people tend to respond with more enthusiasm, dedication, creativity, and initiative.[23]

Linking Rewards to Achieving the Right Outcomes

To create a strategy-supportive system of rewards and incentives, a company must reward people for accomplishing results, related to creating value for customers, not for just dutifully performing assigned tasks. Showing up for work and performing assignments do not, by themselves, guarantee desired results. To make the work environment results-oriented, managers need to focus jobholders' attention and energy on what to *achieve* as opposed to what to *do.*[24] Employee productivity among employees at Best Buy's corporate headquarters rose by 35 percent after the company began to focus on the results of each employee's work rather than on employees' willingness to come to work early and stay late.

> Incentives must be based on accomplishing results, not on dutifully performing assigned tasks.

Ideally, every organizational unit, every manager, every team or work group, and every employee should be held accountable for achieving outcomes that contribute to good strategy execution and business performance. If the company's strategy is to be a low-cost leader, the incentive system must reward actions and achievements that result in lower costs. If the company has a differentiation strategy focused on delivering superior quality and service, the incentive system must reward such outcomes as Six Sigma defect rates, infrequent customer complaints, speedy order processing and delivery, and high levels of customer satisfaction. If a company's growth is predicated on a strategy of new product innovation, incentives should be tied to such metrics as the percentages of revenues and profits coming from newly introduced products.

Incentive compensation for top executives is typically tied to such financial measures as revenue and earnings growth, stock price performance, return on investment, and creditworthiness or to strategic measures such as market share growth. However, incentives for department heads, teams, and individual workers tend to be tied to performance outcomes more closely related to their specific area of responsibility. For instance, in manufacturing, it makes sense to tie incentive compensation to such outcomes as unit manufacturing costs, on-time production and shipping, defect rates, the number and extent of work stoppages due to equipment breakdowns, and so on. In sales and marketing, incentives tend to be based on achieving dollar sales or unit volume targets, market share, sales penetration of each target customer group, the fate of newly introduced products, the frequency of customer complaints, the number of new accounts acquired, and measures of customer satisfaction. Which performance measures to base incentive compensation on depends on the situation—the priority placed on various financial and

The first principle in designing an effective incentive compensation system is to tie rewards to performance outcomes directly linked to good strategy execution and the achievement of financial and strategic objectives.

strategic objectives, the requirements for strategic and competitive success, and the specific results needed to keep strategy execution on track.

Additional Guidelines for Designing Incentive Compensation Systems It is not enough to link incentives to the right kinds of results—performance outcomes that signal that the company's strategy and its execution are on track. For a company's reward system to truly motivate organization members, inspire their best efforts, and sustain high levels of productivity, it is also important to observe the following additional guidelines in designing and administering the reward system:

- *Make the performance payoff a major, not minor, piece of the total compensation package.* Performance bonuses must be at least 10 to 12 percent of base salary to have much impact. Incentives that amount to 20 percent or more of total compensation are big attention-getters, likely to really drive individual or team efforts. Incentives amounting to less than five percent of total compensation have a comparatively weak motivational impact. Moreover, the payoff for high-performing individuals and teams must be meaningfully greater than the payoff for average performers, and the payoff for average performers meaningfully bigger than that for below-average performers.
- *Have incentives that extend to all managers and all workers, not just top management.* It is a gross miscalculation to expect that lower-level managers and employees will work their hardest to hit performance targets if only senior executives qualify for lucrative rewards. Excessive executive pay has produced outrage among workers and the populace at large.
- *Administer the reward system with scrupulous objectivity and fairness.* If performance standards are set unrealistically high or if individual and group performance evaluations are not accurate and well documented, dissatisfaction with the system will overcome any positive benefits.
- *Ensure that the performance targets set for each individual or team involve outcomes that the individual or team can personally affect.* The role of incentives is to enhance individual commitment and channel behavior in beneficial directions. This role is not well served when the performance measures by which company personnel are judged are outside their arena of influence.
- *Keep the time between achieving the performance target and receiving the reward as short as possible.* Nucor, a leading producer of steel products, has achieved high labor productivity by paying its workers weekly bonuses based on prior-week production levels. Annual bonus payouts work best for higher-level managers and for situations where the outcome target relates to overall company profitability.
- *Avoid rewarding effort rather than results.* While it is tempting to reward people who have tried hard, gone the extra mile, and yet fallen short of achieving performance targets because of circumstances beyond their control, it is ill advised to do so. The problem with making exceptions for unknowable, uncontrollable, or unforeseeable circumstances is that once "good excuses" start to creep into justifying rewards for subpar results, the door opens to all kinds of reasons why actual performance has failed to match targeted performance. A "no excuses" standard is more evenhanded, easier to administer, and more conducive to creating a results-oriented work climate.

For an organization's incentive system to work well, the details of the reward structure must be communicated and explained. Everybody needs to understand how their incentive compensation is calculated and how individual and group performance targets contribute to organizational performance targets. The pressure to achieve the targeted financial and strategic performance objectives and continuously improve on strategy execution should be unrelenting. People at all levels must be held accountable for carrying out their assigned parts of the strategic plan, and they must understand that their rewards are based on the caliber of results achieved. But with the pressure to perform should come meaningful rewards. Without an attractive payoff, the system breaks down, and managers are left with the less workable options of issuing orders, trying to enforce compliance, and depending on the goodwill of employees.

The unwavering standard for judging whether individuals, teams, and organizational units have done a good job must be whether they meet or beat performance targets that reflect good strategy execution.

KEY POINTS

1. Implementing a new or different strategy calls for managers to identify the resource requirements of each new strategic initiative and then consider whether the current pattern of resource allocation and the budgets of the various subunits are suitable.
2. Company policies and procedures facilitate strategy execution when they are designed to fit the strategy and its objectives. Anytime a company alters its strategy, managers should review existing policies and operating procedures and replace those that are out of sync. Well-conceived policies and procedures aid the task of strategy execution by (1) providing top-down guidance to company personnel regarding how things need to be done and what the limits are on independent actions and (2) enforcing consistency in the performance of strategy-critical activities, thereby improving the quality of the strategy execution effort and coordinating the efforts of company personnel, however widely dispersed.
3. Competent strategy execution entails visible unyielding managerial commitment to continuous improvement. Business process management tools, such as business-process reengineering, total quality management (TQM), and Six Sigma programs are important management tools for promoting better strategy execution.
4. Company strategies can't be implemented or executed well without well-conceived internal systems to support daily operations. Real-time information systems and control systems further aid the cause of good strategy execution. In some cases, state-of-the-art operating and information systems strengthen a company's strategy execution capabilities enough to provide a competitive edge over rivals.
5. Strategy-supportive motivational practices and reward systems are powerful management tools for gaining employee commitment and focusing their attention on the strategy execution goals. The key to creating a reward system that promotes good strategy execution is to make measures of good business performance and good strategy execution the *dominating basis* for designing incentives, evaluating individual and group efforts, and handing out rewards. While financial rewards provide high-powered incentives, nonmonetary incentives are also important. For an incentive compensation system to work well, (1) the performance payoff should be a major percentage of the compensation package, (2) the use of incentives should extend to all managers and workers, (3) the system should be administered with objectivity and fairness, (4) each individual's performance targets should involve outcomes the person can personally affect, (5) rewards should promptly follow the achievement of performance targets, and (6) rewards should be given for results and not just effort.

ASSURANCE OF LEARNING EXERCISES

LO 11-1

1. Implementing a new or different strategy calls for new resource allocations. Using your university's library resources search for recent articles that discuss how a company has revised its pattern of resource allocation and divisional budgets to support new strategic initiatives. Prepare a one-page report on what you learned.

LO 11-2

2. Netflix avoids the use of formal policies and procedures to better empower its employees to maximize innovation and productivity. The company goes to great lengths to hire, reward, and tolerate only what it considers mature, "A" player employees. How does the company's selection process affect its ability to operate without formal travel and expense policies, a fixed number of vacation days for employees, or a formal employee performance evaluation system?

connect
LO 11-3

3. Illustration Capsule 11.1 discusses Charleston Area Medical Center's use of Six Sigma practices. List three tangible benefits provided by the program. Explain why a commitment to quality control is particularly important in the hospital industry. How can the use of a Six Sigma program help medical providers survive and thrive in the current industry climate?

LO 11-3

4. Read two of the Six Sigma articles found at **www.isixsigma.com** on the sidebar labeled "Recent Posts." Prepare a one-page report to your instructor detailing how Six Sigma is being used in two companies and what benefits the companies are reaping as a result. Further, discuss at least one criticism of, or potential difficulties with, Six Sigma implementation.

LO 11-4

5. Company strategies can't be executed well without a number of support systems to carry on business operations. Using your university's library resources, search for recent articles that discuss how a company has used real-time information systems and control systems to aid the cause of good strategy execution. Provide a one-page summary of your findings.

connect
LO 11-5

6. Illustration Capsule 11.2 provides a description of the motivational practices employed by Wegmans Food Markets, a supermarket chain that is routinely listed as among the top five companies to work for in the United States. Discuss how rewards and practices at Wegman's aid in the company's strategy execution efforts.

EXERCISES FOR SIMULATION PARTICIPANTS

connect

LO 11-1

1. What are the ways that resource allocation contributes to good strategy execution and improved company performance.

LO 11-2, LO 11-3, LO 11-4

2. What actions, if any, is your company taking to pursue continuous improvement in how it performs certain value chain activities?

LO 11-3

3. Are benchmarking data available in the simulation exercise in which you are participating? If so, do you and your co-managers regularly study the benchmarking data to see how well your company is doing? Do you consider the benchmarking information provided to be valuable? Why or why not? Cite three recent instances in which your examination of the benchmarking statistics has caused you and your co-managers to take corrective actions to improve operations and boost company performance.

4. What hard evidence can you cite that indicates your company's management team is doing a *better* or *worse* job of achieving operating excellence and executing strategy than are the management teams at rival companies? **LO 11-3**
5. Are you and your co-managers consciously trying to achieve operating excellence? Explain how you are doing this and how you will track the progress you are making. **LO 11-2, LO 11-3, LO 11-4**
6. What are ways that incentive compensation can affect productivity gains and lower labor cost per unit? **LO 11-5**

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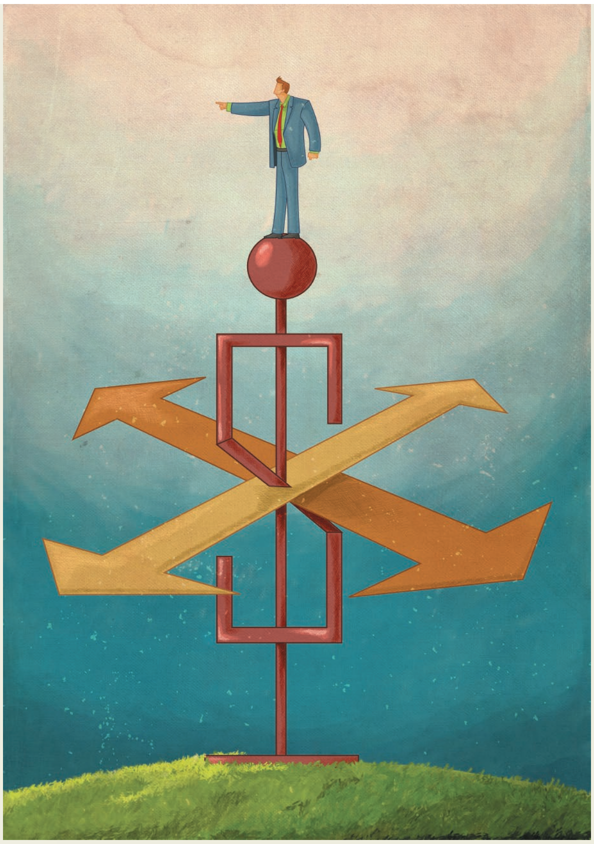
chapter **12**

Corporate Culture and Leadership

Keys to Good Strategy Execution



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Learning Objectives

After reading this chapter, you should be able to

LO 12-1 Understand the key features of a company's corporate culture and the role of a company's core values and ethical standards in building corporate culture.

LO 12-2 Explain how and why a company's culture can aid the drive for proficient strategy execution.

LO 12-3 Identify the kinds of actions management can take to change a problem corporate culture.

LO 12-4 Recognize what constitutes effective managerial leadership in achieving superior strategy execution.

Those who lead with empathy will discover new possibilities to innovate for their customers while simultaneously building inclusive organizations.

Vijay Govindarajan—*Professor and Consultant*

It's simple: Enable somebody else's success. Be a good person, be a good partner, care about them and really mean it. When you do that, you'll be surprised at the success you can have as a team.

Beth Ford—*CEO of Land O'Lakes, on Leadership*

The cliché is that organizations get the behaviors they pay for. Great organizations build a culture where their people enact desired behaviors without direct compensation. The investment is in the macro-culture – not micro-payments.

Alva H. Taylor—*Professor and Consultant*

In the previous two chapters, we examined eight of the managerial tasks that drive good strategy execution: staffing the organization, acquiring the needed resources and capabilities, designing the organizational structure, allocating resources, establishing policies and procedures, employing process management tools, installing operating systems, and providing the right incentives. In this chapter, we explore the two remaining managerial tasks that contribute to good strategy execution: creating a supportive corporate culture and leading the strategy execution process.

INSTILLING A CORPORATE CULTURE CONDUCIVE TO GOOD STRATEGY EXECUTION

CORE CONCEPT

Corporate culture refers to the shared values, ingrained attitudes, core beliefs, and company traditions that determine norms of behavior, accepted work practices, and styles of operating.

LO 12-1

Understand the key features of a company's corporate culture and the role of a company's core values and ethical standards in building corporate culture.

Every company has its own unique **corporate culture**—the shared values, ingrained attitudes, and company traditions that determine norms of behavior, accepted work practices, and styles of operating—and that shapes the company's internal work climate.[1] The character of a company's culture is a product of the company's core values, the standards of what is ethically acceptable and what is not, the "chemistry" and the "personality" that permeate the work environment, the company's traditions, and the stories that get told over and over to illustrate and reinforce the company's values, business practices, and traditions. In a very real sense, the culture is the company's automatic, self-replicating "operating system" that defines "how we do things around here."[2] It can be thought of as the company's psyche or *organizational DNA*.[3] A company's culture is important because it influences the organization's internal work climate, actions, and approaches to conducting business. As such, it plays an important role in strategy execution and may have an appreciable effect on business performance as well.

Corporate cultures vary widely. For instance, the bedrock of Walmart's culture is dedication to customer satisfaction, zealous pursuit of low costs and frugal operating practices, a strong work ethic, ritualistic headquarters meetings to exchange ideas and review problems, and company executives' commitment to visiting stores, listening to customers, and soliciting suggestions from employees. The culture at Apple is customer-centered, supportive of innovation and creativity, secretive, and highly protective of company-developed technology. Apple employees share a common goal of making the best products for the consumer; the aim is to make the customer feel delight, surprise, and connection to each Apple device. The company expects creative thinking and inspired solutions from everyone—as the company puts it, "We're perfectionists. Idealists. Inventors. Forever tinkering with products and processes, always on the lookout for better." According to a former employee, "Apple is one of those companies where people work on an almost religious level of commitment." To spur innovation and creativity, the company fosters extensive collaboration and cross-pollination among different work groups. But it does so in a manner that demands secrecy—employees are expected not to reveal anything relevant about what new project they are working on, not to employees outside their immediate work group and especially not to family members or other outsiders; it is common for different employees working on the same project to be assigned different project code names. The different pieces of a new product launch often come together like a puzzle at the last minute.[4] W. L. Gore & Associates, best known for GORE-TEX, credits its unique culture for allowing the company to pursue multiple end-market applications simultaneously, enabling rapid growth from a niche business into a diversified multinational company. The company's culture is team-based and designed to foster personal initiative, with no traditional organizational charts, no chains of command, no predetermined channels of communication. The culture encourages multidiscipline teams to organize around opportunities, and in the process, leaders emerge. At Nordstrom, the corporate culture is centered on delivering exceptional service to customers, where the company's motto is "Respond to unreasonable customer requests," and each out-of-the-ordinary request is seen as an opportunity for a "heroic" act by an employee that can further the company's reputation for unparalleled customer service. Nordstrom makes a point of promoting employees noted for their heroic acts and dedication to outstanding service.

Identifying the Key Features of a Company's Corporate Culture

A company's corporate culture is mirrored in the character or "personality" of its work environment–the features that describe how the company goes about its business and the workplace behaviors that are held in high esteem. Some of these features are readily apparent, and others operate quite subtly. The chief things to look for include

- The values, business principles, and ethical standards that management preaches and *practices*–these are the key to a company's culture, but actions speak much louder than words here.
- The company's approach to people management and the official policies, procedures, and operating practices that provide guidelines for the behavior of company personnel.
- The atmosphere and spirit that pervades the work climate–whether the workplace is competitive or cooperative, innovative or resistant to change, collegial or politicized, all business or fun-loving, and the like.
- How managers and employees interact and relate to one another–whether there is heavy or weak reliance on collaboration and teamwork, whether communications among employees are free-flowing or restrictive and infrequent, whether employees are empowered to exercise their initiative or whether actions are directed mostly by higher authority, whether co-workers spend little or lots of time together outside the workplace, and so on.
- The strength of peer pressure to do things in particular ways and conform to expected norms.
- The actions and behaviors that management explicitly encourages and rewards and those that are frowned upon.
- The company's revered traditions and oft-repeated stories that exemplify the culture and describe "how we do things around here."
- The manner in which the company deals with external stakeholders–whether it treats suppliers as business partners or prefers hard-nosed, arm's-length business arrangements and whether its commitment to corporate citizenship and environmental sustainability is strong and genuine.

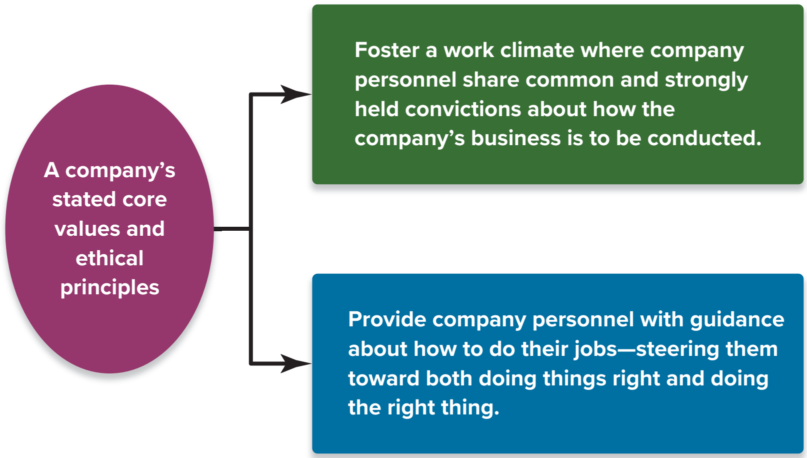
The values, beliefs, and practices that undergird a company's culture can come from anywhere in the organizational hierarchy. Typically, key elements of the culture originate with a founder or certain strong leaders who articulated them as a set of business principles, company policies, operating approaches, and ways of dealing with employees, customers, vendors, shareholders, and local communities where the company has operations. They also stem from exemplary actions on the part of company personnel and evolving consensus about "how we ought to do things around here."[5] Over time, these cultural underpinnings take root, come to be accepted by company managers and employees alike, and become ingrained in the way the company conducts its business.

A company's culture is grounded in and shaped by its core values and ethical standards.

The Role of Core Values and Ethics The foundation of a company's corporate culture nearly always resides in its dedication to certain core values and the bar it sets for ethical behavior. The culture-shaping significance of core values and ethical behaviors accounts for why so many companies have developed a formal value statement and a code of ethics. Many executives want the work climate at their

A company's value statement and code of ethics communicate expectations of how employees should conduct themselves in the workplace.

FIGURE 12.1 The Two Culture-Building Roles of a Company's Core Values and Ethical Standards



companies to mirror certain values and ethical standards, partly because of personal convictions but mainly because they are convinced that adherence to such principles will promote better strategy execution, make the company a better performer, and positively impact its reputation.[6] Not incidentally, strongly ingrained values and ethical standards reduce the likelihood of lapses in ethical behavior that mar a company's public image and put its financial performance and market standing at risk.

As depicted in Figure 12.1, a company's stated core values and ethical principles have two roles in the culture-building process. First, they can foster a work climate in which company personnel share strongly held convictions about how the company's business is to be conducted. Second, they provide company personnel with guidance about the manner in which they are to do their jobs–which behaviors and ways of doing things are approved (and expected) and which are out-of-bounds. These value-based and ethics-based cultural norms serve as yardsticks for gauging the appropriateness of particular actions, decisions, and behaviors, thus helping steer company personnel toward both doing things right and doing the right thing.

Embedding Behavioral Norms in the Organization and Perpetuating the Culture Once values and ethical standards have been formally adopted, they must be institutionalized in the company's policies and practices and embedded in the conduct of company personnel. This can be advanced in a number of different ways.[7] Tradition-steeped companies with a rich folklore rely heavily on word-of-mouth indoctrination and the power of tradition to instill values and enforce ethical conduct. But most companies employ a variety of techniques, drawing on some or all of the following:

1. Screening applicants and hiring those who will mesh well with the culture.
2. Incorporating discussions of the company's culture and behavioral norms into orientation programs for new employees and training courses for managers and employees.
3. Having senior executives frequently reiterate the importance and role of company values and ethical principles at company events and in internal communications to employees.

4. Expecting managers at all levels to be cultural role models and exhibit the advocated cultural norms in their own behavior.
5. Making the display of cultural norms a factor in evaluating each person's job performance, granting compensation increases, and offering promotions.
6. Stressing that line managers all the way down to first-level supervisors give ongoing attention to explaining the desired cultural traits and behaviors in their areas and clarifying why they are important.
7. Encouraging company personnel to exert strong peer pressure on co-workers to conform to expected cultural norms.
8. Holding periodic ceremonies to honor people who excel in displaying the company values and ethical principles.

To deeply ingrain the stated core values and high ethical standards, companies must turn them into *strictly enforced cultural norms.* They must make it unequivocally clear that living up to the company's values and ethical standards has to be "a way of life" at the company and that there will be little toleration for errant behavior.

The Role of Stories Frequently, a significant part of a company's culture is captured in the stories that get told over and over again to illustrate to newcomers the importance of certain values and the depth of commitment that various company personnel have displayed. One of the folktales at Zappos, known for its outstanding customer service, is about a customer who ordered shoes for her ill mother from Zappos, hoping the shoes would remedy her mother's foot pain and numbness. When the shoes didn't work, the mother called the company to ask how to return them and explain why she was returning them. Two days later, she received a large bouquet of flowers from the company, along with well wishes and a customer upgrade giving her free expedited service on all future orders. Specialty food market Trader Joe's is similarly known for its culture of going beyond the call of duty for its customers. When a World War II veteran was snowed in without any food for meals, her son called several supermarkets to see if they offered grocery delivery. Although Trader Joe's technically doesn't offer delivery, it graciously helped the veteran, even recommending items for her low-sodium diet. When the store delivered the groceries, the veteran wasn't charged for either the groceries or the delivery. Stories of employees at Ritz-Carlton going the extra mile for customers both showcase and reinforce its customer-centric culture. Recently, a family arrived at a Ritz-Carlton only to find that the specialized eggs and milk they had brought along for their son had spoiled. (The child had food allergies.) When the products could not be found locally, the hotel's staff had the products flown in from Singapore, approximately 1,050 miles away!

Forces That Cause a Company's Culture to Evolve Despite the role of time-honored stories and long-standing traditions in perpetuating a company's culture, cultures are far from static–just like strategy and organizational structure, they evolve. New challenges in the marketplace, revolutionary technologies, and shifting internal conditions–especially an internal crisis, a change in company direction, or top-executive turnover–tend to breed new ways of doing things and, in turn, drive cultural evolution. An incoming CEO who decides to shake up the existing business and take it in new directions often triggers a cultural shift, perhaps one of major proportions. Likewise, diversification into new businesses, expansion into foreign countries, rapid growth that brings an influx of new employees, and the merger with or acquisition of another company can all precipitate significant cultural change. Evolving attitudes in society at large, such as increasing concern about environmental sustainability, can also affect the evolution of corporate cultures.

The Presence of Company Subcultures Although it is common to speak about corporate culture in the singular, it is not unusual for companies to have multiple cultures (or subcultures). Values, beliefs, and practices within a company sometimes vary significantly by department, geographic location, division, or business unit. Subcultures can exist because a company has recently acquired other companies. Global and multinational companies tend to be at least partly multicultural because cross-country organization units have different operating histories and work climates, as well as members who speak different languages, have grown up under different social customs and traditions, and have different sets of values and beliefs. The problem with subcultures is that they can clash, or at least not mesh well, particularly if they embrace conflicting business philosophies or operating approaches, if key executives employ different approaches to people management, or if important differences between a company's culture and those of recently acquired companies have not yet been ironed out. On a number of occasions, companies have decided not to acquire particular companies because of culture conflicts they believed would be hard to resolve.

Nonetheless, the existence of subcultures does not preclude important areas of commonality and compatibility. Company managements are quite alert to the importance of cultural compatibility in making acquisitions and the need to integrate the cultures of newly acquired companies. Indeed, cultural due diligence is often as important as financial due diligence in deciding whether to go forward on an acquisition or merger. Also, in today's globalizing world, multinational companies are learning how to make strategy-critical cultural traits travel across country boundaries and create a workably uniform culture worldwide. AES Corporation, a sustainable energy company with more than 9,000 employees and operations on four continents, has found that people in most countries readily embrace the five core values that underlie its culture–putting safety first, acting with integrity, remaining nimble, having fun through work, and striving for excellence. Moreover, AES tries to define and practice its cultural values the same way in all of its locations while still being sensitive to differences that exist among various peoples and groups around the world. Top managers at AES have expressed the view that people across the globe are more similar than different and that the company's culture is as meaningful in Brazil, Vietnam, or Kazakhstan as in the United States.

Strong versus Weak Cultures

Company cultures vary widely in strength and influence. Some are strongly embedded and have a big influence on a company's operating practices and the behavior of company personnel. Others are weakly ingrained and have little effect on internal work climate, behaviors, and how company activities are conducted.

Strong-Culture Companies The hallmark of a **strong-culture company** is the dominating presence of certain deeply rooted values, business principles, and behavioral norms that "regulate" the conduct of company personnel and determine the climate of the workplace.[8] In strong-culture companies, senior managers make a point of explaining and reiterating why these values, principles, norms, and operating approaches need to govern how the company conducts its business and how they ultimately lead to better business performance. Furthermore, they make a conscious effort to display these values, principles, and behavioral norms in their own actions–*they walk the talk.* An unequivocal expectation that company personnel will act and behave in accordance with the adopted values and ways of doing business leads to two important outcomes: (1) Over time, the professed values come

CORE CONCEPT

In a **strong-culture company,** deeply rooted values and norms of behavior are widely shared and regulate the conduct of the company's business.

to be widely shared by rank-and-file employees–people who dislike the culture tend to leave and (2) individuals encounter strong peer pressure from co-workers to observe the culturally approved norms and behaviors. Hence, a strongly implanted corporate culture ends up having a powerful influence on behavior because so many company personnel are accepting of the company's culturally approved traditions and because this acceptance is reinforced by both management expectations and co-worker peer pressure to conform to cultural norms.

Strong cultures emerge only after a period of deliberate and rather intensive culture building that generally takes years (sometimes decades). Two factors contribute to the development of strong cultures: (1) a founder or strong leader who established core values, principles, and practices that are viewed as having contributed to the success of the company and (2) a sincere, long-standing company commitment to operating the business according to these established traditions and values. Continuity of leadership, low workforce turnover, geographic concentration, and considerable organizational success all contribute to the emergence and sustainability of a strong culture.[9]

In strong-culture companies, values and behavioral norms are so ingrained that they can endure leadership changes at the top–although their strength can erode over time if new CEOs cease to nurture them or move aggressively to institute cultural adjustments. The cultural norms in a strong-culture company typically do not change much as strategy evolves, either because the culture constrains the choice of new strategies or because the dominant traits of the culture are somewhat strategy-neutral and compatible with evolving versions of the company's strategy. As a consequence, *strongly implanted cultures provide a great deal of help in executing strategy* because company managers can use the traditions, beliefs, values, common bonds, or behavioral norms as levers to mobilize commitment to executing the chosen strategy.

Weak-Culture Companies In direct contrast to strong-culture companies, weak-culture companies lack widely shared and strongly held values, principles, and behavioral norms. They might have the elements of a culture listed on paper, but it has little real effect on the organization. As a result, they lack cultural mechanisms for aligning, constraining, and regulating the actions, decisions, and behaviors of company personnel. In the absence of any long-standing top management commitment to particular values, beliefs, operating practices, and behavioral norms, individuals encounter little pressure to do things in particular ways. Such a dearth of companywide cultural influences and revered traditions produces a work climate where there is no strong employee allegiance to what the company stands for or to operating the business in well-defined ways. While individual employees may well have some bonds of identification with and loyalty toward their department, their colleagues, their union, or their immediate boss, there's neither passion about the company nor emotional commitment to what it is trying to accomplish—a condition that often results in many employees' viewing their company as just a place to work and their job as just a way to make a living.

As a consequence, *weak cultures provide little or no assistance in executing strategy* because there are no traditions, beliefs, values, common bonds, or behavioral norms that management can use as levers to mobilize commitment to executing the chosen strategy. Without a work climate that channels organizational energy in the direction of good strategy execution, managers are left with the options of either using compensation incentives and other motivational devices to mobilize employee commitment, supervising and monitoring employee actions more closely, or trying to establish cultural roots that will in time start to nurture the strategy execution process.

Why Corporate Cultures Matter to the Strategy Execution Process

LO 12-2

Explain how and why a company's culture can aid the drive for proficient strategy execution.

Even if a company has a strong culture, the culture and internal work climate may or may not be compatible with what is needed for effective execution of the chosen strategy. When a company's present culture promotes attitudes, behaviors, and ways of doing things that are *in sync with the chosen strategy and conducive to first-rate strategy execution,* the culture functions as a valuable ally in the strategy execution process. For example, a corporate culture characterized by frugality and thrift prompts employee actions to identify cost-saving opportunities–the very behavior needed for successful execution of a low-cost leadership strategy. A culture that celebrates taking initiative, exhibiting creativity, taking risks, and embracing change is conducive to successful execution of product innovation and technological leadership strategies.[10]

A culture that is grounded in actions, behaviors, and work practices that are conducive to good strategy implementation supports the strategy execution effort in three ways:

1. *A culture that is well matched to the chosen strategy and the requirements of the strategy execution effort focuses the attention of employees on what is most important to this effort.* Moreover, it directs their behavior and serves as a guide to their decision making. In this manner, it can align the efforts and decisions of employees throughout the firm and minimize the need for direct supervision.
2. *Culture-induced peer pressure further induces company personnel to do things in a manner that aids the cause of good strategy execution.* The stronger the culture (the more widely shared and deeply held the values), the more effective peer pressure is in shaping and supporting the strategy execution effort. Research has shown that strong group norms can shape employee behavior even more powerfully than can financial incentives.
3. *A company culture that is consistent with the requirements for good strategy execution can energize employees, deepen their commitment to execute the strategy flawlessly, and enhance worker productivity in the process.* When a company's culture is grounded in many of the needed strategy-executing behaviors, employees feel genuinely better about their jobs, the company they work for, and the merits of what the company is trying to accomplish. Greater employee buy-in for what the company is trying to accomplish boosts motivation and marshals organizational energy behind the drive for good strategy execution. An energized workforce enhances the chances of achieving execution-critical performance targets and good strategy execution.

In sharp contrast, when a culture is in conflict with the chosen strategy or what is required to execute the company's strategy well, the culture becomes a stumbling block.[11] Some of the very behaviors needed to execute the strategy successfully run contrary to the attitudes, behaviors, and operating practices embedded in the prevailing culture. Such a clash poses a real dilemma for company personnel. Should they be loyal to the culture and company traditions (to which they are likely to be emotionally attached) and thus resist or be indifferent to actions that will promote better strategy execution–a choice that will certainly weaken the drive for good strategy execution? Alternatively, should they go along with management's strategy execution effort and engage in actions that run counter to the culture–a choice that will likely impair morale and lead to a less-than-enthusiastic commitment to good strategy execution? Neither choice leads to desirable outcomes. Culture-bred resistance to the actions and behaviors needed for good strategy execution, particularly if strong and widespread, poses a formidable hurdle that must be cleared for a strategy's execution to be successful.

A strong culture that encourages actions, behaviors, and work practices that are in sync with the chosen strategy is a valuable ally in the strategy execution process.

It is in management's best interest to dedicate considerable effort to establishing a corporate culture that encourages behaviors and work practices conducive to good strategy execution.

The consequences of having–or not having–an execution-supportive corporate culture says something important about the task of managing the strategy execution process: *Closely aligning corporate culture with the requirements for proficient strategy execution merits the full attention of senior executives.* The culture-building objective is to create a work climate and style of operating that mobilize the energy of company personnel squarely behind efforts to execute strategy competently. The more deeply management can embed execution-supportive ways of doing things, the more management can rely on the culture to automatically steer company personnel toward behaviors and work practices that aid good strategy execution and veer from doing things that impede it. Moreover, culturally astute managers understand that nourishing the right cultural environment not only adds power to their push for proficient strategy execution but also promotes strong employee identification with, and commitment to, the company's vision, performance targets, and strategy.

Healthy Cultures That Aid Good Strategy Execution

A strong culture, provided it fits the chosen strategy and embraces execution-supportive attitudes, behaviors, and work practices, is definitely a healthy culture. Two other types of cultures exist that tend to be healthy and largely supportive of good strategy execution: high-performance cultures and adaptive cultures.

High-Performance Cultures Some companies have so-called high-performance cultures where the standout traits are a "can-do" spirit, pride in doing things right, no-excuses accountability, and a pervasive results-oriented work climate in which people go all out to meet or beat stretch objectives.[12] In high-performance cultures, there's a strong sense of involvement on the part of company personnel and emphasis on individual initiative and effort. Performance expectations are clearly delineated for the company as a whole, for each organizational unit, and for each individual. Issues and problems are promptly addressed; there's a razor-sharp focus on what needs to be done. The clear and unyielding expectation is that all company personnel, from senior executives to frontline employees, will display high-performance behaviors and a passion for making the company successful. Such a culture–permeated by a spirit of achievement and constructive pressure to achieve good results–is a valuable contributor to good strategy execution and operating excellence.[13]

Epic Systems, a company well-known by healthcare providers for the excellence of its record-keeping software, attributes much of its success to their strong, high-performance culture. By emphasizing the importance of the company's "Ten Commandments" and guiding principles, Epic has created a work climate in which employees have an overarching standard that helps guide and coordinate their actions. Epic fosters this high-performance culture from the get-go. They target top tier universities to hire entry-level talent, focusing on skills rather than personality. A rigorous training and orientation program indoctrinates each new employee. This culture positively affects Epic's strategy execution because employees are focused on the most important actions, there is peer pressure to contribute to Epic's success, and employees are genuinely excited to be involved. Epic's faith in its ability to acculturate new team members and remain true to its core values has helped sustain its status as a premier provider of healthcare IT systems over many years.

The challenge in creating a high-performance culture is to inspire high loyalty and dedication on the part of employees, such that they are energized to put forth their very best efforts. Managers have to take pains to reinforce constructive behavior, reward top performers, and purge habits and behaviors that stand in the way of high productivity and good results. They must work at knowing the strengths and weaknesses of their subordinates to better match

ILLUSTRATION CAPSULE 12.1 PUMA's High-Performance Culture

nexusby/Shutterstock

As the third largest manufacturer of sportswear and equipment in the world, PUMA is racing to catch up with its competitors, Nike and Adidas. Its mission, encapsulated in the phrase "Forever Faster," speaks to its drive to out-innovate and out-pace its formidable rivals. But the more consequential driver of PUMA's speed and agility is its high-performance culture.

In 2023, PUMA was named the global Top Employer by the Top Employers Institute. To inspire and energize employees at the headquarters, PUMA offers a fast-paced, fun work environment, centered on a sporting lifestyle. Employees are encouraged to enjoy the company's organic canteen, state-of-the-art gym, nature running trails, soccer fields, and basketball courts. This not only helps workers to form strong bonds with one another but it provides a kind of test lab for the company's latest innovations and designs.

As a multinational company, with over 19,000 employees in more than 120 countries. PUMA's challenge has been to ensure that this culture spans the entire reach of the company and unites the parts. This requires much more than ensuring that every hub has a sports-driven campus like the one at their headquarters in Germany. It begins with hiring practices to attract and retain those people whose values, drive, and passion for sports match those of others in the company. Accordingly, PUMA is a youthful company, with most employees in the age range of 20 to 30 years old. New employees are exposed to the company culture through learning videos and literature that support their working with "Speed and Spirit" from day one. Rookies are matched with a veteran to show them the ropes and facilitate their becoming acculturated quickly. Talent management and training at PUMA (including International Leadership Programs) contribute similarly to the company's high-performance culture. High potential and high performance individuals are identified and promoted regardless of level and across functions in the belief that successful teams and led by successful leaders.

In their annual survey of employees across many companies, Glassdoor reports that PUMA's employees rave about the speed and spirit ethos that they experience at PUMA. From its flexible hours, generous benefits, personal development opportunities, on-site recreational facilities, team-spiritedness, and commitment to work-life balance, PUMA demonstrates that it puts its people first. For that is ultimately the only sure foundation of a high-performance culture.

Sources: **https://www.worldfootwear.com/news/puma-named-global-top-employer-in-2023/8502.html**; Company website, accessed 3/5/23.

talent with task and enable people to make meaningful contributions by doing what they do best. They have to stress learning from mistakes and must put an unrelenting emphasis on moving forward and making good progress–in effect, there has to be a disciplined, performance-focused approach to managing the organization. Illustration Capsule 12.1 describes the attention that Puma gives toward maintaining its high-performance culture.

Adaptive Cultures The hallmark of adaptive corporate cultures is willingness on the part of organization members to accept change and take on the challenge of introducing and executing new strategies. Company personnel share a feeling of confidence that the organization can deal with whatever threats and opportunities arise; they are receptive to risk taking, experimentation, innovation, and changing strategies and practices. The organizational work climate is supportive of managers and employees who propose or initiate useful change. Internal entrepreneurship (often called *intrapreneurship*) on the part of individuals and groups is encouraged and rewarded. Senior executives seek out, support, and promote individuals who exercise initiative, spot opportunities for improvement, and display the skills to implement them. Managers openly evaluate ideas and suggestions, fund initiatives to develop new or better products, and take prudent risks to pursue emerging market opportunities. As in high-performance cultures, the company exhibits a proactive approach to identifying issues, evaluating the implications and options, and moving ahead quickly with workable solutions. Strategies and traditional operating practices are modified as needed to adjust to, or take advantage of, changes in the business environment.

But why is change so willingly embraced in an adaptive culture? Why are organization members not fearful of how change will affect them? Why does an adaptive culture not break down from the force of ongoing changes in strategy, operating practices, and behavioral norms? The answers lie in two distinctive and dominant traits of an adaptive culture: (1) Changes in operating practices and behaviors must *not* compromise core values and long-standing business principles (since they are at the root of the culture) and (2) changes that are instituted must satisfy the legitimate interests of key constituencies–customers, employees, shareholders, suppliers, and the communities where the company operates. In other words, what sustains an adaptive culture is that organization members perceive the changes that management is trying to institute as *legitimate,* in keeping with the core values, and in the overall best interests of stakeholders.[14] Not surprisingly, company personnel are usually more receptive to change when their employment security is not threatened and when they view new duties or job assignments as part of the process of adapting to new conditions. Should workforce downsizing be necessary, it is important that layoffs be handled humanely and employee departures be made as painless as possible.

As a company's strategy evolves, an adaptive culture is a definite ally in the strategy-executing process as compared to cultures that are resistant to change.

Adaptive cultures can only be sustained if (1) organizational change remains consistent with the company's core values and (2) the changes are viewed as in the best interests of stakeholders.

Technology companies, software companies, and Internet-based companies are good illustrations of organizations with adaptive cultures. Such companies thrive on change–driving it, leading it, and capitalizing on it. Companies like Amazon, Google, Apple, Blue Origin, Adobe, Groupon, Intel, and Yelp cultivate the capability to act and react rapidly. They are avid practitioners of entrepreneurship and innovation, with a demonstrated willingness to take bold risks to create altogether new products, new businesses, and new industries. To create and nurture a culture that can adapt rapidly to shifting business conditions, they make a point of staffing their organizations with people who are flexible, who rise to the challenge of change, and who have an aptitude for adapting well to new circumstances. Wayfair, the largest online retailer of home furnishings in the United States, attributes its rapid growth to an entrepreneurial and collaborative culture that encourages employee innovation. They hire individuals who are willing to solve problems creatively and develop new initiatives and empower them to take measured risks.

In fast-changing business environments, a corporate culture that is receptive to altering organizational practices and behaviors is a virtual necessity. However, adaptive cultures work to the advantage of all companies, not just those in rapid-change environments. Every company operates in a market and business climate that is changing to one degree or another and that, in turn, requires internal operating responses and new behaviors on the part of organization members.

Unhealthy Cultures That Impede Good Strategy Execution

The distinctive characteristic of an unhealthy corporate culture is the presence of counterproductive cultural traits that adversely impact the internal work climate and company performance. Five particularly unhealthy cultural traits are hostility to change, heavily politicized decision making, insular thinking, unethical and greed-driven behaviors, and the presence of incompatible, clashing subcultures.

Change-Resistant Cultures Change-resistant cultures–where fear of change and skepticism about the importance of new developments are the norm–place a premium on not making mistakes, prompting managers to lean toward safe, conservative options intended to maintain the status quo, protect their power base, and guard their immediate interests. When such companies encounter business environments with accelerating change, going slow on altering traditional ways of doing things can be a serious liability. Under these conditions, change-resistant cultures encourage a number of unhealthy behaviors–avoiding risks, not capitalizing on emerging opportunities, taking a lax approach to both product innovation and continuous improvement in performing value chain activities, and responding more slowly than is warranted to market change. In change-resistant cultures, proposals to do things differently face an uphill battle and people who champion them may be seen as something of a nuisance or a troublemaker. Instead, a lot of energy goes into justifying what the company is presently doing, with little discussion of what it should consider doing differently–there is strong aversion to bold action. Executives who don't value managers or employees with initiative and new ideas put a damper on product innovation, experimentation, and efforts to improve.

Hostility to change is most often found in companies with stodgy bureaucracies that have enjoyed considerable market success in years past and that are wedded to the "We have done it this way for years" syndrome. Sears, and Eastman Kodak are classic examples of companies whose change-resistant bureaucracies damaged their market standings and financial performance; clinging to what made them successful, they were reluctant to alter operating practices and modify their business approaches when signals of market change first sounded. As strategies of "hold-the-course" won out over bold innovation, they lost market share to rivals that quickly moved to institute changes more in tune with evolving market conditions and buyer preferences. In consequence, both of these companies ultimately ended up in bankruptcy court and are now struggling to recoup lost ground.

Politicized Cultures What makes a politicized internal environment so unhealthy is that political infighting consumes a great deal of organizational energy, often with the result that what's best for the company takes a backseat to political maneuvering. In companies where internal politics pervades the work climate, empire-building managers pursue their own agendas and operate the work units under their supervision as autonomous "fiefdoms." The positions they take on issues are usually aimed at protecting or expanding their own turf. Collaboration with other organizational units is viewed with suspicion, and cross-unit cooperation occurs grudgingly. The support or opposition of politically influential executives and/or coalitions among departments with vested interests in a particular outcome tends to shape what actions the company takes. All this political maneuvering takes away from efforts to execute strategy with real proficiency and frustrates company personnel who are less political and more inclined to do what is in the company's best interests.

Insular, Inwardly Focused Cultures Sometimes a company reigns as an industry leader or enjoys great market success for so long that its personnel start to believe they have all the answers or can develop them on their own. There is a strong tendency to neglect what customers are saying and how their needs and expectations are changing. Such confidence breeds arrogance–company personnel discount the merits of what outsiders are doing and what can be learned by studying best-in-class performers. Benchmarking and a search for the best practices of outsiders are seen as offering little payoff. Insular thinking, internally driven solutions, and a must-be-invented-here mindset come to permeate the corporate culture. An inwardly focused corporate culture gives rise to managerial inbreeding and a failure to recruit people who can offer fresh thinking and outside perspectives. The big risk of insular cultural thinking is that the company can underestimate the capabilities of rival companies while overestimating its own–all of which diminishes a company's competitiveness over time.

Unethical and Greed-Driven Cultures Companies that have little regard for ethical standards or are run by executives driven by greed and ego gratification are scandals waiting to happen. Executives exude the negatives of arrogance, ego, greed, and an "ends-justify-the-means" mentality in pursuing overambitious revenue and profitability targets.[15] Senior managers wink at unethical behavior and may cross over the line to unethical (and sometimes criminal) behavior themselves. They are prone to adopt accounting principles that make financial performance look better than it really is. Legions of companies have fallen prey to unethical behavior and greed, most notably Turing Pharmaceuticals (whose name was changed to Vyera in the wake of scandal) and Mylan, both known for their unconscionable price hikes on life-saving medications. At the blood testing company, Theranos, a toxic culture of fear drove employees to participate in deceiving customers, partners, investors, and regulators. Its CEO, once considered a darling of the tech world, was recently sentenced to more than 11 years in prison for fraud and conspiracy. Notorious other cases include Enron, BP, Ontrak Health, Bed, Bath, and Beyond, and Wells Fargo, Deutsche Bank, and HSBC (Europe's biggest bank) with executives being indicted and/or convicted of criminal behavior.

Incompatible, Clashing Subcultures Company subcultures are unhealthy when they embrace conflicting business philosophies, support inconsistent approaches to strategy execution, and encourage incompatible methods of people management. Clashing subcultures can prevent a company from coordinating its efforts to craft and execute strategy and can distract company personnel from the business of business. Internal jockeying among the subcultures for cultural dominance impedes teamwork among the company's various organizational units and blocks the emergence of a collaborative approach to strategy execution. Such a lack of consensus about how to proceed is likely to result in fragmented or inconsistent approaches to implementing new strategic initiatives and in limited success in executing the company's overall strategy.

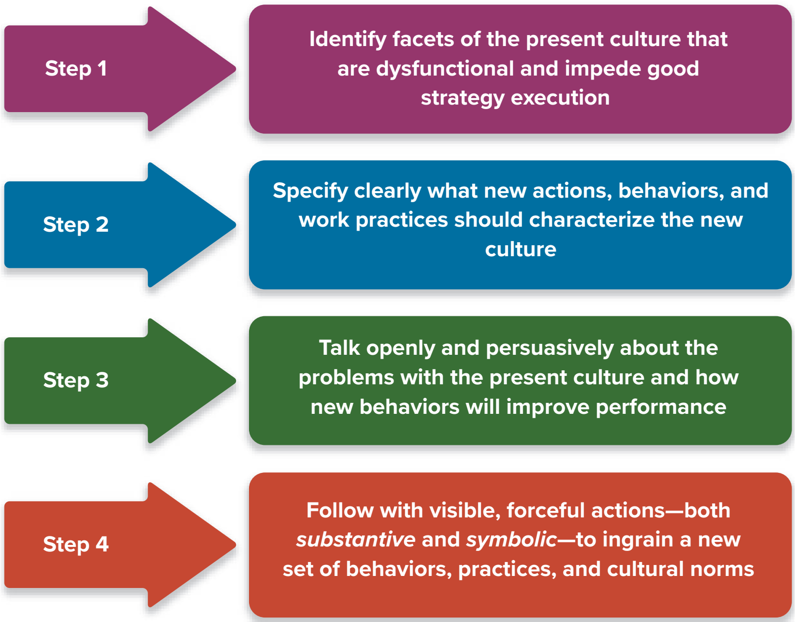
Changing a Problem Culture

> **LO 12-3**
>
> Identify the kinds of actions management can take to change a problem corporate culture.

When a culture is unhealthy or otherwise out of sync with the actions and behaviors needed to execute the strategy successfully, the culture must be changed as rapidly as can be managed. This means eliminating any unhealthy or dysfunctional cultural traits as fast as possible and aggressively striving to ingrain new behaviors and work practices that will enable first-rate strategy execution. The more entrenched the unhealthy or mismatched aspects of a company culture, the more likely the culture will impede strategy execution and the greater the need for change.

Changing a problem culture is among the toughest management tasks because of the heavy anchor of ingrained behaviors and attitudes. It is natural for company personnel to cling to familiar practices and to be wary of change, if not hostile to new approaches concerning how things are to be done. Consequently, it takes concerted management action over a period of time to root out unwanted behaviors and replace an unsupportive culture with more effective ways of doing things. *The single most visible factor that distinguishes successful culture-change efforts from failed attempts is competent leadership at the top.* Great power is needed to force major cultural change and overcome the stubborn resistance of entrenched cultures–and great power is possessed only by the most senior executives, especially the CEO. However, while

FIGURE 12.2 Changing a Problem Culture



top management must lead the change effort, the tasks of marshaling support for a new culture and instilling the desired cultural behaviors must involve a company's whole management team. Middle managers and frontline supervisors play a key role in implementing the new work practices and operating approaches, helping win rank-and-file acceptance of and support for changes, and instilling the desired behavioral norms.

As shown in Figure 12.2, the first step in fixing a problem culture is for top management to identify those facets of the present culture that are dysfunctional and pose obstacles to executing strategic initiatives. Second, managers must clearly define the desired new behaviors and features of the culture they want to create. Third, they must convince company personnel of why the present culture poses problems and why and how new behaviors and operating approaches will improve company performance–the case for cultural reform has to be persuasive. Finally, and most important, all the talk about remodeling the present culture must be followed swiftly by visible, forceful actions to promote the desired new behaviors and work practices–actions that company personnel will interpret as a determined top management commitment to bringing about a different work climate and new ways of operating. The actions to implant the new culture must be both *substantive* and *symbolic.*

Making a Compelling Case for Culture Change The way for management to begin a major remodeling of the corporate culture is by selling company personnel on the need for new-style behaviors and work practices. This means making a compelling case for why the culture-remodeling efforts are in the organization's best interests and why company personnel should wholeheartedly join the effort to do things somewhat differently. This can be done by

- Explaining why and how certain behaviors and work practices in the current culture pose obstacles to good strategy execution.

- Explaining how new behaviors and work practices will be more advantageous and produce better results. A great culture, for example, can improve employee morale, result in better functioning teams, make everyone happier and more productive, and ultimately improve a company's profitability and competitive position. Effective culture-change leaders are good at telling stories to describe the new values and desired behaviors and connect them to everyday practices.
- If the need for cultural change is due to a change in strategy, explain why the current strategy has to be modified and why the present culture must be altered to better support the new strategy. This includes explaining why the new strategic initiatives will bolster the company's competitiveness and performance and how a change in culture can help in executing the new strategy.

It is essential for the CEO and other top executives to talk personally to personnel all across the company about the reasons for modifying work practices and culture-related behaviors. For the culture-change effort to be successful, frontline supervisors and employee opinion leaders must be won over to the cause, which means convincing them of the merits of *practicing* and *enforcing* cultural norms at every level of the organization, from the highest to the lowest. Arguments for new ways of doing things and new work practices tend to be embraced more readily if employees understand how they will benefit company stakeholders (particularly customers, employees, and shareholders). Until a large majority of employees accept the need for a new culture and agree that different work practices and behaviors are called for, there's more work to be done in selling company personnel on the whys and wherefores of culture change. Building widespread organizational support requires taking every opportunity to repeat the message of why the new work practices, operating approaches, and behaviors are good for company stakeholders and essential for the company's future success.

Substantive Culture-Changing Actions No culture-change effort can get very far when leaders merely talk about the need for different actions, behaviors, and work practices. Company executives must give the culture-change effort some teeth by initiating *a series of actions* that company personnel will see as unmistakably indicative of the seriousness of management's commitment to cultural change. The strongest signs that management is truly committed to instilling a new culture include

- Replacing key executives and managers who either openly or covertly oppose needed organizational and cultural changes.
- Promoting individuals who have stepped forward to spearhead the shift to a different culture and who can serve as role models for the desired cultural behavior.
- Appointing outsiders with the desired cultural attributes to influential positions–bringing in new-breed managers sends an unambiguous message that a new era is dawning.
- Screening all candidates for new positions carefully, hiring only those who appear to fit in with the new culture. For example, a company whose culture revolves around creativity, product innovation, and leading change must screen new hires for their ability to think outside the box, generate new ideas, and thrive in a climate of rapid change and ambiguity.
- Mandating that all company personnel attend culture-training programs to better understand the new culture-related actions and behaviors that are expected.
- Designing compensation incentives that boost the pay of teams and individuals who display the desired cultural behaviors. Company personnel are much more inclined to exhibit the desired kinds of actions and behaviors when it is in their financial best interest to do so.

- Letting word leak out that generous pay raises and or promotions have been awarded to individuals who have stepped out front, led the adoption of the desired work practices, displayed the new-style behaviors, and achieved pace-setting results.
- Revising policies and procedures in ways that will help drive cultural change.

Executives must launch enough companywide culture-change actions at the outset to leave no room for doubt that management is dead serious about changing the present culture and that a cultural transformation is inevitable. Management's commitment to cultural change in the company must be made credible. The series of actions initiated by top management must command attention, get the change process off to a fast start, and be followed by unrelenting efforts to firmly establish the new work practices, desired behaviors, and style of operating as "standard."

The most important symbolic cultural-changing action that top executives can take is to lead *by example*.

Symbolic Culture-Changing Actions There's also an important place for symbolic managerial actions to alter a problem culture and tighten the strategy-culture fit. The most important symbolic actions are those that top executives take to *lead by example.* For instance, if the organization's strategy involves a drive to become the industry's low-cost producer, senior managers must display frugality in their own actions and decisions. Examples include inexpensive decorations in the executive suite, conservative expense accounts and entertainment allowances, a lean staff in the corporate office, scrutiny of budget requests, few executive perks, and so on. At Walmart, all the executive offices are simply decorated; executives are habitually frugal in their own actions, and they are zealous in their efforts to control costs and promote greater efficiency. At Nucor, one of the world's low-cost producers of steel products, executives fly coach class and use taxis at airports rather than limousines. Top executives must be alert to the fact that company personnel will be watching their behavior to see if their actions match their rhetoric. Hence, they need to make sure their current decisions and actions will be construed as consistent with the new cultural values and norms.[16]

Another category of symbolic actions includes holding ceremonial events to single out and honor people whose actions and performance exemplify what is called for in the new culture. Such events also provide an opportunity to celebrate each culture-change success. Executives sensitive to their role in promoting strategy-culture fit make a habit of appearing at ceremonial functions to praise individuals and groups that exemplify the desired behaviors. They show up at employee training programs to stress strategic priorities, values, ethical principles, and cultural norms. Every group gathering is seen as an opportunity to repeat and ingrain values, praise good deeds, expound on the merits of the new culture, and cite instances of how the new work practices and operating approaches have produced good results. Ceremonial events can also be used to drive home the commitment to changing culture. The late Steve Jobs, visionary co-founder of Apple, once countered resistance to change by dramatizing the death of "the old way of doing things" with a coffin on stage and a mock funeral.

The use of symbols in culture building is widespread. Numerous businesses have employee-of-the-month awards. The military has a long-standing custom of awarding ribbons and medals for exemplary actions. Mary Kay Cosmetics awards an array of prizes ceremoniously to its beauty consultants for reaching various sales plateaus, including a two-year lease on their iconic pink Cadillac for top sales performers.

How Long Does It Take to Change a Problem Culture? Planting the seeds of a new culture and helping the culture grow strong roots require a determined, sustained effort by the chief executive and other senior managers. Changing a problem culture

ILLUSTRATION CAPSULE 12.2 Driving Cultural Change at Goldman Sachs

Goldman Sachs was long considered one of the best financial services companies to work for, due to its prestige, high salaries, bonuses, and perks. Yet by 2014, Goldman was beginning to have trouble recruiting the best and brightest MBAs at top business schools. Part of this was due to the banking crisis of 2008–2009 and the scandals that continued to plague the industry year after year, tarnishing the industry's reputation. But another reason was a change in the values and aspirations of the younger generation that made banking culture far less appealing than that of consulting, technology, and start-up companies. Newly minted MBAs were no longer as willing to accept the grueling hours and unpredictable schedules that were the norm in investment banking. They wanted to derive meaning and purpose from their work and prized work/life balance over monetary gain. The tech industry was known for fun, youth-oriented, and collaborative working environments, while the excitement and promise of entrepreneurial ventures offered much appeal. Goldman found itself competing with Amazon, Google, Microsoft, and Facebook as well as with start-ups for the best young talent—and losing out.

Goldman's problem was compounded by the fact that its culture was regarded as stuffy and stodgy—qualities not likely to appeal to the young, particularly when contrasted with the hip cultures of tech and start-up companies. Further, it had always been slow-moving in terms of implementing organizational change. Recognizing the problem, the leadership at Goldman attempted to pivot sharply, asking its executives to think of Goldman as a tech company, complete with the associated values. The chief learning office at Goldman Sachs was put in charge of the effort to transform its culture and began taking deliberate steps to enact changes. Buy-in was sought from the full C-suite—the leadership team at the very top of the firm. To foster a more familial atmosphere at work, the company began with small steps, such as setting up sports leagues and encouraging regular team happy hours. More significantly, they instituted more employee-friendly work schedules and policies, more accommodating of work-life balance. They liberalized their parental leave policies, provided greater flexibility in work schedules, and enacted protections for interns and junior bankers designed to limit their working hours. They also overhauled their performance review and promotion systems as well as their recruiting practices and policies regarding diversity. Although cultural change never comes swiftly, the results have been apparent even to outside observers. Since 2017, the career website **Vault.com** has named Goldman Sachs among the Top 5 best banking firms to work for.

JUSTIN LANE/EPA-EFE/Shutterstock

Sources: **http://www.goldmansachs.com/careers/blog/posts/goldman-sachs-vault-2017.html**; **http://sps.columbia.edu/news/how-goldman-sachs-drives-culture-change-in-the-financial-industry.**

is never a short-term exercise; it takes time for a new culture to emerge and take root. And it takes even longer for a new culture to become deeply embedded. The bigger the organization and the greater the cultural shift needed to produce an execution-supportive fit, the longer it takes. In large companies, fixing a problem culture and instilling a new set of attitudes and behaviors can take two to five years. In fact, it is usually tougher to reform an entrenched problematic culture than it is to instill a strategy-supportive culture from scratch in a brand-new organization.

Illustration Capsule 12.2 discusses the approaches used at Goldman Sachs to change a culture that was impeding its efforts to recruit the best young talent.

LEADING THE STRATEGY EXECUTION PROCESS

LO 12-4

Recognize what constitutes effective managerial leadership in achieving superior strategy execution.

For an enterprise to execute its strategy in truly proficient fashion and approach operating excellence, top executives must take the lead in the strategy implementation process and personally drive the pace of progress. They have to be out in the field, seeing for themselves how well operations are going, gathering information firsthand, and gauging the progress being made. Proficient strategy execution requires company managers to be diligent and adept in spotting problems, learning what obstacles lay in the path of good execution, and then clearing the way for progress–the goal must be to produce better results speedily and productively. There must be constructive, but unrelenting, pressure on organizational units to (1) demonstrate excellence in all dimensions of strategy execution and (2) do so on a consistent basis–ultimately, that's what will enable a well-crafted strategy to achieve the desired performance results.

The specifics of how to implement a strategy and deliver the intended results must start with understanding the requirements for good strategy execution. Afterward comes a diagnosis of the organization's preparedness to execute the strategic initiatives and decisions on how to move forward and achieve the targeted results.[17] In general, leading the drive for good strategy execution and operating excellence calls for three actions on the part of the managers in charge:

1. Staying on top of what is happening and closely monitoring progress.
2. Putting constructive pressure on the organization to execute the strategy well and achieve operating excellence.
3. Initiating corrective actions to improve strategy execution and achieve the targeted performance results.

Staying on Top of How Well Things Are Going

To stay on top of how well the strategy execution process is going, senior executives have to tap into information from a wide range of sources. This requires communicating regularly with key subordinates and reviewing the latest operating results, watching the competitive reactions of rival firms, and visiting with key customers and suppliers to get their perspectives. One of the best ways for executives to stay on top of strategy execution is by regularly visiting various company facilities and talking with many different company personnel at many different organizational levels–a technique often labeled **management by walking around (MBWA).** Most managers attach great importance to spending time with people at company facilities, asking questions, listening to their opinions and concerns, and gathering firsthand information about how well aspects of the strategy execution process are going. Facilities tours and face-to-face contacts with operating-level employees give executives a good grasp of what progress is being made, what problems are being encountered, and whether additional resources or different approaches may be needed. Just as important, MBWA provides opportunities to give encouragement, lift spirits, focus attention on key priorities, and create some excitement–all of which generate positive energy and help boost strategy execution efforts.

CORE CONCEPT

Management by walking around (MBWA) is one of the techniques that effective leaders use to stay informed about how well the strategy execution process is progressing.

When Jeff Bezos, Amazon's founder, was its CEO, he was noted for his practice of MBWA, firing off a battery of questions when he toured facilities, insisting that Amazon managers spend time in the trenches with their people to prevent getting disconnected from the reality of what's happening. Walmart executives have had a long-standing practice of spending two to three days every week visiting Walmart's stores and talking with store managers and employees. Sam Walton, Walmart's founder, insisted, "The key is to get out into the store and listen to what the associates have to say." Jack Welch, the highly effective former CEO of General Electric, not only made it a priority to personally visit GE operations and talk with major customers but also routinely spent time exchanging information and ideas with GE managers from all over the world who were attending classes at the company's leadership development center near GE's headquarters.

Many manufacturing executives make a point of strolling the factory floor to talk with workers and meeting regularly with union officials. Some managers operate out of open cubicles in big spaces filled with open cubicles for other personnel so that they can interact easily and frequently with co-workers. Managers at some companies host weekly get-togethers (often on Friday afternoons) to create a regular opportunity for information to flow freely between down-the-line employees and executives. In Japanese companies, such as Toyota, managers practice a variant of MBWA called the Gemba walk, which emphasizes noticing among other things how employees are feeling about their work.

Mobilizing the Effort for Excellence in Strategy Execution

Part of the leadership task in mobilizing organizational energy behind the drive for good strategy execution entails nurturing a results-oriented work climate, where performance standards are high and a spirit of achievement is pervasive. Successfully leading the effort is typically characterized by such leadership actions and managerial practices as

- *Treating employees with dignity and respect, as valued partners.* Some companies symbolize the value of individual employees and the importance of their contributions by referring to them as cast members (Disney), crew members (McDonald's), job owners (Graniterock), partners (Starbucks), or associates (Walmart, LensCrafters, W. L. Gore, Edward Jones, Publix Supermarkets, and Marriott International). Very often, there is a strong company commitment to training each employee thoroughly, offering attractive compensation and benefits, emphasizing promotion from within and promising career opportunities, providing a high degree of job security, and otherwise making employees feel well treated and valued.
- *Fostering an esprit de corps that energizes organization members.* The task here is to skillfully use people-management practices calculated to build morale, foster pride in working for the company, promote teamwork and collaborative group effort, win the emotional commitment of individuals and organizational units to what the company is trying to accomplish, and inspire company personnel to do their best in achieving good results.[18]
- *Using empowerment to help create a fully engaged workforce.* Top executives—and, to some degree, the enterprise's entire management team—must seek to engage the full organization in the strategy execution effort. A fully engaged workforce, where individuals bring their best to work every day, is necessary to produce great results.[19] So is having a group of dedicated managers committed to making a difference in their organization. The two best things top-level executives can do to create a fully engaged organization are (1) delegate authority to middle and lower-level managers to get the strategy execution process moving and (2) empower rank-and-file employees to act on their own initiative. Operating excellence requires that everybody contribute ideas, exercise initiative and creativity in performing their work, and have a desire to do things in the best possible manner.
- *Nurturing a results-oriented work climate and clearly communicating an expectation that company personnel are to give their best in achieving performance targets.* Managers must make it abundantly clear that they expect all company personnel

to put forth every effort to meet performance targets. But executives cannot expect directives to "try harder" to produce the desired outcomes in the absence of a results-oriented work climate. Nor can they expect innovative improvements in operations if they do no more than exhort people to "be creative." Rather, they must foster a strong culture with high performance standards and where innovative ideas and experimentation with new ways of doing things can blossom and thrive.

- *Using the tools of benchmarking, best practices, business process reengineering, TQM, and Six Sigma to focus attention on continuous improvement.* These are proven approaches to getting better operating results and facilitating better strategy execution.
- *Using the full range of motivational techniques and compensation incentives to inspire company personnel and reward high performance.* Individuals and groups should be strongly encouraged to brainstorm, let their imaginations fly in all directions, and come up with proposals for improving the way that things are done. This means giving company personnel enough autonomy to stand out, excel, and contribute. And it means that the rewards for successful champions of new ideas and operating improvements should be large and visible. It is particularly important that people who champion an unsuccessful idea are not punished or sidelined but, rather, encouraged to try again. Finding great ideas requires taking risks and recognizing that many ideas won't pan out.
- *Celebrating individual, group, and company successes.* Top management should miss no opportunity to express respect for individual employees and appreciation of extraordinary individual and group effort.[20] Companies like Google, Mary Kay, Tupperware, and McDonald's actively seek out reasons and opportunities to give pins, ribbons, buttons, badges, and medals for good showings by average performers—the idea being to express appreciation and give a motivational boost to people who stand out in doing ordinary jobs. At Kimpton Hotels and Restaurants, employees who create special moments for guests are rewarded with "Kimpton Moment" tokens that can be redeemed for paid days off, gift certificates to restaurants, flat-screen TVs, and other prizes. Cisco Systems and 3M Corporation make a point of ceremoniously honoring individuals who believe so strongly in their ideas that they take it on themselves to hurdle the bureaucracy, maneuver their projects through the system, and turn them into improved services, new products, or even new businesses.

While leadership efforts to instill a spirit of high achievement into the culture usually accentuate the positive, negative consequences for poor performance must be in play as well. Managers whose units consistently perform poorly must be replaced. Low-performing employees must be weeded out or at least employed in ways better suited to their aptitudes. Average performers should be candidly counseled that they have limited career potential unless they show more progress in the form of additional effort, better skills, and improved ability to execute the strategy well and deliver good results.

Leading the Process of Making Corrective Adjustments

There comes a time at every company when managers have to fine-tune or overhaul the approaches to strategy execution since no action plan for executing strategy can foresee all the problems that will arise. Clearly, when a company's strategy execution effort is not delivering good results, it is the leader's responsibility to step forward and initiate corrective actions, although sometimes it must be recognized that unsatisfactory performance may be due as much or more to flawed strategy as to weak strategy execution.[21]

Success in making corrective adjustments hinges on (1) a thorough analysis of the situation, (2) the exercise of good business judgment in deciding what actions to take, and (3) good implementation of the corrective actions that are initiated. Successful managers are skilled in getting an organization back on track rather quickly. They (and their staffs) are good at discerning what adjustments to make and in bringing them to a successful conclusion. Managers who struggle to show measurable progress in implementing corrective actions in a timely fashion are candidates for being replaced.

The *process* of making corrective adjustments in strategy execution varies according to the situation. In a crisis, taking remedial action quickly is of the essence. But it still takes time to review the situation, examine the available data, identify and evaluate options (crunching whatever numbers may be appropriate to determine which options are likely to generate the best outcomes), and decide what to do. When the situation allows managers to proceed more deliberately in deciding when to make changes and what changes to make, most managers seem to prefer a process of incrementally solidifying commitment to a particular course of action.[22] The process that managers go through in deciding on corrective adjustments is essentially the same for both proactive and reactive changes: They sense needs, gather information, broaden and deepen their understanding of the situation, develop options and explore their pros and cons, put forth action proposals, strive for a consensus, and finally formally adopt an agreed-on course of action. The time frame for deciding what corrective changes to initiate can be a few hours, a few days, a few weeks, or even a few months if the situation is particularly complicated.

The challenges of making the right corrective adjustments and leading a successful strategy execution effort are, without question, substantial.[23] There's no generic, by-the-books procedure to follow. Because each instance of executing strategy occurs under different organizational circumstances, the managerial agenda for executing strategy always needs to be situation-specific. But the job is definitely doable. Although there is no prescriptive answer to the question of exactly what to do, any of several courses of action may produce good results. As we said at the beginning of Chapter 10, executing strategy is an action-oriented task that challenges a manager's ability to lead and direct organizational change, create or reinvent business processes, manage and motivate people, and achieve performance targets. If you now better understand what the challenges are, what tasks are involved, what tools can be used to aid the managerial process of executing strategy, and why the action agenda for implementing and executing strategy sweeps across so many aspects of managerial work, then the discussions in Chapters 10, 11, and 12 have been a success.

A FINAL WORD ON LEADING THE PROCESS OF CRAFTING AND EXECUTING STRATEGY

In practice, it is hard to separate leading the process of executing strategy from leading the other pieces of the strategy process. As we emphasized in Chapter 2, the job of crafting and executing strategy consists of five interrelated and linked stages, with much looping and recycling to fine-tune and adjust the strategic vision, objectives, strategy, and implementation approaches to fit one another and to fit changing circumstances. The process is continuous, and the conceptually separate acts of crafting and executing strategy blur together in real-world situations. *The best tests of good strategic leadership are whether the company has a good strategy (given its internal and external situation), whether the strategy is being competently executed, and whether the enterprise is meeting or beating its performance targets.* If these three conditions exist, then there is every reason to conclude that the company has good strategic leadership and is a well-managed enterprise.

KEY POINTS

1. Corporate culture is the character of a company's internal work climate—the shared values, ingrained attitudes, core beliefs and company traditions that determine norms of behavior, accepted work practices, and styles of operating. A company's culture is important because it influences the organization's actions, its approaches to conducting business, and ultimately its performance in the marketplace. It can be thought of as the company's organizational DNA.
2. The key features of a company's culture include the company's values and ethical standards, its approach to people management, its work atmosphere and company spirit, how its personnel interact, the strength of peer pressure to conform to norms, the behaviors awarded through incentives (both financial and symbolic), the traditions and oft-repeated "myths," and its manner of dealing with stakeholders.
3. A company's culture is grounded in and shaped by its core values and ethical standards. Core values and ethical principles serve two roles in the culture-building process: (1) They foster a work climate in which employees share common and strongly held convictions about how company business is to be conducted; and (2) they provide company personnel with guidance about the manner in which they are to do their jobs—which behaviors and ways of doing things are approved (and expected) and which are out-of-bounds. They serve as yardsticks for gauging the appropriateness of particular actions, decisions, and behaviors.
4. Company cultures vary widely in strength and influence. Some cultures are *strong* and have a big impact on a company's practices and behavioral norms. Others are *weak* and have comparatively little influence on company operations.
5. Strong company cultures can have either positive or negative effects on strategy execution. When they are in sync with the chosen strategy and well matched to the behavioral requirements of the company's strategy implementation plan, they can be a powerful aid to strategy execution. A culture that is grounded in the types of actions and behaviors that are conducive to good strategy execution assists the effort in three ways:
   - By focusing employee attention on the actions that are most important in the strategy execution effort.
   - By inducing peer pressure for employees to contribute to the success of the strategy execution effort.
   - By energizing employees, deepening their commitment to the strategy execution effort, and increasing the productivity of their efforts

   It is thus in management's best interest to dedicate considerable effort to establishing a strongly implanted corporate culture that encourages behaviors and work practices conducive to good strategy execution.
6. Strong corporate cultures that are conducive to good strategy execution are healthy cultures. So are high-performance cultures and adaptive cultures. The latter are particularly important in dynamic environments. Strong cultures can also be unhealthy. The five types of unhealthy cultures are those that are (1) change-resistant, (2) heavily politicized, (3) insular and inwardly focused, (4) ethically unprincipled and infused with greed, and (5) composed of incompatible, clashing subcultures. All five impede good strategy execution.

7. Changing a company's culture, especially a strong one with traits that don't fit a new strategy's requirements, is a tough and often time-consuming challenge. Changing a culture requires competent leadership at the top. It requires making a compelling case for cultural change and employing both symbolic actions and substantive actions that unmistakably indicate serious and credible commitment on the part of top management. The more that culture-driven actions and behaviors fit what's needed for good strategy execution, the less managers must depend on policies, rules, procedures, and supervision to enforce what people should and should not do.
8. Leading the drive for good strategy execution and operating excellence calls for three actions on the part of the manager in charge:
   - Staying on top of what is happening and closely monitoring progress. This is often accomplished through management by walking around (MBWA).
   - Mobilizing the effort for excellence in strategy execution by putting constructive pressure on the organization to execute the strategy well.
   - Initiating corrective actions to improve strategy execution and achieve the targeted performance results.

ASSURANCE OF LEARNING EXERCISES

1. Salesforce has been ranked among the very top of Fortune's list of the Best Companies to Work for more than 13 years. Use your university library's resources to see what their company culture and values might have to do with this. What are the key features of its culture? Do features of Salesforce's culture influence the company's ethical practices? If so, how? — Mc Graw Hill connect, LO 12-1
2. Based on what you learned about Salesforce.com from answering the previous question, how do you think the company's culture affects its ability to execute strategy and operate with excellence? — LO 12-2
3. Illustration Capsule 12.2 discusses culture change at Goldman Sachs. How had its organizational culture become an obstacle to its effectiveness? What substantive culture-changing actions were undertaken at Goldman Sachs? What evidence suggests that the culture change has been effective at Goldman Sachs? — Mc Graw Hill connect, LO 12-1, LO 12-2
4. If you were an executive at a company that had a pervasive yet problematic culture, what steps would you take to change it? Using Google Scholar or your university library's access to EBSCO, LexisNexis, or other databases, search for recent articles in business publications on "culture change." What role did the executives play in the culture change? How does this differ from what you would have done to change the culture? — LO 12-3
5. Leading the strategy execution process involves staying on top of the situation and monitoring progress, putting constructive pressure on the organization to achieve operating excellence, and initiating corrective actions to improve the execution effort. Using your university library's resources discuss an example of how a company's managers have demonstrated the kind of effective internal leadership needed for superior strategy execution. — LO 12-4

EXERCISES FOR SIMULATION PARTICIPANTS

LO 12-1, LO 12-2

1. If you were making a speech to company personnel, what would you tell employees about the kind of corporate culture you would like to have at your company? What specific cultural traits would you like your company to exhibit? Explain.

LO 12-2

2. What core values would you want to ingrain in your company's culture? Why?

LO 12-3, LO 12-4

3. Following each decision round, do you and your co-managers make corrective adjustments in either your company's strategy or the way the strategy is being executed? List at least three such adjustments you made in the most recent decision round. What hard evidence (in the form of results relating to your company's performance in the most recent year) can you cite that indicates that the various corrective adjustments you made either succeeded at improving or failed to improve your company's performance?

LO 12-4

4. What would happen to your company's performance if you and your co-managers stick with the status quo and fail to make any corrective adjustments after each decision round?

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PART 2

Cases in Crafting and Executing Strategy

CASE 1

SpaceX: Its Vision, Business Model, and Achievements in Space Exploration

John E. Gamble
Texas A&M University-Corpus Christi

SpaceX (Space Exploration Technologies Corporation) celebrated the successful launch of its Starship rocket in May 2023. The Starship was the largest rocket the company had produced and had more than 1.5 times the mass of NASA's Saturn 5 rocket that traveled to the Moon. NASA had not returned to the Moon since 1972, but SpaceX planned to eventually land astronauts on the moon and to, even beyond, Mars. The company's next major milestone would be a planned orbit of the Moon by the Starship before year-end 2023.

SpaceX was founded in 2002 by Elon Musk with the vision of making humanity multiplanetary. The central element of the company's business model was the development and deployment of next-generation, fully reusable, rockets. SpaceX believed it was essential to build fully and rapidly reusable rockets to make space access more affordable through the distribution of design and construction costs across multiple flights of the same spacecraft. Reusability offered tremendous cost advantages of rockets produced by rivals such as Martin Marietta, Northrop Grumman, Blue Origin, and Boeing as all rockets produced prior to SpaceX's models of rockets were designed to be flown only once. In 2023, SpaceX had a considerable cost advantage in deploying satellites for commercial firms.

In September 2008, SpaceX became the first private company to send a liquid-fueled rocket into orbit when its Falcon 1 rocket orbited Earth. In 2012, SpaceX became the first private spacecraft to autonomously travel to the International Space Station (ISS). The company had performed more than 20 cargo docking missions to the ISS by 2023. Included in these missions was a May 2023 flight crewed by three former NASA astronauts and three paying customers wishing to experience space travel.

By mid-2023, SpaceX had become the world's leading provider of launch services with 234 rocket launches, conducted 195 successful landings of returning rockets, and completed 168 reusable rocket re-flights. The company had also deployed more than 2,200 proprietary satellites supporting its Starlink satellite-based Internet service. Ownership of the company was closely held by Elon Musk and other private investors but had an estimated market value of $137 billion in 2023.

Going into the second half of 2023, SpaceX continued to test its Super Heavy rocket stage which would help power the Starship on a mission to orbit the Moon with a human crew. The 7-day dearMoon mission was planned for late 2023 and would allow Japanese entrepreneur Yusaku Maezawa and ten crew members to orbit the Moon and safely return to Earth. The Polaris Dawn missions planned for summer 2023 would be precursors to the dearMoon mission and would involve three human spaceflight missions to the highest Earth orbit every flown by a SpaceX craft. A crew of four astronauts would pilot the Polaris Dawn mission and utilize the SpaceX Dragon capsule attached to a SpaceX Falcon 9 rocket. There was some concern that SpaceX was setting an unrealistic timeline given its stage separation failure on a May 2023 launch. Also, while the company's business model that involved fees for satellite deployment and subscription fees for its Starlink satellite-based Internet service appeared viable, beyond NASA-funded flights, the profit formula for human spaceflight was less understood.

Company History

Space Exploration Technologies Corporation (SpaceX) was founded in 2002 by Elon Musk in Hawthorne, California, with the mission of creating an era of commercial space travel. The company's business model was based on the development of reusable rockets that would greatly reduce the cost of space travel as all prior rockets developed by NASA, Lockheed Martin, Boeing, and others had been designed as a single-use craft. Another cost advantage of SpaceX vehicles was its proprietary Merlin engine, which had a much lower cost of development, fabrication, and assembly than rocket engines produced by defense contractors and other manufacturers.

The company's first rocket, Falcon 1, underwent a series of unsuccessful launches between 2006 and mid-2008 but became the first rocket owned by a private company to orbit Earth in September 2008. The successful orbit aided SpaceX in obtaining a $1 billion contract with NASA to build spacecraft able to provide deliveries to the International Space Station (ISS). The deliveries by SpaceX were planned to begin after the Space Shuttle was decommissioned. In 2010, SpaceX began development of a larger Falcon 9 craft which featured 9 Merlin engines. The company also broke ground on its Star Base launch site in Boca Chica, Texas. Both the Falcon 9 and another even larger Falcon Heavy craft would launch from the Texas Gulf Coast. Also in 2010, SpaceX became the first private company to orbit and return to Earth when the Dragon capsule performed the feat in December of that year.

In 2012, a SpaceX Dragon successfully autonomously traveled to the ISS. NASA also selected SpaceX to develop and build a successor to the space shuttle in 2012. The company was also the first to successfully execute a vertical landing of a rocket component when the Falcon 9 first stage landed near the launch site after separation from the capsule. The same rocket stage was reused for a second launch in 2017. Also, SpaceX successfully reused a previously flown Dragon capsule for a flight to the ISS in 2017. The company began testing its Falcon Heavy rocket in 2018 and successfully carried a Tesla Roadster to space and deployed it for orbit around the Sun in 2019.

The company also initiated its Starlink satellite Internet service in 2019. About 50 Starlink satellites could be launched in each Falcon 9 flight for orbit around Earth. SpaceX had deployed more than 2,200 Starlink satellites to orbit in 2022 and would eventually launch more than 30,000 Starlink satellites. The company announced in 2020 that the Falcon 9 and Falcon Heavy would be succeeded by a Super Heavy-Starship that would be capable of lifting 220,000 pounds to low Earth orbit. In 2023, SpaceX announced that Japanese entrepreneur Yusaku Maezawa and ten crew members would embark on a 7-day Starship flight that would orbit the Moon and return to Earth by year-end. Exhibit 1 presents key milestones in the development and achievements of the SpaceX Falcon, Falcon Heavy, Dragon, Super Heavy, and Starship. Images of SpaceX's rockets in use in 2023 are presented in Exhibit 2.

Vision and Mission

Elon Musk's strategic vision for SpaceX was focused on "making humanity multiplanetary." Musk's immediate mission and goals were keyed to developing next-generation, fully reusable spacecraft capable of carrying humans to Mars and other destinations in the solar system. Elon Musk believed that life should be multi-planetary to ensure the continuation of the human race given some catastrophic event impacting Earth. "If you think really long term, there will eventually be some natural disaster, even if not made by humans, that destroys all life on Earth. Eventually the Sun will expand and evaporate the oceans and we will be like Venus—so hot that no life can exist... so the only way that we can prolong life as we know it is to become multi-planetary and ultimately multi-stellar."[1]

In addition to making humanity multiplanetary, Musk also suggested that the company's powerful rockets such as the Starship could play a role in the defense of Earth against asteroids and comets.

"Earth currently has no ability to stop asteroids. With Starship, we have some ability to stop an asteroid. A comet would be the real danger because there are billions or trillions of objects in the outer solar system. For example, the comet Shoemaker-Levy hit Jupiter, making a hole in Jupiter the size of Earth. So, if that did hit Earth, then 'Game Over' everything's dead."[2]

Business Model and Strategy

Musk believed that reusability was the key to developing a cost-effective way to access space travel for

EXHIBIT 1 SpaceX's Milestone Achievements in Space Exploration

Date	Spacecraft	Milestone Achievement
2008	Falcon 1	Successful orbit of Earth by a SpaceX craft.
2010	Falcon 9/Dragon capsule	Successful orbit of Earth by a human crewed SpaceX craft.
2012	Falcon 9/Dragon capsule	First private company to successful autonomously travel to the ISS.
2015	Falcon 9	First successful vertical landing of an orbital class unmanned rocket booster.
2016	Falcon 9	First successful vertical landing of an unmanned rocket booster to an ocean-based landing platform.
2017	Falcon 9/Dragon capsule	First successful re-flight of a rocket used in previous flights.
2018	Falcon Heavy	First launch to orbit of the 27-engine Falcon Heavy with successful return of both boosters and placement of a Tesla Roadster into an orbit of the Sun.
2019	Starlink	First deployment of 60 Starlink satellites into Earth's orbit.
2019	Dragon	First successful autonomous docking with the ISS by an American spacecraft.
2020	Falcon 9/Dragon capsule	First cargo mission to the ISS using a human crewed SpaceX craft piloted by seasoned NASA astronaut team of Bob Behnken and Doug Hurley.
2021	Dragon	World's first civilian mission to Earth's orbit.
2021	Starship	First successful high-altitude flight test of the craft.
2021	Dragon	Longest duration mission for a U.S. spacecraft. The 167-day mission was piloted by four astronauts and docked with the ISS.
2022	Starship	Selected by NASA to perform its Artemis III human crewed lunar landing.
2023	VAST Haven-1/Falcon Heavy	Space exploration company, VAST, selected SpaceX to launch its commercial space station using the Falcon Heavy rocket.
2023	Starship Super Heavy	Successful launch of the world's most powerful launch vehicle.

EXHIBIT 2 Images of SpaceX's Rocket Models in 2023

Falcon 9

Dragon capsule

Falcon Heavy

Starship Super Heavy

Source: **SpaceX.com**

satellite deployment, exploration, and fights to the Moon, Mars, or beyond. Whereas the Saturn V that flew every NASA mission between 1967 and 1973 cost approximately $50 billion in 2020 to construct, SpaceX's Starship cost about $5 billion. Additionally, Starships were reusable, spreading the development and construction costs across multiple flights.

The efficiency and reusability of SpaceX craft gave the company a considerable cost advantage over its rivals in obtaining contracts to deploy satellites. In addition, NASA had become so impressed with SpaceX's business model and efficiency that in 2022 SpaceX had been selected to develop and construct human lunar landing craft to fulfil NASA's forthcoming Artemis III mission to return to the Moon. SpaceX was also selected by NASA to dock with the Gateway space station that was planned to orbit the Moon. Each flight would allow four crew members to deliver supplies, equipment, and science payloads to the Gateway. SpaceX also offered its Starshield service to governmental customers beyond NASA and the military. The service included rapid development and deployment of end-to-end satellite systems for earth observation, communications, and hosted payloads. Starshield met the security needs of governmental customers through end-to-end data encryption and high-assurance cryptographic capabilities.

By 2021, SpaceX had deployed 143 satellite payloads, surpassing the 104 deployed satellites of the previous leading commercial satellite deployment rocket firm. SpaceX's cost advantage allowed it to charge as little as $275,000 to deploy small satellites weighing 50 kilograms. The cost to deploy satellites as large as 831 kilograms was $5.4 million in 2023. The company had also deployed more than 2,200 of its own low-orbit Starlink satellites with a planned deployment of more than 30,000 Starlinks in low-orbit. Starlink was a satellite-based Internet service launched by SpaceX that offered consumers anywhere in the world high-speed bandwidth allowing for streaming, video calls, online gaming, and most other activities requiring broadband access. The Starlink Internet service was the world's most advanced broadband satellite service because of its low Earth orbit deployment at about 550 kilometers. A signal coming from a mobile phone or computer could be transmitted to a Starlink satellite and then be received by another user anywhere in the world in 25 milliseconds. Competing satellite Internet services utilized single geostationary satellites that orbit Earth at 35,786 kilometers and required more than 600 milliseconds to receive and transmit a signal.

Among the other technological innovations of Starlink satellites was its low mass, compact flat-panel design that allowed more than 50 satellites to be deployed during each Falcon 9 flight. Starlink satellites were also capable of autonomously avoiding collisions with orbital debris and other spacecraft. The company was also developing optical space laser technology that would allow for data transmission without local ground stations and necessary for global service coverage. The ground-based Standard, High Performance, and Flat High-Performance antennas used by subscribers allowed residential customers, businesses, governments, or mobile phone providers to access the satellite Internet signal. The Starlink Flat High-Performance antenna could also be installed on vehicles, maritime vessels, and aircraft.

In 2023, Starlink's low-bandwidth Swarm satellite Internet connectivity service was offered at $5 per month. Starlink's high-bandwidth service plans were offered at $90 per month for residential customers, $150 per month for mobile service for RVs and campers, and $250 per month for high demand businesses and maritime and emergency response customers. Starlink service was available throughout Europe, the United States, Mexico, Brazil, Peru, Australia, Nigeria, Chile, Peru, Ecuador, Colombia, Japan, and the Philippines in 2023.

The company's goals and strategies related to human crewed flights were progressing with a planned launch of the Starship Super Heavy in 2023. The company had selected its crew for the first planned orbit of the Moon utilizing a human crew for the craft rather than piloting from a control room. SpaceX also announced in 2022 that Dennis Tito, the first commercial astronaut to visit the ISS, would be a crew member on The Starship Super Heavy's second planned orbit on the Moon. Dennis Tito's wife, Akiko Tito was also selected for the flight and would be among the first women to fly around the Moon on a Starship. The Titos requested to be considered for the trip to contribute to advance human spaceflight and contribute to SpaceX's vision of making life multiplanetary. The SpaceX Dragon capsule was capable of carrying up to 7 passengers to and from Earth orbit and beyond. The Starship being tested in 2023 with planned human crewed flights by year-end was capable of carrying up to 150 metric tonnes of cargo and 100 passengers on long-duration interplanetary trips. The company was accepting applications from individuals wishing to join a crew for an orbital mission. More than 1 million people applied to be considered for the two planned lunar orbits scheduled in 2023 and 2024.

Strategic Issues Confronting SpaceX in Mid-2023

By mid-2023, SpaceX's achievements in space exploration were far beyond what most would have envisioned at the company's founding in 2002. The company's development of reusable rockets had not been achieved by NASA or established rocket developers such as Boeing, Northrop Grumman, and Martin Marietta. And the company's progress in space exploration was unmatched by rival Blue Origin, which was founded by Jeff Bezos in 2000. Jeff Bezos had stated that Blue Origin's New Glenn heavy lift reusable rocket was only in the design stage in 2023 and was not expected to launch before 2029. Blue Origin's smaller New Sheppard rocket had completed six missions between 2021 and 2023 but only of a short 10-minute duration to the boundary of Earth's atmosphere and outer space 54 miles from Earth's surface. However, Blue Origin had also signed a $1 billion-plus contract with NASA to participate in the Artemis III project.

Also, as the last half of 2023 approached, it was undecided if SpaceX would be able to meet its timeline for the launch of the dearMoon mission planned for before year-end. The first flight test of Starship Super Heavy in May 2023 successfully launched but multiple engines failed, causing the first stage to not separate properly. The tumbling craft soon crashed to into the Gulf of Mexico. However, the company was routinely conducting successful launches of the Falcon 9 and Falcon Heavy for satellite deployment. The company completed seven launches in the month of May 2023 alone. Also, in May 2023, SpaceX contracted with the space exploration company, VAST, to deploy the first commercial space station in 2025 using the Falcon 9.

SpaceX also continued to launch Starlink satellites and had invited wireless service providers the opportunity to collaborate with the company to offer text services anywhere on the planet. At the time of the offer in 2023, wireless providers only had coverage on 80 percent of the United States and 10 percent of the Earth's service terrestrial wireless networks. While Starlink customers were already able to access broadband service capable of supporting streaming, online gaming, and video calls in 2023, its Starlink 2 satellites under development were capable of transmitting even more data. The company had the capacity to build up to 45 satellites per week and had launched as many as 240 satellites in a single month. However, only the Starship Super Heavy was capable of deploying the larger Starlink 2 satellites. Elon Musk had commented in May 2023 that, "We need Starship to work and to fly frequently or Starlink 2 will be stuck on the ground."[3]

SpaceX had become the first private company to deliver astronauts to the ISS, the only company to complete an all-civilian crewed mission to orbit and was committed to maintaining a sustainable and safe orbital environment. The company's satellites flew at low altitudes, had a reliability rating of greater than 99 percent, and were designed to heat to a plasma and demise if a satellite were deorbited. The deorbiting super heating design kept space free from debris and posed no risk to people or property on the ground. The achievement of the company's vision and success of its business model would be determined as it continued to advance or stall in developing and operating spacecraft and satellites.

ENDNOTES

[1] As quoted in "SpaceX's Starship—catching robotic launch tower with Elon Musk," *Everyday Astronaut*, **www.youtube.com/watch?v=XP5k3ZzPf_0** (accessed May 18, 2023).

[2] Ibid.

[3] Ibid.

CASE 2

Airbnb in 2023

John E. Gamble,
Texas A&M University-Corpus Christi

John D. Varlaro,
Johnson & Wales University

Airbnb was launched in 2007 when Brian Chesky and a friend decided to rent their apartment to guests for a local convention. To accommodate the guests, they used air mattresses and referred to it as the "Air Bed & Breakfast." It was that weekend when the idea—and the potential viability—of a peer-to-peer room-sharing business model was born. During its 16-year existence Airbnb had experienced immense growth and had successfully launched an IPO in 2020. By 2022, Airbnb had entered over 220 countries with more than 5 million locations. In 2023, Airbnb seemed positioned to continue revolutionizing the hotel and tourism industry through its business model that allowed hosts to offer spare rooms or entire homes to potential guests in a peer-reviewed digital marketplace.

The global COVID-19 pandemic had presented challenges to Airbnb and other businesses such as hotels operating in the travel and accommodation market during 2020. However, by 2021, Airbnb's bookings and revenues grew to more than 300 million and nearly $6 billion. In 2022, the company's bookings increased by 31 percent over 2021 and its revenues had increased to $8.4 billion. The additional scale and booking volume had validated Airbnb's business model with the company recording its first profitable year with net income of $1.9 billion. Airbnb also generated a free cash flow of $3.4 billion in 2022. The company's growth occurred in all geographic regions, with revenues in North America and Europe, Middle East and Africa increasing by 31.5 percent and 51.4 percent, respectively.

While the company seemed poised to capture growth in the travel market, Airbnb announced in early 2023 that it would reduce new employee recruiting efforts in anticipation of slowing growth. The Airbnb's chief managers would be pressed to assess the company's business model and strategy to sustain its growth in bookings and revenues and to ensure sufficient scale to generate profits and free cash flow. Exhibit 1 provides Airbnb's income statements for 2019–2022. The company's balance sheets for 2021 and 2022 are presented in Exhibit 2. The company's bookings, gross booking value, and revenues by geographic region are provided in Exhibit 3.

OVERVIEW OF ACCOMMODATION MARKET

Hotels, motels, and bed and breakfasts competed within the larger, tourist accommodation market. All businesses operating within this sector offered lodging but were differentiated by their amenities. Hotels and motels were defined as larger facilities accommodating guests in single or multiple rooms. Motels specifically offered smaller rooms with direct parking lot access from the unit and amenities such as laundry facilities to travelers who were using their own transportation. Motels might also be located closer to roadways, providing guests quicker and more convenient access to highways. It was also not uncommon for motel guests to segment a longer road trip as they commuted to a vacation destination, thereby potentially staying at several motels during their travel. Hotels, however, invested heavily in additional amenities as they competed for all segments of travelers. Amenities, including on-premise spa facilities and fine dining, were often offered by the hotel. Further, properties offering spectacular views, bolstering a

EXHIBIT 1 Airbnb, Inc.'s Income Statements, 2019–2022 (in millions, except per share amounts)

	2022	2021	2020	2019
Revenue	$ 8,399	$5,992	$3,378	$4,805
Costs and expenses:				
Cost of revenue	1,499	1,156	876	1,196
Operations and support	1,041	847	878	815
Product development	1,502	1,425	2,753	977
Sales and marketing	1,516	1,186	1,175	1,622
General and administrative	950	835	1,135	697
Restructuring charges	89	113	151	–
Total costs and expenses	6,597	5,562	6,968	5,307
Income (loss) from operations	1,802	430	(3,590)	(502)
Interest income	186	13	27	86
Interest expense	(24)	(438)	(172)	(10)
Other income (expense), net	25	(305)	(947)	14
Income (loss) before income taxes	1,989	(300)	(4,682)	(412)
Provision for (benefit from) income taxes	96	52	(97)	263
Net income (loss)	$1,893	($352)	($4,585)	($675)
Net loss per share attributable to Class A and Class B common stockholders:				
Basic	$2.97	($0.57)	($16.12)	($2.59)
Diluted	$2.79	($0.57)	($16.12)	($2.59)
Weighted-average shares used in computing net loss per share attributable to Class A and Class B common stockholders:				
Basic	637	616	284	261
Diluted	680	616	284	261

Source: Airbnb, Inc. 2022 Form 10-K.

EXHIBIT 2 Airbnb, Inc.'s Balance Sheets, 2021–2022 (in millions, except par value)

	As of December 31,	
	2022	2021
Assets		
Current assets:		
Cash and cash equivalents	$7,378	$ 6,067
Marketable securities	2,244	2,255
Funds receivable and amounts held on behalf of customers	4,783	3,715
Prepaids and other current assets (including customer receivables of $200 and $143 and allowances of $39 and $31, respectively)	456	349
Total current assets	14,861	12,386

(*continued*)

	As of December 31,	
	2022	2021
Property and equipment, net	121	157
Operating lease right-of-use assets	138	272
Intangible assets, net	34	52
Goodwill	650	653
Other assets, noncurrent	234	188
Total assets	$16,038	$13,708
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	137	118
Operating lease liabilities, current	59	63
Accrued expenses and other current liabilities	1,817	1,559
Funds payable and amounts payable to customers	4,783	3,715
Unearned fees	1,182	904
Total current liabilities	7,978	6,359
Long-term debt, net of current portion	1,987	1,983
Operating lease liabilities, noncurrent	295	372
Other liabilities, noncurrent	218	219
Total liabilities	10,478	8,933
Commitments and contingencies		
Stockholders' equity:		
Common stock, $0.0001 par value		
Class A—authorized 2,000 shares, 408 shares issued and outstanding as of December 31, 2022		
Class B—authorized 710 shares, 223 shares issued and outstanding as of December 31, 2022		
Class C—authorized 2,000 shares, zero shares of Class C common stock issued and outstanding as of December 31, 2022		
Class H—authorized 26 shares, 9 shares issued and none outstanding as of December 31, 2022	–	–
Additional paid-in capital	11,557	11,140
Accumulated other comprehensive income (loss)	(32)	(7)
Accumulated deficit	(5,965)	(6,358)
Total stockholders' equity	5,560	4,775
Total liabilities and stockholders' equity	$16,038	$13,708

Source: Airbnb, Inc. 2022 Form 10-K.

hotel as the vacation destination, may contribute to significant operating costs. In total, wages, property, and utilities, as well as purchases such as food, accounted for 57 percent of the industry's total costs—see Exhibit 4. The primary market segments of hotels and motels are presented in Exhibit 5.

Bed and breakfasts, however, were much smaller, usually where owner–operators offered a couple of rooms within their own home to accommodate guests. The environment of the bed and breakfast—one of a cozy, home-like ambiance—was what the guest desired when booking a room. Contrasted

EXHIBIT 3 Airbnb, Inc.'s Bookings, Gross Booking Value, and Revenues by Geographic Region, 2020–2022 (in millions, except percentages)

	2020	% of Total	2021	% of Total	2022	% of Total
	(in millions, except percentages)					
Nights and Experiences Booked						
North America	75.5	39%	114	38%	133	34%
EMEA	67.7	35%	118.1	39%	168	43%
Latin America	22.4	12%	38.8	13%	53	13%
Asia Pacific	27.6	14%	29.7	10%	40	10%
Total	193.2	100%	300.6	100%	394	100%
Gross Booking Value						
North America	$13,169.90	55%	$25,305.50	54%	$32,246	51%
EMEA	6,660.10	28	14,606.90	31	21,486	34
Latin America	1,700.80	7	3,706.00	8	4,838	8
Asia Pacific	2,366.10	10	3,258.60	7	4,642	7
Total	$23,896.90	100%	$46,877.00	100%	$63,212	100%
Revenue						
North America	$ 1,772.70	53%	$ 3,201.10	54%	$ 4,210	50%
EMEA	1,023.80	30	1,930.80	32	2,924	35
Latin America	242	7	431.2	7	643	8
Asia Pacific	339.7	10	428.7	7	622	7
Total	$ 3,378.20	100%	$ 5,991.80	100%	$ 8,399	100%

Source: Airbnb, Inc. 2021 Form 10-K.

EXHIBIT 4 Hotel, Motel, and Bed & Breakfast Industry Estimated Costs as Percentage of Revenue, 2021

Costs	Hotels/ Motels	Bed & Breakfasts
Wages	32%	30%
Purchases	21	23
Depreciation	9	5
Marketing	2	2
Rent and Utilities	4	4
Other	29	30

Source: www.ibisworld.com.

EXHIBIT 5 Major Market Segments for Hotels/Motels in the United States, 2021

Market Segment	Hotels
Domestic leisure	59.5%
Domestic business	19.0
International leisure	13.8
International business	7.7
Total	100.0%

Source: www.ibisworld.com.

with the hotel or motel, a bed and breakfast offered a more personalized, quieter atmosphere. Further, many bed and breakfast establishments were in rural areas where the investment to establish a larger hotel may have been cost prohibitive, yet the location itself could be an attraction to tourists. In these areas, individuals invested in a home and property, possibly with a historical background, to offer a bed and breakfast with great allure and ambiance for the guests' experiences. Thus, the bed and breakfast competed through offering an ambiance associated with a more rural, slower pace through which travelers connected with their hosts and the surrounding community.

While differing in size and target consumer, all hotels, motels, and bed and breakfasts were subject to city, state, and federal regulations. These regulations covered areas such as the physical property and food safety, access for persons with disabilities, and even alcohol distribution. Owners and operators were subject to paying fees for different licenses to operate. Due to operating as a business, these properties and the associated revenues were also subject to state and federal taxation.

In addition to regulations, the need to construct physical locations prevented hotels and motels from expanding quickly, especially in new international markets. Larger chains tended to expand by purchasing pre-existing physical locations or through mergers and acquisitions, such as Marriott International Inc.'s acquisition of Starwood Hotels and Resorts Worldwide in 2016.

A BUSINESS MODEL FOR THE SHARING ECONOMY

Startup companies have been functioning in a space commonly referred to as the "sharing economy" for several years. According to Chesky, the previous model for the economy was based on ownership.[1] Thus, operating a business first necessitated ownership of the assets required to do business. Any spare capacity the business faced—either within production or service—was a direct result of the purchase of hard assets in the daily activity of conducting business.

Airbnb and other similar companies, however, operated through offering a technological platform, where individuals with spare capacity could offer their services. By leveraging the ubiquitous usage of smartphones and the continual decrease in technology costs, these companies provided a platform for individuals to instantly share a number of resources. Thus, a homeowner with a spare room could offer it for rent, or the car owner with spare time could offer his or her services a couple of nights a week as a taxi service. The individual simply signed up through the platform and began to offer the service or resource. The company then charged a small transaction fee as the service between both users was facilitated.

Within its business model, Airbnb received a percentage of what the host received for the room. For Airbnb, its revenues were decoupled from the considerable operating expenses of traditional lodging establishments and provided it with significantly smaller operating costs than hotels, motels, and bed and breakfasts. Rather than expenses related to owning and operating real estate properties, Airbnb's expenses were that of a technology company. Airbnb's business model, therefore, was based on the revenue-cost-margin structure of an online marketplace, rather than a lodging establishment. For example, Marriott International, Inc. reported over 120,000 employees in 2022, while Airbnb, Inc. had just 6,800 employees. A comparison of Airbnb's 2020 revenue to the world's largest hoteliers is presented in Exhibit 6.

EXHIBIT 6 Annual Revenues for Airbnb, Inc. and Leading Hotel Chains, 2022 (in billions)

Competitor	2022 Revenues (in billions)
Marriott International, Inc.	$20.8
Hilton Worldwide Holdings	8.8
Airbnb, Inc.	8.4
Intercontinental Hotels Group	3.9

Source: **www.wsj.com** (accessed March 28, 2023).

A CHANGE IN THE CONSUMER EXPERIENCE

Airbnb, however, had not just been leveraging technology. It had also leveraged the change in how the current consumer interacted with businesses. In conjunction with this change seemed to be how the consumer had deemphasized ownership. Instead of focusing on ownership, consumers seemed to prefer sharing or renting. According to Airbnb, the majority of their guests were under 34 years of age.[2] Other startup companies had been targeting these segments through subscription-based services and on-demand help. From luxury watches to clothing, experiencing—and not owning—assets seemed to be on the rise. Citing a more experiential-based economy, Chesky believed Airbnb guests desired a community and a closer relationship with the host—and there seemed to be support for this assertion.[3] A Goldman Sachs study showed that, once someone used Airbnb, their preference for a traditional accommodation was

EXHIBIT 7 Airbnb, Inc.'s Market Capitalization Relative to Leading Hotel Chains, March 2023 (in billions)

Competitor	Market Capitalization (in billions)
Airbnb, Inc.	$74.5
Marriott International Inc.	48.3
Hilton Worldwide Holdings	35.3
Intercontinental Hotels Group	11.1

Source: **www.wsj.com** (accessed March 28, 2023).

greatly reduced.[4] The appeal of the company's value proposition with customers had allowed it to readily raise capital to support its growth. A comparison of Airbnb's March 2023 market capitalization to the world's largest hoteliers is presented in Exhibit 7.

Recognizing this shift in consumer preference, traditional brick-and-mortar operators responded. Hilton was considering offering a hostel-like option to travellers.[5] Other entrepreneurs were constructing urban properties to specifically leverage Airbnb's platform and offer rooms only to Airbnb users, such as in Japan[6] where rent and hotel costs were extremely high.

To govern the community of hosts and guests, Airbnb instituted a rating system. Popularized by companies such as Amazon, eBay, and Yelp, peer-to-peer ratings helped police quality. Both guests and hosts rated each other in Airbnb. This approach incentivized hosts to provide quality service, while encouraging guests to leave a property as they found it. Further, the peer-to-peer rating system greatly minimized the otherwise significant task and expense of Airbnb employees assessing and rating each individual participant within Airbnb's platform.

AIRBNB'S AGILE RESPONSE TO THE COVID-19 PANDEMIC

In 2019, Airbnb finally announced that the long-awaited IPO would occur during 2020. However, Airbnb dampened expectations with the announcement that it had experienced a net loss of over $300 million through September 2019 due to increases in operating costs.[7] Then, in the spring of 2020, the pandemic and efforts by the subsequent state and local governments to stop the spread of COVID-19 presented a significant threat to Airbnb and its business model. Instead of preparing for the IPO, Airbnb had to raise $2 billion in private equity funding and debt to support operations during the pandemic.[8] And in May 2020, Airbnb announced 1,900 employees, or about one quarter of the workforce, would be let go.[9]

Quickly, Airbnb adjusted its business operations. As guests cancelled their stays with hosts, Airbnb adjusted its cancellation policy. Normally, hosts had discretion over how to handle cancellations. Due to travel restrictions imposed by state and local governments, guests were forced to cancel their stays. Yet some hosts were still charging these guests based on their own cancellation policies. In response, Airbnb adjusted the policy by offering refunds for reservations made prior to March 14, 2020, through the end of June 2020.

Airbnb also offered safety and cleaning guidelines for its hosts. Given the nature of the pandemic, it had become paramount to ensure cleanliness. A guest or a host contracting COVID-19 due to an Airbnb stay could most certainly make people reluctant to use Airbnb in the future. For the hosts, however, the loss of the revenue streams seemed to be the most immediate problem. Many hosts depended on their revenue from rentals to afford the properties they owned, either as private homes or as short-term rental properties. Over the years, many hosts had built their finances around the anticipated revenue from guests. Since the pandemic began, some hosts reported they had experienced monetary losses in the tens of thousands of dollars. To support hosts, Airbnb established a $17 million fund to help support hosts that had acquired long-term status with Airbnb.[10]

To confront the challenges of the pandemic in 2020, Airbnb expanded its sharing-economy model by entering the "Online Experiences" market. Virtual experiences, such as cigar tastings and virtual guided tours of cities were all being offered for patrons to book and experience from their own home–whether or not they were under stay-at-home orders. As hybrid and remote work became normalized due to the pandemic in 2021, Airbnb focused its efforts on the business travel segment. While Airbnb's organizational agility allowed to the company to persist in 2020, its performance rebounded quickly in 2021 as global travel restrictions began to ease. The resilience of its business model and strength of its brand contributed to increased bookings of 31 percent and revenue growth of 40 percent between 2021 and 2022. The growth in bookings and revenues allowed for a net income of $1.9 billion and free cash flow of $3.4 billion in 2022.

AIRBNB'S STRATEGIC SITUATION IN 2023

In 2023, it seemed evident that Airbnb's business model had been validated with a value proposition that resonated with consumers and a profit formula that was generating attractive net income and free cash flow. However, there was great economic uncertainty in mid-2023 with inflation and a possible recession, large layoffs at many prominent companies, and household credit card debt that had jumped 15.5 percent between 2021 and 2022. Airbnb management appeared to be taking action to prepare for a slowdown in the travel industry with its announcement that its new employee recruiting efforts would be reduced. The upcoming months would disclose if organizational agility at Airbnb would allow it to successfully pivot once again in response to rapidly changing macroeconomic factors.

ENDNOTES

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CASE 3

Costco Wholesale in 2023: Mission, Business Model, and Strategy

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The University of Alabama

In 2023, Costco Wholesale's shareholders had ample reason to be highly pleased with the leadership of the company's CEO Craig Jelinek and the company's sustained competitive standing and record of long-term growth. Jelinek was the company's second CEO, having been elevated from his position as Costco's president to CEO in January 2012 to succeed Jim Sinegal, the company's legendary co-founder and chief executive officer (CEO) from 1983 until his retirement at year-end 2011. Sinegal had been the driving force behind Costco's 37-year evolution from a startup entrepreneurial venture into the third largest retailer in the United States and the world and the undisputed leader of the discount warehouse and wholesale club segment of the North American retailing industry.

Under Jelinek's leadership the past 11 years, Costco had grown from annual revenues of $89 billion and 598 membership warehouses at year-end fiscal 2011 to annual revenues of $227.0 billion and 838 membership warehouses at year-end fiscal 2022 (August 28, 2022). Costco's growth continued in the first nine months of fiscal 2023; nine-month revenues were $161.3 billion, up 5.5 percent over the first nine months of fiscal 2022, earnings per share were up 4.0 percent over fiscal 2022, and the company had opened 15 additional warehouses and relocated 3 others as of July 2023. As of July 2023, Costco remained solidly entrenched as the third largest retailer in both the United States and the world (behind Walmart and Amazon) and as the dominant revenue leader of the discount warehouse and wholesale club segment of the North American retailing industry (over $100 billion ahead of second place Sam's Club and over $150 billion ahead of third place BJ's Wholesale Club). Moreover, Costco was widely regarded as one of the world's best consumer goods merchandisers.

COMPANY BACKGROUND

The membership warehouse concept was pioneered by discount merchandising sage Sol Price, who opened the first Price Club in a converted airplane hangar on Morena Boulevard in San Diego in 1976. Price Club lost $750,000 in its first year of operation, but by 1979 it had two stores, 900 employees, 200,000 members, and a $1 million profit. Years earlier, Sol Price had experimented with discount retailing at a San Diego store called Fed-Mart. Jim Sinegal got his start in retailing at the age of 18, loading mattresses for $1.25 an hour at Fed-Mart while attending San Diego Community College. When Sol Price sold Fed-Mart, Sinegal left with Price to help him start the San Diego Price Club store; within a few years, Sol Price's Price Club emerged as the unchallenged leader in member warehouse retailing, with stores operating primarily on the West Coast.

Although Price originally conceived Price Club as a place where small local businesses could obtain needed merchandise at economical prices, he soon concluded that his fledgling operation could achieve far greater sales volumes and gain buying clout with suppliers by also granting membership to individuals—a conclusion that launched the deep-discount warehouse club industry on a steep growth curve.

When Sinegal was 26, Sol Price made him the manager of the original San Diego store, which had become unprofitable. Price saw that Sinegal had a special knack for discount retailing and for spotting what a store was doing wrong (usually either not being in the right merchandise categories or not selling items at the right price points)—the very things that Sol Price was good at and that were at the root of Price Club's growing success in the marketplace. Sinegal soon got the San Diego store back into the black. Over the next several years, Sinegal continued to build his prowess and talents for discount merchandising. He mirrored Sol Price's attention to detail and absorbed all the nuances and subtleties of his mentor's style of operating—constantly improving store operations, keeping operating costs and overhead low, stocking items that moved quickly, and charging ultra-low prices that kept customers coming back to shop. Realizing that he had mastered the tricks of running a successful membership warehouse business from Sol Price, Sinegal decided to leave Price Club and form his own warehouse club operation.

Sinegal and Seattle entrepreneur Jeff Brotman founded Costco, and the first Costco store began operations in Seattle in 1983—the same year that Walmart launched its warehouse membership format, Sam's Club. By the end of 1984, there were nine Costco stores in five states serving over 200,000 members. In December 1985, Costco became a public company, selling shares to the public and raising additional capital for expansion. Costco became the first ever U.S. company to reach $1 billion in sales in less than six years. In October 1993, Costco merged with Price Club. Jim Sinegal became CEO of the merged company, presiding over 206 PriceCostco locations, with total annual sales of $16 billion. Jeff Brotman, who had functioned as Costco's chairman since the company's founding, became vice chairman of PriceCostco in 1993 and was elevated to chairman of the company's board of directors in December 1994, a position he held until his unexpected death in 2017.

In January 1997, after the spin-off of most of its non-warehouse assets to Price Enterprises Inc., PriceCostco changed its name to Costco Companies Inc. When the company reincorporated from Delaware to Washington in August 1999, the name was changed to Costco Wholesale Corporation. The company's headquarters is in Issaquah, Washington, not far from Seattle.

Jim Sinegal's Leadership Style

Sinegal was far from the stereotypical CEO. He dressed casually and unpretentiously, often going to the office or touring Costco stores wearing an open-collared cotton shirt that came from a Costco bargain rack and sporting a standard employee name tag that said, simply, "Jim." His informal dress and unimposing appearance made it easy for Costco shoppers to mistake him for a store clerk. He answered his own phone, once telling ABC News reporters, "If a customer's calling and they have a gripe, don't you think they kind of enjoy the fact that I picked up the phone and talked to them?"[1]

Sinegal spent considerable time touring Costco stores, using the company plane to fly from location to location and sometimes visiting 8 to 10 stores daily (the record for a single day was 12). Treated like a celebrity when he appeared at a store (the news "Jim's in the store" spread quickly), Sinegal made a point of greeting store employees. He observed, "The employees know that I want to say hello to them, because I like them. We have said from the very beginning: 'We're going to be a company that's on a first-name basis with everyone.'"[2] Employees genuinely seemed to like Sinegal. He talked quietly, in a commonsensical manner that suggested what he was saying was no big deal.[3] He came across as kind yet stern, but he was prone to display irritation when he disagreed sharply with what people were saying to him.

In touring a Costco store with the local store manager, Sinegal was very much the person-in-charge. He functioned as producer, director, and knowledgeable critic. He cut to the chase quickly, exhibiting intense attention to detail and pricing, wandering through store aisles firing a barrage of questions at store managers about sales volumes and stock levels of particular items, critiquing merchandising displays or the position of certain products in the stores, commenting on any aspect of store operations that caught his eye, and asking managers to do further research and get back to him with more information whenever he found their answers to his questions less than satisfying. Sinegal had tremendous merchandising savvy, demanded much of store managers and employees, and definitely set the tone for how the company operated its discounted retailing business. Knowledgeable observers regarded Jim Sinegal's merchandising expertise as being on a par with Walmart's legendary founder, Sam Walton.

In September 2011, at the age of 75, Jim Sinegal informed Costco's Board of Directors of his intention to step down as CEO of the company effective January 2012. The Board elected Craig Jelinek, Costco's President and Chief Operating Officer since February 2010, to succeed Sinegal and hold the titles of both President and CEO. At the time, Jelinek was a highly experienced retail executive with 37 years in the industry, 28 of them at Costco, where he started as one of the Company's first warehouse managers in 1984. He had served in every major role related to Costco's business operations and merchandising activities during his tenure. When he stepped down as CEO, Sinegal retained his position on the company's Board of Directors and, at the age of 79, was reelected to another three-year term on Costco's board in December 2015; he retired from Costco's Board at the end of his term in January 2018.

COSTCO WHOLESALE IN 2023

At year-end 2022, Costco operated 838 warehouses, including 583 in the United States and Puerto Rico, 107 in Canada, 40 in Mexico, 31 in Japan, 29 in the United Kingdom, 18 in Korea, 14 in Taiwan, 14 in Australia, four in Spain, two each in France and China, and one each in Iceland, Sweden, and New Zealand. Costco also operated e-commerce sites in the U.S., Canada, the United Kingdom, Mexico, Korea, Taiwan, Japan, and Australia; e-commerce sales represented about seven percent of total net sales (about $13.5 billion) in fiscal 2022 versus 3 percent in 2014. Nearly 119 million cardholders were entitled to shop at Costco as of January 2023; in fiscal year 2022, membership fees generated $4.2 billion in revenues for the company. Prior to the COVID-19 pandemic, foot traffic at Costco's warehouse locations averaged over 3.2 million members per day; during much of 2020, foot traffic fell off significantly, but in 2021 member visits were higher each month compared to 2019 and in 2022 were higher than pre-pandemic levels. Annual sales per Costco warehouse averaged about $245 million ($4.7 million per week) in fiscal 2022, an amount that was double the $122.7 million per year average for Sam's Club warehouses in the United States and Puerto Rico, Costco's chief warehouse competitor. In 2022, Costco was the only national retailer in the history of the world that could boast of average annual revenue of $245 million *per location.*

Exhibit 1 contains a financial and operating summary for Costco for fiscal years 2019 through 2022.

EXHIBIT 1 Selected Financial and Operating Data for Costco Wholesale Corp., Fiscal Years 2019–2022 ($ in millions, except for per share data)

	Fiscal Years Ending			
Selected Income Statement Data	**Aug. 28, 2022**	**Aug. 29, 2021**	**Aug. 30, 2020**	**Sept. 1, 2019**
Net sales	$222,730	$192,052	$163,220	$149,351
Membership fees	4,224	3,877	3,541	3,352
Total revenues	226,954	195,929	166,761	152,703
Operating expenses				
Merchandise costs	199,382	170,684	144,939	132,886
Selling, general and administrative	19,779	18,537	16,332	14,994
Total operating expenses	219,161	189,221	161,326	147,966
Operating income	7,793	6,708	5,435	4,737
Other income (expense)				
Interest expense	(158)	(171)	(160)	(150)
Interest income and other, net	205	143	92	178
Income before income taxes	7,840	6,680	5,367	4,765

continued

	Fiscal Years Ending			
Selected Income Statement Data	**Aug. 28, 2022**	**Aug. 29, 2021**	**Aug. 30, 2020**	**Sept. 1, 2019**
Provision for income taxes	1,925	1,601	1,308	1,061
Net income attributable to Costco	$5,844	$5,007	$4,002	$3,659
Diluted net income per share	$13.14	$11.27	$9.02	$8.26
Dividends per share (not including a special dividend of $10.00 per share paid in December 2020)	$3.38	$2.98	$2.75	$2.44
Millions of shares used in per share calculations	444.8	444.3	443.9	442.9
Selected Balance Sheet Data				
Cash and cash equivalents	$10,203	$11,258	$12,277	$8,384
Merchandise inventories	17,907	14,215	12,242	11,395
Current assets	32,696	29,505	28,120	23,485
Current liabilities	31,998	29,441	24,844	23,237
Net property and equipment	24,646	23,492	21,807	20,890
Total assets	64,166	59,268	55,556	45,400
Long-term debt, excluding current portion	6,484	6,692	7,514	5,124
Stockholders' equity	20,642	17,564	18,284	15,584
Cash Flow Data				
Net cash provided by operating activities	$7,792	$8,958	$8,861	$6,356
Warehouse Operations				
Warehouses in operation at beginning of fiscal year	815	794	782	762
New warehouses opened (including relocations)	26	22	16	25
Existing warehouses closed (including closures due to relocations)	(3)	(1)	(4)	(5)
Warehouses at end of fiscal year	838	815	794	782
Net sales per warehouse open at year-end (in millions)	$267	$236	$206	$191
Average annual growth at warehouses open more than a year (excluding the impact of changing gasoline prices and foreign exchange rates)	11%	13%	9%	6%
Members at year-end				
Businesses, including add-on members (000s)	11,800	11,500	11,300	11,000
Gold Star members (000s)	54,000	50,200	46,800	42,900
Total paid members	65,800	61,700	58,100	53,900
Household cardholders that both business and Gold Star members were automatically entitled to receive	53,100	49,900	47,400	44,600
Total cardholders	118,900	111,600	105,500	98,500

Note: Some totals may not add due to rounding and to not including some line items of minor significance in the company's income statement.
Sources: Company 10-K reports for fiscal years 2019, 2020, 2021, and 2022.

COSTCO'S MISSION, BUSINESS MODEL, AND STRATEGY

Costco's stated mission in the membership warehouse business was: "To continually provide our members with quality goods and services at the lowest possible prices."[4] However, in a "Letter to Shareholders" in the company's 2011 Annual Report, Costco's three top executives—Jeff Brotman, Jim Sinegal, and Craig Jelinek—provided a more expansive view of Costco's mission, stating:

> The company will continue to pursue its mission of bringing the highest quality goods and services to market at the lowest possible prices while providing excellent customer service and adhering to a strict code of ethics that includes taking care of our employees and members, respecting our suppliers, rewarding our shareholders, and seeking to be responsible corporate citizens and environmental stewards in our operations around the world."[5]

In the company's 2017 Annual Report, Craig Jelinek elaborated on how environmental sustainability fit into Costco's mission:

> Sustainability to us is remaining a profitable business while doing the right thing. We are committed to lessening our environmental impact, decreasing our carbon footprint, sourcing our products responsibly, and working with our suppliers, manufacturers, and farmers to preserve natural resources. This will remain at the forefront of our business practices.[6]

The centerpiece of Costco's business model going into 2023 was a powerful value proposition that featured a combination of (1) ultra-low prices on a limited selection of nationally branded and Costco's private-label Kirkland Signature products in a wide range of merchandise categories, (2) very good to excellent product quality, and (3) intriguing product selection that included both everyday items and ongoing special purchases from a big variety of merchandise suppliers that turned shopping at Costco into a money-saving treasure hunt. Management strived diligently to make shopping at Costco a pleasant, worthwhile experience—one that delivered enough value and satisfaction to prompt many members to spend more money and /or to increase the frequency with which they shopped at a nearby warehouse. A complementary element of the business model was to rely on positive member word-of-mouth to inform acquaintances about the benefits of shopping at Costco and thereby help spur membership growth at the company's warehouses. Costco's track record in growing warehouse sales volumes and membership created opportunities to achieve even faster revenue growth by opening new warehouses both domestically and internationally.

Big sales volumes and rapid inventory turnover—when combined with the low operating costs achieved by volume purchasing, efficient distribution, and reduced handling of merchandise in no-frills, self-service warehouse facilities—enabled Costco to operate profitably at significantly lower gross margins than traditional wholesalers, mass merchandisers, supermarkets, and supercenters. Membership fees were a critical element of Costco's business model because they provided sufficient supplemental revenues to boost the company's overall profitability to acceptable levels. Costco's revenues from membership fees accounted for a low of 57.7 percent to a high of 70.8 percent of the company's operating profits in fiscal years 2018 to 2021.

Membership fees were a critical element of Costco's business model in two important respects:

1. The revenues from membership fees provided a very significant boost to the company's profit margins and bottom-line profitability. Costco's revenues from membership fees accounted for 91.6 percent of Costco's net profits in fiscal 2019, 88.5 percent in fiscal 2020, 77.4 percent in 2021, and 72.3 percent in 2022. And, as shown in Exhibit 2, the company's revenues from membership fees transformed its otherwise razor-thin operating profit and net profit margins into much improved overall profitability.
2. The revenues from membership fees were strategically and competitively important in enabling Costco to charge prices for its good and services that were no higher than needed to generate a revenue stream that would just barely cover the company's total operating expenses (as shown in part A of Exhibit 2). But Costco's "barely breakeven approach to pricing its merchandise" meant that Costco members quickly learned that the prices at Costco were typically substantially lower than what they had to pay at establishments selling items comparable to those that Costco stocked—this was largely due to the fact that most merchandisers had no stream of membership fees to supplement their revenues and boost their profitability—their profitability was largely a function of their revenues from merchandise sales that enabled it to charge prices fractionally above breakeven levels and barely cover the company's total operating expenses.

EXHIBIT 2 The Importance of Costco's Membership Fees to Costco's Overall Profitability, Fiscal Years 2019–2022 (in millions of dollars except for percentages)

A. Costco's profitability without revenues from membership fees

	Fiscal Years Ending			
	Aug. 28, 2022	Aug. 29, 2021	Aug. 30, 2020	Sept. 1, 2019
Net sales revenues	$222,730	$192,052	$163,220	$149,351
Total operating expenses	219,631	189,221	161,326	147,966
Operating income without membership fees	3,569	2,832	1,894	1,385
Operating profit margin without membership fees	**1.60%**	**1.47%**	**1.16%**	**0.93%**
Net income attributable to Costco without membership fees	**$1,620**	**$1,130**	**$461**	**$307**
Net profit margin without membership fees	**0.73%**	**0.59%**	**0.28%**	**0.21%**

B. Costco's profitability with revenues from membership fees

Net sales revenues	$222,730	$192,052	$163,220	$149,351
Membership fees	4,224	3,877	3,541	3,352
Total revenues	226,954	195,929	166,761	152,703
Total operating expenses	219,161	189,221	161,326	147,966
Operating income with membership fees	7,793	6,708	5,435	4,737
Operating profit margin with membership fees	**3.43%**	**3.42%**	**3.26%**	**3.10%**
Net income attributable to Costco with membership fees	**$5,844**	**$5,007**	**$4,002**	**$3,659**
Net profit margin with membership fees	**2.57%**	**2.56%**	**2.40%**	**2.40%**
Percentage of net income attributable to revenues from membership fees	**72.3%**	**77.4%**	**88.5%**	**91.6%**

Source: Calculated by the case author from the Selected Income Statement Data in Exhibit 1.

A final element of Costco's business model was that its high sales volume and rapid inventory turnover generally allowed it to sell and receive cash for inventory in time to take advantage of early payment discounts offered by its merchandise suppliers. As a consequence, Costco was able to finance a big percentage of its merchandise inventory through the payment terms provided by vendors rather than by having to maintain sizable working capital (defined as current assets minus current liabilities) to earn the early payment discounts that suppliers offered.

Two outcomes made Costco's business model unusually powerful: (1) its strong ability to deliver significant value to its members in the form of attractively low prices and a money-saving treasure hunt shopping environment and (2) its potency, over the years, in delivering significant value to shareholders via strong growth in sales and earnings, higher earnings per share, a rising dividend, and a rising stock price. The first three drivers of shareholder value for the 2019 to 2022 fiscal years are shown in the income statement data section of Exhibit 1; the value delivered to shareholders via a rising stock price has been especially impressive—Costco's stock price rose from $195 at yearend 2017 to $352 at yearend 2020, and to $569.78 as of July 27, 2023.

Costco's Strategy

The key elements of Costco's strategy were ultra-low prices, a limited selection of nationally branded and top-quality Kirkland Signature products covering diverse merchandise categories, a "treasure hunt" shopping environment that stemmed from a constantly changing inventory of about 900 "while-they-last specials," strong emphasis on low operating costs, and ongoing expansion of its geographic network of store locations.

Pricing Costco's philosophy was to keep customers coming in to shop by wowing them with low prices and thereby generating big sales volumes. Examples of Costco's 2015 sales volumes that contributed to low prices in particular product categories included 156,000 carats of diamonds (up to 400,000 carats in 2019), meat sales of $6.4 billion, seafood sales of $1.3 billion, television sales of $1.8 billion, fresh produce sales of $5.8 billion (sourced from 44 countries), 7.9 million tires, 41 million prescriptions, 6 million pairs of glasses, and 128 million hot dog/soda pop combinations. Costco was the world's largest seller of fine wines ($965 million out of total 2015 wine sales of $1.7 billion). In 2022, Costco's five most popular products were:[7]

1. Kirkland Signature bath tissue, with sales of 1 billion rolls a year and revenues of over $400 million annually. Costco's toilet paper was thicker, more absorbent, and less expensive per sheet than many other brands.
2. Costco's legendary rotisserie chicken, with sales of over 100 million over-sized chickens in 2021 at the company's longstanding price of $4.99 (which resulted in annual losses of $30 to $40 million).
3. Costco's Kirkland Signature Hickory Smoked bacon which was thick-cut, priced about $1.25 per pound below rival brands, and had been rated as the No. 1 best-tasting bacon in a 2013 *Consumer Reports* taste test.[8] In the taste test, Costco's Kirkland Signature bacon was the only brand to receive a rating of "excellent."
4. Costco's $1.50 hot dog and soda combo sold in the warehouse food courts produced sales of about 100 million hot dog-soda combos annually, not only because of its popularity with members but also because the $1.50 price had not changed since 1985.
5. Gasoline, which generated billions in sales annually and generated waiting lines at its pumps. Prices varied by location but typically ranged from 10 to 15 cents per gallon to sometimes as much 30 cents per gallon lower than nearby gas stations. Most Costco warehouses sold only two grades of gasoline, regular and premium; select locations in 24 states sold Kirkland Signature Diesel.

For many years, a key element of Costco's pricing strategy had been to cap its markup on brand-name merchandise at 14 percent (compared to 25 percent and higher markups for other discounters and most supermarkets and 50 percent and higher markups for department stores). Markups on Costco's private-label Kirkland Signature items were a maximum of 15 percent, but the sometimes fractionally higher markups still resulted in Kirkland Signature items being priced about 20 percent below comparable name-brand items. Except for Walmart, Costco's prices for fresh foods and grocery items ranged 20 to 30 percent below of the leading supermarket chains. Aside from being lower-priced, Costco's Kirkland Signature products—which included vitamins, juice, bottled water, coffee, spices, olive oil, canned salmon and tuna, nuts, laundry detergent, baby products, dog food, luggage, cookware, trash bags, batteries, wines and spirits, paper towels and toilet paper, and clothing—were designed to be of *equal or better* quality than national brands. Sales of Kirkland Signature products were $52 billion in fiscal 2020, $59 billion in 2021, and "exhibited strong global growth" in 2022.[9]

Due to the company's ultra-low pricing strategy and practice of capping the margins on branded goods at 14 percent and private-label goods at 15 percent, Costco's prices produced worldwide revenues from merchandise sales that were just fractionally above breakeven levels—as shown in Exhibit 2, Costco's net sales revenues (not counting membership fees) exceeded *all operating expenses* by only $1.34 billion to $3.65 billion in fiscal years 2019 to 2022, equal to operating profit margins ranging from a high of 1.60 percent to a low of 0.93 percent. Such small operating profit margins meant that Costco's prices at its warehouses across the world were exceptionally low compared to the prices that Costco members paid when shopping elsewhere. However, Costco's overall profitability was still attractive because Costco's membership fees significantly supplemented Costco's net sales revenues, thus boosting its actual operating profit margins and net profit margins, along with its after-tax net income and earnings.

Jim Sinegal explained the company's approach to pricing:

> We always look to see how much of a gulf we can create between ourselves and the competition. So that the competitors eventually say, "These guys are crazy. We'll compete somewhere else." Some years ago, we were selling a hot brand of jeans for $29.99. They were $50 in a department store. We got a great deal on them and could have sold them for a higher price but we went down to $29.99. Why? We knew it would create a riot.[10]

At another time, he said:

> We're very good merchants, and we offer value. The traditional retailer will say: "I'm selling this for $10. I wonder whether we can get $10.50 or $11." We say: "We're selling this for $9. How do we get it down to $8?" We understand that our members don't come and shop with us because of the window displays or the Santa Claus or the piano player. They come and shop with us because we offer great values.[11]

Indeed, Costco's markups and prices were so fractionally above the level needed to cover company-wide operating costs and interest expenses that Wall Street analysts had criticized Costco management for going all out to please customers at the expense of increasing profits for shareholders. One retailing analyst said, "They could probably get more money for a lot of the items they sell."[12] During his tenure as CEO, Sinegal had never been impressed with Wall Street calls for Costco to abandon its ultra-low pricing strategy, commenting: "Those people are in the business of making money between now and next Tuesday. We're trying to build an organization that's going to be here 50 years from now."[13] He went on to explain why Costco's approach to pricing would remain unaltered during his tenure:

> When I started, Sears, Roebuck was the Costco of the country, but they allowed someone else to come in under them. We don't want to be one of the casualties. We don't want to turn around and say, "We got so fancy we've raised our prices, and all of a sudden a new competitor comes in and beats our prices."[14]

On occasion, Costco reduced its prices on select merchandise to drive increased sales or to meet competitors' prices. Also, there were times when management decided to hold the prices of certain items steady despite cost increases instead of passing the cost increases on to members.

Product Selection Whereas typical supermarkets stocked about 40,000 items and a Walmart Supercenter or a SuperTarget might have 125,000 to 150,000 items for shoppers to choose from, Costco's merchandising strategy was to provide members with a selection of approximately 3,700 active items in its warehouses and a little more than double that number online that could be priced at bargain levels and thus provide members with significant cost savings. Of these, about 75 percent of its in-warehouse offerings were quality brand-name products and 25 percent carried the company's private-label Kirkland Signature brand. According to Craig Jelinek, "The working rule followed by Costco buyers is that all Kirkland Signature products must be equal to or better than the national brands, and must offer a savings to our members." Management believed that there were opportunities to increase the number of Kirkland Signature selections and achieve sales penetration of Kirkland-branded items to more than 30 percent of total sales—in fiscal 2021, sales of Kirkland Signature products totaled $59 billion (30.7 percent of merchandise sales), versus $52 billion (31.9 percent in fiscal 2020). Costco executives in charge of sourcing Kirkland Signature products constantly looked for ways to make all Kirkland Signature items better than their brand name counterparts and even more attractively priced. Costco members were very much aware that one of the great perks of shopping at Costco was the opportunity to buy top quality Kirkland Signature products at prices substantially lower than comparable name brand products.

Costco's product range covered a broad spectrum—rotisserie chicken, all types of fresh meats, seafood, fresh and canned fruits and vegetables, paper products, cereals, coffee, dairy products, cheeses, frozen foods, flat-screen televisions, cell phones and assorted other electronics products, jewelry, fresh flowers, fine wines, baby strollers, toys and games, musical instruments, ceiling fans, vacuum cleaners, books, apparel, cleaning supplies, DVDs, light bulbs, batteries, cookware, electric toothbrushes, vitamins, office supplies, and home appliances—but the selection in each product category was deliberately limited to fast-selling models, sizes, and colors. Many consumable products like detergents, canned goods, office supplies, and soft drinks were sold only in big-container, case, carton, or multiple-pack quantities. In a few instances, the selection within a product category was restricted to a single offering.

For example, Costco stocked only a 325-count bottle of Advil—a size many shoppers might find too large for their needs. Sinegal explained the reasoning behind limited selections:

> If you had 10 customers come in to buy Advil, how many are not going to buy any because you just have one size? Maybe one or two. We refer to that as the intelligent loss of sales. We are prepared to give up that one customer. But if we had four or five sizes of Advil, as most grocery stores do, it would make our business more difficult to manage. Our business can only succeed if we are efficient. You can't go on selling at these margins if you are not.[15]

In the last several years, organics had become a fast-growing category in both the fresh produce section and the grocery items section, and Costco buyers were devoting increased attention to growing the selection of organic items. In the fresh meats category, Costco was pursuing increased vertical integration, constructing a second meat plant in Illinois and a state-of-the-art poultry plant in Nebraska capable of processing 2 million chickens per week—in fiscal 2022 Costco warehouses sold a record 117 million oversized rotisserie chickens at its longstanding price of $4.99 (a price the company deliberately refrained from raising into to help entice members to shop at Costco warehouses more frequently). A baking commissary had been opened in Canada that supplied warehouses in much of Canada and the United States with bread and cookie dough for on-premise baking. Net sales accounted for by each major category of items stocked by Costco is shown in Exhibit 3.

EXHIBIT 3 Costco's Sales by Major Product Category, 2019–2022 (in millions of dollars)

	Fiscal Years Ending			
	2022	**2021**	**2020**	**2019**
	Aug. 28, 2022	Aug. 29, 2021	Aug. 30, 2020	Sept. 1, 2019
Food and Sundries (cereals, canned and packaged foods, coffee, spices, baking goods, freezer and cooler foods, groceries, snack foods, candy, alcoholic and nonalcoholic beverages, paper products, and cleaning supplies)	$85,629	$77,277	$68,659	$59,672
Fresh Foods (fresh produce, meats and fish, bakery, and deli products)	29,527	27,183	23,204	19,948
Non-Foods (major appliances, electronics, health and beauty aids, hardware, office supplies, postage and tickets, sporting goods, apparel, domestic goods and housewares, toys, seasonal items, books and DVDs, tires and automotive care, furniture, garden and patio items, small appliances, jewelry, and special order kiosks, garden and patio, sporting goods, tires, toys and seasonal, office supplies, automotive care, postage, tickets, apparel, small appliances, furniture, domestics, housewares, special order kiosk, and jewelry, small appliances, furniture, cameras, and automotive supplies)	61,100	55,966	44,807	41,160
Warehouse Ancillary and Other Businesses (gasoline, pharmacy, food court, optical and/or hearing aid centers, tire installation, e-commerce, business centers, travel, and assorted member services)	46,474	31,626	26,550	28,571

Note: Sales at the company's e-commerce websites and in its business centers have been allocated to the applicable merchandise categories. Most Costco warehouses were engaged in operating some, if not all, of the company's various ancillary businesses (food courts, pharmacies, tire centers, vision and hearing aid centers, business centers, gasoline stations, travel services, and assorted member services).

Source: Company 10-K reports, 2021 and 2022.

Management believed that Costco's ancillary offerings gave members reasons to shop at Costco more frequently and make Costco more of a one-stop shopping destination.

Costco's pharmacies were highly regarded by members because of the low prices. Costco Travel offers vacation packages, hotels, cruises, and other travel products exclusively for Costco members in the United States, Canada, and the United Kingdom. The company's practice of selling gasoline at discounted prices (typically 15 to 25 cents per gallon below the prices at nearby offsite stations) contributed significantly to the frequency with which nearby members shopped at Costco and made in-store purchases (at most Costco warehouses with gasoline operations, only members were eligible to buy gasoline). As of 2022, about 80 percent of Costco's existing warehouses in the United States and Canada sold gasoline (the remainder did not have sufficient space to install gas pumps). Almost all new Costco locations in the United States and Canada were opening with gas stations; globally, gas stations were being added at locations where local regulations and space permitted. Costco did not sell gasoline in South Korea or China.[16] Gasoline sales at 668 of Costco's 838 warehouses accounted for 14 percent of Costco's total net sales in fiscal 2022; this percentage varied as the price of gasoline rose and fell. The company's gross profit percentage on gasoline sales was significantly lower than on non-gasoline sales.

Treasure-Hunt Merchandising While Costco's product line consisted of approximately 3,700 active items, some 20 to 25 percent of its product offerings were constantly changing. Costco's merchandise buyers were continuously making one-time purchases of items that would appeal to the company's clientele and likely to sell out quickly. A sizable number of these featured specials were high-end or luxury-brand products that carried big price tags; examples included $1,000 to $3,000 big-screen TVs, $800 espresso machines, expensive jewelry and diamond rings (priced from $10,000 to $400,000+), Omega watches, Waterford Crystal, exotic cheeses, Coach bags, cashmere sports coats, $1,500 digital pianos, $800 treadmills, $2,500 memory foam mattresses, and Dom Perignon champagne. Many of the featured specials came and went quickly, sometimes in several days or a week—like Italian-made Hathaway shirts priced at $29.99 and $800 leather sectional sofas. The strategy was to entice shoppers to spend more than they might by offering irresistible deals on big-ticket items or name-brand specials and, further, to keep the mix of featured and treasure-hunt items constantly changing so that bargain-hunting shoppers would go to Costco more frequently rather than only for periodic "stock up" trips. Costco's buyers made a point of seeking opportunities to introduce new headline brands to its warehouse and online "treasure hunt" offerings, including products from Kitchen Aid, Nautica, Weber, Hickey-Freeman, Samsonite, Keurig, Instant Pot, Sperry, Kate Spade, Vera Wang, Tommy Bahama, John Hardy, Calvin Klein, Pendleton, DKNY, Banana Republic, Jacuzzi, Sonos, Samsung, LG, Sony, and Sealy Posturepedic.

Costco members quickly learned that they needed to go ahead and buy treasure-hunt specials that interested them because the items would very likely not be available on their next shopping trip. In many cases, Costco did not obtain its upscale treasure hunt items directly from high-end manufacturers like Calvin Klein or Waterford (who were unlikely to want their merchandise marketed at deep discounts at places like Costco); rather, Costco buyers searched for opportunities to source such items legally on the gray market from other wholesalers or distressed retailers looking to get rid of excess or slow-selling inventory. Management believed that these practices kept its marketing expenses low relative to those at typical retailers, discounters, and supermarkets.

Low-Cost Emphasis Keeping operating costs at a bare minimum was a major element of Costco's strategy and a key to its low pricing. As first explained by Jim Sinegal and later reiterated by Craig Jelinek:

> Costco is able to offer lower prices and better values by eliminating virtually all the frills and costs historically associated with conventional wholesalers and retailers, including salespeople, fancy buildings, delivery, billing, and accounts receivable. We run a tight operation with extremely low overhead which enables us to pass on dramatic savings to our members.[17]

While Costco management made a point of locating warehouses on high-traffic routes in or near upscale suburbs that were easily accessible by small businesses and residents with above-average incomes, it avoided prime real estate sites in order to contain land costs.

Because shoppers were attracted principally by Costco's low prices and merchandise selection, most warehouses were of a metal pre-engineered design, with concrete floors and minimal interior décor. Floor plans were designed for economy and efficiency in use of selling space, the handling of merchandise, and the control of inventory. Merchandise was often stored on racks above the sales floor and/or displayed on pallets containing large quantities of each

EXHIBIT 4 Images of Costco's Warehouses

Source: Costco management presentation, May 29, 2008 and March 2010. Used with permission from Costco.

Image Courtesy of Costco Wholesale

Felix Mizioznikov/Shutterstock

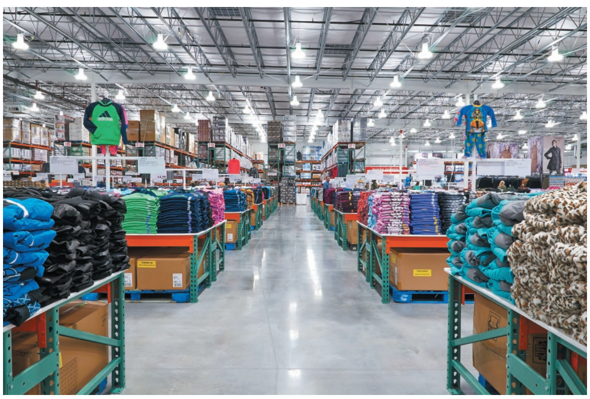

Image Courtesy of Costco Wholesale

Image Courtesy of Costco Wholesale

Image Courtesy of Costco Wholesale

Image Courtesy of Costco Wholesale

item, thereby reducing labor required for handling and stocking. In-store signage was done mostly on laser printers; there were no shopping bags at the checkout counter—merchandise was put directly into the shopping cart or sometimes loaded into empty boxes. Costco warehouses ranged in size from 73,000 to 205,000 square feet; the average size was about 146,000 square feet. Newer units were usually in the 150,000- to 205,000-square-foot range, but the world's largest Costco warehouse was a 235,000 square-foot store in Salt Lake City that opened in 2015.

Warehouses generally operated on a seven-day, 70-hour week, typically being open between 10:00 a.m. and 8:30 p.m. weekdays, with earlier closing hours on the weekend; the gasoline operations outside many stores usually had extended hours. The shorter hours of operation as compared to those of traditional retailers, discount retailers, and supermarkets resulted in lower labor costs relative to the volume of sales. By strictly controlling the entrances and exits of its warehouses and using a membership format, Costco had inventory losses (shrinkage) well below those of typical retail operations.

Growth Strategy Costco's growth strategy was to increase sales at existing stores by five percent or more annually and to open additional warehouses, both domestically and internationally. Average annual growth at stores open at least a year was 10 percent in fiscal 2011, six percent in both fiscal 2013 and 2014, seven percent in fiscal 2015, four percent in fiscal 2016 and 2017, seven percent in 2018, six percent in 2019, 7 percent in 2020, and a COVID 19-induced 13 percent in 2021.

Costco had been aggressive in opening new warehouses and entering new geographic areas.

As of December 2000, the Company operated a chain of 349 warehouses in 32 states (251 locations), nine Canadian provinces (59 locations), the United Kingdom (11 locations, through an 80 percent-owned subsidiary), South Korea (four locations), Taiwan (three locations, through a 55 percent-owned subsidiary), and Japan (two locations), as well as 19 warehouses in Mexico through a 50 percent joint venture partner. Ten years later, in December 2010, Costco was operating 585 warehouses in 42 states (425 locations), nine Canadian provinces (80 locations), Mexico (32 locations), the United Kingdom (22 locations), Japan (nine locations), South Korea (seven locations), Taiwan (six locations), and Australia (one location). Some twelve years and eight months later in August 2023, Costco had opened an additional 275 warehouses, giving it a total of 860 warehouses, including 591 in the United States and Puerto Rico, 107 in Canada, 40 in Mexico, 33 in Japan, 29 in the United Kingdom, 18 in Korea, 14 in Taiwan, 15 in Australia, four in Spain and China, two in France, and one each in Iceland, New Zealand and Sweden.

Exhibit 4 shows a breakdown of Costco's geographic operations for fiscal years 2020 to 2022.

Marketing and Advertising

Costco's low prices and its reputation for making shopping at Costco something of a treasure-hunt made it unnecessary to engage in extensive advertising or sales campaigns. Marketing and promotional activities were generally limited to monthly coupon mailers to members, daily e-mails to members from **Costco.com** publicizing "hot deals" and other special promotional offerings and sales events at warehouses, occasional direct mail to prospective new members, and regular direct marketing programs (such as *The Costco Connection,* a magazine published for members), in-store product sampling, and special campaigns for new warehouse openings.

For new warehouse openings, marketing teams personally contacted businesses in the area that were potential wholesale members; these contacts were supplemented with direct mailings during the period immediately prior to opening. Potential Gold Star (individual) members were contacted by direct mail or by promotions at local employee associations and businesses with large numbers of employees. After a membership base was established in an area, most new memberships came from word of mouth (existing members telling friends and acquaintances about their shopping experiences at Costco), follow-up messages distributed through regular payroll or other organizational communications to employee groups, and ongoing direct solicitations to prospective business and Gold Star members.

Online Sales

Costco operated websites in the United States, Canada, Mexico, the United Kingdom, Taiwan, South Korea, Japan, and Australia—both to enable members to shop for many in-store products online and to provide members with a means of obtaining

EXHIBIT 5 Selected Geographic Operating Data, Costco Wholesale Corporation, Fiscal Years 2020–2022 ($ in millions)

	United States Operations	Canadian Operations	Other International Operations	Total
Fiscal Year Ended August 28, 2022				
Total revenue (including membership fees)	$165,294	$31,675	$29,954	$226,954
Operating income	5,268	1,346	1,179	7,793
Capital expenditures	2,795	388	708	3,891
Number of warehouses (as of August 28, 2022) 2017	578	107	153	83809
Fiscal Year Ended August 29, 2021				
Total revenue (including membership fees)	$141,398	$27,298	$27,233	$195,929
Operating income	4,470	1,093	1,145	6,708
Capital expenditures	2,612	272	704	3,588
Number of warehouses (as of August 29, 2021) 2017	564	106	139	809
Fiscal Year Ended August 30, 2020				
Total revenue (including membership fees)	$122,142	$22,434	$22,185	$166,761
Operating income	3,822	778	942	5,435
Capital expenditures	2,060	258	492	2,810
Number of warehouses (as of August 30, 2020) 2017	552	101	142	795

Note: The dollar numbers shown for the "Other International" categories represent only Costco's ownership share, since all foreign operations were joint ventures (although Costco was the majority owner of these ventures). Countries with warehouses in the Other International category at the end of fiscal 2022 included Mexico, United Kingdom, Japan, South Korea, Taiwan, Australia, Spain, Iceland, France, and China; Costco's two warehouses in Puerto Rico were included in the United States Operations category.

Source: Company 10-K report, 2022, p. 63.

a much wider variety of value-priced products and services that were not practical to stock at the company's warehouses. Craig Jelinek was committed to an e-commerce strategy that provided exceptional service and value to Costco members who wanted to shop online. In recent years, online merchandise offerings had expanded significantly (to about 11,000 stocking keeping units), and the company was continuously exploring opportunities to deliver added value to members via a broader array of online offerings. Examples of value-priced items that members could buy online in addition to merchandise stocked in company warehouses included all types of furniture, entertainment centers and TV lift cabinets, outdoor furniture, fitness equipment, lawn and gardening supplies, outdoor power equipment, outdoor grills, storage sheds, greenhouses, awnings and window coverings, office furniture, kitchen appliances, billiard tables, backyard playground sets, pools, and hot tubs. Members could also use the company's websites for such services as same-day or next-day delivery of orders (via Instacart), digital photo processing, prescription fulfillment, travel, the Costco auto program (for purchasing selected new and used vehicles at prearranged discount prices through participating dealerships and for 15 percent discounts on auto parts and repair services through these same dealers), travel (vacation packages, cruises, car rental, and hotels), order delivery to business members, mortgage financing, identity protection, home and installation services, insurance, dental plans, and a variety of business services (including truck rentals, check printing, payroll processing, and business phone services). In 2020, Costco sold 689,000 vehicles through its 3,000 dealer partners (up 32.5 percent over the 520,000 vehicles sold in 2017); the big attraction to members of buying a new or used vehicle through Costco's auto program was being able to skip the hassle of bargaining with the dealer over price and, instead, paying an attractively low price pre-arranged by Costco. At Costco's online photo center, customers could upload images and pick up the prints at their local warehouse in little over an hour.

In 2017, Costco made improvements in website functionality, search capability, checkout, and delivery times. New offerings were added at Costco Travel, and the company introduced hotel-only booking reservations. Costco Travel's rental car rates were consistently some of the lowest in the marketplace and in 2017 car rentals became available to members in Canada and the United Kingdom. Additionally, the annual two percent reward for Executive members was extended to apply to Costco Travel purchases in the United States and Canada. Lastly, the company launched Costco Grocery, a two-day delivery on dry grocery items, and a same-day delivery offering both fresh and dry grocery items through partnering with Instacart.

In 2018, Costco began opening business centers in selected warehouses. Business centers carried items tailored specifically for restaurants, food services, convenience stores, hotels, and offices, and offered walk-in shopping and order delivery. Products included commercial kitchen equipment and supplies of all kinds (commercial-sized storage containers, cookware, bakeware, plates, cups, glasses, serving bowls, oven mitts, and uniforms), giant bags of pre-chopped onions, 5-gallon buckets of soy sauce, giant tubs of peanut butter, a 60-pound bucket of honey, cases of frozen cookie dough, a massive refrigerated selection of select-and choice-grade meats that included whole lamb, goats and hogs for roasting or barbecuing, cases of snacks and candies, a big selection of beverages, cleaning supplies, and office supplies. By the end of fiscal 2022, it had opened 23 business centers in the United States (15 were in California) and two in Canada that carried several hundred products for business members. About 70 percent of the items carried in business centers were not stocked in the company's warehouses. All Costco members were welcome to shop in the business centers.

Supply Chain and Distribution

Costco bought the majority of its merchandise directly from manufacturers, routing it either directly to its warehouse stores or to one of the company's cross-docking depots that served as distribution points for nearby stores and for shipping orders to members making online purchases. In 2022 Costco had geographically scattered cross-docking depots and logistics facilities with a combined space of approximately 31 million square feet in the United States, Canada, and various other countries where it had warehouses. Depots received container-based shipments from manufacturers, transferred the goods to pallets, and then shipped full-pallet quantities of several types to goods to individual warehouses via rail or semi-trailer trucks, generally in less than 24 hours. This maximized freight volume and handling efficiencies. Depots were also used to ship bulky merchandise to members that had been ordered online; members often picked up online orders that would fit in their vehicles at nearby warehouses. In 2022 Costco began testing the use of electric-powered trucks to deliver merchandise from its depots to nearby warehouses.

Costco's transportation team always looked for ways to reduce empty trucks returning to the depots from the warehouses to improve efficiencies, reduce costs, and take more trucks off the road. Such cost-saving efforts included:

- Having empty trucks stop off at supplier facilities to pick up truckloads of merchandise otherwise destined for a Costco depot and dropping the merchandise off to a group of nearby warehouses.
- Loading trailers dropping off goods at warehouses with returnable goods that were headed to salvagers or needed to be returned to the supplier, and consolidating those shipments into truckloads.
- Donating various returnable goods to nearby communities in need.
- Loading the trailers dropping off merchandise at warehouses with recyclable materials to be consolidated and resold, such as corrugated cardboard, polyethylene stretch wrap, metal, and plastic containers.

Such efforts helped reduce Costco's merchandise handling costs and/or free up sales floor space in its warehouses.

When merchandise arrived at a warehouse, forklifts moved the full pallets straight to the sales floor and onto racks and shelves (without the need for multiple employees to touch the individual packages/cartons on the pallets)—the first time most items were physically touched at a warehouse was when shoppers reached onto the shelf/rack to pick it out of a carton and put it into their shopping cart. Very little incoming merchandise was stored in locations off the sales floor in order to minimize receiving and handling costs.

Costco had direct buying relationships with many producers of national brand-name merchandise and with manufacturers that supplied its Kirkland Signature products. Costco's merchandise buyers were always alert for opportunities to add products of top quality manufacturers and vendors on a one-time or ongoing basis. No one manufacturer supplied a significant percentage of the merchandise that Costco stocked. Costco had not experienced difficulty in obtaining sufficient quantities of merchandise, and management believed that if one or more of its current sources of supply became unavailable, the company could switch its purchases to alternative manufacturers without experiencing a substantial disruption of its business.

Costco's Membership Base and Member Demographics

Costco had 69.1 million members and 124.7 million cardholders as of May 2023. The company was widely believed to attract the most affluent customers in discount retailing—the average annual income of Costco members was approximately $100,000 (in 2015 Costco management believed the 8.6 million subscribers to the company's monthly *Costco Connection* magazine had an average annual income of $156,000).[18] Many members were affluent urbanites, living in nice neighborhoods not far from Costco warehouses. One loyal Executive member, a criminal defense lawyer, said, "I think I spend over $20,000 to $25,000 a year buying all my products here from food to clothing—except my suits. I have to buy them at the Armani stores."[19] Another Costco loyalist said, "This is the best place in the world. It's like going to church on Sunday. You can't get anything better than this. This is a religious experience."[20]

Costco had two primary types of memberships: Business and Gold Star (individual). Business memberships were limited to businesses, but included individuals with a business license, retail sales license, or other evidence of business existence. A business membership also included a free household card (a significant number of business members shopped at Costco for their personal needs). Business members also had the ability to purchase "add-on" membership cards for up to six partners or associates in the business. Costco's current annual fee for Business and Gold Star memberships was $60 in the United States and Canada and varied by country in its Other International operations. Individuals in the United States and Canada who did not qualify for business membership could purchase a Gold Star membership, which included a household card for another family member (additional add-on cards could not be purchased by Gold Star members). All types of members (including household card members) could shop at any Costco warehouse.

Business, Business add-on, and Gold Star members in the United States and Canada could upgrade to Executive membership for an additional $60 (an annual membership fee of $120); upgrade fees to Executive memberships elsewhere varied by country. The primary appeal of upgrading to Executive membership was eligibility for a two percent annual reward (rebate) on qualified pre-tax purchases. Reward certificates were issued annually and could be used toward purchases of most merchandise at the front-end registers of Costco warehouses—rebate awards could not be used to purchase alcohol and tobacco products, gasoline, postage stamps, and food court items. The two percent rebate for Executive members was capped at $1,000 for any 12-month period in the United States and Canada (equivalent to annual qualified pre-tax purchases of $50,000); the maximum rebate varied in other countries. Executive members also were eligible for savings and benefits on various business and consumer services offered by Costco, including merchant credit card processing, small-business loans, auto and home insurance, long-distance telephone service, check printing, and real estate and mortgage services; these services were mostly offered by third-party providers and varied by state—Executive members did not receive two percent rebate credit on purchases of these ancillary services.

At the end of fiscal 2022, Costco had 29.1 million executive members versus 22.6 million at the end of fiscal 2020; executive members represented 57 percent of paid members (excluding affiliates) in the United States and Canada and 22 percent of paid members in the International Operations segment. Executive members generally shopped more frequently and spent more than other members; in fiscal 2022, Executive members accounted for 71 percent of net sales worldwide. Costco's member renewal rate in fiscal 2022 was 93 percent in the United States and Canada and almost 90 percent worldwide. Recent trends in membership are shown at the bottom of Exhibit 1.

In general, with variations by country, Costco members could pay for their purchases with certain debit and credit cards, co-branded Costco credit cards, cash, or checks; in the United States and Puerto Rico, members could use a co-branded Citi/Costco Visa Anywhere credit card for purchases at Costco and elsewhere, Costco Cash cards, and all Visa cards. Since the June 2016 launch of Citi/Costco Visa® Anywhere Card, 1.8 million new member accounts (approximately 2.4 million new credit cards) were opened. The enhanced cash-back Visa Anywhere rewards included earning four percent on gas; three percent on restaurant, hotel, and eligible travel; two percent at Costco and **Costco.com**; and one percent on all other purchases, exceeding the company's previous co-branded credit card offering with American Express. Executive Members using the new Visa Anywhere card continued to earn a two percent rebate on qualified purchases.

Costco accepted merchandise returns when members were dissatisfied with their purchases. Losses associated with dishonored checks were minimal because any member whose check had been dishonored was prevented from paying by check or cashing a check at the point of sale until restitution was made. The membership format facilitated strictly controlling the entrances and exits of warehouses, resulting in limited inventory losses of less than two-tenths of one percent of net sales—well below those of typical discount retail operations.

Warehouse Management

Costco warehouse managers were delegated considerable authority over store operations. In effect, warehouse managers functioned as entrepreneurs running their own retail operation. They were responsible for coming up with new ideas about what items would sell in their stores, effectively merchandising the ever-changing lineup of treasure-hunt products, and orchestrating in-store product locations and displays to maximize sales and quick turnover. In experimenting with what items to stock and what in-store merchandising techniques to employ, warehouse managers had to know the clientele who patronized their locations—for instance, big-ticket diamonds sold well at some warehouses but not at others. Costco's best managers kept their finger on the pulse of the members who shopped their warehouse location to stay in sync with what would sell well, and they had a flair for creating a certain element of excitement, hum, and buzz in their warehouses. Such managers spurred above-average sales volumes—sales at Costco's top-volume warehouses ran about $5 million to $7 million a week, with sales exceeding $1 million on many days. Successful managers also thrived on the rat race of running a high-traffic store and solving the inevitable crises of the moment.

Compensation and Workforce Practices

Top management's objective was to provide its employees not merely with employment but with careers.[21] This was accomplished in large part by doing three things: (1) paying competitive wages and salaries to those employees working in its warehouses and distribution facilities and providing them with an attractive package of fringe benefits, (2) instituting a strong commitment to promotion from within, and (3) maintaining a workforce that consisted of at least 50 percent full-time employees.[22] Management believed these practices contributed to its strong ability to attract and retain capable and energized employees who could successfully execute the company's low-cost strategy and demanding requirement for achieving a high level of efficiency throughout its entire operations.

As of December 2022, Costco had 314,000 employees worldwide. Approximately 17,000 hourly employees at locations in California, Maryland, New Jersey, and New York, as well as at one warehouse in Virginia, were represented by the International Brotherhood of Teamsters. All remaining employees were non-union. Costco employees were considered to be well-satisfied with working at Costco, and they were viewed as being among the best-paid employees in the retail sector.[23]

In March 2019, Costco raised its minimum wage for hourly employees to $15 per hour and also bumped up pay scales for a variety of other jobs, including supervisory positions. In response to the COVID-19 pandemic and its associated challenges, Costco began providing $2 per hour premium pay to the majority of its hourly employees in March 2020, which continued through February 2021. In fall 2020, Costco also began offering employees additional paid time off to attend to child care and schooling needs through the 2021 school year. In March 2021, Costco permanently built an increase of $1 into its wage scales in the United States. In October 2021, hourly wage scales were increased by a minimum of $0.50 per hour In the United States and Canada. In March 2022, a number of compensation changes were initiated, including a $0.75 per hour increase to the top of the U.S. wage scales, an increase in the starting wage to $17.50, and granting all employees one additional day of paid time off. In July 2022, Costco raised the top of its wage scales for different jobs by an additional $0.50 per hour. Throughout 2020 to 2022, Costco remained firmly committed to helping protect the health and safety of both Costco employees and members by complying with COVID-19 public health guidance.

Hourly pay scales for warehouse jobs at Costco ranged from $19 to $24.50 as of March 2023. The highest paid full-time warehouse employees could earn close to $30.00 per hour after four years. Front-end supervisors averaged about $29.50 per hour. Compensation averaged $19.50-$24.50 per hour for pharmacy technicians, $70.00 per hour for licensed pharmacists, and about $146,000 annually for pharmacy managers.[24] Total compensation for cashiers (wages and bonuses) averaged $41,000.[25] Compensation for a sales clerk ranged from $34,000 to $47,000, with an average of $39,800. Base pay for licensed opticians ranged from $30,000 to $83,000, with an average of about $60,000 and average bonuses of $5,950.

Salaried Costco employees earned anywhere from $30,000 to close to $200,000 annually, depending on job type.[26] For example, salaries for merchandise managers, membership managers, and meat department managers reportedly were in the $55,000 to $85,000 range; salaries for supervisors ranged from $45,000 to $75,000; salaries for database, computer systems, and software applications developers/analysts/project managers were in the $85,000 to $125,000 range. Average salaries for pharmacy managers were in the $150,000 range. Average total compensation (including bonuses) for assistant general managers of warehouses averaged $93,000.[27] Average total pay for general managers of warehouses ranged from $90,000 to $180,000 and reportedly averaged about $135,000.[28]

Employees enjoyed the full spectrum of benefits. Salaried employees were eligible for benefits on the first of the second month after the date of hire. Full-time hourly employees were eligible for benefits on the first day of the second month after completing 250 eligible paid hours; part-time hourly employees became benefit-eligible on the first day of the second month after completing 450 eligible paid hours. The benefit package included the following:

- Health care plans for full-time and part-time employees that included coverage for mental illness, substance abuse, and professional counseling for assorted personal and family issues.
- A choice of a four dental plans.
- A pharmacy plan that entailed (1) co-payments of $3 for generic drugs and $10 to $50 for brand-name prescriptions filled at a Costco warehouse or online pharmacy and (2) co-payments of $15 to $50 for generic or brand-name prescriptions filled at all other pharmacies. Coverage also included certain over-the-counter medications and vaccinations.
- A vision program that paid up to $80 for a refraction eye exam (the amount charged at Costco's Optical Centers) and had $175 annual allowances for the purchase of glasses and contact lenses at Costco Optical Centers.
- A prescription hearing aid benefit of up to $1,750 every four years (available only to employees and their eligible dependents enrolled in a Costco medical plan, and the hearing aids had to be purchased either at a Costco Hearing Aid Center or a network provider within 25 miles of the employee's location).
- A 401(k) plan open to all employees over the age of 18 who had completed 90 days of employment. Costco matched hourly employee contributions by 50 cents on the dollar for the first $1,000 annually (the maximum company match was $500 per year). The company's union employees on the West Coast qualified for matching contributions of 50 cents on the dollar up to a maximum company match of $250 a year. In addition to the matching contribution, Costco also normally made an annual discretionary contribution to the accounts of employees who had completed one year of Certain Costco subsidiaries in the Other International operations had defined benefit and defined contribution plans. Company contributions to all the various employee 410(k) plans were $646 million in 2020, $748 million in 2021, and $824 million in 2022.

- A dependent care reimbursement plan in which Costco employees whose families qualified could pay for day care for children under 13 or adult day care with pretax dollars and realize savings of anywhere from $750 to $2,000 per year.
- Long-term and short-term disability coverage.
- Generous life insurance and accidental death and dismemberment coverage, with benefits based on annual earnings and years of service and whether the employee worked full-time or part-time. Employees could elect to purchase supplemental coverage for themselves, their spouses, or their children.
- An employee stock purchase plan allowing all employees to buy Costco stock via payroll deduction so as to avoid commissions and fees.

Costco did not maintain a pension plan or post-retirement medical plan for any employee.[29]

Although Costco's longstanding practice of paying good wages and good benefits was contrary to conventional wisdom in discount retailing, co-founder and former CEO Jim Sinegal, who originated the practice, firmly believed that having a well-compensated workforce was very important to executing Costco's strategy successfully. He said, "Imagine that you have 120,000 loyal ambassadors out there who are constantly saying good things about Costco. It has to be a significant advantage for you. . . . Paying good wages and keeping your people working with you is very good business."[30] When a reporter asked him about why Costco treated its workers so well compared to other retailers (particularly Walmart, which paid lower wages and had a skimpier benefits package), Sinegal replied: "Why shouldn't employees have the right to good wages and good careers. . . . It absolutely makes good business sense. Most people agree that we're the lowest-cost producer. Yet we pay the highest wages. So it must mean we get better productivity. Its axiomatic in our business—you get what you pay for."[31]

Good wages, benefits, and working conditions were said to be why the worldwide employee turnover rate of less than 15 percent at Costco was far below the roughly 60 percent annual turnover rate at retail enterprises in the United States. The turnover rate typically averaged 10 percent or less after the first year of employment.[32] Some Costco employees had been with the company since its founding in 1983. Many others had started working part-time at Costco while in high school or college and opted to make a career at the company. One Costco employee told an ABC *20/20* reporter, "It's a good place to work; they take good care of us."[33] A Costco vice president and head baker said working for Costco was a family affair: "My whole family works for Costco, my husband does, my daughter does, my new son-in-law does."[34] Another employee, a receiving clerk who made about $40,000 a year, said, "I want to retire here. I love it here."[35] An employee with over two years of service could not be fired without the approval of a senior company officer.

Selecting People for Open Positions Costco's top management wanted employees to feel that they could have a long career at Costco. It was company policy to fill the vast majority of its higher-level openings by promotions from within; at one recent point, the percentage ran close to 98 percent, which meant that the majority of Costco's management team members (including warehouse, merchandise, administrative, membership, front end, and receiving managers) had come up through the ranks. Costco had instituted a program called "Supervisor in Training" whereby both hourly and salaried warehouse employees could sign up for training in an area of the business they would like to pursue and thereby become better qualified for future management openings.

Many of the company's vice presidents had started in entry-level jobs. According to Jim Sinegal, "We have guys who started pushing shopping carts out on the parking lot for us who are now vice presidents of our company."[36] Costco made a point of recruiting at local universities; Sinegal explained why: "These people are smarter than the average person, hardworking, and they haven't made a career choice."[37] On another occasion, he said, "If someone came to us and said he just got a master's in business at Harvard, we would say fine, would you like to start pushing carts?"[38] Those employees who demonstrated smarts and strong people management skills moved up through the ranks.

But without an aptitude for the details of discount retailing, even up-and-coming employees stood no chance of being promoted to a position of warehouse manager. Top Costco executives who oversaw warehouse operations insisted that candidates for warehouse managers be top-flight merchandisers with a gift for the details of making items fly off the shelves. To expand the pool of candidates for positions as assistant warehouse manager and general warehouse manager, Costco had created a 12-week program designed to provide supervisor-level merchandising training to managerial employees without merchandising experience. In his years as CEO, Jim Sinegal had learned the importance of selecting only people with strong merchandising skills for positions as general warehouse managers; at one point he said, "People who have a feel for it just start to get it. Others, you look at them and it's like staring at a blank canvas. I'm not trying to be unduly harsh, but that's the way it works."[39] Most newly appointed warehouse managers at Costco came from the ranks of assistant warehouse managers who had a track record of being shrewd merchandisers and tuned into what new or different products might sell well given the clientele that patronized their particular warehouse. Just having the requisite skills in people management, crisis management, and cost-effective warehouse operations was not enough.

Executive Compensation Executives at Costco did not earn the outlandish salaries that had become customary over the past decade at most large corporations. In Jim Sinegal's last two years as Costco's CEO, he received a salary of $350,000 and a bonus of $190,400 in fiscal 2010 and a salary of $350,000 and a bonus of $198,400 in fiscal 2011. Craig Jelinek's compensation as Chief Executive Officer in fiscal 2022 included a salary of $1,230,769, no cash bonus, and a stock award worth $7.9 million; Ron M. Vachris's compensation as President and Chief Operating Officer in fiscal 2022 included a salary of $993,308, a cash bonus of $15,483, and a stock award of $6.06 million; and Richard Galanti's compensation as Executive Vice-President and Chief Financial Officer in fiscal 2022 included a salary of $850,000, a cash bonus of $13,600, and a stock award worth $4.39 million. Other Costco executive officers received salaries in the $700,000 to $745,000 range, cash bonuses of $13,600, and stock awards worth $3.3 million to $3.95 in fiscal 2022.

Asked why executive compensation at Costco was only a fraction of the amounts typically paid to top-level executives at other corporations with revenues and operating scale comparable to Costco's, Sinegal replied: "I figured that if I was making something like 12 times more than the typical person working on the floor, that that was a fair salary."[40] To another reporter, he said: "Listen, I'm one of the founders of this business. I've been very well rewarded. I don't require a salary that's 100 times more than the people who work on the sales floor."[41] During his tenure as CEO, Sinegal's employment contract was only a page long and provided that he could be terminated for cause.

However, while executive salaries and bonuses were modest in comparison with those at other companies Costco's size, Costco did close the gap via an equity compensation program that featured restricted stock awards based on defined performance criteria. The philosophy at Costco was that equity compensation should be the largest component of compensation for all executive officers and be tied directly to achievement of pre-tax income targets.

Costco's Business Philosophy, Values, and Code of Ethics

Jim Sinegal, who was the son of a steelworker, had ingrained five simple and down-to-earth business principles into Costco's corporate culture and the manner in which the company operated. These five principles and the associated operating approaches were incorporated into Costco's Code of Ethics which was last updated in March 2010 and was posted in the Governance section of Costco's Investors Relations website[42]:

1. **Obey the law**—This principle called for the company to conduct its business in compliance with all laws and legal requirements, safety and security standards, wage and hour laws, antitrust standards, and provisions of the Foreign Corrupt Practices Act and similar laws in other countries where it did business. In addition, it obligated Costco to exceed ecological standards required in every community where it conducted business and to be fair, accurate, and timely in filing reports with the Securities and Exchange Commission and in other public communications.
2. **Take care of our members**—Costco management viewed this principle as the company's reason for being and the key to its success, stating "if we don't keep our members happy, little else that we do will make a difference." Executing this principle called for the company to (1) provide members with top quality products at the best prices in the market, (2) ensure that its food products were high-quality, safe, wholesome, and in compliance with the highest food safety standards in the industry, (3)

provide members with a 100 percent satisfaction guaranteed warranty on every product and service it sold, including the membership fee they paid, (4) make shopping at Costco warehouses a pleasant experience, (5) provide members with the best customer service in the retail industry, and (6) give back to the communities where it operated through employee volunteerism and contributions to United Way and Children's Hospitals.

3. **Take care of our employees—**This principle reflected top management's beliefs that the company's employees were its our most important asset, that Costco had the very best employees in the warehouse club industry, and that the company should be committed to providing them with rewarding challenges and ample opportunities for personal and career growth. Properly executing this principle called for the company to provide employees with competitive wages, attractive benefits, a safe and healthy work environment, challenging and fun work, career opportunities, an atmosphere free from harassment or discrimination, access to ascending levels of management to resolve issues, and opportunities to give back to their communities through volunteerism and fundraising.
4. **Respect our suppliers—**This principle was predicated upon a belief that the company's suppliers were partners and for Costco to prosper, its suppliers must also prosper. Consequently, it was incumbent on Costco to strive to treat all suppliers and their representatives as it would expect to be treated, honor all commitments made to suppliers, protect all suppliers' property assigned to Costco, and not accept gratuities of any kind from a supplier.

   Costco executives believed that if the first four principles of the Code of Ethics were followed throughout the organization—and further if all company personnel conducted themselves in an honest and ethical manner every day and understood that dishonest conduct would not be tolerated, then the company would achieve the fifth principle.
5. **Reward our shareholders—**this principle explicitly recognized that Costco could only be successful so long as it provided its shareholder business partners with a good return on their investment in the company. Hence the company pledged to operate in such a way that its present and future stockholders, as well as its employees, would be rewarded for their efforts.

Costco's code of ethics applied to all directors, officers, and employees of the company. The company expressly stated that any conduct violating the code of ethics would constitute grounds for disciplinary action, ranging from reprimand to termination and possible criminal prosecution. All employees were expected to promptly report actual or suspected violations of law or the code of ethics. Violations involving employees were directed to the responsible executive vice president, who was expected to take prompt and appropriate action to investigate and respond. Violations involving suppliers and those involving accounting, internal control and auditing were directed to either the company's general counsel or chief compliance officer; they were charged with taking prompt and appropriate action to investigate and respond.

Environmental Sustainability and Responsible Sourcing of Meat and Dairy Products

In recent years, Costco management had undertaken a series of initiatives to invest in various environmental and energy saving systems, the use of packaging that could be recycled or composted, reduction of both packaging materials and food waste, greater sourcing of sustainable seafood products from wild fisheries and farmed aquaculture, working with recognized experts and suppliers to increase the percentage of cage-free eggs it sold, and compliance with best practices in dairy farming, animal care, and animal well-being. The stated objective was to ensure that the company's carbon footprint grew at a slower rate than the company's sales growth and that Costco was a responsible steward of the animals, land, and other environmental resources utilized in the products it sold.

Costco's metal warehouse design, which included use of recycled steel, was consistent with the requirements of the Silver Level LEED Standard—the certification standards of the organization Leadership in Energy and Environmental Design (LEED) were nationally accepted as a benchmark green building design and construction. However, Costco was not satisfied and proceeded to quickly develop and implement a non-metal warehouse design that gave it the ability to meet Gold Level LEED Standards.

All new Costco facilities were being designed and constructed to be more energy efficient; this included using LED lighting and energy efficient mechanical systems for heating, cooling, and refrigeration in both new and existing facilities. In 2016, Costco began retrofitting existing facilities with LED lighting; as of year-end fiscal 2018, 1,166 retrofits had been completed, resulting in a total estimated energy savings of 206 million kilowatt-hours per year.[43] All lighting in new construction utilized LED technology. At the end of fiscal 2018, Costco had rooftop solar photovoltaic systems in operation at 109 of its warehouses; some warehouses used solar power to light their parking lots. In 2017, Costco began piloting the use of fuel cells as an alternate source of electricity at a handful of locations and was continuing to evaluate their use in future facilities. So far, Costco had found the fuel cells at test sites had resulted in lower combined power and natural gas expenses. The company was also exploring use of new HVAC and refrigerant systems that were more energy efficient and increasing its use of refrigerants that further reduced global warming potential and greenhouse gas emissions.

Another energy-saving initiative had been to install Internet-based energy management systems at all Costco warehouses in North America and at some international locations, giving Costco the ability to regulate energy usage on an hourly basis. These, along with installation of LED lighting and warehouse skylights, had reduced the lighting loads on Costco's sales floors by over 50 percent since 2001. Costco had undertaken a series of initiatives at company facilities worldwide to reduce water usage, reduce or remove potential chemical harm to humans and to the environment, use recycled asphalt for paving most warehouse parking lots, and use best practices to irrigate landscapes and manage groundwater runoff. Empty store cartons were given to members to carry their purchases home. Costco had been an active member of the Environmental Protection Agency's Energy Star and Climate Protection Partnerships since 2002 and was a major retailer of Energy Star qualified compact florescent lamp (CFL) bulbs and LED light bulbs.

Costco was committed to sourcing all of the seafood it sold from responsible and environmentally sustainable sources that were certified by the Marine Stewardship Council; in no instances did Costco sell seafood species that were classified as environmentally endangered and it monitored the aquaculture practices of its suppliers that farmed seafood. The company had long been committed to enhancing the welfare and proper handling of all animals used in food products sold at Costco. According to the company's official statement on animal welfare, "This is not only the right thing to do, it is an important moral and ethical obligation we owe to our members, suppliers, and most of all to the animals we depend on for products that are sold at Costco."[44] As part of the company's commitment, Costco had established an animal welfare audit program that utilized recognized audit standards and programs conducted by trained, certified auditors and that reviewed animal welfare both on the farm and at slaughter.

During fiscal 2020 and 2021, Costco, with the help of an experienced sustainability consultant, did a comprehensive assessment of its sustainability efforts and established 78 sustainability goals in seven areas of its business, all of which made sense for its particular business operations. The seven areas were:

- Clean Water and Sanitation (6 goals)
- Decent Work and Economic Growth (8 goals)
- Reduced Inequalities (10 goals)
- Responsible Consumption and Production (12 goals)
- Climate Action (13 goals)
- Life Below Water (14 goals) and
- Life on Land (15 goals)

Specific performance metrics to track the company's progress in achieving these goals were identified, and internal efforts to measure and achieve these goals were well underway in 2022 to 2023.[45] There was monthly reporting to Costco's global executive team and regular reporting to the Board of Directors.

COMPETITION

According to IBISWorld, the Warehouse Clubs and Supercenters industry—defined as companies that provided a range of general merchandise including food and beverages, furniture and appliances, health and wellness products, apparel and accessories, fuel and ancillary services—was expected to have sales of about $632 billion in the United States alone in 2023 and to grow at an annualized rate of 3.2 percent during the 2023 to 2028 period.[46] There were three main wholesale club competitors—Costco Wholesale, Sam's Club, and BJ's Wholesale Club; their combined revenues in 2022 were roughly $340 billion.

Competition among the warehouse clubs was based on such factors as price, merchandise quality and selection, location, and member service. However, warehouse clubs also competed with a wide range of other types of retailers, including retail discounters like Walmart and Dollar General, supermarkets, general merchandise chains, specialty chains, gasoline stations, and Internet retailers. Not only did Walmart, the world's largest retailer, compete directly with Costco via its Sam's Club subsidiary, but its Walmart Supercenters sold many of the same types of merchandise at attractively low prices as well. Target, Kohl's, Kroger, and **Amazon.com** had emerged as significant retail competitors in certain general merchandise categories. Low-cost operators selling a single category or narrow range of merchandise—such as Trader Joe's, Lowe's, Home Depot, Office Depot, Staples, Best Buy, PetSmart, and Barnes & Noble—had significant market shares in their respective product categories. Notwithstanding the competition from other retailers and discounters, the low prices and merchandise selection found at Costco, Sam's Club, and BJ's Wholesale were attractive to small business owners, individual households (particularly bargain-hunters and those with large families), churches and nonprofit organizations, caterers, and small restaurants. The internationally located warehouses faced similar types of competitors.

Brief profiles of Costco's two primary competitors in North America are presented in the following sections.

Sam's Club

The first Sam's Club opened in 1984, and Walmart management in the ensuing years proceeded to grow the warehouse membership club concept into a significant business and major Walmart division. The concept of the Sam's Club format was to sell merchandise at very low profit margins, resulting in low prices to members. The mission of Sam's Club was "to make savings simple for members by providing them with exciting, quality merchandise and a superior shopping experience, all at a great value."[47] The target market at Sam's Club was small businesses and suburban families with incomes of $75,000 to $125,000.

In early 2023, Sam's Club operated 600 locations in 44 states, the District of Columbia, and Puerto Rico, many of which were adjacent to Walmart Supercenters, and over 200 Sam's Club locations in Mexico, Brazil, and China. (Financial and operating data for the Sam's Club locations in Mexico, Brazil, and China were not separately available because Walmart grouped its reporting of all store operations in countries outside the United States into a segment called Walmart International that did not break out the international operations of Sam's Club.) In fiscal year 2023 (ending January 31, 2023), the Sam's Club locations in the United States and Puerto Rico and operations at **www.samsclub.com** had record revenues of $73.6 billion (including membership fees), making it the eighth largest retailer in the United States.

Sam's Clubs generally ranged between 94,000 and 168,000 square feet, with an average at the end of fiscal 2022 of approximately 136,000 square feet; several newer locations were as large as 190,000 square feet. All Sam's Club warehouses had concrete floors, sparse décor, and goods displayed on pallets, simple wooden shelves, or racks in the case of apparel. In 2009 and 2010, Sam's Club began a long-term warehouse remodeling program for its older locations. During fiscal 2018, management closed 63 underperforming Sam's Club locations; about 12 of these were converted to e-commerce distribution centers for merchandise sold at **www.samsclub.com** and **www.walmart.com**.

Exhibit 6 provides financial and operating highlights for fiscal years from 2019 to 2023.

Merchandise Offerings

Sam's Club warehouses stocked about 4,000 items, a big fraction of which were standard and a small fraction of which represented special buys and one-time offerings. The treasure-hunt items at Sam's Club tended to be less upscale and less expensive than those at Costco. The merchandise selection included brand-name merchandise in a variety of categories and a selection of private-label items sold under the "Member's Mark," "Daily Chef," and "Sam's Club" brands. Most club locations had fresh-foods departments that included bakery, meat,

EXHIBIT 6 Selected Financial and Operating Data for Sam's Club, Fiscal Years 2019–2022

Sam's Club	2022	2021	2020	2019
Net sales in the United States and Puerto Rico (billions of $)	$ 73.6	$ 63.9	$58.8	$57.8
Operating income in the United States and Puerto Rico (billions of $)	2.3	1.9	1.6	1.5
Assets in the United States and Puerto Rico (billions of $)	14.7	13.4	13.5	12.9
Number of U.S. and Puerto Rico locations at year-end	600	599	599	599
Average sales per year-end U.S. and Puerto Rican location, including membership fees (in millions of $)	$122.7	$106.7	$98.2	$96.6
Sales growth at existing U.S. and Puerto Rico warehouses open more than 12 months:				
Including gasoline sales	15.1%	8.7%	1.6%	(2.3)%
Not including gasoline sales	9.6%	12.1%	0.9%	(3.9)%
Average warehouse size in the United States and Puerto Rico (square feet)	136,000	136,000	136,000	134,000

[a] The net sales figure does not include membership fees and is only for warehouses in the United States and Puerto Rico. For financial reporting purposes, Walmart consolidates the operations of all foreign-based stores into a single "international" segment figure. Thus, separate financial information for the foreign-based Sam's Club locations in Mexico, China, and Brazil is available.

Source: Walmart's 10-K reports and annual reports, fiscal years 2022 and 2020.

produce, floral products, and a Sam's Café. Most locations also had a one-hour photo processing department, a pharmacy that filled prescriptions, hearing aid and optical departments, tire and battery centers, and self-service gasoline pumps; car wash services were available at about 40 locations. Sam's Club guaranteed it would beat any price for branded prescriptions. Members could shop for a wider assortment of merchandise (about 59,000 items) and services online at **www.samsclub.com**; e-commerce sales totaled about $6.2 billion in fiscal 2022, $5.1 billion in fiscal 2021, and $3.6 billion in fiscal 2020; the big gains in e-commerce sales in 2020 to 2021 were a result of buyers making greater use of online purchases during the COVID-19 pandemic. **Samsclub.com** had an average of about 21 million unique visitors per month and provided members the option of pick-up at local Sam's Club locations or direct-to-home delivery.

The percentage composition of sales (including e-commerce sales) across major merchandise categories was:

	Fiscal Years		
	2022	2021	2020
Grocery and consumables (dairy, meat, bakery, deli, produce, dry, chilled or frozen packaged foods, alcoholic and nonalcoholic beverages, floral, snack foods, candy, other grocery items, health and beauty aids, paper goods, laundry and home care, baby care, pet supplies, and other consumable items)	64%	66%	60%
Fuel and other categories (gasoline, tobacco, tools and power equipment, and tire and battery centers)	15%	12%	18%
Technology, office, and entertainment (electronics, wireless, software, video games, movies, books, music, toys, office supplies, office furniture, photo processing, and gift cards)	4%	5%	5%
Home and apparel (home improvement, outdoor living, grills, gardening, furniture, apparel, jewelry, housewares, toys, seasonal items, mattresses, and small appliances)	12%	11%	11%
Health and wellness (pharmacy, hearing and optical services, and over-the-counter drugs)	5%	5%	6%

Source: Walmart's Fiscal Year 2022 10-K Report.

Membership and Hours of Operation

The annual fee for Sam's Club members was $45 for a Club membership card, with a spouse card available at no additional cost. Club members could purchase up to eight "add-on" memberships for an additional $40 each. Alternatively, members could purchase a "Plus" membership for $100, and up to 16 "add-on" memberships for $40 each. Plus members were eligible for free shipping on e-commerce orders and for Cash Rewards, a benefit that provided 2 percent back for qualifying Sam's Club purchases up to an annual maximum cash reward of $500. Cash-back rewards could be used for purchases, membership fees, or redeemed for cash. About 600,000 members shopped at Sam's Club weekly. Income from membership fees was a significant percentage of the operating income earned by Sam's Club.

Regular hours of operations were Monday through Friday from 10:00 a.m. to 8:30 p.m., Saturday from 9:00 a.m. to 8:30 p.m., and Sunday from 10:00 a.m. to 6:00 p.m.; all Plus cardholders had the ability to shop before the regular operating hours Monday through Saturday, starting at 7:00 a.m. All club members could use a variety of payment methods, including Visa credit and debit cards, American Express cards, and a co-branded Sam's Club "Cash-Back" Mastercard. Sam's Club also offered "Scan and Go," a mobile checkout and payment solution, which allowed members to bypass the checkout line. The pharmacy and optical departments accepted payments for products and services through members' health benefit plans.

Distribution Approximately 73 percent of the nonfuel merchandise at Sam's Club was shipped either from some 28 distribution facilities dedicated to Sam's Club operations that were strategically located across the continental United States or, in the case of perishable and certain other items, from nearby Walmart grocery distribution centers; the balance was shipped by suppliers direct to Sam's Club locations. Like Costco, Sam's Club distribution centers employed cross-docking techniques whereby incoming shipments were transferred immediately to outgoing trailers destined for Sam's Club locations; shipments typically spent less than 24 hours at a cross-docking facility and in some instances were there only an hour. A combination of company-owned trucks and independent trucking companies were used to transport merchandise from distribution centers to club locations. Sam's Club shipped merchandise purchased on **www.samsclub.com** and through its mobile commerce applications by a number of methods including shipments made directly from Clubs, 12 dedicated e-commerce fulfillment centers, and certain Walmart distribution centers.

Employment In 2023, Sam's Club employed about 90,000 people across all aspects of its operations in the United States. While the people who worked at Sam's Club warehouses were in all stages of life, a sizable fraction had accepted job offers because they had minimal skill levels and were looking for their first job, or needed only a part-time job, or were wanting to start a second career. Approximately 75 percent of the management staff at Sam's Club had begun their careers at Sam's Club as hourly warehouse employees and had moved up through the ranks to their present positions.

BJ's Wholesale Club

BJ's Wholesale Club introduced the member warehouse concept to the northeastern United States in the mid-1980s and, as of April 2023, operated 237 warehouses and 166 BJ's gas locations in 18 eastern states extending from Maine to Florida. The company planned to open 10 new locations in 2023, including its first location in Tennessee. In its core New England market region, BJ's had about three times the number of locations compared to its next largest warehouse club competitor. Approximately 85 percent of BJ's warehouse clubs had at least one Costco or Sam's Club warehouse operating in their trading areas (within a distance of 10 miles or less). Six distribution centers served BJ's existing locations and had the capacity to support up to 100 additional clubs along the East Coast of the United States. BJ's warehouse clubs ranged in size from 63,000 square feet to 163,000 square feet; newer clubs were typically about 85,000 square feet. BJ's market target was price-sensitive households with an average annual income of approximately $75,000.

In late June 2011, BJ's Wholesale agreed to a buyout offer from two private equity firms and shortly thereafter became a privately held company. However, in May 2018, the private company (recently renamed BJ's Wholesale Club Holdings) announced its intent to become a public company again and filed the necessary registration for an initial public offering of common stock with the Securities and Exchange Commission. In late June 2018, BJ's became a public company with an initial public offering of 37.5 million shares at a public offering price of $17 per share; its stock traded on the New York Stock Exchange under the ticker symbol BJ.

A new three-member top executive team with experience in consumer-packaged goods and digital know-how in 2018 was hired to implement significant cultural and operational changes that included transforming how BJ's used data to improve member experience, instilling a culture of cost discipline, adopting a more proactive approach to growing its membership base, building a much more comprehensive collection of online merchandise offerings, installing the capability to deliver products to members' homes or office, and introducing a mobile app that enabled members to save coupon offers directly onto the app and self-checkout. In April 2021, a new four-member top executive team was appointed to speed the company's market coverage and otherwise direct the company's strategy and operations.

Exhibit 7 shows selected financial and operating data for BJ's Wholesale Club Holdings, Inc. for the fiscal years 2019 to 2022.

Product Offerings and Merchandising Like Costco and Sam's Club, BJ's Wholesale sold high-quality, brand-name merchandise at prices that were significantly lower than the prices found at supermarkets, discount retail chains, department stores, drugstores, and specialty retail stores like Best Buy. Its merchandise lineup of about 7,000

Its merchandise lineup of about 7,000 items were divided into two groupings: grocery and general merchandise and services.

- The grocery grouping included meat, produce, dairy, bakery, deli and frozen products, packaged foods, beverages, detergents, disinfectants, paper products, beauty care, adult and baby care, and pet foods. The grocery category generated about 85 percent of merchandise sales in fiscal year 2023.
- The general merchandise and services grouping included optical, tires, small appliances, televisions, electronics, seasonal goods, gift cards, and apparel. The general merchandise and services category accounted for approximately 15 percent of merchandise sales in fiscal year 2023.

About 70 percent of BJ's product line could be found in supermarkets, and BJ's measurements of supermarket pricing in its market region indicated its prices were consistently about 25 percent or more below a representative basket of groceries compared to its four primary supermarket competitors.[48] Sales of the company's two private-label brands, Wellsley Farms® and Berkley Jensen®, were primarily premium quality and priced below the competing branded products. BJ's private-label sales accounted for about 24 percent of total net sales (excluding gasoline) in fiscal 2023. Members could purchase thousands of additional products at **www.bjs.com**, **www.wellsleyfarms.com**, and **www.berkleyjensen.com**, and by using BJ's mobile app, which members could also use to access BJ's buy-online-pick-up-in-club (BOPIC) service, curbside delivery, same day home delivery, or traditional ship-to-home service. BJ's mobile app further made it convenient for members to review a particular product, look at member reviews of products, digitally add coupons to their membership card, and view annual member savings. Beginning in the fourth quarter of fiscal 2021, BJ's launched ExpressPay®, which allowed members to skip checkout lines when they shopped in clubs by paying with their phones.

BJ's warehouses offered a number of specialty services that were designed to enable members to complete more of their shopping at BJ's and to encourage more frequent trips to the clubs. Like Costco and Sam's Club, BJ's sold gasoline at a discounted price as a means of displaying a low-price image to prospective members and providing added value to existing members. Other specialty services included full-service optical centers; tire installation services; a propane tank filling service; home improvement services; travel services; cell phone kiosks; and product protection plans for appliances, electronics, and jewelry. Most of these services were provided by outside operators in space leased from BJ's. In early 2007, BJ's abandoned prescription filling and closed all of its 46 in-club pharmacies.

Membership BJ's Wholesale Club had more than 6.8 million paid memberships as of April 2023 that generated membership fee revenues of $397 million in fiscal 20232. Individuals could become Club Card members for a fee of $55 per year that included a second card for a household member; cards for up to three other family members and friends could be added to a Club Card member's account for an additional $30 per card. Club Card members (including

EXHIBIT 7 Selected Financial and Operating Data, BJ's Wholesale Club Holdings, Inc., Fiscal Years 2020–2023

	Fiscal Years Ended			
	February 1, 2020	January 30, 2021	January 29, 2022	January 28, 2023
Selected Income Statement Data (in millions, except per share data)				
Net sales	$12,888.6	$15,096.9	$16,307.0	$18,918.4
Membership fee incomes	302.2	333.1	360.9	396.7
Total revenues	13,190.7	15,430.0	16,667.3	19,315.2
Cost of sales	10,763.9	12,451.1	13,588.6	15,883.7
Selling, general and administrative expenses	2,059.4	2,326.8	2,446.5	2,668.6
Preopening expenses	15.2	9.8	14.9	24.9
Operating income	303.5	642.4	617.3	738.0
Interest expense, net	108.2	84.4	59.4	47.5
Provision for income taxes	56.2	136.8	131.1	176.3
Net income	$ 187.2	$ 421.0	$ 426.7	$ 513.2
Income per share attributable to common shareholders—diluted	$1.35	$3.03	$3.09	$3.77
Weighted average number of shares outstanding—diluted (in millions)	139.1	138.9	138.0	136.5
Balance Sheet and Cash Flow Data (in millions)				
Cash and cash equivalents	$30.2	$43.5	$45.4	$33.9
Merchandise inventories	1,081.5	1,205.7	1,243.0	1,378.6
Total current assets	1,360.9	1,470.6	1,517.1	1,703.2
Property and equipment, net	760.2	797.8	942.3	1,337.0
Total assets	5,569.8	5,411.5	5,696.5	6,350.0
Total current liabilities	1,801.4	2,031.2	2,002.5	2,545.3
Long-term debt	1,337.3	846.2	748.6	447.9
Total stockholders' equity (deficit)	(54.3)	319.3	648.1	1,046.8
Net cash provided by operating activities	355.1	868.5	831.7	788.2
Capital expenditures	196.9	218.3	323.6	397.8
Selected Operating Data				
Clubs open at end of fiscal year	217	221	226	235
Sales growth at existing clubs open more than 12 months	0.7%	15.9%	6.5%	13.4%
Sales growth at existing clubs open more than 12 months, excluding gasoline sales	(0.9%)	21.3%	(0.5)%	6.5%
Average sales per club location, including online sales	$59.4	$68.3	$72.1	$80.5
Membership renewal rate	87%	88%	89%	90%

Source: Company 10-K Report 2019, 2020, and 2022.

household cardholders but not other supplemental members) could upgrade their membership to a Club+ Card membership for an additional $55 ($110 per year). U.S. military personnel—active and veteran—could obtain a personal Club Card membership for $40 and a Club+ Card for $80. In early 2023, BJ's offered an educational membership to teachers, staff, and educators for $25 for a 1-year Club Card Membership. Club+ members earned two percent cash back on in-club and online purchases.

A business could become a Business Club Card member for $55 per year, which included one free Business Club supplemental membership; a Business Club primary member could purchase up to eight additional supplemental business memberships for business associates at $30 each. Business Club Card members could upgrade to a Business Club+ Card membership for an additional $55. Club+ members earned two percent cash back on in-club and online purchases.

Individuals and businesses could upgrade to a BJ's Perks Rewards membership card for $110; Perks Reward members received a free second card for a household member and could add up to three additional members for $30 each. BJ's Perks Rewards members earned two percent cash back on in-club and online purchases.

Effective February 27, 2023, BJ's rebranded its higher tier membership from BJ's Perks Rewards® to Club+, which offered members the opportunity to earn 2 percent cash back on most in-club and website purchases and a 5-cent per gallon discount on gasoline. The annual fee for a Club+ membership was generally $110 per year.

Individuals and business could apply for a BJ's One™ and BJ's One+™ Mastercard® credit card. These cards provided members with the opportunity to earn up to 5 percent cash back on purchases made at BJ's clubs or website and up to a 15-cent per gallon discount on gasoline when paying with a BJ's One™ or BJ's One+™ Mastercard® at BJ's Gas locations. Club+ rewards could not exceed $500 in any 12-month period. Since fiscal year 2014, BJ's had grown its co-branded Mastercard® holders by over 900 percent. In fiscal year ending January 28, 2023, Club+ members accounted for 38 percent of all members and co-branded BJ's One™ or BJ's One+™ Mastercard ® members accounted for 52 percent of merchandise spend. BJ's management claimed that members could save over ten times their $55 Club+ membership fee versus what they would have paid at traditional supermarket competitors if they spent $2,500 or more per year at BJ's on manufacturer-branded groceries.[49]

BJ's accepted MasterCard, Visa, Discover, and American Express cards at all locations; members could also pay for purchases by cash, check, or magnetically encoded Electronic Benefit Transfer cards (issued by state welfare departments). Manufacturer's coupons were accepted for merchandise purchased in any Club where the product was sold. BJ's accepted returns of most merchandise within 30 days after purchase.

Marketing and Promotion BJ's increased customer awareness of its clubs primarily through social media, direct mail, public relations efforts, community involvement programs, marketing programs for newly opened clubs, and various publications mailed to members throughout the year. BJ's also had dedicated marketing personnel who solicited potential business members and who contacted other selected organizations to increase the number of members. Periodically, it also ran free promotional membership and initially discounted membership promotions to attract new members, with the objective of converting them to paid members.

Warehouse Club Operations BJ's warehouses were located in both freestanding locations and shopping centers. Construction and site development costs for a full-sized owned BJ's club were in the $6 million to $10 million range; land acquisition costs ranged from $3 million to $10 million but could be significantly higher in some locations. Each warehouse generally had an investment of $3 to $4 million for fixtures and equipment; other pre-opening expenses at a new club were usually in the $1.0 to $2.0 million range. Including space for parking and gas station operations, a typical full-sized BJ's club required 13 to 14 acres of land; smaller clubs typically required about 8 acres.

In May 2022, BJ's completed a $376 million acquisition of the assets and operations of four distribution centers and the related transportation fleet formerly owned and operated by Burris Logistics. This acquisition brought all of its end-to-end perishable supply chain in-house to complement its four cross-dock distribution centers for non-perishables, all of which were leased. In times past, BJ's had contracted with Burris to operate the perishables distribution centers and deliver perishable products to all of its warehouse locations. Non-perishables merchandise purchased from manufacturers was routed either to a BJ's cross-docking facility or directly to clubs. Personnel at the company's cross-docking distribution facilities broke down truckload quantity shipments from manufacturers and reallocated goods for shipment to individual clubs, generally within 24 hours. BJ's worked closely with manufacturers to minimize the amount of handling required once merchandise was received at a club.

Merchandise in BJ's warehouses was generally displayed on pallets containing large quantities of each item, thereby reducing labor required for handling, stocking, and restocking. Backup merchandise was generally stored in steel racks above the sales floor. Most merchandise was pre-marked by the manufacturer so it did not require ticketing at the club. Full-sized clubs had approximately $4 million in inventory. Management was able to limit inventory shrinkage to a small fraction of one percent of net sales by strictly controlling the exits of clubs, generally limiting customers to members, and using state-of-the-art electronic article surveillance technology.

ENDNOTES

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[3] As described in Nina Shapiro, "Company for the People," *Seattle Weekly,* December 15, 2004, **www.seattleweekly.com** (accessed November 14, 2006).
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[6] Costco Wholesale, 2017 Annual Report for the year ended September 3, 2017, p. 3.
[7] David Chang, "Here are 5 of Costco's most popular products," posted October 5, 2022, at **https://www.fool.com/the-ascent/personal-finance/articles/** (Accessed November 30, 2022).
[8] The results of the taste test of multiple types and brands of bacon were reported in the November 2013 issue of *Consumer Reports.*
[9] As stated by CEO Craig Jelinek in his letter to shareholders in Costco's 2022 Annual Report.
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[20] Ibid.
[21] Company 10-K report, 2022, p. 6.
[22] Ibid.
[23] According to "Costco by the Numbers: 22 Surprising Facts," **https://blog.cheapism.com/costco-numbers-18090/** (accessed November 29, 2022).
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[25] Based on information posted at **www.glassdoor.com** (accessed March 4, 2023).
[26] Ibid.
[27] Ibid.
[28] Ibid.
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[30] Ibid.
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[32] The 60 percent turnover rate for all retail enterprises in the United States was attributed to the National Retail Federation and cited in "Costco by the Numbers: 22 Surprising Facts," **https://blog.cheapism.com/costco-numbers-18090/**, accessed November 29, 2022. The 10 percent turnover rate (90 percent retention rate) at Costco in 2022 was cited in the company's 2022 10-K report, p. 6.
[33] As quoted in Goldberg and Ritter, "Costco CEO Finds Pro-Worker Means Profitability," an ABC News original report on *20/20,* August 2, 2006, **http://abcnews.go.com/2020/Business/story?id=1362779** (accessed November 15, 2006).
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[43] Information posted in the environmental sustainability section of Costco's Investor relations website, accessed October 17, 2019.
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[46] According to information in "Warehouse Clubs & Supercenters in the U.S.–Market Size 2003-2028," posted at **www.ibisworld.com**, July 19, 2022, accessed April 21, 2023.
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CASE 4

Twitter/X Corp. in 2023: The Elon Musk Era Begins

David L. Turnipseed,
University of South Alabama

John E. Gamble,
Texas A&M University–Corpus Christi

Going into mid-2023, the business press was undecided on Twitter's progress under the leadership of Elon Musk. Musk had acquired Twitter in October 2022 and his strategy for the company was to embrace a free speech online town square with minimal censorship, expand the company's business model to develop new revenue streams, and dramatically cut operating costs. Key elements of the turnaround plan crafted by Musk were the requirement for paid subscriptions to earn Blue Check verification, improvements in the efficiency and functionality of the Twitter app, and the addition of a Community Notes functionality to allow users to clarify posts of others rather than the post being indiscriminately removed by a Twitter staff member. Musk also implemented an account ban policy that required a much higher bar for offensive content leading to an account ban. While Musk's turnaround plan seemed appropriate to tech sector analysts, Musk's persona and opinions had become off-putting to many top advertisers who had reduced their spending on Twitter ads. The company's revenue was estimated to have plunged by 50 percent since the acquisition. In May 2023, Fidelity Investments, a key Twitter investor, reported that the market value of Twitter was only about one-third of its $44 billion acquisition cost.

Musk's acquisition of Twitter began in January 2022 and within four months he became its largest shareholder. After several months of contentious negotiations, he ultimately purchased the company on October 27, 2022, at $54.20 per share price; however, during the lengthy negotiation period, the company's shares experienced significant price fluctuations—ranging from approximately $39 in April 2022 to $53.70 per share on the date of the finalization of the acquisition. Twitter's stock was delisted from the NYSE on November 8, 2022.

The potentially inflated purchase price of $44 billion for Twitter was only one reason for Musk to have concern. Musk's new content moderation policies and $8 per month Blue Check subscription continued to be unpopular with advertisers into 2023. This unrest contributed to Musk hiring a new CEO for Twitter. In May 2023, Elon Musk announced that Linda Yaccarino would become Twitter CEO in the coming months. Musk explained that he would become Twitter's Chief Technology Officer and focus on platform improvements rather than business operations. There was a great deal of interest in how Ms. Yaccarino would lead the company, regain the trust of advertisers, and execute business model and platform improvements.

COMPANY HISTORY

Twitter was created in 2006 by Jack Dorsey, Biz Stone, Noah Glass, and Evan Williams as an outgrowth of their podcasting tool Odeo. Profitability evaded the company until the fourth quarter of 2017, when financial results showed the first profitable quarter since the company went public in 2013. In 2018, the company reported revenues of $3.0 billion and net income of $1.2 billion. Despite reaching profitability, investors had concern as the 2018 net income resulted largely to the impact of the Tax Act. Total costs and expenses were 11 percent lower than 2016, and research and development costs were 20 percent below 2014 levels.

Twitter had experienced rapid growth since its founding and had 336 million active monthly users in January 2018. However, the number of active monthly users had fallen 321 million by year-end 2018. The first quarter of 2019 showed a small recovery to 330 million, but the company had discovered that a large percentage of Twitter users were actually bots programmed to post comments or posts that fit the agenda of the bot developer. Twitter changed the method of reporting usage to “monetized daily users,” which were 145 million in the third quarter of 2019. The monetized daily usage climbed a bit in 2019, with Twitter reporting 152 million average daily users on December 31, 2019. The number of monetized daily active users consistently increased annually to reach 229 million by March 31, 2022.

Fiscal 2019 was another profitable year, with net income of $1.5 billion, but again the 2019 net profit was largely due to a $1.075 billion tax benefit from loss carryforward from prior years. Although revenue increased by 14 percent from 2018, the cost of revenue increased to 33 percent of revenue, up slightly from 32 percent in 2018. More troubling, total costs and expenses increased from 85 percent of revenue in 2018, to 89 percent in 2019: consequently, the operating margin fell from 15 percent in 2018 to 11 percent in 2019. Twitters’ market capitalization was $33.5 billion in November of 2019, down from $35 billion in September 2019, and $40 billion in 2014, and again there were suggestions in the media that Twitter was ripe for a buyout.

Twitter was a giant in the industry; however, it faced serious competition from companies such as Facebook (including Instagram and WhatsApp), Snap, TikTok, Alphabet (including Google and YouTube), Microsoft (including LinkedIn), and Verizon Media Group. There were also foreign competitors that were regional social media and messaging companies, with strong positions in particular countries, including WeChat, Kakao, and Line, which posed competitive challenges. Many of these competitors were growing at a multiple of Twitter’s growth—over the three-year period 2017 to 2020, Facebook had an increase of 450 million monthly active users (+35 percent), WhatsApp increased by 800 million (+67 percent) and Instagram had increases of 300 million (+43 percent). Over the two-year period 2017 to 2019, although there were small variations in the numbers of users, Twitter had no increase. In 2019, Twitter’s share of worldwide digital ad revenue had only increased by 0.9 percent, compared to Google’s and Facebook’s advertising revenue gains of 32.2 percent and 22.1 percent, respectively.

Twitter’s Financial Performance: 2019–Second Quarter, 2022

Twitter’s 2020 revenue of $3.716 billion, comprising $3.2 billion in advertising revenue and $509 million in data licensing and other revenue, was an increase of 7 percent over 2019. Revenue sources were the United States, with $509 billion, and international of $1,1.64 billion, with increases of 7 and 8 percent, respectively. Ad engagements increased 23 percent in 2020, compared to 2019 and average monetized daily active usage increased by 27 percent, to 193 million in the fourth quarter of 2020. Despite the healthy increases in revenues metrics, Twitter had a net loss of $1.135 billion in 2020, compared to net income of $1.465 billion in 2019, largely due to increased expenses. Twitter’s consolidated statements of operations for 2019 to 2021 are presented in Exhibit 1. The company’s consolidated balance sheets for 2020 to 2021 are shown in Exhibit 2.

The next year, 2021, saw Twitter’s total revenue increase to $5.077 billion, a 37 percent increase from 2020, driven in large part by $4.505 billion in advertising revenue, which was a 40 percent increase over 2020. Revenue from data licensing and other revenue increased by 12 percent, compared to the prior year and totaled $572 million. U.S. revenue totaled $2.84 billion, a 36 percent increase over the prior year, exceeding international revenue which increased 37 percent over 2020, and totaled $2.24 billion. Despite a healthy increase in revenue, increased cost and expenses (110 percent of revenue) resulted in a net loss of $221 million in fiscal 2021.

Twitter’s first quarter of 2022 average monetizable daily active usage (mDAU) was 229 million, an increase of 15.9 percent over the prior year. Second quarter 2022 mDAU was 237.8 million, up 16.6 percent compared to the same period in the prior year (Exhibit 2). Management attributed the increase to continuing product improvements and the global conversation about current events. Average U.S. mDAU was 41.5 million, up 14.7 percent, and

EXHIBIT 1 Twitter, Inc. Consolidated Statement of Operations, 2019–2021 ($ in thousands, except per share data)

	Year Ended December 31,		
	2021	2020	2019
Revenue	$ 5,077,482	$ 3,716,349	$ 3,459,329
Costs and Expenses:			
Cost of revenue	1,797,510	1,366,388	1,137,041
Research and development	1,246,704	873,011	682,281
Sales and marketing	1,175,970	887,860	913,813
General and administrative	584,336	562,432	359,821
Litigation settlement, net	765,701	—	—
Total costs and expenses	5,570,221	3,689,691	3,092,956
Income (loss) from operations	(492,739)	26,658	366,373
Interest expense	(51,186)	(152,878)	(138,180)
Interest income	35,683	88,178	157,703
Other income (expense), net	97,129	(12,897)	4,243
Income (loss) before income taxes	(411,113)	(50,939)	390,139
Provision (benefit) for income taxes	(189,704)	1,084,687	(1,075,520)
Net income (loss)	$ (221,409)	$ (1,135,626)	$ 1,465,659
Net income (loss) per share:			
Basic	$ (0.28)	$ (1.44)	$ 1.90
Diluted	$ (0.28)	$ (1.44)	$ 1.87
Weighted-average shares used to compute net income (loss) per share:			
Basic	797,573	787,861	770,729
Diluted	797,573	787,861	785,531

Source: Twitter, Inc. 2021 Annual Report.

average international mDAU was 196.3 million, up 17.0 percent for the second quarter of 2022, compared to the same period in the prior year.

The first quarter of 2022 produced revenue of $1.2 billion, a 16 percent increase, year over year (Exhibit 7). Advertising revenue increased by 23 percent to $1.11 billion, while subscription and other revenue fell by 31 percent to $94.4 million. Revenue from the United States increased 21 percent, and international revenue increased 10 percent, when compared to the same quarter in 2021 (Exhibit 8). First quarter 2022 net income was $513.3 million, compared to $68 million for first quarter 2021, however, this profit was due to sale of assets. Second quarter 2022 revenue totaled $1.176 billion, a one percent decrease from the prior year. Exhibit 3 provides the company's consolidated statements operations for Q1 2021 through Q2 2022. The company's revenue by source for Q1 2021 through Q2 2022 is presented in Exhibit 4.

Twitter's management believed this reflected headwind of the advertising industry connected to the macroenvironment and uncertainty regarding Twitter's pending acquisition by Elon Musk. Advertising revenue in the second quarter was $1.08 billion, a 2 percent increase, and subscription and other revenue totaled $100.7 million, a 27 percent decrease, year over year. Twitters' net loss for the second quarter was $270 million, compared to net income of $65.6 million for the same period of 2021.

EXHIBIT 2 Twitter, Inc. Consolidated Balance Sheets, 2020–2021 ($ in thousands, except par value)

	December 31, 2021	December 31, 2020
Assets		
Current assets:		
Cash and cash equivalents	$ 2,186,549	$ 1,988,429
Short-term investments	4,207,133	5,483,873
Accounts receivable, net of allowance for doubtful accounts of $15,278 and $16,946	1,217,404	1,041,743
Prepaid expenses and other current assets	266,484	123,063
Assets held for sale	40,800	—
Total current assets	7,918,370	8,637,108
Property and equipment, net	2,082,160	1,493,794
Operating lease right-of-use assets	1,195,124	930,139
Intangible assets, net	69,324	58,338
Goodwill	1,301,520	1,312,346
Deferred tax assets, net	1,148,573	796,326
Other assets	344,445	151,039
Total assets	$ 14,059,516	$ 13,379,090
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	$ 203,171	$ 194,281
Accrued and other current liabilities	918,350	663,532
Convertible notes, short-term	—	917,866
Operating lease liabilities, short-term	222,346	177,147
Total current liabilities	1,343,867	1,952,826
Convertible notes, long-term	3,559,023	1,875,878
Senior notes, long-term	693,996	692,994
Operating lease liabilities, long-term	1,071,209	819,748
Deferred and other long-term tax liabilities, net	40,691	31,463
Other long-term liabilities	43,531	36,099
Total liabilities	6,752,317	5,409,008
Commitments and contingencies (Note 16)		
Stockholders' equity:		
Preferred stock, $0.000005 par value—200,000 shares authorized; none issued and outstanding	—	—
Common stock, $0.000005 par value—5,000,000 shares authorized; 799,384 and 796,000 shares issued and outstanding	4	4
Additional paid-in capital	8,432,112	9,167,138
Treasury stock, at cost—120 and 98 shares	(5,295)	(5,297)
Accumulated other comprehensive loss	(117,320)	(66,094)
Accumulated deficit	(1,002,302)	(1,125,669)
Total stockholders' equity	7,307,199	7,970,082
Total liabilities and stockholders' equity	$ 14,059,516	$ 13,379,090

Source: Twitter, Inc. 2021 Annual Report.

EXHIBIT 3 Twitter, Inc. Consolidated Statements of Operations, Quarterly Results, Q1 2021–Q2 2022 ($ in thousands, except per share data)

	Three Months Ended March 31,		Three Months Ended June 30,	
	2022	2021	2022	2021
Revenue	$ 1,200,984	$1,036,018	$1,176,660	$1,190,427
Costs and expenses:				
Cost of revenue	507,450	381,008	540,676	416,932
Research and development	371,695	250,709	454,859	299,859
Sales and marketing	299,809	234,592	308,301	301,902
General and administrative	149,863	117,527	216,586	141,482
Total costs and expenses	1,328,817	983,836	1,520,422	1,160,175
Income (loss) from operations	(127,833)	52,182	(343,762)	30,252
Interest expense	(15,444)	(13,185)	(23,342)	(13,893)
Interest income	7,962	11.001	13,595	9,202
Other income (expense), net	(6,506)	6	17,616	55,739
Gain (loss) on sale of asset group	970,474	—	(11)	—
Income before income taxes	828, 653	50,004	(335,904)	81,300
Provision (benefit) for income taxes	315,367	(18,001)	(65,897)	15,651
Net income (loss)	$ 513,286	$ 68,005	$ (270,007)	$ 65,649
Net income (loss) per share:				
Basic	$ 0.66	$ 0.09	$ (0.35)	$ 0.08
Diluted	$ 0.61	$ 0.08	$ (0.35)	$ 0.08
Numerator used to compute net income (loss) per share:				
Basic	$ 513,286	$ 68,005	$ (270,007)	$ 65,649
Diluted	$ 515,313	$ 68,005	$ (270,007)	$ 68,501
Weighted-average shares used to compute net income (loss) per share:				
Basic	778,937	795,633	766,837	796,472
Diluted	838,590	872,187	766,837	869,180

The accompanying notes are an integral part of these consolidated financial statements.
Source: Twitter, Inc. Quarterly Report, June 30, 2022.

Post Purchase Dissonance

In October 2022, during Tesla's third quarter earnings call, Musk admitted that he likely overpaid for Twitter, tweeting he did not realize he had paid $44 billion for a not-for-profit. Also, Musk's use of debt financing would result in principal and interest payments of approximately $1 billion per year.

Twitter's financial woes were intensified by a 50 percent drop in advertising revenue between October 2022 and May 2023. Twitter historically depended on advertising for about 90 percent of its revenue, and shortly after Musk closed the acquisition deal, many significant advertisers reduced or totally eliminated their advertising on the platform. In November 2022, Musk announced that Twitter had suffered a large decline in revenue, and by January 2023, about 625 of its top 1,000 advertisers had ceased advertising on Twitter, resulting in a $3 billion negative cash flow situation.

EXHIBIT 4 Twitter Inc. Sources of Revenue, Q1 2021–Q2 2022 ($ in thousands)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2022	2021	2022	2021
Revenue by services:				
Advertising services	$1,076,003	$1,053,411	$2,182,581	$ 1,952,251
Subscription and other (1)	100,657	137,016	195,063	274,194
Total revenue	$1,176,660	$1,190,427	$2,377,644	$ 2,226,445
Revenue by geographic area:				
United States	$ 661,278	$ 653,075	$1,332,778	$ 1,209,295
Japan	153,277	151,443	332,870	321,407
Rest of World	362,105	385,909	711,996	695,743
Total revenue	$1,176,660	$1,190,427	$2,377,644	$ 2,226,445

Source: Twitter, Inc. Quarterly Report, June 30, 2022.

Musk responded to the decline in revenues by slashing Twitter expenses. Actions to lower operating expenses included closing one data center, reducing its cloud services bill by 40 percent, and laying off thousands of employees. Musk also announced to company employees that they would no longer be allowed to work from home and would be expected to be in the office for at least 40 hours per week, effectively immediately. He also abolished monthly days off. Also, shortly after purchasing Twitter, Musk fired prior CEO Parag Agrawal, the board of directors, and about half of the 7,500 employees. By mid-January 2023, Twitter had reduced its workforce to about 2,300. In February, about 200 more were laid off. The result of the spending cuts initiated by Musk had reduced non-debt expenditures from the forecasted $4.5 billion in 2023 to $1.5 billion.

Policy and Practice Changes at Twitter

Immediately after taking control of Twitter, Musk made changes to several policies and operating practices, some of which were viewed as controversial and resulted in significant backlash. One of the first changes announced was that he planned to abolish permanent bans on Twitter users. Musk described himself as a free speech absolutist, while simultaneously expressing his intent to prevent Twitter from harboring division and hate. He also expressed his intention of defeating spam bots and making the content algorithm publicly available to users. As part of cost reduction, Musk cut a significant number of the content moderation staff and relied more on automation. He implemented a policy to ban links to rival social media platforms, which was soon reversed because of user dissatisfaction with the new policy. As he progressively implemented changes, with varying degrees of success, Musk acknowledged that mistakes would be made, but that he would keep what worked and change what did not.

Musk announced that he intended to increase the company's subscription base, thereby reducing its dependence on advertising, and improving users' experience on the platform. He changed the terms of the blue checkmark verification icon which distinguished authenticated accounts. The verification icon had been launched in 2009 to prevent impersonation of public officials and had been a free service to users who met certain requirements. To boost revenues, Musk instituted an $8.00 per month fee Twitter Blue subscription requirement for verified accounts. Paying subscribers to Twitter Blue were also promised 50 percent fewer ads, SMS two-factor authentication, tweets up to 10,000 characters, and the ability to edit tweets. In April 2023, Twitter began to remove the blue verification checks from users who had not subscribed to Twitter Blue. The company also announced a new icon, a gray checkmark, to designate certain accounts as official, belonging to a government official or governmental organization.

Another significant change at Twitter was its doxxing policy, which had its origin in Musk's son being confronted by a stalker. After this incident, Musk announced that tweets revealing a person's location would be removed and accounts that focused on sharing individual's location would be suspended. Twitter expressly prohibited publishing other people's private information, such as addresses, phone numbers, and IDs, and included threatening to expose private information or incentivizing others to do so.

There were significant alterations in the newsfeed recommendation algorithm. Previously, when users opened the Twitter app, they saw a stream of tweets from accounts they were following, which was the newsfeed. Musk divided the newsfeed: half of the content was an algorithmically selected "For You" tab which contained tweets from people the user did not follow and suggested new interests and topics. The other half of the newsfeed content was in the "Following" tab.

Twitter modified the order in which subscribers saw tweets on their timelines: they could choose between tweets recommended by Twitter and the most recent tweets by people being followed, and additional metrics were added. Musk believed that showing the number of views would be superior to the number of likes or dislikes to indicate a tweet's popularity. Each tweet had the number of views, likes, dislikes, retweets, and bookmarks appended. Musk also added stock market data to Twitter capabilities in December 2022. This function, $Cashtags, enabled Twitter subscribers to type a dollar sign before a stock symbol to see live price charts and the most recent tweets about a company.

Musk created a poll on December 18, 2022, to allow Twitter users to vote on whether he should step down as CEO. The poll results revealed that 57.5 percent of the 17.5 million who voted supported Musk stepping down. Musk agreed with the vote and planned to have a successor CEO in place by the end of 2023. On May 11, 2023, he announced that he had hired a new CEO, Linda Yaccarino to serve Twitter as new CEO. While Linda Yaccarino would focus on advertising sales and business operations, Elon Musk would manage software, system operations, and products as chief technology officer. Ms. Yaccarino had held various leadership positions in advertising of NBCUniversal since 2011. Ms. Yaccarino held the title of chairman of global advertising and partnerships at the time of Musk's announcement and had most recently developed a strategy to provide advertising revenue support for the Peacock streaming service in 2020. Prior to her time at NBCUniversal, Ms. Yaccarino had been working with Turner Broadcasting for almost 20 years and served as executive vice president of advertising sales.

EXPECTATIONS FOR LINDA YACCARINO

Linda Yaccarino's primary charge was to rebuild Twitter's advertising business, which according to Musk, had dropped by about 50 percent since the October 2022 acquisition. Musk also announced that Ms. Yaccarino would help move Twitter to an everything app to expand the business model to include additional revenue streams. Features of the comprehensive super app named X would be similar to China's WeChat. He envisioned X app users would eventually be able to open and manage bank accounts, pay bills, shop for goods, buy and sell stocks, and more. Mr. Musk announced in April 2023 that Twitter's name would be changed to X Corp.

X CORP. IN MID-2023

Musk announced in mid-April 2023 that Twitter was at about 20 percent of its pre-acquisition size, with about 1,500 employees, down from about 8,000. He said that many advertisers had returned, cost-cutting efforts were beginning to show results, and the company was roughly breaking even. Increasing ad revenue was essential, as subscription revenue was not a significant revenue source in mid-2023. Yaccarino's major challenges were to grow Twitter's revenue, oversee the development and implementation of the proposed X app, maintain a positive cash flow, and reestablish profitability. It was also important that Yaccarino as X Corp. CEO to generate forward momentum out of the chaos at the company. Musk had stated he would not fully surrender control of Twitter, as he remained a self-described nano-manager at his other companies. An engineer who had worked at Twitter during and shortly after Musk's acquisition wrote in his personal blog that Musk's managerial philosophy was to continually create chaos which would prevent rigid processes from forming. Musk believed that culturally ingrained process compliance limited the creativity and innovation of employees and also forced employees to focus on process rather than outcomes.

At an influential marketers' conference in April 2023, Ms. Yaccarino, as moderator, nudged Musk to reassure the conference attendees, who were unconvinced of him. According to Yaccarino, the marketers were Twitter's accelerated path to profitability and wished to have the opportunity to influence what Musk was building. She suggested that the marketers were challenged to separate Elon Musk's persona and opinions from the company and recommended that he tweet less, and never after 3 a.m. Musk agreed to limit tweets after 3 a.m., but firmly resisted agreeing to be influenced, saying that would be wrong and diminish free speech. Ms. Yaccarino proposed an open feedback loop with advertisers to encourage them to spend more and develop greater understanding and comfort with Musk. In Linda Yaccarino's first few months as X Corp. CEO, the company's fortunes, at least in the short term, appear tied to advertising revenue. Fidelity Investments and other investors were eager to learn if Yaccarino may be the one capable of driving revenue increases to yield positive returns on their investments in Twitter.

CASE 5

Competition in the Energy Drink Market in 2023

John E. Gamble
Texas A&M University-Corpus Christi

Diana R. Garza
Our Lady of the Lake University

Alternative beverages such as energy drinks, sports drinks, and vitamin-enhanced beverages had been stars of the beverage industry for more than a decade, but signs of an industry slowdown had emerged by 2023. Previous rapid growth in the category, coupled with premium prices and high profit margins made alternative beverages an important part of beverage companies' lineup of brands. Global beverage companies such as Coca-Cola and PepsiCo had relied on such beverages to sustain volume growth in mature markets where consumers were reducing their consumption of carbonated soft drinks. PepsiCo had expanded its lineup of enhanced beverages with the introduction of Gatorlyte Zero, Gatorade Fast Twitch energy drinks, Gatorade Rapid Rehydration, Gatorade Super Shake, and Celsius energy drink. Similarly, Monster Beverage Corporation had extended the line of Monster Energy drinks distributed by Coca-Cola to 11 flavors and varieties.

While attempting to expand the market for alternative beverages and increase sales and market share, beverage producers also were forced to contend with criticism from some that energy drinks and energy shots presented health risks for consumers and that some producers' strategies promoted reckless behavior. Excessive consumption of high-caffeine-content beverages could produce arrhythmias and insomnia. But as 2024 approached, the primary concern of most producers of energy drinks, sports drinks, and vitamin-enhanced beverages was how to best improve their competitive standing in the marketplace and achieve additional growth despite slowing growth in demand.

INDUSTRY OVERVIEW

The global alternative beverage industry in 2023 had seen robust growth over the past decade with worldwide dollar sales of alternative beverages (sports drinks, energy drinks, and vitamin-enhanced beverages) projected to reach $284 billion by 2026. Global energy drinks sales were estimated at $16.1 billion in 2022 and were expected to grow by 2.9 percent annually through 2027. The energy drink market growth rated in 2022 of 0.8 percent had declined from 5.7 percent in 2020. North Americans consumed more energy drinks than any other geographic market in the world, followed closely by the European market. Lifestyle and demographic changes in the Asia-Pacific region were projected to drive annual growth in energy drink sales of 5.1 percent by 2026.

The U.S. market for energy drink brands in 2022 was concentrated with Red Bull dominating the market with €9.684 billion in sales and a 42.5 percent market share. The industry leader was followed by Monster with a 30.1 market share and Bang with an 8.2 percent share. In 2022, both Red Bull and Monster outperformed the broader market, ended the year with growth in revenues of 13.6 percent and 12.7 percent, respectively. Exhibit 1 presents sales and market shares of the leading energy drink brands in 2022.

Alternative beverages were especially popular with consumers seeking out products that would benefit their health, such as energy-boosting products that contained vitamins and electrolytes but without the added sugar. Companies such as Monster Beverage Corporation and Red Bull utilized

EXHIBIT 1 Market Shares of the Leading Energy Drink Brands, 2022

Brand	Market Share
Red Bull	42.5%
Monster	30.1%
VPX	8.2%
Rockstar	4.4%
Category Total	100.0%

Source: Market shares of the leading energy drink brands in the United States in 2022, *Statista*, https://www.statista.com/statistics/306864/market-share-of-leading-energy-drink-brands-in-the-us-based-on-case-volume-sales/ (accessed April 25, 2023).

distinctive ingredients to make their products unique. Ingredients such as Ribose, a sugar substitute produced by Bioenergy Life Sciences, was 60 percent as sweet as table sugar and was used by some energy drink producers. Another such ingredient was coffee cherry fruit which was a source of caffeine that was 70 percent naturally occurring and contains 5 percent polyphenol antioxidants. Other stimulants, such as guarana and ginseng, are popular among teenagers and young adults to improve focus and physical performance.

Alternative beverages tended to carry high price points, which made them attractive to both new entrants and established beverage companies such as the Coca-Cola Company and PepsiCo. Energy drinks tended to carry retail prices that were 50 to 75 percent higher than similar-size carbonated soft drinks and bottled water and allowed for an industry average profit margin of 11.3 percent in 2022.

Suppliers to the Alternative Beverage and Energy Drink Industry

The suppliers to the alternative beverage industry included the makers of such nutritive and non-nutritive ingredients as sugar, aspartame, fructose, glucose, natural and artificial flavoring, artificial colors, caffeine, taurine, glucuronolactone, niacin, sodium, potassium, chloride, and other nutritional supplements. Suppliers to the industry also included the manufacturers of aluminum cans, plastic bottles and caps, label printers, and secondary packaging suppliers. While unique supplements like taurine might be available from only a few sources, most packaging supplies needed for the production of alternative beverages were readily available for a large number of suppliers. The numerous suppliers of secondary packaging materials (e.g., cardboard boxes, shrink-wrap, six-pack rings, printed film or paper labels) aggressively competed for the business of large alternative beverage producers. All but the largest sellers of alternative beverages contracted procurement and production activities to contract bottlers who produced energy drinks and other alternative beverages to the sellers' specifications.

Distribution and Sale of Alternative Beverages and Energy Drinks

Consumers could purchase most alternative beverages in supermarkets, supercenters, natural foods stores, wholesale clubs, and convenience stores. Convenience stores accounted for 65.5 percent of energy drink sales and were a particularly important distribution channel since energy drinks were usually purchased for immediate consumption. Energy drinks and alternative beverages were also sold through warehouse clubs and supercenters, supermarkets, vending machines, and sometimes at sporting events and other special events like concerts, outdoor festivals, and carnivals.

PepsiCo and Coca-Cola's soft drink businesses aided the two companies in making alternative beverages available in supermarkets, supercenters, wholesale clubs, and convenience stores. Soft drink sales were important to all types of food stores since soft drinks made up a sizable percentage of the store's sales and since food retailers frequently relied on soft drink promotions to generate store traffic. Coca-Cola and PepsiCo were able to encourage their customers to purchase items across their product lines to ensure prompt and complete shipment of key soft drink products.

Because of the difficulty for food service distributors to restock vending machines and provide alternative beverages to special events, Coca-Cola and Pepsi-Cola were able to dominate such channels since they could make deliveries of sports drinks and vitamin-enhanced drinks along with their deliveries of carbonated soft drinks. Coca-Cola and Pepsi-Cola's vast beverage distribution systems made it easy for the two companies to make Gatorade, Rockstar, Monster, and Powerade available anywhere Coke or Pepsi could be purchased.

Convenience stores were aggressive in pressing alternative beverage producers and food distributors for low prices and slotting fees. Most convenience stores carried only two to four brands of alternative beverages beyond what was distributed by Coca-Cola and PepsiCo, and required sellers to pay annual slotting fees in return for providing bottle facings on a cooler shelf. Food and beverage distributors usually allowed alternative beverage producers to negotiate slotting fees and any rebates directly with convenience store buyers.

Key Competitive Capabilities in the Market for Alternative Beverages and Energy Drinks

Product innovation had been among the most important competitive features of the alternative beverage industry since the introduction of Gatorade in 1967. Alternative beverages competed on the basis of differentiation from traditional drinks such as carbonated soft drinks or fruit juices and were also positioned within their respective segments on the basis of differentiation. For example, all energy drink brands attempted to develop brand loyalty based on taste, the energy-boosting properties of their ingredients, and image. An energy drink's image was a factor of its brand name and packaging, clever ads, endorsements from celebrities and extreme sports athletes, and sponsorships of extreme sports events and music concerts. Differentiation among vitamin-enhanced beverages tended to center on brand name and packaging, advertising, unique flavors, and nutritional properties. Because of the importance of brand recognition, successful sellers of alternative beverages were required to possess well-developed brand-building skills. The industry's largest sellers were global food and beverage companies—having built respected brands in snack foods, soft drinks, and fruit juices prior to entering the alternative beverage industry.

Alternative beverage sellers also needed to have efficient distribution systems to super-market and convenience store channels to be successful in the industry. It was imperative for alternative beverage distributors (whether direct store delivery by bottlers or delivery by third parties) to maximize the number of deliveries per driver since distribution included high fixed costs for warehouses, trucks, handheld inventory tracking devices, and labor. It was also critical for distributors and sellers to provide on-time deliveries and offer responsive customer service to large customers. Also, volume and market share were key factors in keeping marketing expenses at an acceptable per-unit level.

PROFILES OF THE LEADING ALTERNATIVE BEVERAGE AND ENERGY DRINK PRODUCERS

Red Bull GmbH

Red Bull's dominance in energy drinks began in 1988 with the first-ever Red Bull event held in Lienz, Austria, and known as the Dolomitenmann, a race that has spawned thousands of hardman legends. In 1989, Austrian F1 legend Gerhard Berger became the first Red-Bull-sponsored athlete. In 1994, Red Bull signed watermen Robby Naish and Björn Dunkerbeck as the first company's international sports stars. A number of sponsorships followed, as well as sporting and music events. Red Bull made its debut in the United States in 1997, specifically marketed to athletes, busy professionals, and college students. As of 2021, Red Bull was sold in 172 countries, with sales surging in emerging markets such as India, Brazil, and Africa. The company continues to focus on global expansion into the United States, Western Europe, in the Far East.

In 2022, the company sold 11.6 billion cans representing an 18.1 percent increase in revenues in 2021. The company's 2022 revenue of €9.684 billion was 23.9 percent greater than in 2021. The company's slogan, "Red Bull gives you wings," signaled its energy-boosting properties, and the company's endorsements involved almost every high-energy sport worldwide.

The Coca-Cola Company

The Coca-Cola Company was the world's leading manufacturer, marketer, and distributor of nonalcoholic beverage concentrates in 2023. Its product portfolio included non-alcoholic beverages such as soft drinks, bottled water, sports drinks, and energy drinks. Almost one-third of the company's total revenue was generated in North America, making it their most lucrative operating segment in 2022. The company was ranked as the top carbonated soft drink company in 2022 with a volume share of almost 45 percent. A summary of the Coca-Cola Company's financial performance between 2020 and 2022 is presented in Exhibit 2.

Along with the universal appeal of the Coca-Cola brand, Coca-Cola's vast global distribution system—which included independent bottlers, bottlers partially owned by Coca-Cola, and company-owned bottlers—made Coke an almost unstoppable international powerhouse. Coca-Cola, Diet Coke, Fanta, and Sprite all ranked among the top five best-selling nonalcoholic beverages worldwide.

The company had an impressive track record of innovation propelling the company to become one of the most successful brands. The company's advertising efforts made the company a widely recognized symbol of American culture through its influence on politics, pop culture, and music around the globe.

Monster Energy Drink. Monster energy drink brand was owned by Monster Beverage Corporation but entered into a strategic partnership with the Coca-Cola company in 2015 with the goal of combining Coca-Cola's existing energy drink business with that of Monster. The partnership included an equity investment by Coca-Cola and expanded distribution for Monster. Coca-Cola's portfolio of energy drink brands in 2023 included Monster, Monster Energy Ultra, Monster MAXX maximum strength, Java Monster, Espresso Monster, Café Monster, Monster Rehab, Muscle Monster shakes, Monster HydroSport Super Fuel advanced hydration, Monster Dragon Tea, Reign Total Body Fuel, Reign Inferno thermogenic fuel high-performance, Full Throttle, Burn, Samurai, Relentless, Mother, Power Play, BPM, Gladiator, Ultra Energy, and Predator energy drinks.

Monster had enhanced its image through sponsorships of some of the world's most popular sports events and athletes, as well as music artists. Some notable sponsorships include UFC, Motorsports, Formula 1, PBR, Supercross, and NASCAR, among other events. They also have a strong presence in the music industry, promoting artists such as Luke Bryan, Chris Stapleton, Lil Xan, Rob Zombie, Machine Gun Kelly, and Korn, among other artists. A summary of Monster Beverage Corporation's financial performance for 2021 and 2022 is presented in Exhibit 3.

EXHIBIT 2 Financial Summary for the Coca-Cola Company, 2020–2022 ($ millions)

	2022	2021	2020
Net operating revenues	$43,004	$38,655	$33,014
Cost of goods sold	18,000	15,357	13,433
Gross profit	25,004	23,298	19,581
Selling, general and administrative expenses	12,880	12,144	9,731
Other operating charges	1,215	846	853
Operating income	10,909	10,308	8,997
Interest income	449	276	370
Interest expense	882	1,597	1,437
Equity income (loss)—net	1,472	1,438	978
Other income (loss)—net	(262)	2,000	841
Income before income taxes	11,686	12,425	9,749
Income taxes	2,115	2,621	1,981
Consolidated net income	9,571	9,804	7,768
Less: Net income (loss) attributable to noncontrolling interests	29	33	21
Net income attributable to shareowners of the Coca-Cola Company	$9,542	$9,771	$7,747

Source: Coca-Cola Company, 2022 10-K report.

EXHIBIT 3 Financial Summary for Monster Beverage Corporation, 2021–2022 ($ thousands, except per share information)

Six Months Ended June 30	2022	2021
Net sales	$3,173,833	$2,705,751
Cost of sales	1,617,306	1,153,976
Gross profit	1,556,527	1,551,775
Operating expenses	784,088	611,652
Operating income	772,439	940,123
INTEREST and OTHER (EXPENSE) INCOME, net	(14,080)	111
Income before provision for income taxes	758,359	940,234
Provision for income taxes	190,796	221,278
Net income	$567,563	$718,956
Net Income per Common Share:		
Basic	$1.07	$1.36
Diluted	$1.06	$1.34
WEIGHTED AVERAGE NUMBER OF SHARES OF COMMON STOCK AND COMMON STOCK EQUIVALENTS:		
Basic	529,009	528,425
Diluted	535,209	535,324

Source: Monster Beverage Corporation, 2022 10-K report.

PEPSICO

PepsiCo generated more than $86 billion in net revenue in 2022, driven by its beverage and convenient foods portfolio that includes Lay's, Doritos, Cheetos, Gatorade, Pepsi-Cola, Mountain Dew, Quaker, and Soda Stream. PepsiCo was the second largest food and beverage company in the world with dozens of brands distributed across more than 200 countries. PepsiCo entered into an agreement to acquire Rockstar Energy for $3.85 billion in 2019 to bolster its market share in energy drinks. In 2022, PepsiCo also acquired a $550 million stake in the energy drink maker Celsius.

Rockstar Energy Drinks. Rockstar was founded in San Francisco, California in 2001. The company's marketing strategy focused on affiliations with action sports, motorsports, live music, and models. The company was sold to PepsiCo in 2020 for $3.85 billion, adding it to the PepsiCo beverage lineup, which already included Gatorade, which was the number-one sports drink brand. Rockstar energy drink sales declined from $193 million in 2021 to $169 million in 2022. While the performance of Rockstar was disappointing, PepsiCo dominated the alternative beverage industry with Gatorade selling 2.47 billion cases in 2022 and holding a 29.3 percent global market share. The company was also expanding its lineup of alternative beverages with a goal that 67 percent of its beverage portfolio volume would contain fewer than 100 calories added from sugar by 2025. A summary of PepsiCo's financial performance between 2020 and 2022 is presented in Exhibit 4.

Other Sellers

In addition to the industry's leading sellers of alternative beverages, there were a large number of regional and specialty brands of energy drinks, sports drinks, and enhanced beverages in the United States and internationally. Most of these companies were privately held bottlers with distribution limited to either small geographic regions or specialty grocers and health food stores. In some cases, regional brands were produced by divisions of large corporations and might have a commanding market share in one

EXHIBIT 4 Financial Summary for PepsiCo, 2020–2022 ($ millions, except per share information)

	2022	2021	2020
Net revenue	$86,392	$ 79,474	$ 70,372
Cost of sales	40,576	37,075	31,797
Gross profit	45,816	42,399	38,575
Selling, general and administrative expenses	34,459	31,237	28,495
Operating profit	11,512	11,162	10,080
Other pension and retiree medical benefits income/(expense)	132	522	117
Net interest expense and other	(939)	(1,863)	(1,128)
Income before income taxes	10,705	9,821	9,069
Provision for income taxes	1,727	2,142	1,894
Net income	8,978	7,679	7,175
Less: Net income attributable to noncontrolling interests	68	61	55
Net income attributable to PepsiCo	$8,910	$7,618	$7,120
Net income attributable to PepsiCo per common share			
Basic	$6.45	$5.51	$5.14
Diluted	$6.42	$5.49	$5.12
Weighted-average common shares outstanding			
Basic	1,380	1,382	1,385
Diluted	1,387	1,389	1,392

Source: PepsiCo, 2022 10-K report.

particular country but limited distribution outside that market. Overall, the relative strength of the energy drink, enhanced beverage, and sports drink beverage segments would likely attract additional entrants over the next several years.

The third best-selling energy drink brand, Bang, was among the smaller companies in the industry. Bang Energy Drink was owned by Florida-based Vital Pharmaceuticals, Inc. The company developed and manufactured Bang Energy drinks, VPX Redline Energy Drinks, and other sports supplements and performance beverages. The company's products had been distributed by PepsiCo, but the relationship dissolved in 2022 when Vital Pharmaceuticals filed for bankruptcy. The restructuring program would shift its distribution to direct store distribution and a network of 269 distributors. The company's energy drink lineup includes over 40 flavors and varieties marketed under the Bang and VPX brands.

CASE 6

Netflix's 2023 Strategy for Battling Rivals in the Global Market for Streamed Video Subscribers

Arthur A. Thompson,
The University of Alabama

Heading into 2023, Netflix was making a series of strategic and operating adjustments in order to strengthen its position as the world leader in the global market for streamed entertainment content and to reaccelerate its growth in revenues, net income, and subscriber membership. Netflix grew its paid membership base from 139.3 million at year-end 2018 to 230.7 million in 190 countries at year-end 2022, equal to a compound annual growth rate of 13.4 percent; but subscriber membership at year-end 2022 was up only 4.0 percent over year-end 2021. And its 2022 financial performance was uninspiring. The company generated revenues of $31.6 billion in 2022 (up 6.5 percent over 2021), operating income of profit of $5.6 billion (down 9.1 percent from $6.2 billion in 2021), and net income of $4.5 billion (down 12.2 percent from $5.1 billion in 2021). Netflix's long-term financial objectives were to sustain double-digit revenue growth, expand the company's operating margin, and deliver growing positive free cash flow.

The primary actions currently being taken to improve Netflix's performance in 2023 and to achieve the company's long-term financial objectives included (1) continuing to increase releases of new original content (something the company had been doing for the past several years), (2) focusing efforts to grow its user base on country markets with the highest potential for acquiring new subscribers, (3) launching a new "Basic with Ads" plan costing $6.99 per month for subscribers unable or unwilling to pay a higher fee for any of the other Netflix subscription plans (which in March 2023 in the United States ranged from $6.99 to $19.99, depending on the subscription tier chosen and the country where a subscriber was located), and (4) increasing efforts to prevent the 100+ million households who shared the password for their account with individuals in other households (all Netflix accounts were intended solely for the use of people living together in the *same* household) from continuing to share their password with other households *unless they paid extra to do so by switching to a paid sharing account.*[1]

In releasing the company's Fourth Quarter 2022 performance results, Netflix co-founder and long-time CEO, Reed Hastings, announced that the company had completed its executive succession process whereby he would become Executive Chairman of the board of directors and Ted Sarandos and Greg Peters would become co-CEOs. Hastings and Sarandos has a long history of collaboration on corporate strategy, planning, and all aspects of company management, and both men had functioned as co-CEOs since 2020 when the two were appointed Co-Chief Executive Officers; Sarandos also held the title of Chief Content Officer and Hastings held the titles President and Chairman of the Board in addition to being co-CEO. Prior to being appointed co-CEO, Greg Peters held the title of Chief Operating Officer and Chief Product Officer. Earlier, Peters was International Development Officer for Netflix, responsible for the global partnerships with consumer electronics companies, Internet service providers and multi-channel video programming distributors that enabled Netflix to deliver movies and TV shows across a full range of devices and platforms; he joined Netflix in 2008. All three—Hastings, Sarandos, and Peters—had worked closely together for 15 years. In addition to the changing roles of the company's three top executives, Bela Bejaria, formerly Head of Global TV, was elevated to the role of Chief Content Officer and Scott Stuber was appointed Chairman of Netflix Film.

NETFLIX'S REINVENTION OF ITS BUSINESS MODEL, 2010–2022

During the past 12 years, Netflix had successfully transformed its business model from one where subscribers paid a monthly fee to receive an unlimited number of DVDs each month (delivered and returned by mail with one to three titles out at a time) to a model where subscribers paid a monthly fee to watch an unlimited number of movies and TV episodes streamed over the Internet. During the same time frame, Netflix had expanded its geographic coverage to over 190 countries, making it the world's leading Internet television network and biggest global provider of subscriber-based streamed entertainment programming. Households across the world had quickly adapted to watching streamed entertainment because their subscriptions (to Netflix or any other subscription-based entertainment provider) entitled them to watch as much streamed content as they wanted—anytime, anywhere, on nearly any Internet-connected screen—but they could also play, pause, and resume watching, all without commercials.

During the past 10 years, a second major adjustment to Netflix's business model had been to shift from a content library consisting mainly of titles licensed from movie studios, broadcast TV networks, and other sources to a content library that increasingly consisted of its own self- produced original content (feature films, multi-episode series, and documentaries). From 2012 forward, Netflix steadily increased its annual spending on new original content; expenditures for original content approximated $10 billion in 2018 and by 2022 were estimated to exceed $20 billion. Netflix debuted its first original series, *House of Cards,* in 2013, which proved to be a blockbuster hit. Over the next several years, it launched several of the most popular shows of the decade—*Orange is the New Black, Stranger Things,* and *Narcos.* Amazon's Prime Video soon followed in 2015, with its first original content programs *The Man in the High Castle* and *Mr. Robot.*

In 2021–2023 it was standard practice for Netflix to begin streaming freshly-produced titles or new seasons/episodes of previous series at least every month, increasing on a weekly or even daily basis. Netflix's top executive team believed that the ongoing availability of new titles and new seasons/episodes of its most popular programs were critical to keeping existing subscribers actively engaged with the entertainment Netflix provided and to attracting new subscribers.

Already solidly entrenched as the global leader in paid memberships for streamed content, the principal questions for Netflix in 2023 seemed to be

- Whether the company had sufficient competitive and financial strength to combat the efforts of larger, resource-rich rivals looking to steal subscribers away from Netflix.
- Whether the company could grow its subscriber base fast enough to achieve sustained double-digit revenue growth, improved profit margins and attractive bottom-line profitability, and ever-higher free cash flows.

Financial statement data for Netflix for 2015 through 2022 are shown in Exhibits 1 and 2. Netflix had never paid a dividend to its shareholders and the company had declared it had no present intention of paying any cash dividends in the foreseeable future.

THE FAST-CHANGING MARKET FOR STREAMED ENTERTAINMENT

Going into 2023, faster Internet speeds, fast-growing consumer preferences worldwide for watching content streamed directly to whatever device they wanted to use at whatever times they wanted to watch it, rapid entry of new streamed content providers in most countries across the world, and aggressive efforts of like HBO Max, Disney+, Comcast subsidiary NBC Universal's Peacock offering, Warner Media's Paramount Plus, Apple TV+, Hulu, YouTube, and other enterprises in various geographic regions (like Tencent Video and Baidu's iQuivi in China, ITV and Channel 4 in the United Kingdom, and Hotstar in India) looking to compete with Netflix and Amazon's Prime Video had combined

EXHIBIT 1 Netflix's Consolidated Statements of Operations, 2015–2022 (in millions, except per share data)

	2015	2018	2020	2021	2022
Revenues	$6,779.5	$15,794.3	$24,996.1	$29,697.8	$31,615.6
Cost of revenues (almost all of which relates to amortization of content assets)	4,591.5	9,967.5	15,276.3	17,332.7	19,168.3
Gross profit	2,188.0	5,826.8	9,719.8	12,365.1	12,447.3
Operating expenses					
Technology and development	650.8	1,221.8	1,829.6	2,273.9	2,711.0
Marketing	824.1	2,369.5	2,228.4	2,545.1	2,530.5
General and administrative	407.3	630.3	1,076.5	1,351.6	1,572.9
Total operating expenses	1,882.2	4,221.6	5,134.5	6,170.6	6,814.4
Operating income	305.8	1,605.2	4,585.3	6,194.5	5,632.8
Interest expense	132.7	420.5	(767.5)	(765.6)	(706.2)
Interest and other income (expense)	(31.2)	(378.8)	(618.4)	411.2	337.3
Income before income taxes	141.9	1,226.5	3,199.3	5,840.1	5,263.9
Provision for income taxes	19.2	15.2	438.0	723.9	772.0
Net income	$ 122.6	$ 1,211.2	$ 2,761.4	$ 5,116.2	$ 4,491.9
Net income per share:					
Basic	$ 0.29	$ 2.78	$ 6.26	$ 11.55	$ 10.10
Diluted	0.28	2.68	6.08	11.24	9.95
Weighted average common shares outstanding (in millions):					
Basic	425.9	435.4	440.9	443.2	444.7
Diluted	436.5	451.2	454.2	455.4	451.3

Note 1: Some totals may not add due to rounding.

Source: Company 10-K reports for 2015, 2020, and 2022.

to unleash an increasingly intense competitive battle among streaming providers to become serious contenders in the rapidly growing global market for *subscriber-based* streamed content. This rapidly growing and fast evolving market had quickly become "the wave of the future." It had already attracted some 2 billion individuals/households and was proving highly disruptive to the businesses of traditional cable and satellite providers, whose global subscriber counts had deceased from just under 600 million in 2017 to 527 million in 2021.[2] College graduates and many millennials were avoiding subscribing to cable and satellite providers with increasing frequency because of the "high" monthly prices and the growing availability of cheaper substitutes for viewing the programs they really wanted to watch or were satisfied with watching. According to one source, the app-based video streaming industry had revenues of $72 billion in 2021 (most of which came from the United States) and was projected to reach $115 billion by 2026.[3] Including entertainment streaming by cable and satellite providers, the global video streaming market size was an estimated $372 billion in 2021 and was projected to grow from $473 billion in 2022 to $1,690 billion by 2029.[4]

Competition had been further enhanced by the introduction of the TikTok app to the Western World by China's Bytedance in 2018; Tiktok quickly became one of the most used video apps in the world, with availability in 75 languages in 154 countries (as of March 2023),

EXHIBIT 2 Selected Balance Sheet and Cash Flow Data for Netflix, 2015–2022 (in millions)

	2015	2018	2020	2021	2022
Selected Balance Sheet Data					
Cash and cash equivalents	$ 1,809.3	$ 3,794.5	$ 8,205.6	$ 6,027.8	$ 5,147.2
Current assets	5,431.8	9,694.1	9,761.6	8,069.8	9,266.5
Content assets, net	7,218.8	20,107.5	25,384.0	30,919.5	32,736.7
Total assets	10,202.9	25,974.4	38,280.4	44,584.7	48,594.8
Current liabilities	3,529.6	6,487.3	7,805.8	8,489.0	7,931.0
Long-term debt*	2,371.4	10,360.1	15,801.9	14,693.1	14,353.1
Total liabilities	7,979.4	20,735.6	28,215.1	28,735.4	27,817.4
Stockholders' equity	2,223.4	5,238.8	11,605.2	15,849.3	20,777.4
Cash Flow Data					
Net cash (used in) provided by operating activities	$ (749.4)	$ (2,680.5)	$ 2,427.1	$ 392.6	$ 2,026.3
Net cash provided by (used in) investing activities	(179.2)	(339.1)	(505.4)	(1,339.9)	(2,076.4)
Net cash provided by (used in) financing activities	1,640.3	4,048.5	1,237.3	(1,149.8)	(664.3)

*All of Netflix's long-term debt consisted of senior unsecured notes that were issued at various points in time and had various maturity dates and various fixed rates of interest.

Sources: Company 10-K Reports 2015, 2018, 2020, and 2022.

downloads of over 2.6 billion as of January, 2020, and an estimated 1 billion monthly active users in March 2023.[5] In addition, video game streaming had boomed, with the entry of Amazon's Twitch (which hosted games with millions of followings like Ninja, Shroud, PewDiePie, Rubius, Pokimane, Tfue, and Auronplay), YouTube Gaming (which hosted games with millions of followings like Mr. Beast, Myth, and TimTheTatman), Facebook Gaming (which ended in August 2022), Prime Gaming, Huya and Douyu in China, and TikTok (which introduced its gaming app in November 2022).[6] NCSOFT, headquartered in Pangyo, South Korea, was the world's premier developer and publisher of massively multiplayer online games; its best-known game titles included *Lineage, AION, Blade & Soul,* and *Guild Wars* plus it had a number of casual games.

Netflix entered the market for video game streaming in November 2021 and by early 2023 had 55 games available that subscribers could play at no additional charge; the selection included 12 of the best Android games. Netflix planned to expand its game options in 2023 and beyond in an effort to capture a bigger share of the roughly $130 billion that consumers were currently spending on gaming software.[7] The company was endeavoring to add around 40 more games in the remainder of 2023 in an attempt to make sure it had at least one game that each of its 230+ million subscribers could enjoy.[8]

Netflix was not put off by the stronger competitive forces at work. Reed Hastings said in January 2023:

> The silver lining is that that the market for entertainment is huge and Netflix is still small by comparison. For example, in the more than 190 countries we operate in, our $30 billion of annual revenue compares against the combined $300 billion pay TV/streaming industry. . . . .in Mexico, Brazil, and Poland, we are less than 5 percent of TV viewing. And in our largest markets like the US and the UK, we are still less than 10 percent of TV screen time. . . . .(and) streaming overall across all markets accounts for less than 40 percent of viewing.[9]

Netflix top executives firmly believed going forward that the vast majority of time people spent

EXHIBIT 3 Estimated Number of Internet Users in Selected Countries as of January 2023

Country	Millions of Internet Users	Country	Millions of Internet Users
China	1,050.0	Vietnam	78.0
India	692.0	Germany	77.5
United States	311.3	United Kingdom	66.1
Indonesia	212.9	Thailand	61.2
Brazil	181.8	France	59.9
Russia	127.6	Italy	50.8
Nigeria	122.5	South Korea	50.6
Japan	102.5	Spain	45.1
Mexico	100.6	Argentina	39.8
Philippines	85.2	Poland	36.7
Egypt	80.8		

Source: Statista, **www.statista.com** (accessed March 23, 2023).

watching entertainment would come from sources that streamed programming directly to their Internet-connected devices, thereby providing Netflix with a long runway for growing its business.

Exhibit 3 shows the number of Internet users, by country, with the ability to watch streamed entertainment on any Internet-connected device.

A SAMPLING OF NETFLIX'S COMPETITORS IN THE GLOBAL MARKET FOR STREAMED VIDEO SUBSCRIBERS

Going in 2020, Netflix' principal direct competitors included Amazon's Prime Video, The Walt Disney Company (Disney Plus, Hulu), Warner Bros. Discovery's HBO Max, Apple TV+, Comcast's new Peacock offering, and Paramount Plus, all of whom had professed or exhibited a strategic intent to rank among the industry leaders—YouTube was not considered a direct competitor because its free and paid video content was distinctly different from the titles offered by Netflix and its direct competitors. Following is a brief description of the media resources and competitive capabilities of the chief rivals Netflix expected to battle in competing for streamed entertainment subscribers in countries across the world.

Amazon's Prime Video

Amazon competed directly with Netflix via its Amazon Prime membership service, which included access to the content on Amazon's Prime Video streaming service as well as free shipping on purchases at Amazon.com. In 2023, individuals and households could become an Amazon Prime member for a fee of $139 per year or $14.99 per month (after a one-month free trial); there was a discounted price for students and qualifying government assistance recipients of 50% off and a discount for seniors of $6.99 per month. Membership in just Prime Video was $8.99 per month. Amazon reported on April 29, 2021 that it had over 200 million paying Prime members worldwide.[10] Going into 2023, Amazon very likely had about 220 million Amazon Prime members globally, although all Prime members did not use the Prime Video benefit. In 2022, Amazon had net sales revenues of $514 billion, of which some $35.2 billion represented revenues from subscription services.

While Amazon had originally created its Amazon Prime membership program as a means of providing unlimited two-day shipping (more recently, one-day shipping in many locations and 2-hour grocery delivery in 2,000 cities) on Prime-eligible items to customers who ordered merchandise from Amazon and wanted to receive their orders quickly, in 2012 Amazon began including movie and music streaming as a standard benefit of Prime membership. Amazon Prime members were not, however, eligible to view every title in the Prime Video library for free; titles that were not Prime-eligible could be watched on a pay-per-view basis or else purchased. Going into 2023, many Amazon Prime members did not utilize their Prime Video membership benefit (Amazon did not disclose the overall percentage). Another video benefit of Amazon Prime membership was the ability to use the Prime Video app on their Internet-connected device to gain immediate access to subscribe to the content of some 100 entertainment providers that had become Prime Video Channel Partners.

In 2010, Amazon established Amazon Studios to oversee the development and production of new in-house original movies and multi-episode series; approximately 200 new original titles were released during 2015–2018. In 2017 and continuing forward, Amazon began a strategic initiative to upgrade its content library, with both higher caliber new original content and licensed content. As of early 2023, Amazon Prime Video had an estimated 10, 400 titles in its content library for the United States.[11] Amazon paid the National Football League $65 million a year for three seasons starting with 2017 season to live stream *Thursday Night Football* games globally to Prime Video members in 200 countries (these broadcasts attracted more than 18 million total viewers over 11 games in 2017). In 2021 Amazon agreed to pay the NFL $11 billion ($1 billion per year) for a new 11-year media rights package to exclusively live stream 15 *Thursday Night Football* games and one preseason game, beginning with the 2022 season and running through the 2033 season. During the 2022 NFL season, Amazon's *Thursday Night Football* telecasts had an average audience of 11.3 million viewers, and four of the telecasts made the list of *Variety's* Top 100 Primetime Telecasts of 2022.

Amazon Studios spent a reported $250 million for licensing rights to *Lord of the Rings,* with plans for spending up to $1 billion to produce 5 seasons of episodes. The first season of *Lord of the Rings: The Ring of Power,* which premiered on Labor Day 2022, attracted more than 100 million viewers worldwide, was the most watched Amazon Original series in every region of the world (with more than 24 billion minutes streamed), and drove more Prime sign-ups worldwide during its launch window than any previous Prime Video content. Over the years 2015–2023, Amazon Originals received 241 nominations and 72 wins at various movie and TV awards shows.[12]

In 2022, Amazon's new original content included *The English, Dr. Seuss Baking Challenge, My Policeman, The Terminal List,* documentary *Good Night Oppy,* the fourth volume of Rihanna's annual fashion experience *Savage X Fenty,* the third season of Tom Clancy's *Jack Ryan,* and the first season of *Jack Reacher* (based on Lee Child's best-selling series of crime novels featuring a veteran military police investigator and two successful Jack Reacher films starring Tom Cruise); these programs were available globally in over 240 countries and territories. Amazon also had a deal that brought new Universal movies to Amazon Prime Video four months after they appeared on NBCUniversal's Peacock streaming service. In addition, in 2022 Amazon added HBO Max (renamed Max in 2023) to its Prime Video Channels lineup in the United States—for a subscription of $15.99 per month (collected by Prime Video), Prime Video members could gain access to approximately 15,000 hours of Max's premium content without having to switch over to the Max app. Prime Video Channels was a feature that enabled entertainment companies to use the Prime Video app installed on most TVs to offer Prime Video's large member base monthly subscriptions to their content. Streaming services like Warner Bros. Discovery's Max, Paramount+, Starz, Showtime, AMC+, Freevee and Boomerang (both free with ads), Cinemax, MGM+, Acorn TV, and many others had elected to become a Prime Video Channel Partner because such partnership enabled them to gain substantial numbers of new subscribers/viewers. Using Prime Video Channels to check out all the different content options was attractive to Prime members because they could conveniently access a very broad range of content categories and titles in one place without having to switch to the app of each different streamer to view a streamer's content library.

In 2022, Amazon acquired MGM Studios for $8.5 billion, giving it access to MGM's library of 4,000 films and 17,000 episodes of TV shows. MGM's film library included the James Bond, Rocky, and Creed franchises, *Candyman, Sonic the Hedgehog,* and *Top Gun: Maverick.* Its TV Shows included *Survivor, The Voice, The Consultant, Vikings,* and *Act Your Age.* Amazon rapidly moved to relaunch MGM's streaming platform EPIX as MGM+, drawing not only on MGM's content library but also forthcoming original films, series, and TV shows from MGM Studios. In 2023, MGM+ was a Prime Video Channel partner with a subscription price of $5.99 a month. In April 2023, there were reports in the medias that Amazon was ready to take action on investing in about a dozen new titles for films and/or TV shows to be produced by MGM Studios.[13]

Like Netflix, Prime Video had also entered the market for streaming video games. Its game offerings were available at Prime Gaming. New games were made available weekly and monthly and were free to Prime members who created a Prime Gaming account; gameplayers could also go to amazongames.com and play online games for free. Prime members with a Prime Gaming account got a free subscription to Twitch. Some games had ending dates. Amazon Games also had four studios and teams that developed original multiplayer games, and it published best-in-class third-party games, some of which could be played free on Prime Gaming.

In December 2022, Amazon announced that Amazon Studios would spend more than $1 billion annually to produce films for release in movie theaters in 2023.[14] Further, Amazon broke new ground by opening its first theater, The Culver Theater, in a 41,000 square foot building across the street from Culver Studios in Culver City, California, where Amazon Studios occupied more than 530,000 square feet for film and TV production. The theater had six screens, with tables and plush seat in its lobby along with a full bar of wine, beer, and cocktails and such food offerings nachos, chicken tenders, buffalo chicken sliders, popcorn, candy, and sodas.[15] Moviegoers purchased tickets on digital kiosks using a touch screen; tickets for a noon showing cost $17.99. In December 2022, the Culver Theater's website was advertising upcoming show times for "Avatar: The Way of Water," "Bones and All," "Top Gun: Maverick," "Good Night Oppy," "Nanny," and "Triangle of Sadness."

The Walt Disney Company, Disney+, and Hulu

The Walt Disney Company in 2023 was a broadly diversified international family entertainment and media enterprise with businesses that included (1) the ABC television network; (2) eight ABC broadcasting TV stations; (3) multiple cable channels (the ESPN family of 5 domestic channels and 15 international channels that operated under such brands as Disney, ESPN, Fox, and Star, 3 domestic Disney branded channels and approximately 75 Disney branded international channels (broadcast in approximately 25 languages and 175 countries/territories), 3 FX channels, Freeform, 3 National Geographic cable channels, and 50 percent ownership of A&E Television Networks, which operated the A&E, HISTORY, Lifetime, Lifetime Movie Network, and FYI cable channels); (4) multiple content production studios, including ABC Signature studios, Walt Disney Pictures, Twentieth Century Studios, Marvel, Lucasfilm, Pixar, Searchlight Pictures, Disney Television Animation, and FX Productions, which also sold and licensed their film and television content to third-party television, cable, and video streaming services; (5) theme parks and resorts; (6) Disney Cruise Lines; (7) content sales/licensing of Disney's wide-ranging intellectual property; (8) sales/licensing of the Disney-related merchandise at The Disney Stores and assorted online sites; (9) 73 percent ownership of National Geographic magazine; and (10) direct-to-consumer video streaming services which included Disney+, Disney+ Hotstar, ESPN+, Hulu (co-owned with NBC Universal), and Star+.[16] The Walt Disney Company reported 2022 revenues of $82.7 billion and earnings of $3.1 billion.

In early 2023, Disney CEO Robert Iger was wrestling with the strategic direction the company's streaming and digital businesses should pursue and whether the company should sell its 80 percent stake in ESPN and its 50 percent stake in Hulu. Disney acquired 80 percent of ESPN when it bought ABC in 1996; ESPN was acquired by ABC in 1984, and in 1990 ABC sold a 20 percent equity stake in ESPN to Hearst Communications (now Hearst, Inc). Disney ended up with its 50 percent ownership stake in Hulu in a series of transactions in 2018–2019.

Disney+ Disney debuted its new Disney+ streaming service in November 2019 in the United States, Canada, and The Netherlands and quickly proceeded to expand its geographic coverage. By early 2023, Disney+ was available in 108 countries and 12 territories; its subscription prices were $7.99 per month for Disney+ Basic (with ads) and $10.99 per month or $109.99 per year for Disney+ Premium (no ads). Disney+ offerings included existing and forthcoming movies and TV shows Walt Disney Studios, the three Disney TV channels, Pixar, Marvel, National Geographic, and 20th Century Fox. Concurrent with the launch of Disney+ in November 2019, Disney began offering a bundle of Disney+, Hulu (ad supported), and ESPN+ for $12.99 per month with no free trial included at the Disney+ website in the United States. There were about 161.8 million Disney+, Disney+ Hotstar, and Star subscribers as of January 2023; this number fell to 157.8 million as of April 1, 2023.[17] As of April 1, 2023, average revenue per paid subscriber was $6.47 at Disney+ (versus $5.77 as of yearend 2023), and $0.59 at Disney+ Hotstar (versus $0.74 at yearend 2022); the decrease at Disney+ Hotstar was due to lower per-subscriber advertising revenue.[18]

Disney+ Hotstar Disney+ Hotstar was a subscription-based direct-to-consumer service available in India, Indonesia, Malaysia, and Thailand. Programming included television shows, movies, sports and original series in approximately 10 languages, in addition to gaming and social features. Disney+ Hotstar had exclusive streaming rights to cricket from the International Cricket Council (ICC) and the Board of Control for Cricket in India (BCCI), along with other cricket rights. Disney+ Hotstar has 52.9 million paid subscribers as of April 1, 2023, versus 57.5 million paid subscribers as of ear-end 2022.

ESPN+'s Streaming Service ESPN+ was a subscription-based conglomeration offering live sports programs (select live MLB, NHL, NBA, MLS, and Canadian Football League games, as well as multiple college sports games, PGA golf events, boxing, tennis matches, and cricket games that were *not* broadcast live on any of ESPN's family of channels (ESPN, ESPN2, ESPNU—which was dedicated to college sports, ESPN Classic, ESPNews—which aired select ESPN studio shows and a variety of other programming, ESPN Deportes—which aired professional and college sports as well as studio shows in Spanish, SEC Network—which was dedicated to Southeastern Conference college athletics, ACC Network—which was dedicated to Atlantic Coast Conference college athletics, and Longhorn Network—which was dedicated to The University of Texas athletics). As of October 1, 2022, the estimated number of paid ESPN+ subscribers was 24 million.[19]

Hulu's Streaming Service Hulu was a direct-to-consumer streaming service with general entertainment content from the Disney's various studios as well as content licensed from third parties. Hulu's revenue was primarily derived from subscription fees and advertising sales. As of 2023, Hulu had a number of subscription plans:

- Hulu only for $14.99 per month (which included Hulu originals, hit movies, a variety of current season TV shows (the day after they aired on the major TV broadcast networks and select cable channels), back seasons of hundreds of TV shows, and several thousand movies in the Hulu library.
- Hulu with ads for $7.99 per month.
- Hulu and Disney+ (both with ads) for $9.99 per month.
- Hulu, Disney+, and ESPN+, all with ads, for $12.99 per month.
- Hulu, Disney + (with ads), and ESPN+ (with ads) plus Live TV for $69.99 per month. Hulu's Live TV option included live linear program streams of all the major broadcast networks (NBC, ABC, CBS, and cable networks (a total of 85 channels in 2023).
- Hulu (no adds) plus Live TV for $82.99

In 2023, certain TV programming from ABC, Freeform, and the FX Channels became available on the Hulu streaming service one day after airing on these channels. In May 2023, Disney Chairman and CEO Bob Iger announced that Disney would begin offering a one-app experience in the United States that incorporated all Hulu content as part of a Disney+ subscription price; Iger said the new app would provide greater opportunities for advertisers while giving bundles of subscribers access to more robust and streamlined content, resulting in greater audience engagement and a more unified streaming experience. The rollout of the one-app offering was to begin by year-end 2023; plans were to increase the one-app subscription price for the ad-free tier to better reflect the added value of the content offering. As of April 1, 2023, the number of paid Hulu subscribers was approximately 48.2 million.

According to research by Wells Fargo, in 2022 the Walt Disney Co. spent $33 billion on content across all of its operations.[20] However, as part of a Disney-wide $5.5 billion cost-cutting initiative that began in 2023, expenditures for new content at Disney+ were being cut back.

Warner Bros. Discovery and HBO Max

On April 8, 2022, Discovery, Inc. completed its merger with the WarnerMedia business of AT&T Inc. and changed its name to Warner Bros. Discovery, Inc. (WBD). The merger created a global media and entertainment company that included Warner Bros. Pictures Group; Warner Bros. Television Group; DC Comics; a host of cable channels (HBO, Discovery Channel, CNN, HGTV, Food Network, TNT, TBS, TLC, OWN, Cartoon Network, truTV, Magnolia Channel, Travel Channel, Science Channel); direct-to-consumer streaming series (HBO Max and discovery+), and Warner Bros. Games.

WBD had 2022 revenues of $33.8 billion and beginning in 2023 was organized into three operating segments:

- *Studios*—This segment primarily consisted of (1) the production and release of feature films for initial exhibition in theaters; (2) the production and initial licensing of television programs to third parties, WBD cable networks, and the company's streaming services/DTC services; and (3) the distribution of films and television programs to various third-party and internal television and streaming services, distribution through the home entertainment market (physical and digital), related consumer products and themed experience licensing, and interactive gaming.
- *Networks*—This segment primarily consisted of WBD's domestic and international television networks.
- *Direct-to-consumer*—The DTC segment consisted of WBD's premium pay-TV (HBO) and HBO Max and Discovery+ streaming services. At year-end 2022, WBD had 96.1 million DTC subscribers. In March 2023, HBO Max had two subscription plans: HBO Max (no ads) $15.99 per month or $149.99 per year and HBO Max (with ads) $9.99 per month or $99.99 per year. Discovery+ had a subscription price of $$4.99 per month with ads and $6.99 per month ad-free.

In April 2023, WBD announced that it was merging HBO Max and Discovery+ and rebranding the merged streaming service as "Max." The new Max debuted on May 23, 2023, with a broader range of content that included HBO Originals, Warner Bros. films, Max Originals, the DC universe, the Wizarding World of Harry Potter, an expansive offering of kids content, and best-in-class programming across food, home, reality, lifestyle, and documentaries from cable channels HGTV, Food Network, Discovery Channel, TLC (The Learning Channel), Adult Swim, and Investigation Discovery. Newly announced titles included a Max Original *Harry Potter* series, a Max Original comedy series derived from *The Big Bang Theory,* an HBO Original "Game of Thrones" prequel *A Knight of the Seven Kingdoms: The Hedge Knight,* a Max Original drama series based on *The Conjuring* films, Magnolia Network's *Fixer Upper: The Hotel,* Discovery Channel's *Survive the Raft,* Max Original *Peter & the Wolf,* and Cartoon Network's *Tiny Toons Looniversity.* According to Wells Fargo research, WBD planned to spend $22.4 billion in 2022 on content (including sports).[21]

Max had three subscription plans:

- Max Ad-Lite for $9.99 per month or $99.99 per year. This Plan allowed 2 concurrent streams, 1080p resolution, no offline downloads, and 5.1 surround sound quality.
- Max Ad Free for $15.99 per month or $149.99 per year. This plan allowed 2 concurrent streams, 1080p resolution, 30 offline downloads, and 5.1 surround sound quality.
- Max Ultimate Ad Free for $19.99 per month or $199.99 per year. This plan allowed 4 concurrent streams, up to 4K UHD resolution, 100 offline downloads, and Dolby Atmos sound quality.

In the April 2023 announcement, WBD said that existing HBO Max subscribers would have access to

Max for the same HBO Max subscription price and the existing features of their pan would remain available for at least six months.

WBD had spent much of 2022 removing programming on HBO Max that was bought from outside content providers and returning it to the studios that made the programs (in an effort to reduce costs and free funds for reducing its almost $50 billion in long-term debt). It also purged titles shown on HBO Max that were from WBD's own content libraries (such as *Westworld, Minx, The Nevers, Raised by Wolves, FBoy Island, Legendary, Finding Magic Mike, Head of the Class, Gordita Chronicles, Love Life, The Garcias, Made for Love,* and *The Time Traveler's Wife*) that could readily be used to generate revenues from licensing to other cable channels or licensed to free ad-supported streamers like Pluto TV, Amazon's Freevee, Tubi, XUMO, and the Roku Channel that shared some of the advertising revenues such shows generated with the content provider. Some industry analysts speculated that WBD might use content from HBO's vast library of TV shows and films to create its own free ad-supported streaming channel or as a Max ad-free subscription plan as a means of new revenue generation.

Comcast, NBC Universal, and the Peacock Streaming Service

In January 2020, Comcast and its subsidiary NBCUniversal, jointly announced the launch of a new Peacock subscription video streaming service that would become available at no additional cost for Comcast's cable subscribers on April 15 and then launch July 15 for everyone else. Up until March 2023, there was a free ad-supported tier of Peacock (Peacock TV Free) that contained more than 13,000 hours of ad-supported programming including next-day access to first season TV shows broadcast on NBC, a collection of Universal movies, and access to back seasons of such iconic NBC shows as *Saturday Night Live, Family Movie Night,* and *Vault.* However, beginning in March 2023, Peacock stopped offering the free tier to new subscribers and began offering only two subscription plans: a Premium $4.99 per month or $49.99 per year plan that included ads and a Premium Plus $9.99 per month or $99.99 per year plan with no advertising. The Premium version included New & Hit Shows, Films and Originals, LIVE Sports & Events, current NBC & Bravo Shows, and 50+ Always-On Channels. The Premium Plus plan included everything available with Premium, no ads, the ability to download and watch select titles offline, and access to the subscriber's local NBC channel, live and 24/7. Comcast's cable subscribers continued to receive Peacock programming at no charge.

Comcast management decided to use NBC's familiar peacock logo as the logo for the Peacock streaming service to remind customers that NBC was a network with great TV shows and live sports programming. Top management at Comcast and NBCUniversal believed that while streamed video might indeed be the future of watching TV and movies, the cable business would remain profitable for years to come (despite the likely permanent and hopefully slow declines in the number of cable and satellite subscribers worldwide) and, further, that free ad-supported viewing was likely to remain far more prevalent and popular with consumers than subscription-supported viewing. Further, Comcast management was attracted to bundling Peacock Free for customers with Comcast cable subscriptions as a means of helping reduce the number of customers dropping the company's cable service and switching to one or more rival streaming providers whose fee(s) were less than Comcast's monthly cable subscription plans. In their mind, there was no good business reason to create a streaming platform with features and fees that would undercut the profitability and longevity of company's cable business.

Comcast was a leading provider of Xfinity-branded broadband, video, voice, wireless, home security, and other services to 31.8 million residential customers (year-end 2022) at various locations in the United States, and it also provided an assortment of services to 2.5 million business customers (year-end 2022). NBCUniversal (NBCU), a 100-percent owned subsidiary acquired in 2011 and 2013 transactions, owned the NBC broadcasting network (with more than 200 affiliated stations), the Spanish-language Telemundo broadcasting network (with 111 affiliated stations), 11 NBC-affiliated and 30 Telemundo-affiliated local broadcast television stations, a portfolio of cable networks (USA Network, E!, Bravo, MSNBC, CNBC, NBC Sports, Golf Channel, Oxygen, Syfy, Universal Kids, Universo, CNBC World, and an assortment of regional and international cable networks), the Peacock streaming service, a number of movie and TV production studios and distribution operations, and theme parks in Orlando, Florida; Hollywood, California; Osaka, Japan; and Beijing, China. NBCU produced films under the names Universal, Illumination, Dream Works animation, Focus Features, and Working Title; its film library included over 6,000 titles. NBCU content was distributed for exhibition in movie theaters, utilized internally for NBC and Telemundo programming plus Peacock streaming, and licensed to other television networks, cable networks, pay-per-view-services, and DTC streaming providers. Some films were distributed globally by selling them on DVDs/Blu-ray discs and through digital distribution services.

Comcast had a third business, Sky—a leading entertainment company in Europe that was acquired in 2018. Sky's operations included (1) a direct-to-consumer business that provided video, broadband, voice, and wireless phone services and (2) a content business that operated entertainment networks, the Sky News broadcast network, and Sky Sports network.

In 2022, Comcast's revenues from all operations totaled $121.4 billion, of which $66.3 billion (54.6 percent) came from its Cable operations, $23.4 billion (19.3 percent) came from its Media operations, $11.6 billion (9.6 percent) came from its Studio operations, $7.5 billion (6.2 percent) came from its theme parks business, and $17.9 billion (14.7 percent) came from Sky. At year-end 2022, Peacock had 20 million subscribers, generated annual revenue of $2.1 billion, and had an adjusted earnings before interest, taxes, depreciation and amortization (EBITDA) loss of $978 million versus an EBITDA loss of $578 million in 2021.[22]

Paramount Global, Paramount+, and Showtime

In 2023, Paramount Global was a global media, streaming, and entertainment company with a business portfolio that included the CBS broadcasting network and its library of 140,000+ TV episodes, the CBS Sports network, 29 CBS TV stations, Showtime Networks, Paramount Pictures (which included Paramount studios and a library of 3,660+ movies, Nickelodeon, MTV, CMT (Country Music Television), Comedy Central, BET, Paramount+ (a subscriber-based streaming service), Pluto TV (a free ad-supported streaming network with 78.5 million global monthly active users), and content production capabilities in Latin America, the United Kingdom, Europe, the Middle East, Africa, and Asia. Paramount Global operated in three business segments:

- *TV Media* which consisted of (1) domestic and international broadcast networks and owned television stations; (2) domestic and international extensions of the company's cable networks; and (3) domestic and international television studio operations, and production and distribution of first-run syndicated programming. The TV Media segment generated $21.7 billion (72.1 percent) of Paramount's total revenues of $30.1 billion in 2022.
- *Direct-to-Consumer* which consisted of domestic and international pay and free streaming services. Direct-to-Consumer generated $4.9 billion (16.3 percent) of the company's revenues in 2022.
- *Filmed Entertainment* which consisted of films, series, and short-form content released and/or licensed to media around the world, including theaters, streaming services, television, digital home entertainment, and DVDs. The Filmed Entertainment segment generated $3.7 billion 12.3% of the company's revenues in 2022.

In early 2023, Paramount+ had 4 subscription plans: Paramount Essential (with ads) for $4.99 per month or $49,99 per year; Paramount Premium (no ads except for live TV and a few shows) for $9.99 per month or $99.99 per year; and Paramount Essential with Showtime for $11.99 per month or $119.99 per year; and Paramount Premium with Showtime for $11.99 per month or $119.99 per year. The Paramount Essential plans did not include the subscriber's local CBS TV station. Paramount had 77.3 million global streaming subscribers at the end of 2022, up 38 percent over year-end 2021.[23] Its slate of original series in 2022 included *Halo, 1883, 1923, Tulsa King Criminal Minds, Evolution,* and *Seal Team;* its original films included *Orphan: First Kill and Beavis and Butt-Head Do the Universe.* In January 2023, Paramount announced that it would be merging its Paramount Plus streaming service and its premium Showtime channel company later in 2023; the merger would entail select Paramount originals being shown on the rebranded Paramount Plus with Showtime cable channel and all the various Showtime programs being included on the merged streaming Paramount Plus with Showtime streaming service.

Apple TV+

Apple launched its Apple TV+ video streaming service on November 1, 2019, in over 100 countries that could be accessed on smart TVs connected to an Apple TV box or on new TV models that had the Apple TV app already installed, or Apple devices with a downloaded Apple TV app. The service was $4.99 per month when first released, but the price was raised to $6.99 or $69.99 per year in October 2022. Pitched as Apple's strategic means of competing directly with Netflix, Amazon Prime Video, and Disney+, the Apple TV+ service streamed Apple's *original programming only* through Apple TV-capable devices. An Apple TV+ subscription could be shared by up to six family members.

In 2023, at $6.99 per month (or $69.99 per year or free for 3 months with the purchase of a new Apple device) with up to six family members on the same account, the cost of Apple's streaming service was competitively priced with the monthly subscription fees for its video streaming rivals with ad-supported plans. In late 2020, Apple introduced Apple One, a subscription which bundled Apple Music, Apple TV+, Apple Arcade, and iCloud storage into three tiered packages:

- Individual ($16.95 per month) for Apple Music, Apple TV+, Apple Arcade, and iCloud+ (with 50 gigabytes of storage)
- Family ($22.95 per month, which could be shared with 5 other people) for Apple Music, Apple TV+, Apple Arcade, and iCloud+ (with 200 gigabytes of storage)
- Premier ($32.95 per month, which could be shared with 5 other people) for Apple Music, Apple TV+, Apple Arcade, iCloud+ (with 2 terabytes of storage), Apple News+, and Apple Fitness+. The Apple One subscription prices were cheaper than subscribing to the same services individually.

At launch, there were just nine Apple Originals available to view. But Apple quickly began to increase its offerings of Apple-produced content and acquired content. In 2021, 33 new Apple shows and seasons of shows premiered on Apple TV+, in 2022 there were 41 new shows and seasons of shows that premiered on Apple TV+. In addition, there were premiers of Apple original movies, short films (some animated), shows with limited episodes, and a few specials.

By 2023, there were new Apple Originals streaming every month; subscribers could watch more than 45 Apple TV+ shows (such as *Shrinking, Severance, Ted Lasso, For All Mankind, Bad Sisters,* and *The Afterparty*), *Friday Night Baseball,* and the option to subscribe to MLS Season Pass featuring every match of the Major League Soccer season. Among the best movies on Apple TV+ in 2023 were *Ghosted, Tetris, Sharper, Emancipation, Causeway,* and *The Boy, the Mole, the Fox and the Horse.* A number of Apple TV Originals had received Golden Globe, Screen Actors Guild, Directors Guild of America, Emmy, and Writers Guild of America Award nominations. So far, Apple had not revealed how many paid subscribers Apple TV+ had. Nor had it licensed any content from outside sources to show on Apple TV+, and it had not disclosed how much it was spending on Original Content for Apple TV+.

NETFLIX'S BUSINESS MODEL AND STRATEGY IN 2023

Since launching the company's online movie rental service in 1999, Reed Hastings, founder and CEO of Netflix, had been the chief architect of Netflix's subscription-based business model and strategy that had transformed Netflix into the world's largest online entertainment subscription service. His goals for Netflix were simple—build the world's best Internet service for entertainment content; keep improving Netflix's content offerings and services faster than rivals; attract growing numbers of subscribers every year; and grow long-term revenues, earnings, and free cash flow. Throughout his tenure as CEO, he had exhibited a strong track record in moving early and fast to initiate strategic changes that would help Netflix outcompete rivals, strengthen its brand image and reputation, fortify its position as the industry leader, and improve the company's financial performance.

A Quick Overview of the Evolutionary Changes in Netflix's Subscription-Based Business Model and Strategy, 1999–2022

Netflix had employed a subscription-based business model throughout its history, with members having the option to choose from a variety of subscription plans whose prices and terms had varied over the years. Originally, all of the subscription plans were based on obtaining and returning DVDs by mail, with monthly prices dependent on the number of titles out at a time. But as more and more households began to have high-speed Internet connections, in 2007 Netflix began bundling unlimited streaming with each of its DVD-by-mail subscription options, with the long-term intent of encouraging subscribers to switch to watching instantly streamed content rather than using DVD discs delivered and returned by mail. As increasing numbers of subscribers gained access high-speed Internet connections, most quickly switched over to unlimited streaming subscription plans, enabling Netflix to avoid incurring the order fulfillment costs and postage costs associated with servicing tens of millions of DVD-by-mail subscribers.

A second major shift in Netflix's strategy began in 2010 when Netflix started to expand its streaming service internationally, beginning with Canada. Entry into other countries followed quickly, as shown in Exhibit 4, and Netflix became a truly global company in 2016. Netflix had not entered the streaming market in China because of barriers erected by the Chinese government; Chinese officials steadfastly refused to issue Netflix a license to operate in China, preferring instead to control the content its citizens were allowed to see—for example, government censors required that an entire series of a multi-episode offering had to be approved before it could begin to be shown on an online platform. Aside from the censorship issue, most observers believed the Chinese government was also blocking Netflix's entry in order to protect aspiring local providers of Internet-streamed content from foreign competition. The U.S. government had instituted restrictions precluding all U.S.-based companies from having operations in North Korea, Syria, and Crimea.

Netflix's experience with entering new country markets had revealed that it usually took about two years after the initial launch in a new country or geographic region to attract sufficient subscribers to generate a positive "contribution profit"—Netflix defined "contribution profit (loss)" as revenues less cost of revenues (which consisted of amortization of content assets and expenses directly related to the acquisition, licensing, and production/delivery of such content) and marketing expenses associated with its streaming business (the company ceased all marketing activities related to its domestic DVD business prior to 2015).

A third important shift in Netflix's business model and strategy began in 2011–2012. CEO Reed Hastings and other senior Netflix executives realized that there were low barriers to entry into the subscription-based video streaming business for movie producers and TV broadcasters that had over the years amassed big libraries of attractive content. Indeed, many of the titles that Netflix was streaming to subscribers were being licensed from these very

EXHIBIT 4 Netflix's Rapidly-Executed Entry into New Geographic Areas

Year	Entry into New Geographical Areas
September 2010	Canada
September 2011	42 countries in Central America, South America, and the Caribbean
January 2012	United Kingdom, Ireland
October 2012	Denmark, Sweden, Norway, Finland
September 2013	Netherlands
September 2014	Austria, Belgium, France, Germany, Luxembourg, Switzerland
March 2015	Australia, New Zealand
September 2015	Japan
October 2015	Spain, Portugal, Italy
January 2016	Rest of the world—some 130 countries (but excluding the People's Republic of China, North Korea, Syria, and Crimea)

Source: Company 2017 10-K Report, p. 21.

same entities, and the license fees for these titles were rising rapidly, as content owners recognized that their title libraries had significant value to Netflix, Amazon, and others who were in the streamed entertainment business and that they commanded significant bargaining power to raise licensing fees as current licenses expired. Netflix executives further foresaw that the company was likely to be put at a significant competitive disadvantage when these content owners concluded they could make bigger profits from their content libraries by starting up their own video streaming businesses to compete against Netflix for subscribers in many country markets rather than licensing titles to Netflix.

The Netflix top executive team believed that when content-rich rivals entered the streamed entertainment business (as they were certain to do at some point) and triggered a head-on competitive battle for subscribers that the winners would be those companies that potential subscribers viewed as having attractive and fresh content they were willing to pay monthly or annual fees to watch. Furthermore, they were certain that when these rivals emerged, they would discontinue renewing their licenses for popular programs (especially TV shows) with Netflix, preferring to use these titles to attract new subscribers to their own streamed entertainment services.

These realizations resulted in Netflix undertaking a long-term strategic initiative to change its portfolio of titles from mainly all licensed to a portfolio of titles that was increasingly comprised of original content created, produced, and owned by Netflix. The company immediately moved to develop and continually strengthen its in-house content creation and production capabilities, but it also elected to supplement its internal efforts by entering into multiyear collaborative agreements with outside developers and producers not owned by its rivals to license portions of their existing titles to Netflix and to produce new original content that would be owned by Netflix or exclusively licensed to Netflix.

Netflix started streaming its first original content title, *House of Cards,* in February 2012; *House of Cards,* a political drama that ran six seasons, was a major hit with subscribers, garnered acclaim from critics and reviewers, and received 213 awards nominations (Golden Globe, Primetime Emmys, Screen Actors Guild, and others) and 35 overall wins during 2013–2018. Netflix's spending for new original content mushroomed during the ensuing years, with total spending for new origienal and licensed content of $12 billion in 2018, $15 billion in 2019, and about $17–$20 billion in 2020–2022, of which roughly 85 percent was thought to be for original content.[24]

However, to increase subscriber satisfaction with its streamed offerings to each country, Netflix began a long-term initiative in 2018–2019 to stream title offerings to more and more countries in their native languages so that subscribers could better enjoy Netflix's programs. Initially, this entailed licensing content from local producers of movies and TV shows and bundling them with the titles Netflix was streaming to that country from its own title collection. But very quickly Netflix also began to partner with local producers of films and TV shows to produce original content for Netflix that would be built around local storylines and that would either be owned outright by Netflix or licensed for Netflix's exclusive use. Because of the positive local subscriber response to new films and series produced in local languages and containing locally appealing content, Netflix's library of titles (1) produced in languages other than English, (2) filmed in different locations, and (3) built around local country storylines grew significantly headed into 2023.

To the surprise of Netflix executives, a Brazilian science-fiction show produced in Portuguese in 2017 for Brazil scored well with audiences around the world—this was Netflix's first instance of a local-language program working well in locations where other languages dominated. Local language films produced in India, South Korea, Japan, Turkey, Thailand, Sweden, and the United Kingdom were among Netflix's most popular 2019 titles. An original Spanish series titled *La Casa de Papel,* which was retitled *Money Heist* in English-speaking countries, developed a wide audience, appearing on the top 10 most watched titles in more than 70 countries. *Money Heist* began its fifth (concluding) season in 2021 and a spinoff show named *Berlin* was set to debut in 2023. Netflix discovered that often animated films traveled more predictably across countries than other types of titles.

In 2022, Netflix launched seven of its Top 10 most-popular non-English films ever, and two of its Top 10 most popular non-English TV shows ever. It also launched five of its Top 10 most popular English language Original Series ever, and four of its Top 10 most popular English language films ever. Furthermore, in 2022 Netflix subscribers watched more returning season titles and sequels to popular films than ever before across a broad range of genres—film, drama, local language series, and animation.

Netflix's Award-Winning Original Content From 2014 through 2023, Netflix received 132 Oscar nominations in 24 categories and recorded 22 wins in 13 categories. Counting Academy Awards, Emmy Awards, Grammy Awards, Golden Globe Awards, Screen Actors Guild Awards, America Film Institute Awards, British Academy of Film and Television Awards, and Peabody Awards, programs streamed and/or produced by Netflix won 265 awards from 619 nominations during the same period.[25] As far as Netflix top executives were concerned, the more viewer hours spent watching Netflix originals, the more critically acclaimed reviews of its original titles, the more award nominations, and the more award wins, the better. All contributed to improving subscribers' experiences with Netflix and to stimulating subscriber growth, which in turn resulted in higher company revenues, better operating margins, bigger internal cash flows from operations, and more funds available for creating more new original content or licensing outside content going forwards.

Netflix's Use of Viewership Tracking and Recommendation Software to Enhance Its Engagement with Subscribers Early in Netflix's history, the company had developed proprietary software technology that allowed members to easily scan a movie's length, appropriateness for various types of audiences (G, PG, or R), primary cast members, genre, and an average of the ratings submitted by other subscribers (based on 1 to 5 stars). With one click, members could watch a trailer previewing a movie or original series or TV show if they wished. Most importantly, perhaps, were the company's proprietary algorithms that created a personalized "percentage match" for each title that was a composite of a subscribers' own ratings of previously viewed titles, titles the member had placed on a "watchlist" for future viewing, and the overall or average rating of all subscribers (several billion ratings had been provided by subscribers over the years).

Subscribers often began their search for titles by viewing a list of personalized recommendations that Netflix's software automatically generated for each member. Each member's list of recommended titles was also partly the product of Netflix-created algorithms that organized the company's entire content library into clusters of similar movies/TV shows and then sorted the titles in each cluster from most liked to least liked based on subscriber ratings. Those subscribers who favorably or unfavorably rated similar movies/TV shows in similar clusters were categorized as like-minded viewers. When a subscriber was online and browsing through the selections, the software was programmed to check the clusters the subscriber had previously viewed, determine which selections in each cluster the customer had yet to view or place on watchlist, and then display those titles in each cluster in an order that started with the title that Netflix's algorithms predicted the subscriber was most likely to enjoy down to the title the subscriber was predicted to least enjoy. In other words, the subscriber's ratings of titles viewed, the titles on the subscriber's watchlist, and the title ratings of all Netflix subscribers determined the order in which the available titles in each cluster or genre were displayed to a subscriber—with one click, subscribers could see a brief description of the content of each title and Netflix's predicted rating (from 1 to 5 stars) for the subscriber. When subscribers came upon a title they wanted to view, that title could be watch-listed for future viewing with a single click. A member's complete watchlist of titles was immediately viewable with one click whenever the member visited Netflix's website. With one additional click, any title on a member's watchlist could be activated for immediate viewing. Netflix management saw its title recommendation software as a quick and personalized means of helping subscribers identify and then watch titles they were likely to enjoy. Netflix's subscriber tracking data indicated that 80 percent of subscribers' watch choices came from their personal recommendation engine.

Over the years, Netflix had continually invested in developing new software tracking capabilities and refining its existing capabilities. As of 2023, Netflix had data pertaining to

- The titles each subscriber had viewed in the past several days, the past week, the past month, the current calendar year, the past calendar year, and the entire period the subscriber had been a member.
- The subscriber's ratings of each title.
- The titles on the subscriber's watch list.

- The number of times each title had been viewed by all subscribers *in both each country and worldwide* the past several days, the past week, the past month, the current calendar year, the past calendar year, and the entire period that title had been on Netflix.
- The total number of hours subscribers spent watching Netflix titles for each month of each year in each country and worldwide.

Netflix management relied heavily on its viewership tracking data for each title to guide decision-making on how to allocate upcoming expenditures for new original content. For example, if season 1 of a new original series was highly popular with subscribers, the series was renewed for a second season, and if a new series failed to spark widespread viewing and garnered only small audiences, with declining views of succeeding episodes, the series was canceled. If a new original series or film was viewed by 40 to 70 million subscribers in the first few weeks or months or if its viewership built significantly over a 4- to12-month period, management was likely to invest in the development of a second season of the series or sequel to the film. There were also situations where a popular series or film would trigger investment in a new original series or a new movie in the same genre (action, suspense thriller, mystery, historical drama, science fiction, or adult comedy) for release as soon as production concluded.

In addition, Netflix's title tracking data revealed there were very big differences in the 20 to 30 most-watched titles from country to country. This was partly because of (1) the different languages spoken in different countries and the varying percentages of subscribers that understood storylines produced in one language versus another and (2) varying subscriber preferences from country-to-country for some types/genres of movies, series, and documentaries versus others. This caused Netflix executives to quickly conclude that a strategy of streaming much the same number and combination of titles to all countries was inferior compared to a strategy of customizing the types of titles streamed to each country to match up well with what each country's subscribers were watching and to discontinue streaming of titles not watched or watched very infrequently. Thus, it became standard practice at Netflix to use the title-viewing data for each country to guide decisions of which newly available titles to stream to which countries and further to make changes in each country's title mix as shifts occurred in the viewing hours devoted to particular genres and the popularity of newly released titles.

However, there was a second big reason why there were differences in the titles streamed to different countries. Headed into 2023, Netflix had bulked its original content offerings up to a total of 3,100+ titles, but its streaming library also included a substantial number of *licensed* movies and television shows. Worldwide, Netflix was said by one source to have the rights to 13,612 titles; another source said the total was about 17,000 titles. But whatever the total number of titles that Netflix had in its overall content library, the company's licensed rights to stream any given a title typically applied only to certain countries and only rarely was global.[26] Consequently, viewing hours, licensing rights, and the languages spoken/understood were factors in causing the number of titles streamed to different countries to be different.

As of early 2023, the number of titles Netflix streamed to each of the 241 countries where it had subscribers varied widely—according to one source from a high of 5,087 in the United States to a low of 908 in Sudan and according to another source covering only 100 countries from a high of 6,590 titles in the United Kingdom to a low of 4,590 titles in Norway.[27]

NETFLIX'S STRATEGY IN 2023

Almost 5.2 billion (64.4 percent) of the world's population of over 8 billion people used the Internet as of January 2023.[28] However, the size of the Netflix's near-term market potential for securing streaming subscribers worldwide was close to the number of people/households currently having high-speed wired and wireless Internet service. In many parts of the world, smartphones were a primary gateway to the Internet, and in 2023 the number of global smartphone users was estimated at some 6.8 billion people, although not all of these could access *high-speed* Internet service. But with Netflix having only about 231 million subscribers, its current membership represented only a small fraction of the total global market it was in a position to address.

Netflix's strategy in 2023 was focused on

- Cracking down on the roughly 100+ million subscribers who shared the password for their account with individuals in other households *unless they paid an "extra-member" fee to do so by switching to a paid sharing account.*
- Launching its Basic with ads subscription plans in more countries as fast as its marketing personnel could recruit companies to allocate advertising dollars to programs Netflix was streaming. Netflix executives were convinced that over the long-term advertising-supported streaming would become a major new revenue source for Netflix, enabling the company to achieve faster revenue growth than from relying solely on acquiring more subscribers and charging higher monthly subscription prices.
- Putting greater emphasis on producing *higher quality* original movies and original series in-house and in collaboration with outside movie and TV show producers with demonstrated capability to produce good quality content that would please subscribers, boost subscriber retention percentages, and help drive faster subscriber growth.

Netflix's Revised Subscription Pricing Strategy in 2023

Going into 2023, Netflix offered four types of streaming membership plans in the United States:

- Netflix Basic with ads for $6.99 per month. This plan allowed streaming for only one device, had 1080p video quality, and did not include access to high-definition viewing.
- Netflix Basic (without ads) for $9.99 per month. This plan also allowed streaming for only one device, had 1080p video quality, and did not include access to high-definition viewing.
- Netflix Standard for $15.49 per month. This plan allowed simultaneous streaming for two devices in the same physical location and permitted high-definition viewing. Subscribers who engaged in password-sharing and wanted to simultaneously stream a program to two devices in *different* locations were expected to pay an extra fee of $7.99 per month
- Netflix Premium for $19.99 per month. This plan allowed simultaneous streaming for 4 devices in the same physical location and permitted high-definition viewing. Premium plan subscribers who engaged in password-sharing and wanted to simultaneously stream a program to devices in *different* locations were expected to pay an extra fee of $7.99 per month per user in a different location, up to a maximum of two users (equal to an additional $15.98 per month).
- In those countries where Netflix had begun cracking down on password-sharing across households in different locations, subscribers were notified by email about the limitations on who could access their account outside their household and to inform them about the availability of paid account-sharing options and the associated fees. Netflix expected that some users in each market would cancel their account when the paid-sharing fees were rolled out. But it also expected some account-borrowing households would either pay the "extra member" account-sharing fees or activate their own standalone accounts, such that over time the company's revenues and the number of subscribers would grow in each country where paid account-sharing was instituted.
- On September 30, 2023, Netflix closed down its disc-mailing business. The company canceled the subscriptions of members who were on a DVD-only plan. Members that were signed up for both streaming and DVDs were changed to streaming-only plans.

Netflix recommended 3 Mbps of download speed for standard definition streaming, 5 Mbps for high definition, and 25 Mbps for 4K Ultra HD.

Outside of the United States, the monthly prices for Netflix's different subscription plans varied considerably in terms of U.S. dollars. As of April 2023, the Netflix Basic with ads plan was still early in the process of becoming an option internationally—introduction of the Netflix Basic with ads plan began in late 2022 in 12 countries. The monthly cost of the Netflix Basic plan varied from lows of $1.72 in Pakistan, $2.29 in Egypt, $2.38 in Kenya, and $2.40 in India to highs of $8.99 in Uruguay, $9.50 in Sweden, $ 9.68 in Singapore, $10.59 in Barbados, $11.25 in Greenland, $12.78 in Switzerland.[29] In most countries the monthly price for Netflix Basic was in the $3.99 to $7.99 range. The monthly prices for the Netflix Standard plan ranged from lows of $3.06 in Pakistan, $5.19 in Turkey, $5.55 in Kenya, $5.99

in Bolivia, $6.02 in India, and $6.66 in Argentina to highs of $12.38 in Sweden, $12.71 in Portugal, $13.24 in the United Kingdom, $13.78 in Spain and Germany, $14.31 in Monaco, $16.24 in Denmark, and $20.29 in Switzerland. The monthly price internationally for the Netflix standard plan was typically in the $7.99 to $10.99 range. The monthly prices for the Netflix Premium plan ranged from lows of $7.82 in Colombia, $7.83 in India, and $7.99 in Venezuela and Nicaragua to highs of $19.08 in Austria, $19.99 in Puerto Rico, $21.23 in Denmark, $22.26 in Ireland, and $26.73 in Switzerland. The monthly price for Premium was in the $9.99 to $15.99 range in most countries.

In recent years, there had been a very gradual shift toward the highest-priced premium plan, a trend likely being driven by more households purchasing big-screen ultra-high-definition TVs. Netflix executives expected that the prices of the various subscription plans in each country would likely rise over time, thereby helping boost the global monthly average revenue the company received per paying subscriber.

Netflix tested a cheaper mobile-only $3 a month plan in 2018 in India, one of its key developing markets because of the size of India's population and the country's heavy use of mobile devices for video streaming. The $3 mobile-only plan test in India was successful in boosting subscriber growth and in increasing member retention, prompting Netflix to expand its low-priced mobile offering to Malaysia and Indonesia in 2019; the tests in these countries also positively impacted subscriber growth and member retention. Later, mobile-only plans were tested in other large-population countries where wired high-speed Internet connections were not widely available and where mobile devices were frequently or exclusively used for video streaming. In 2022, Netflix announced that about 40 percent of its subscribers watched a Netflix program streamed to a mobile phone at least once a month.

Netflix's Strategy to Improve the Quality of Its Original Content in 2023

The overriding objective of Netflix's spending to produce and license new titles was to deliver a broad, diverse slate of content to entertain, please, and engage subscribers, add value to their subscription, and attract new subscribers. As new CEO and former Chief Content Officer Ted Sarandos noted, "We're bringing out something new pretty much every day on Netflix—multiple titles, multiple movies, multiple series and across every disciple of television, from original Japanese anime in Japan, Mexican novellas out of our Mexico group, our animated series, animated features, big-budget action movies—everything you want to watch, we're making."[30] However, Netflix's viewership tracking software revealed that a meaningful fraction of the titles the company had produced in-house or licensed from outsiders over the past five years had attracted relatively small audiences in a given country and/or in countries speaking a common language and/or had received low ratings by subscribers watching the title. While some of these titles had been produced by "name brand" studios, a significant number had been sourced from studios with a weaker reputation for quality products and/or weaker ratings by subscribers .

Hence, there was opportunity to keep the 2023 cash spending for new content acquisition to about $17 billion (including both original and licensed titles), trim the number of new titles for 2023, and get a bigger bang for the buck. The plan developed by Netflix's new top executive team was (1) to curtail investments in new original content with those studios whose titles had frequently attracted small audiences and/or received weak ratings, (2) to reallocate *part* of the savings to investments in new titles deemed to have more interesting content and audience appeal that could be sourced from studios with strong production capabilities and/or consistently higher subscriber ratings, and (3) to identify ways to streamline the in-house production process and lower the production costs of many titles, especially those with multiple episodes—the costs of the episodes in some titles (like *The Crown*) were said to range as high as $10 million, while the costs of episodes in other titles were said to be as low as $1–3 million per episode. Netflix's top executive team believed that it was feasible to introduce a smaller but more impactful number of new titles in 2023 for less than was spent in 2022 and allocate the savings to boosting the company's operating profit margins—one of the company's primary objectives for 2023.

While Netflix had every intention of continuing to partner with outside producers in specific countries to produce new titles for audiences in that country's language (like Japanese or Korean or Norwegian), the task of successfully upgrading the quality of the company's new 2023 titles produced by local studios hinged on (1) doing a better job of screening the proposals for new titles to identify those most likely to excite and please existing local subscribers (or subscribers in multiple countries speaking a common language) and thereby spur subscriber growth in these locations and (2) being careful to choose local film and TV show producers with a proven track record of attracting sizable audiences and pleasing subscribers with what they watched. As new CEO Ted Sarandos said, "the key for me is not that you have to spend more and more money, but it's can you get more impact per million-dollar spend than anybody else?"[31] Netflix's cash spend for content acquisition was roughly $17 billion in 2022, and the company expected to keep the cash spend in 2023 and 2024 at roughly the same $17 billion level.[32] In April 2023, Netflix announced it would invest $2.5 billion in Korean content over the next four years, double the amount it had invested since 2016 when it began partnering with Korean content producers. The new investment to deepen partnership with Korea's creative producers was because they had produced such hits as *Squid Game, The Glory,* and *Physical 100.*

Marketing and Advertising Strategy in 2022–2023

Netflix's principal new marketing initiative in 2023 was to task its marketing personnel to secure advertising to support its new, lower priced Basic-with-ads subscription plan in the 12 countries where the plan was introduced in late 2022 and in the additional countries where Netflix wanted to introduce the plan in 2023. Top management saw the campaign to recruit local advertisers to allocate a portion of their ad budgets to Netflix programs being streamed in each of the countries with the ad-supported subscription plan as being "a substantial long term incremental revenue and profit opportunity for Netflix."[33] Management had not publicly indicated how many new marketing personnel would be required to staff the company's effort to first procure and then grow advertising revenues.

Netflix's marketing and advertising strategy in 2023 was to continue to devote a big portion of its marketing and advertising resources to activities in the countries and geographic regions deemed to have the biggest subscriber growth and revenue growth potential.

Netflix spent $2.53 billion on marketing and advertising in 2022, $2.55 billion in 2021, and $2.23 billion in 2020. Netflix used multiple marketing approaches to attract subscribers, but especially digital and television advertising. Advertising expenditures included paid search listings, banner ads on social media sites, permission-based e-mails, ads on regional and national television, and payments to such marketing partners as consumer electronics manufacturers, mobile operators, and Internet service providers (to include the Netflix app on their devices or as a downloadable app on their websites). Marketing costs also included

- Costs pertaining to free trial subscriptions.
- Payments to consumer electronics manufacturers to include a Netflix app preloaded on their devices.
- Payments to mobile operators across the world to create quick and easy-to-use procedures for smartphone users to access Netflix streamed or downloadable programming. Netflix believed it was particularly important to make mobile streaming from Netflix instantly accessible to those people who basically only wanted to have their relationship with Netflix on a mobile device.
- Promotional campaigns for new original titles to generate more density of viewing and conversation around each title. Such campaigns involved sending emails to subscribers at least weekly and often more frequently announcing the availability of new titles, calling attention to titles highly matched to a title viewed the previous day, previous several days, or previous week.
- Emails were also sent to Netflix members multiple times weekly to announce the availability of new releases that matched well with the subscriber's viewing history. When users were browsing titles in various genres of interest, there always were rows of titles with such headings as "New Originals" "Top Ten Movies," "Trending Now, " and "Because you watched [title]," along with a row of titles on the subscriber's watch list.
- Payroll and related expenses for personnel that supported marketing activities.

Advertising campaigns of one type or another were underway at Netflix more or less continuously, with the lure of one-month free trials and announcements of new and forthcoming original titles usually being the prominent ad features. Netflix's advertising expenses were $1.59 billion in 2022, $1.67 billion in 2021, and $1.45 billion in 2020.[34]

Netflix executives were strongly supportive of the marketing and advertising activities the company undertook. On several occasions while he was CEO, Reed Hastings had made note of why it was important to conduct marketing efforts calling a subscriber's attention to titles closely matched to recently viewed titles or to help make certain new titles a bigger hit in a particular nation or among a particular demographic segment. These were deemed valuable contributors to heightening subscriber satisfaction with the entertainment value Netflix was providing. Most recently, Hastings had said[35]

> We believe people typically sign up for a streaming service because they've heard about a title "you simply must watch" from a friend, seen the excitement on social media or read about it in the press. Generating conversation is our primary marketing goal because we see that it drives acquisition [of new subscribers] and encourages existing members to watch more, which in turn helps retention.

Because Netflix operated in so many countries, Hastings was also a big fan of experimenting with different marketing approaches in different markets and thereby learning more about what worked well in marketing Netflix's original content and differentiating Netflix from rival streaming providers.[36] Those approaches that were successful became candidates for use in other locations.

NETFLIX'S PERFORMANCE, BY GEOGRAPHIC REGION

Beginning with the fourth quarter of 2019 and going forward, Netflix management determined that the company's operations had evolved into a single business—global streaming operations—and revealed that top management, especially the CEO, had begun making operating decisions, assessing financial performance, and allocating resources based on the performance of its streaming operations in four geographic regions: the United States and Canada; Europe, the Middle East, and Africa; Latin America; and the Asia-Pacific. The company's revenue and membership performance in each of these four geographic regions for 2020–2022 is shown in Exhibit 5. Netflix's quarterly and full-year revenue and membership performance in each of the four regions for 2022 is shown in Exhibit 6; this exhibit clearly lays out the company's revenue and membership performance struggle in 2022 and why top management had placed top priority on improving the company's performance in 2023 and the years going forward.

Reed Hastings made special mention of the fact that while subscription prices were different in every country around the world and while management definitely took note of the average monthly revenues per subscriber in each country and region, Netflix was not managing its business to boost average revenue per subscriber in each country. Rather, management was managing to maximize revenues worldwide. Hastings said[37]

> Obviously, as we have lower-priced mobile offers, that's going to bring down a blended [average revenue per subscriber] in a country or in a market. But if we're doing that in a revenue-accretive way, we think that's great for our long-term business. We're growing subscribers, and we're growing revenue.

The Debt Burden Created by Netflix's Rapid Buildout of Its Content Library

The company's strategic emphasis on building a much larger library of original content during 2014–2020 had resulted in multi-billion-dollar annual increases in Netflix's financial obligations to pay for original content produced in-house and new titles licensed from outside producers. The company's cash flows from operations were negative every year during 2015–2019. Netflix covered the billions of dollars required to pay for these new content acquisitions by issuing additional shares of common stock and issuing additional long-term bonds (in the form of senior notes, usually payable in ten years) at varying interest rates. The company's long-term debt rose from $900 million at year-end 2014 to $15.8 billion at year-end 2020. The details of Netflix's outstanding senior notes as of December 31, 2022,

EXHIBIT 5 Netflix's Revenue and Membership Performance by Geographic Region, 2020–2022 (in millions, except for average monthly revenues per paid membership)

	2020	2021	2022
United States and Canada			
Revenues	$11,455.4	$12,972.1	$14,084.6
Paid Memberships (at end of period)	73.9	75.2	74.3
Paid Net Additions (Losses)	6.274	1.279	(0.919)
Average Monthly Revenue per Paying Membership	$ 13.32	$ 14.56	$ 15.86
Europe, Middle East, and Africa			
Revenues	$ 7,772.3	$ 9,700.0	$ 9,745.0
Paid Memberships (at end of period)	73.73	72.96	73.53
Paid Net Additions (Losses)	14.940	7.338	2.693
Average Monthly Revenue per Paying Membership	$ 10.72	$ 11.63	$ 10.99
Latin America			
Revenues	$ 3,156.7	$ 3,577.0	$ 4,070.0
Paid Memberships (at end of period)	37.54	39.96	41.70
Paid Net Additions (Losses)	1.74	2.42	1.43
Average Monthly Revenue per Paying Membership	$ 7.45	$ 7.73	$ 8.48
Asia-Pacific			
Revenues	$ 2,372.3	$ 3,266.6	$ 3,570.2
Paid Memberships (at end of period)	25.49	32.63	38.02
Paid Net Additions (Losses)	9.26	7.14	5.39
Average Monthly Revenue per Paying Membership	$ 9.12	$ 9.56	$ 8.50
Global Totals			
Streaming Revenues	$24,756.7	$29,515.5	$31,469.9
DVD Revenues	239.4	182.3	145.7
Total Revenues	24,996.1	29,697.8	31,615.6
Global Streaming Paid Memberships (at end of period)	203.7	221.8	230.7
Paid Net Additions (Losses)	36,573	18,181	8,903
Average Monthly Revenue per Paying Membership	$ 10.91	$ 11.67	$ 11.76

Source: Netflix, 2022 10-K report, pp. 20-21.

are shown in Exhibit 7. Because Netflix was past the most cash intensive phase of building an extensive library of original content and because the company generated free cash flows of $1.6 billion in 2022 and expected at least $3.5 billion in free cash flow in 2023, Netflix's top executive team was confident that Netflix would be able to keep its long-term debt ($14.5 billion as of March 31, 2023) within the targeted $10 billion to $15 billion range and have sufficient cash to repay the outstanding senior notes as they matured. The company strived to maintain a minimum cash and cash equivalent balance of two months revenue (roughly $5.4 billion based on Q1 2023 revenue).[38]

EXHIBIT 6 Netflix's Quarterly and Full-Year Performance by Geographic Region, 2022 (in millions, except for average monthly revenues per paid membership)

	Three months ended				
	March 31, 2022	June 30, 2022	Sept. 30, 2022	Dec. 31, 2022	Full Year 2022
United States and Canada					
Revenues	$ 3,350	$ 3,538	$ 3,602	$ 3,595	$ 14,085
Paid memberships (at end of period)	74.58	73.28	73.39	74.30	73.30
Paid net additions (losses)	(.64)	(1.30)	0.10	0.91	(.92)
Average monthly revenue per paid membership	$ 14.91	$ 15.95	$ 16.37	$ 16.23	$ 15.86
Europe, Middle East, and Africa					
Revenues	$ 2,562	$ 2,457	$ 2,376	$ 2,350	$ 9,745.0
Paid memberships (at end of period)	73.73	72.96	73.53	76.73	76.73
Paid net additions (losses)	(.30)	(.77)	57	3.20	2.69
Average monthly revenue per paid membership	$ 11.56	$ 11.17	$ 10.81	$ 10.43	$ 10.99
Latin America					
Revenues	$ 999	$ 1,030	$ 1,024	$ 1,017	$ 4,070.0
Paid memberships (at end of period)	39.61	39.62	39.94	41.70	41.70
Paid net additions (losses)	(.35)	0.01	.31	1.76	1.74
Average monthly revenue per paid membership	$ 8.37	$ 8.67	$ 8.58	$ 8.30	$ 8.48
Asia-Pacific					
Revenues	$ 917	$ 908	$ 889	$ 857	$ 3,570
Paid memberships (at end of period)	33.72	34.80	36.23	38.02	38.02
Paid net additions (losses)	1.09	1.08	1.43	1.80	5.39
Average monthly revenue per paid membership	$ 9.21	$ 8.83	$ 8.34	$ 7.69	$ 8.50
Global Streaming					
Revenues	$7,828.0	$7,933.0	$7,891.0	$7,819.0	$31,470.0
Paid memberships (at end of period)	221.64	220.67	223.09	230.75	230.75
Paid net additions (losses)	(.20)	(0.97)	2.41	7.66	8.90
Average monthly revenue per paid membership	$ 11.21	$ 11.45	$ 11.36	$ 10.90	$ 11.76

Source: Company website Excel spreadsheet regional information for 2022, posted in the Investor Relations section as part of the company's report of Fourth Quarter 2022 Financial Results, posted at **www.netflix.com,** accessed March 27, 2023, and Netflix 2022 10-K report, p. 20.

Netflix's first priority for its cash was to reinvest in its core business and to fund new opportunities like gaming and ads, followed by selective acquisitions.[39] It bought back 1.2 million shares for $400 million in the first quarter of 2023 and planned to accelerate its share repurchases over the course of 2023.

EXHIBIT 7 Netflix's Outstanding Long-Term Debt as of December 31, 2022

Debt Issues	Principal Amount at Par	Issue Date	Maturity Date
5.750% Senior Notes	$400 million	February 2014	March 2024
5.875% Senior Notes	$800 million	February 2015	February 2025
3.000% Senior Notes (1)	$503 million	April 2020	June 2025
3.650% Senior Notes	$500 million	April 2020	June 2025
4.375% Senior Notes	$1,000 million	October 2016	November 2026
3.625% Senior Notes (1)	$1.391 million	May 2017	May 2027
4.875% Senior Notes	$1,600 million	October 2017	April 2028
5.875% Senior Notes	$1,900 million	April 2018	November 2028
4.625% Senior Notes (1)	$1,177 million	October 2018	May 2029
6.375% Senior Notes	$800 million	October 2018	May 2029
3.875% Senior Notes (1)	$1,284 million	April 2019	November 2029
5.375% Senior Notes	$900 million	April 2019	November 2029
4.875% Senior Notes	$1,000 million	October 2019	June 2030
3.625% Senior Notes (1)	$1,177 million	October 2019	June 2030
Total	$14,432 million		

(1) The following Senior Notes have a principal amount denominated in euro: 3.000% Senior Notes for €470 million, 3.625% Senior Notes for €1,300 million, 4.625% Senior Notes for €1,100 million, 3.875% Senior Notes for €1,200 million, and 3.625% Senior Notes for €1,100 million.

Source: Company 2022 10-K Report, p. 52.

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CASE 7

Chewy, Inc.: Are Changes to Its Business Model and Strategy Necessary?

Marlene M. Reed
Baylor University

Rochelle R. Brunson
Baylor University

Chewy, Inc. had built tremendous name recognition through an advertising campaign that allocated over $100 million annually for digital, print, and national television commercials. The name recognition helped attract pet owners to its website and allowed the company to become a leading online source for pet products, supplies, prescriptions, and services with revenues of $10.1 billion in 2022. The company's 2022 revenues were 13.6 percent higher than in 2021 and allowed for a 28 percent increase in gross margin and a net income of $49.2 million. Chewy CEO Sumit Singh summarized the significance of the company's 2002 financial results by commenting, "Our fourth quarter and full year fiscal 2022 results cap an incredible year. Against the backdrop of a rapidly changing operating and economic environment, Chewy produced record-high revenue, profitability, and free cash flow." Singh added, "Chewy's disciplined execution and dedication to serving pet parents and partners with a widening ecosystem of offerings led to another year of market share gains in the pet category, which continues to demonstrate its resilience in the present environment."[1]

Despite the company's strong performance in fiscal 2022, on January 18, 2023, Lauren Schenk, a Morgan Stanley financial analyst, downgraded the stock price of **Chewy.com**. Schenk's lower price target implied that Chewy's shares could fall by another 21 percent from their levels at that time. As a result of the analyst's downgrade becoming public, the company's stock fell by 9.85 percent the next day.[2] Then as had been predicted, on January 23 the stock price was 31.12 percent off its 52-week high price of $54.19. Other analysts covering the stock had also raised concerns about the strength of Chewy's discretionary item business in 2023. That segment made up 20 percent of the company's annual revenue. If a mild recession were to hit the United States in 2023 as many economists had suggested, that key component of the company's revenues would undoubtedly take a hit. Chewy was at risk of producing a net loss for 2023. Clearly, the company's management had a mandate from its stockholders to evaluate its business model and strategy for competing in the online market for pet food and pet supplies.

Background on Chewy

The company was founded in June 2011 under the name "Mr. Chewy" by Ryan Cohen and Michael Day.[3] Cohen suggested that he used Jeff Bezos's 1997 letter to shareholders as a roadmap for how to grow Chewy by applying Amazon's guidelines for online shopping and providing excellent customer service.[4] That recipe proved more successful than expected in the rapid growth and initial profitability of the company.

In 2018, Sumit Singh took over as chief executive officer of the company having served as the chief operating officer from 2015 to 2017. At that time, founder and former CEO Ryan Cohen left the company to pursue other entrepreneurial ventures. After taking over leadership of the company, Singh increased the store's selection of items from 35,000 to 75,000. By the fourth quarter of 2020, Chewy had 19 million active customers. This represented the total number of individual customers who had ordered from them, and those for whom an application had been submitted in the last 364 days.

Corporate overview. Chewy's stated mission in 2021 was to be the most trusted and convenient online destination for pet parents everywhere. The company had always viewed pets (and pet parents) as family and were obsessed with meeting their needs and exceeding customer expectations through every interaction.

The company suggested that it had provided the personalized service of a neighborhood pet store alongside the convenience and speed of e-commerce and m-commerce. From the beginning, Chewy offered products at competitive prices and fast one-to-two-day shipping. Their management believed utilizing a strong commitment to customer service was the core of their brand. From an easy-to-navigate website and highly rated mobile apps to detailed order tracking and personalized "Pet Profile" features, the company claimed to be transforming the way pet parents shop.[5]

Chewy Pharmacy. In 2018, Chewy launched Chewy Pharmacy, an online pharmacy which provided pet prescriptions (see Exhibit 1 entitled "Advertisement of Chewy Pharmacy"). Any orders placed on the site were completed by a team of in-house veterinarians.[6] By November of 2020, Chewy had launched a free tele-triage service called "Connect with a Vet," and the company announced they would produce and fulfill prescriptions by compounding when alternatives were absent.[7] CEO Singh saw an opportunity to increase their service to pet owners with the

EXHIBIT 1 Chewy, Inc.'s Consolidated Statements of Operations, Fiscal 2020–Fiscal 2022 (in thousands, except per share data)

	Fiscal Year		
	2022	2021	2020
Net sales	$10,098,939	$ 8,890,773	$7,146,264
Cost of goods sold	7,268,034	6,517,191	5,325,457
Gross profit	2,830,905	2,373,582	1,820,807
Operating expenses:			
Selling, general and administrative	2,125,766	1,826,858	1,397,969
Advertising and marketing	649,386	618,902	513,302
Total operating expenses	2,775,152	2,445,760	1,911,271
Income (loss) from operations	55,753	(72,178)	(90,464)
Interest income (expense), net	9,291	(1,639)	(2,022)
Other expense, net	(13,166)	—	—
Income (loss) before income tax provision	51,878	(73,817)	(92,486)
Income tax provision	2,646	—	—
Net income (loss)	$ 49,232	$ (73,817)	$ (92,486)
Earnings (loss) per share attributable to common Class A and Class B stockholders:			
Basic	$ 0.12	$ (0.18)	$ (0.23)
Diluted	$ 0.12	$ (0.18)	$ (0.23)
Weighted-average common shares used in computing earnings (loss) per share:			
Basic	422,331	417,218	407,240
Diluted	427,770	417,218	407,240

Source: Chewy, Inc. Fiscal 2022 Form 10-K.

company's tele-health service. It was originally set to launch in about three years' time, but the plans were brought forward during the Covid-19 pandemic as many veterinary clinics shut their doors.

As more people adopted and fostered pets during the Covid 19 pandemic, the vet clinics that did not temporarily shut down did have reduced hours or fewer pet visits each day to allow for social distancing. At that point, the company sped up its development of this service. The service had handled such events as a puppy eating chocolate or a cat with skin that was itchy. The vets were allowed to give assistance or refer the pet owner to an emergency clinic, but they could not diagnose a condition or prescribe a medication.

As the Covid-19 restrictions eased, Chewy was looking forward to capitalizing on the rollout of its pet healthcare service. From October of 2020 until April of 2021, Chewy hosted more than 30,000 remote consultations over its "Connect with a Vet" program.

Locations and personnel. The company was launched in Dania Beach, Florida, and opened a facility in Mechanicsburg, Pennsylvania, to facilitate overnight delivery in the Northeast in 2014.[8] Later, the company opened an office in Boston and a new customer service center in Goodyear, Arizona, which was 19 miles from PetSmart's corporate headquarters. By 2021, Chewy had 12 fulfillment centers and 3 customer service centers and a fully automated distribution center.[9] The company reported that they employed over 18,000 employees in the United States in that year.

Operations. According to **Chewy.com**'s Investor Relations, by 2023 Chewy offered over 2,000 different brands on its website as well as employed over 20,000 employees.[10] These products ranged from pet food to toys and prescription medications (see Exhibit 2 entitled "Chewy Food Supplement Advertisement"). In 2021, CEO Singh stated, "Two years ago on Chewy's website you would have seen a $45 dog bed. And that's it.

EXHIBIT 2 Chewy, Inc.'s Consolidated Balance Sheets, 2021–2022 (in thousands, except per share data)

	January 29, 2023	January 30, 2022
Assets		
Current assets:		
Cash and cash equivalents	$ 330,441	$ 603,079
Marketable securities	346,944	—
Accounts receivable	126,349	123,510
Inventories	675,520	560,430
Prepaid expenses and other current assets	41,067	36,513
Total current assets	1,520,321	1,323,532
Property and equipment, net	478,738	367,166
Operating lease right-of-use assets	423,423	372,693
Goodwill	39,442	—
Other non-current assets	53,152	22,890
Total assets	$ 2,515,076	$ 2,086,281
Liabilities and stockholders' equity		
Current liabilities:		
Trade accounts payable	$ 1,030,882	$ 883,316
Accrued expenses and other current liabilities	738,467	761,563
Total current liabilities	1,769,349	1,644,879
Operating lease liabilities	471,765	410,168
Other long-term liabilities	60,005	16,498
Total liabilities	2,301,119	2,071,545

(continued)

EXHIBIT 2 (continued)

	January 29, 2023	January 30, 2022
Commitments and contingencies (Note 7)		
Stockholders' equity:		
Preferred stock, $0.01 par value per share, 5,000,000 shares authorized, no shares issued and outstanding as of January 29, 2023 and January 30, 2022	—	—
Class A common stock, $0.01 par value per share, 1,500,000,000 shares authorized, 114,160,531 and 108,918,032 shares issued and outstanding as of January 29, 2023 and January 30, 2022, respectively	1,141	1,089
Class B common stock, $0.01 par value per share, 395,000,000 shares authorized, 311,188,356 shares issued and outstanding as of January 29, 2023 and January 30, 2022, respectively	3,112	3,112
Additional paid-in capital	2,171,247	2,021,310
Accumulated deficit	(1,961,543)	(2,010,775)
Total stockholders' equity	213,957	14,736
Total liabilities and stockholders' equity	$ 2,515,076	$ 2,086,281

Source: Chewy, Inc. Fiscal 2022 Form 10-K.

Today you can buy a $220 orthopedic dog bed from us. Customers love that. I didn't even know orthopedic dog beds was a category."[11]

The company worked with several nonprofit organizations to provide food and other items for animals in shelters. By 2021, Chewy had donated more than $76 million in products to shelters and for rescue pets to ensure the quality care Chewy's management believed they deserved. To celebrate their 10-year anniversary, Chewy made a promise to donate $1 million worth of products through the Greater Good Charities' Rescue Bank Program.[12]

Important to Chewy's success in selling pet food and supplies was their data-driven recommendation engine. This engine was powered by the creation of "Pet Profiles" for which users uploaded information about their pets such as the breed and birth date. CEO Singh said, "We have 170 million data points. Imagine the power of this data. We know if 'Dave' has a Labrador, and that lab is six years old, at year seven it might display hip dysplasia and that allows me to recommend Cosequin as a remedy."[13]

In unbranded online searches, Chewy's private label pet food named American Journey had done better than Amazon's Wag. A buyer searching Chewy's website would find American Journey as well as established rivals Wellness by WellPet and Hill's Pet Nutrition. In addition, American Journey was found on the first page of search results for 31 percent of unbranded pet food items on Chewy's website.

Chewy's marketing department discovered through their research in 2019 that 69.4 percent of their sales came from customers who signed up for automatic recurring shipments (see Exhibit 3

EXHIBIT 3 Market Share Comparison of the Leading Online Sellers of Pet Food and Supplies, 2021

Rank	Company	Market Share
1	Amazon.com	35.1%
2	Petsmart Inc.	28.7%
3	Petco Animal Supplies	5.5%
	Others	30.7%
	Total	100.0%

Source: "Online Pet Food & Pet Supply Sales in the US, 2021," **Ibisworld.com**.

entitled "Chewy Autoship Program").[14] Another advantage of this program was the reduction in advertising costs.[15] Their active customers increased from 13,459 in 2019 to 20,663 in 2021. Net sales per active customer increased from $360 in 2019 to $430 in 2021.[16]

Financials. In March 2012, Chewy's management estimated an annual revenue for the first year of $26 million, although the company lost money in the first half of the year. From 2014 to 2015, sales grew from $205 million to $423 million. In 2017, the company had revenues of approximately $2 billion and had garnered 51 percent of the online pet sales in the United States. Between 2017 and 2018, Chewy's sales increased from $2.1 billion to $3.5 billion.

In 2017, Ryan Cohen prepared to take the company public since both Petco and PetSmart came forward with offers to merge. However, by May of that year, Chewy was acquired by PetSmart for $3.35 billion, and Cohen laid aside his plans to go public. At the time of the acquisition, the deal was the largest acquisition of an online business.[17]

In a later deal, PetSmart transferred 20 percent of its stake in the company to private equity firm BC Partners which had owned PetSmart since 2014. Then in 2018, PetSmart spun off 16.5 percent of Chewy to an unrestricted subsidiary.[18]

On April 29, 2019, under the leadership of Singh, Chewy filed an S-1 for an initial public offering to trade under the ticker symbol of CHWY. In this filing, Chewy reported a net loss of $268 million on sales of $3.5 billion in 2018. The company went public on June 24, 2019, at $22 a share.[19] By January of 2023, the stock price of Chewy had ranged from $22.22 to $54.19 for the past 52 weeks.

In 2020, the company announced that PetSmart and Chewy would be separated by private equity firm BC Partners in a recapitalization plan. That year, annual net sales increased 47 percent to $7.15 billion over 2019 sales. The company recorded losses of $92.5 million and $73.8 million in 2020 and 2021, respectively. However, the company's strong 13.6 percent growth in revenues in 2022 allowed for net income of $49.2 million in 2022. Exhibit 1 presents Chewy, Inc.'s consolidated statements of operations for Fiscal 2020–Fiscal 2022. The company's consolidated balance sheets for Fiscal 2021 and Fiscal 2022 are presented in Exhibit 2.

The Online Pet Food and Supply Industry

The online pet food industry was estimated at $27.6 billion in sales in 2021 and was projected to grow annually by 3.4 percent between 2023 and 2028. The industry generated $1.2 billion in profit in 2021 with an average net profit margin of 4.3 percent. Industry growth was expected to be driven by the following factors during the 2018–2023 period:

1. Per capita disposable income (.5 percent average annual growth).
2. Number of cats and dogs (.7 percent average annual growth).
3. Number of broadband connections (.6 percent average annual growth).

While the industry's annual revenues were expected to improve by 3.4 percent from 2023 to 2028, this represented a major decline from the industry annual growth rate of 15.6 percent from 2018 to 2023. The reason for this predicted decline was that online pet retailers would experience increasing competition from brick-and-mortar stores as well as grocery stores and big-box retailers that sold pet food and supplies. These physical stores were also able to offer additional services such as grooming and training.

By 2023, this industry was in the growth stage of the industry life cycle. Industry globalization was low but increasing in intensity. Both capital intensity and industry regulations were medium but increasing. Concentration was very high in the industry with only three companies accounting for most of the pet food and supply sales. These companies accounted for 70 percent of sales in the online industry. However, over 2,000 other companies competed for the remaining 30 percent of the industry market share.[20] The industry concentration was expected to decline as small-scale locally owned companies entered the market. Although dominant leaders such as Amazon would benefit from higher demand for e-commerce sales, so would locally based pet stores that could offer sales to their existing customers online.[21]

Some of the important movers of individual companies in this industry in 2023 were the following:

1. Ability to control stock on hand.
2. Having a loyal customer base.

3. Establishment of brand names.
4. Economies of scope.
5. Ability to quickly adopt new technology.
6. Company's website was user friendly.

One of the most intriguing qualities of the pet industry to investors had been consistency. Pets had become members of families, and pet owners appeared to be willing to give up expenditures on themselves to fully fund their pets—even in recessions. Potential new entrants into the market will face capital requirements limited to Internet technology infrastructure and the acquisition of inventory which suggests low barriers to entry in the industry.

Major Online Sellers of Pet Food and Supplies

By 2023, there were 1,580 businesses operating in the online pet food and pet supply industry in the United States. However, the industry was highly consolidated with the two leading firms accounting for 63.8 percent of the market share—see Exhibit 3. In terms of the products and services within this industry, 50 percent of the revenues were from pet food and treats; 38.7 percent from pet supplies; 9.5 percent for other services; and 1.8 percent from veterinary services.

Some of the key trends in this industry were[22]

1. Operators were affected by consumer access to the Internet and comfort using e-commerce tools.
2. Positive industry conditions, such as strong revenue growth, had spurred new players to enter this industry.
3. Growth in single-person households and the elderly population propelled industry demand.
4. Premium pet products were one of the factors that helped mitigate price competition.
5. Personalized diets, including special food catered for obese animals, served as a potential niche market.
6. Online stores benefitted from an increasing number of pets in the United States.

Effect of Covid-19

In the midst of the pandemic from 2020 to 2021, families turned to pets in record numbers, with 4 million American households welcoming their first animal according to research group Packaged Facts.[23] With the purchase of pets, came the necessity of feeding, medicating, and equipping those animals.

The coronavirus had a unique impact on this industry. Industry leaders such as Amazon and PetSmart benefitted from higher online sales since consumers tended to work from home and engage in greater online purchasing during this time. However, because of the shelter-in-place orders and greater e-commerce demand, even brick-and-mortar stores were finding new ways to reach their existing customers online. Because of this, market share concentration declined in 2020—at the height of the pandemic. An additional problem during this time was a slowdown in the supply chains for most goods. This slowdown lasted for an additional two years and hampered the efficient flow of products in all industries.

Future Concerns for Chewy, Inc.

By mid-2023, Chewy's chief managers were required to address several concerns despite the company's impressive financial performance in 2022. To begin with, the surge in online pet product sales during the Covid-19 pandemic was beginning to decline as employees had gone back to the office with their two-year hiatus at home behind them. There were also concerns by Wall Street analysts that their discretionary item business was showing little strength even though it accounted for 20 percent of the company's revenues. Now it was possible to take advantage of the additional services that retail stores provided such as grooming and training. Their "Connect with a Vet" program had worked well during the pandemic, but now it was possible for pet parents to return to their regular veterinarian who had a long history with their pets.

In addition, the consensus among analysts in mid-2023 was that Chewy Inc. (CHWY) was an overweight stock with some analysts rating the stock as a sell. The expected earnings per share for Chewy's common stock for Q2 2022 was −\$0.3. Also, the company's common shares were trading at approximately \$35 in April 2023, which was \$118 in February 2021. Management needed a sound recovery strategy to provide profitability for the company and assuage investors' concerns.

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CASE 8

FIFA in 2023: It's Strategy to Lead the Worldwide Football Industry

Diana R. Garza
Our Lady of the Lake University

Dianna Carmenaty
Park University

Every four years, the Federation Internationale de Football Association (FIFA) had a remarkable platform to exhibit the exceptional talents of the world's premier football players. Beyond the exhibition of extraordinary athletic mastery, this occasion also served as a crucible for exceptional leaders fulfilling the role. From the opening match to the thrilling final, the FIFA World Cup Qatar 2022 was hailed as the best World Cup ever. The World Cup was one of FIFA's biggest sports events and a major source of revenue. President Gianni Infantino's strategy was to increase the size and frequency of FIFA competitions while making football global and available for all. FIFA's strategy and objectives included improving and promoting the game of football on a global scale. The organization's goal was to develop a landscape that would positively impact men's, women's, and youth football, futsal, and beach soccer.

FIFA operated on a four-year cycle, with the World Cup being the final event of the fourth year and the primary source of income. For the 2019–2022 cycle, FIFA reported record revenue of $7,568 million, an 18 percent increase from the 2015–2018 cycle. FIFA's balance sheet remained strong, with total assets amounting to $6,796 million at the end of 2022. FIFA's reserves reached a new high of $3,971 million, 45 percent higher than the 2015–2018 cycle. The 211 member federations saw annual funding increase from $250,000 to $2 million since President Gianni Infantino took office in 2016.

While crafting an all-encompassing strategic vision with commendable objectives was a familiar task for most seasoned organizational leaders, only a select few have an opportunity to navigate the challenges contemporaneous of multiculturalism and the social and political dynamics associated with a global economy. Moreover, many aspire to stand at the center of the spotlight; however, few are adequately equipped to handle the ensuing scrutiny and critique from those intimately acquainted with the integrity-bound intricacies of the organizational scheme. Nevertheless, we have observed every FIFA leader rise to the challenge, defying all odds and surpassing seemingly insurmountable obstacles.

Considering the greatest challenges FIFA faced at the time, sports enthusiasts were prepared to retire their soccer cleats for good, especially after the 53rd Ordinary FIFA Congress held in Seoul on May 29, 2002. In fact, the 2002 FIFA World Cup could be seen as the necessary transilient and impetus change of an aging organizational framework and one that may be of equal value when considering the 2026 World Cup. Despite internal and external factors that posed significant threats to the organization's sustainability in 2002, the combination of astute leadership and unwavering determination enabled the emergence of much-needed streamlined policies, procedures, and practices. To understand how the 2002 FIFA World Cup served as a catalyst for the organization's policies in 2023, it was crucial to acknowledge the backdrop against which it unfolded. The world had recently witnessed the tragic events of September 11, leading to a widespread hesitancy in travel. Simultaneously, FIFA's insurance coverage was canceled, the global economy was grappling with a downturn, marketing and television partners faced bankruptcy, and the 2002 FIFA World Cup looming ahead was at a projected deficit of approximately 134 million (CHF-Swiss Franc), and the sequence of events obscured the organizational frame of reference.

Navigating through a multitude of unfamiliar obstacles, then FIFA President Defranco demonstrated an exceptional ability to grasp the intricacies of the organization's challenges. Overcoming perceived barriers, Defranco first introduced the SCORE program (Smart Cost Optimization and Revenue Enhancement) to ensure that all practices met and exceeded the International Financial Reporting Standards (IFRS). To preserve and protect the organization and respective stakeholders, Defranco also initiated a financial committee separate from the audit committee, thereby ensuring that FIFA implemented rigorous quality control measures, elevated transparency standards, and seized the opportunity to optimize revenue. As a result of the strategic measures undertaken by Defranco, the organization yielded a surplus of 115 million (CHF-Swiss Franc). As a steward of organizational trust and leadership, Defranco afforded a significant turnaround through initiatives such as reclaiming the marketing funds from the marketing and television partner going through bankruptcy, launching FIFA Marketing AG, and introducing an electronic tracking system, which served as an added revenue stream. Since that time, every FIFA leader had met and overcome similar challenges.

The announcement of Qatar as the host of the FIFA World Cup raised numerous concerns that sparked considerable interest. Prior to the announcement, Qatar was relatively unknown globally or was often associated with a dusty landscape somewhere in the Middle East near Saudi Arabia. Although few soccer enthusiasts were familiar with Qatar, the country had successfully organized large-scale sporting events for over two decades before bidding on the World Cup. While there were initially legitimate concerns surrounding the decision to hold the 2022 FIFA World Cup in Qatar, it was important to note that the country had emerged as one of the wealthiest states, thanks to its abundant oil and gas reserves. This significant economic factor made the decision less unrealistic since Qatar had the means to make the necessary infrastructure upgrades prior to the competition. Qatar also experienced a multitude of benefits as a result of hosting the 2022 FIFA World Cup, including the acquisition of a global reputation, the development of a fresh cultural identity, and a remarkable surge in tourism revenue, surpassing a staggering growth rate of 347 percent.

HISTORY OF FÉDÉRATION INTERNATIONALE DE FOOTBALL ASSOCIATION

FIFA, or Fédération Internationale de Football Association, came into existence in 1904, predominantly serving eight European countries, which included: Belgium, Denmark, France, Netherlands, Spain, Sweden, Switzerland, and Germany. While the primary objective of FIFA was to foster the advancement of football by promoting beneficial relationships between national athletics organizations, players, and officials, the association faced significant challenges in handling the complex social, cultural, and political pressures that arose. Due to these challenges, a governing body was established to regulate the increasing number of international games and address the discord among existing clubs and soccer leaders. FIFA, established and headquartered in Zurich, Switzerland, steadily emerged as the most esteemed sports organization globally, boasting 211 members representing 19 countries worldwide.

Since then, soccer had emerged as the most popular sport worldwide, captivating the participation of over 250 million registered athletes, including 10 million women, and captivating billions of fans through stadium attendance and television viewership. FIFA assumes authority over various aspects of the sport, encompassing the regulation of game rules, player transfers, organization of international competitions, the establishment of coaching, refereeing, and sports medicine standards, as well as global promotion of soccer.

FIFA CONFEDERATIONS

FIFA had grown from 7 members to 211 member associations. Nations are divided into six different confederations, one for each continent. These include the Asian Football Confederation – AFC, Confédération Africaine de Football – CAF, Confederation of North, Central America and Caribbean Association Football – CONCACAF, Confederación Sudamericana du Fútbol – CONMEBOL, Oceania Football Confederation – OFC, and Union des Associations Européenes de Football – UAEF. Each of these confederations hosts their own tournaments, organizes various member associations, and develops outreach programs.

COMPETING FOOTBALL ASSOCIATIONS

EUFA—European Football Association

There had been a constant battle between FIFA and the Union of European Football Association (EUFA), headquartered in Nyon, Switzerland. EUFA, the governing body of European football, was the umbrella organization for 55 national football associations across Europe. EUFA's objectives include promoting football in the spirit of unity, solidarity, and peace. The organization promotes ethical standards and good governance, maintains relations with stakeholders, and safeguards its member associations for the well-being of European games.

ICC—International Champions Cup

The ICC was an annual club football exhibition competition. Competitions were played between 2013 to 2019. Due to the COVID-19 pandemic, the 2020 tournament was canceled, and no games have been played since. The organization was founded in 2012 by Relevant Sports and billionaire real-estate magnate and Miami Dolphins owners Stephen Ross and Matt Higgins. ICC teams include FC Barcelona, Real Madrid, Atletico de Madrid, Manchester United, Manchester City, Liverpool FC, Arsenal, Tottenham Hotspur, Chelsea FC, FC Bayern, Borussia Dortmund, Benfica, Juventus, AC Milan, Inter Milan, AS Roma, and Paris Saint–German.

ICC was best known for its 2014 tournament between Manchester United and Real Madrid at Michigan Stadium, which set an all-time record for attendance at a soccer game with 109,318 spectators. The ICC also established a Women's International Champions Cup in 2018.

IOC—International Olympic Committee

Based in Lausanne, Switzerland, the IOC acts as a catalyst for collaboration between all Olympic stakeholders and collaborates with public and private authorities, including the United Nations and other international organizations. The IOC was established in 1894 as a not-for-profit independent international organization and distributes 90 percent of its revenues to sporting movements that develop sports and athletes at all levels.

FIFA Development and Education—Forward 2.0 Programme

In 2021 FIFA incurred $376 million in expenses related to the FIFA Forward Programme for member associations. Forward 2.0 includes operational funding for day-to-day activities, administration, and general running costs, as well as engaging member associations in creating and operating domestic men's, women's, and youth competitions. Under this funding, member associations are entitled to receive up to $1 million per year.

Each of the 211 member associations was entitled to receive up to $2 million for projects incurred during the 2019–2022 cycle. Projects must have been for the development of football infrastructure and competitions as well as advancing women's football.

The six confederations recognized by FIFA are entitled to receive $12 million per year each to fund and promote the interests of football and contribute to global football development.

Member associations identified as needing assistance with annual revenues of less than 4 million are awarded up to $0.2 million per year for travel and accommodation and up to $0.2 million for equipment. In 2021, 105 member associations were awarded funds totaling $31.6 million.

Each confederation was divided into zonal/regional associations, each entitled to receive up to $1 million to promote and organize youth competitions for boys and girls. Other football associations that are not FIFA members but are recognized by a member confederation also benefit from the FIFA Forward Programme. Other projects include governance support to sharing good practices that stimulate knowledge sharing and promote collaboration. Members are provided visibility through programs such as the FIFA Connect Programme and FIFA's Football Executive Programme. Member Associations are supported by FIFA's Regional Development Offices located around the world. FIFA's investments have increased fivefold over 2011–2014, 2015–2018, and 2019–2022 cycles.

FIFA'S VISION, MISSION, GOALS, AND STRATEGIES

According to President Gianni Infantino, "FIFA's vision was to make football truly global, diverse and inclusive, for the benefit of the entire world." FIFA's mission statement was to "*Develop the Game, Touch the World, Build a Better Future.*" These statements speak to FIFA's goal of wide-ranging reforms, global expansion, and investments in football development through the Forward Programme.

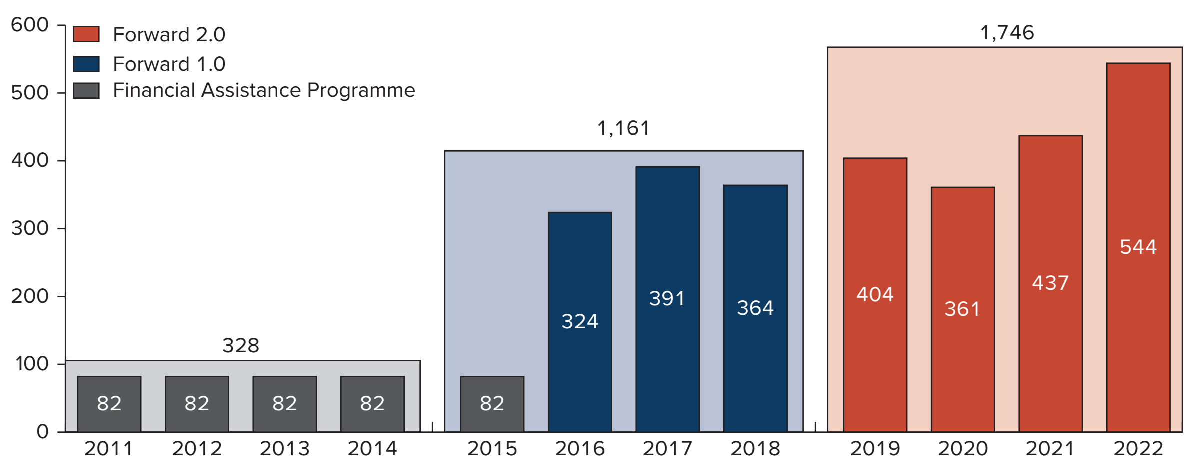
The organization had outlined its comprehensive plan to transform football into a worldwide sport through *The Vision 2020–2023* report, which outlines 11 objectives. These 11 objectives have emerged as a blueprint for the organization's pursuit of goals. The vision encompasses 11 key aspirations, each supported by four fundamental pillars. These pillars encompass a wide range of areas, including organizing sustainable tournaments, expanding opportunities, fostering memorable experiences, and combating racism and all other types of discrimination.

Goal number one includes modernizing the football regulatory framework. This goal seeks to continuously modernize regulations to ensure transparency on a global scale. Goal number two includes growing revenues to reinvest in the sport of football. Goal three focuses on increased efficiency and efficacy of the organization. Goal number four seeks to ensure the success of its iconic competitions, such as the FIFA World Cup, the FIFA Women's World Cup, and FIFA's new global club football tournament. Goal five ensures that FIFA's competitions are genuinely global by focusing on inclusivity, location, audience, and impact. FIFA recognized that the world had been steadily widening; goal six seeks to bridge this gap by bringing together at least 15 national teams and 50 clubs from all continents to a top competitive level. Goal number seven seeks to maximize its impact on the development of football, whether it includes men's, women's, youth futsal, or beach soccer. Goal number eight focuses on the growth of women's football worldwide. Goal number nine seeks to use technology to its fullest potential to improve the quality of football. Goal number ten emphasizes the game's core values and seeks to protect and foster these values. Goal number eleven focuses on positively impacting society through the power of football. FIFA President Gianni Infantino had set out to make football a truly global sport at every level.

SUSTAINABILITY, HUMAN RIGHTS, AND ANTIDISCRIMINATION

Sustainability in sports had become a growing field due to a growing sense of responsibility among the sports industry. FIFA's sustainability framework focuses on

EXHIBIT 1 FIFA's Forward Programme Timeline, 2011–2022



Source: Publications FIFA, 2022.

delivering a shared vision and setting benchmarks for the sustainability of mega-sporting events.

The FIFA World Cup Qatar 2022 Sustainability Framework was based on policy commitments, goals, material topics, and strategic objectives, and organized according to five pillars. These pillars include human, social, economic, environmental, and governance. FIFA sought to align with Qatar's 2030 National Vision while focusing on good governance and ethical business practices.

FIFA was committed to use the World Cup Qatar 2022 sustainability framework as a model for future events. FIFA's Women's World Cup 2023 had been published and closely aligns with FIFA's long-standing sustainability framework and ambitions and includes social, economic, and environmental priorities.

TECHNICAL DEVELOPMENT PROGRAMS

The technical development programs included strategic revisions of the international match calendars, feasibility studies on men's, women's, and youth world cups, and dedicated consultations with stakeholders. FIFA's Talent Development Programme also published individual reports with recommendations and benchmarks for its member associations.

FIFA developed a Coach Educator Pathway as part of its coaching education, including 36 online workshops, individual mentoring, six types of online workshops, and a new program to develop coach education managers. In 2021 FIFA launched its FIFA Training Centre featuring cutting-edge content which can be accessed by the public in various formats, such as articles, videos, and podcasts.

FIFA'S FINANCIAL PERFORMANCE

FIFA was a nonprofit organization that invested most of its income back into the development of the game. Earnings come from organizing international competitions, with the World Cup being the most popular event and occurring every four years. Revenue streams come from the sale of television, marketing, licensing rights for soccer events, and ticket sales; other costs, such as infrastructure, are left up to the host country.

FIFA's largest source of revenue was organizing the Men's and Women's World Cup. Each event generates billions of dollars which are then put back into promoting the sport. The host country was selected based on a competitive bidding process. Qatar hosted the 2022 Men's World Cup; the Women's World Cup took place in 2023 in Australia and New Zealand. The 2026 Men's World Cup will be hosted by the United States, Canada, and Mexico.

FIFA generated revenue of $7,568 million for 2019–2022, representing an increase of 18 percent compared to $6,421 million for 2015–2018. The largest revenue was generated from the sale of television broadcasting rights, accounting for 45 percent of the full-cycle revenue. World Cup Qatar became the most watched edition in FIFA tournament history, with over 5 billion viewers, accounting for over half of the world's population. Exhibit 2 presents revenue from television broadcasting rights for 2019–2022.

Marketing rights became the second largest source of income. Blue chip companies are known for being nationally and internationally recognized, well-established, and financially sound. FIFA's blue-chip partners included companies such as Adidas, Coca-Cola, Hyundai/Kia, the Wanda Group, Qatar Airways, Qatar Energy, and Visa. FIFA World Cup Sponsors included Budweiser, McDonalds, vivo, Hisense, Mengniu, Byju's, and **Crypto.com**. Additional revenue came from the sale of global and regional sponsorship packages.

The number of regional supporters, partners, and sponsors amounted to 32, generating $1,795 million in marketing rights revenues for the 2019–2022 cycle. Exhibit 3 presents 2019–2022 sponsors, supporters, and partner revenue.

Exhibit 4 presents revenue from licensing rights. Revenue totaled $769 million, a 28 percent increase from the 2015–2018 cycle. Licensing rights were sold to and included retail tournament outlets and the permanent flagship FIFA store, which was opened at Doha's Hamad International Airport in November 2022. FIFA also launched **fifastore.com**, which included new products. Other licensing revenue came from FIFA's branded licensees, such as Taittinger, Hublot, and Louis Vuitton. FIFA's esports tournament brands, FIFAe Club Series™, FIFAe Nations Series™, FIFAe World Cup™, and FIFAe Continental Cup™ were either launched or relaunched. A new marketing innovation included FIFA+ Collect, a platform that allowed fans to

EXHIBIT 2 FIFA's Revenue from Television Broadcasting Rights, 2019–2022 ($ in millions)

	2022	2021	2020	2019
Europe	$1,030,880	$ 2,179	$ 0	$ 27,963
Asia and North Africa	875,120	46,888	0	102,735
South and Central America	351,526	24,294	0	75,478
North America and the Caribbean	518,965	38,986	0	92,090
Rest of the world	103,111	1,810	0	3,263
Total revenue from television broadcasting rights by region	2,879,602	114,157	0	301,529
Other broadcasting revenue	75,416	2,246	1,626	12,807
Other FIFA event revenue	3,334	6,716	98	28,266
Total revenue from television broadcasting rights	$2,958,352	$123,119	$1,724	$342,602

Source: FIFA 2022 Annual Report.

EXHIBIT 3 FIFA's Revenue from Marketing Rights, 2019–2022 ($ in millions)

	2022	2021	2020	2019
FIFA Partners	$762,568	$93,172	$56,723	$139,090
FIFA World Cup Sponsors/FIFA Women's World Cup Sponsors	534,527	30,078	17,138	17,379
FIFA Regional Supporters	122,028	5,326	589	0
FIFA National Supporters	2,793	1,059	0	8,379
World Cup Partners/Women's Football Partners	2,608	1,752	0	0
Total revenue from marketing rights	1,424,524	131,387	74,450	164,848

Source: FIFA 2022 Annual Report.

EXHIBIT 4 FIFA's Revenue from Licensing Rights, 2019–2022 (In $ millions)

	2019	2020	2021	2022	Total
Brand licensing rights	$153,433	$157,302	$178,573	$268,139	$757,447
Other licensing rights	6,094	1,579	1,629	2,258	11,560
Total revenue from licensing rights	$159,527	$158,881	$180,202	$270,397	$769,007

Source: FIFA 2022 Annual Report.

own and collect digital FIFA World Cup and FIFA Women's World Cup moments.

Hospitality rights and ticket sales generated a total of $949 million, from which $686 million came from the sale of tickets, and $243 million were generated through the sale of hospitality rights for the FIFA World Cup Qatar. Other FIFA tournaments and events generated the remaining $20 million. Exhibit 5 shows each category's revenue. Exhibit 5 presents revenue from hospitality rights and ticket sales for 2019–2022.

Exhibit 6 presents revenue generated from the FIFA Club World Cup, contributions received from Olympic Football Tournaments and the FIFA Quality Programme.

The exhibit provides a breakdown of revenue generated from other sources. The 2019–2022 revenue amounted to $629 million, nearly double the previous cycle amount of $323 million. The most significant contribution came from an award of approximately $92 million by the United States Department

EXHIBIT 5 FIFA's Revenue from Hospitality Rights and Ticket Sales V, 2019–2022 (In $ millions)

	2019	2020	2021	2022	Total
Revenue from hospitality rights— FIFA World Cup™	$ 0	$0	$ 0	$242,900	$242,900
Revenue from ticket sales—FIFA World Cup™	0	0	0	685,881	685,881
Revenue from ticket sales—other FIFA events	7,931	0	12,172	235	20,338
Total revenue from hospitality rights and ticket sales	$7,931	$0	$12,172	$929,016	$949,119

Source: FIFA 2022 Annual Report.

EXHIBIT 6 FIFA's Other Revenue, 2019–2022 ($ in millions)

	2019	2020	2021	2022	Total
FIFA Club World Cup™	$23,118	$ 0	$26,567	$26,080	$ 75,765
FIFA Quality Programme	16,493	9,441	17,386	11,133	54,453
Olympic Football Tournaments	0	0	25,950	0	25,950
Penalties/appeals	7,571	6,029	3,029	5,241	21,870
Income from the sale of film and video rights	1,899	3,524	3,971	10,176	19,570
FIFA Museum	3,492	1,518	2,539	5,163	12,712
Revenue from prior cycles and other	16,711	8,508	6,179	4,279	35,677
Total other revenue	$69,284	$29,020	$85,621	$62,072	$245,997

Source: FIFA 2022 Annual Report.

of Justice for losses suffered by FIFA as a victim of corruption schemes.

The 2022 World Cup Quatar was the first time a World Cup was held in the Middle East. Expenses incurred in 2021 were deferred and recognized as profits or losses in 2022. In the process of organizing the World Cup Qatar, costs reached $255.8 million by the end of 2021.

Other events for 2021 included the FIFA Beach Soccer World Cup Russia 2021, FIFAe tournaments, and the FIFA Arab Cup 2021. The host country offset operational costs for hosting and staging the FIFA Arab Cup, which served as a test event for the FIFA World Cup in 2022. FIFA events were recognized in the year they were held and included event-organizing costs such as promotion, production, prize money, accommodation, and operations.

Events such as FIFA World Cup Qatar, the FIFA Futsal World Cup Lithuania 2021, and the FIFA Olympic Football Tournament Tokyo 2020 were postponed from 2020 to 2021 and 2022 due to the global pandemic. The pandemic also caused the cancellation of the FIFA U-20 World Cup Indonesia 2021 and FIFA U-17 World Cup Peru 2021. The original hosting countries were allowed to host the events in 2023. Exhibit 8 includes the consolidated statement of comprehensive income for the years 2021 and 2022.

Value-in-kind and other expenses include predetermined services and goods delivered in connection with FIFA events. The FIFA Club Protection Programme provides compensation for injuries due to accidents sustained by players while on duty. FIFA provides compensation to the football club during the time the player was temporarily disabled. These costs are recognized in the year in which they were incurred.

FIFA World Cup expenses are relatively low; FIFA was able to bargain and dictate most of the terms. FIFA was responsible for paying a local committee to organize and conduct the World Cup. FIFA was also responsible for paying prize money to the participating nations, travel and accommodations, as well as paying for support staff and match officials.

FIFA's 2022 budget accounts for competitions and events that occurred in 2022. The 2019–2022 budget included the FIFA World Cup Qatar 2022 with a total investment of $1,696 million. Development and education consists of the FIFA Forward 2.0 Programme, which provides entitlements to member associations and confederations. Football governance also covers the costs of football judicial bodies, preventing match manipulation, and the Transfer Matching System, including the TMS clearing house and electronic player passport. FIFA governance and administration are also included in the FIFA budget, including legal costs, communication operations, information technology, building and maintenance, and personnel expenses. Marketing and TV broadcasting focuses on commercializing marketing rights, media and TV broadcasting, and enhancements to FIFA's digital landscape.

Exhibit 7 presents FIFA's consolidated statement of comprehensive income 2021–2022. Exhibit 8 presents FIFA's consolidated balance sheet 2021–2022 and Exhibit 9 presents FIFA's consolidated cash flow statement for 2021–2022.

EXHIBIT 7 FIFA's Consolidated Statement of Comprehensive Income for 2021–2022 (In $ millions)

	2022	2021
REVENUE		
Revenue from television broadcasting rights	$2,958,352	$123,119
Revenue from marketing rights	1,424,524	131,387
Revenue from licensing rights	270,397	180,202
Revenue from hospitality rights and ticket sales	929,016	12,172
Other revenue	62,072	85,621
Other income	124,852	233,987
Total revenue and other income	5,769,213	766,488
EXPENSES		
Competitions & Events	(2,005,358)	(234,380)
Development & Education	(1,038,113)	(554,763)
Football Governance	(40,278)	(43,877)
Total expenses from football activities	(3,083,749)	(833,020)
FIFA Governance & Administration	(187,846)	(191,967)
Marketing & TV Broadcasting	(132,396)	(52,384)
Total expenses from administrative activities	(320,242)	(244,351)
COVID-19 Relief Plan — grants (stage 3)	(6,500)	(44,500)
Total other expenses	(6,500)	(44,500)
Result before taxes and financial result	2,358,722	(355,383)
Taxes and duties	(22,716)	(1,591)
Financial income and costs, net	31,877	44,762
Net result for the year	2,367,883	(312,212)
Other comprehensive income		
Items that will not be reclassified to profit or loss		
Remeasurements of post-employment benefit obligations	55,537	43,270
Items that may be subsequently reclassified to profit or loss		
Foreign currency translation differences	(760)	(228)
Net gain / (loss) on cash flow hedges	(13,884)	35,894

	2022	2021
Net gain / (loss) on debt instruments at FVOCI	(75,587)	(9,482)
Total other comprehensive income	(34,694)	69,454
Total comprehensive income for the year	2,333,189	(242,758)
Net result for the year	2,367,883	(312,212)
Allocation to restricted reserves	(2,367,883)	312,212
Result for the year after allocation	$0	$0

Source: FIFA 2022 Annual Report.

EXHIBIT 8 FIFA's Consolidated Balance Sheet for 2021–2022 ($ in millions)

	December 31, 2022	December 31, 2021
Assets		
Cash and cash equivalents	$1,708,102	$ 832,089
Receivables	357,850	398,985
Derivative financial assets	10,696	41,328
Financial assets	2,855,744	2,158,442
Contract assets	195,227	88,723
Prepaid expenses and accrued income	157,729	352,577
Inventories	992	4,336
Current assets	5,286,340	3,876,480
Property and equipment	272,835	289,224
Intangible assets	27,730	20,007
Derivative financial assets	8,126	5,195
Financial assets	1,180,680	1,279,360
Prepaid expenses	19,831	21,541
Non current assets	1,509,202	1,615,327
Total assets	6,795,542	5,491,807
Liabilities and reserves		
Payables	653,434	100,437
Contract liabilities	233,458	2,511,451
Accrued expenses and deferred income	1,305,740	659,512
Derivative financial liabilities	102,970	19,675
Lease liabilities	10,063	8,938
Current liabilities	2,305,665	3,300,013
Contract liabilities	31,677	114,582
Accrued expenses and deferred income	238,272	22,856
Post-employment benefit obligation	16,989	65,187
Provisions	54,960	172,685
Lease liabilities	176,720	178,414
Noncurrent liabilities	518,618	553,724

	December 31, 2022	December 31, 2021
Total liabilities	2,824,283	3,853,737
Association capital	4,104	4,104
Cash flow hedge reserves	12,255	26,139
Foreign currency translation reserves	(445)	315
Fair value reserves of financial assets at FVOCI	(82,504)	(6,917)
Restricted reserves	4,037,849	1,614,429
Total reserves	3,971,259	1,638,070
Total liabilities and reserves	$6,795,542	$5,491,807

Source: FIFA 2022 Annual Report.

FIFA IN MID-2023

FIFA's 2022 World Cup Quatar had been a spectacular success. In mid-2023, the company's managers were developing plans for another record-breaking World Cup in 2026. The decisions made or options being discussed by FIFA leadership were controversial to some football clubs and fans. The 2026 World Cup would take place in the United States, Canada, and Mexico rather than a single nation. Another issue that was based more upon competition rather than tradition, was the discussion of expanding World Cup participation to 48 nations. The organization was also accepting proposals from all nations interested in hosting the 2030 World Cup. A decision would be made by 2024, with applications already submitted by Morocco, and a four-nation alliance involving Uruguay, Argentina, Paraguay, and Chile and a joint application from Spain and Portugal. FIFA leadership would be required to navigate the site selection issue and other strategically important considerations, while continuing to expand the worldwide market for football.

EXHIBIT 9 Consolidated Cash Flow Statement for 2021 – 2022

	2022	2021
Net result for the year	$2,367,883	$ (312,212)
Depreciation	33,372	37,105
Net financial result	(31,877)	(44,762)
Gain on disposal of property and equipment	0	(18,547)
Other non cash items	−25	(56)
Taxes and duties	22,716	1,591
(Increase)/Decrease in receivables	39,949	18,083
(Increase)/Decrease in prepaid expenses and accrued income	202,557	(210,061)
(Increase)/Decrease in derivative financial assets and liabilities	61,182	2,026
(Increase)/Decrease in inventories	3,345	114
(Increase)/Decrease in contract assets	(106,504)	23,766
Increase/(Decrease) in payables	550,531	37,978
Increase/(Decrease) in accrued expenses and deferred income	850,818	90,040
Increase/(Decrease) in contract liabilities	(2,410,682)	1,177,397
Increase/(Decrease) in provisions	(120,196)	(4,871)
Taxes and duties paid	(3,296)	(17,397)

	2022	2021
Net cash (used)/generated by operating activities	1,459,773	780,194
Purchase of property and equipment	(3,692)	(4,102)
Purchase of intangible assets	(12,307)	(18,440)
Sale of property and equipment	0	20,986
Investment in financial assets	(9,439,027)	(5,877,351)
Repayments and sale of financial assets	8,847,149	4,760,971
Interest received	45,056	30,200
Net cash (used)/generated in investing activities	(562,821)	(1,087,736)
Interest paid	(7,105)	(5,920
Repayment of lease liabilities	(9,858)	(9,678
Net cash (used)/generated in financing activities	(16,963)	(15,598)
Net (Decrease)/increase in cash and cash equivalents	$ 879,989	$ (323,140)

Source: FIFA Annual Report 2022 Finances.

CASE 9

Beyond Meat in 2023: Will a Major Shift in Its Operating Model Save It from Possible Bankruptcy?

McGraw Hill connect

Arthur A. Thompson
The University of Alabama

Going into 2023, Beyond Meat cofounder and CEO Ethan Brown was cautiously optimistic that the company's abrupt transition starting in the third quarter of 2022 from an operating model that prioritized rapid revenue growth above other outcomes to one that prioritized positive cash flow, sustainable revenue growth, and profitability would produce positive results. He believed the transition was necessary because of the challenges confronting the company—persistently high inflation, the actions of budget-constrained consumers to substitute lower-cost proteins for Beyond Meat's higher-cost plant-based proteins, a slowing economy in key markets, rising costs for materials used to produce the company's products, increased operating expenses in a number of areas, and mounting competitive pressures from rivals. Beyond Meat's 2022 revenues of $418.8 million were down 9.8 percent from 2021. Net losses were $366.1 million, equal to a stunning high 87.4 percent of revenues—the company had never earned a profit during 2016–2022.

Although the company's stock price soared after its initial public stock offering in May 2019 to an all-time high of $238 in July 2019 (largely on inflated investor expectations regarding the company's prospects for sustained rapid growth and long-term profitability), the stock price fell abruptly in the last half of 2019, then quickly evolved into a wild roller-coaster ride with five peaks and valleys before reaching the fifth peak of $150 in mid-2021, at which point the stock price trended steadily downward, to trade in the $54–$63 range the last week of January 2022. After Beyond Meat announced a loss of $179 million for full-year 2021 and a downbeat forecast for 2022, the stock price dropped steadily to a low of $12.31 in December 2022.

Throughout 2022 Beyond Meat had gone all-out to boost its revenues by partnering with fast-food chains to test putting Beyond Meat products on their menus in hopes that favorable customer responses would result in these menu additions becoming permanent. Fast-food customer approval of Beyond Meat dishes would not only trigger a high level of repeat purchases of these menu items that would spur the company's sales of Beyond Meat products to the fast-food chains but could also stimulate consumers to buy more Beyond Meat products for in-home consumption when shopping at supermarkets and grocery stores. During 2022, Beyond Meat was successful in getting three high-profile fast-food chains—KFC (formerly Kentucky Fried Chicken), Pizza Hut, and McDonald's—and several other fast-food chains to put Beyond Meat products on their menus.

- **Beyond Meat's New Menu Item at KFC.** KFC had tested the response of earlier-generation Beyond Meat's plant-based chicken nuggets at multiple locations that met with good (but not good enough) success to justify a national or international rollout. However, in January 2022, KFC began selling the latest reformulated Beyond Fried Chicken Nugget menu item at all of its 4,000 locations in the United States for four weeks. The plant-based fried chicken nuggets were offered in 6- and 12-piece orders, as well as part of a combo meal. According to foodie publication Eater.com:[1]

> . . .when Beyond Fried Chicken is dunked into the signature KFC Sauce it is pretty indistinguishable from a nugget that is made with actual chicken. The flavor is observed to be appropriately meaty and seasoned well, although the texture is not a perfect match with real chicken. KFC is making clear that Beyond Fried Chicken is not being made specifically for vegans and vegetarians. . . . For plant-based meat alternatives to have a real, meaningful future in the world of fast food, chains like KFC have to figure out how to better mimic the texture of the meats they're seeking to replace.

KFC removed the Beyond Fried Chicken Nuggets from its menu in February 2022, partly because of customer complaints that the texture of the chicken became unpleasant after it cooled. KFC had tested earlier versions of Beyond's chicken products in 2019, 2020, and 2021.

- **New Beyond Meat Menu Selections at Pizza Hut.** On January 11, 2022, following a successful market test in Toronto and Edmonton, Pizza Hut Canada launched Beyond Italian Crumbles as a permanent menu item at its 450 Canadian locations. Pizza Hut Canada believed the Crumbles delivered a meaty texture and savory taste that made them an attractive substitute for Pizza Hut's traditional Italian pork sausage ingredient for customers wanting a plant-based meat ingredient in their pizzas. The Beyond Meat menu selections at Pizza Hut included:
  - **The Great Beyond™:** A specialty pizza crafted with savory Beyond Italian Sausage Crumbles, paired perfectly with fresh veggie toppings that include sliced red onions and tangy banana peppers, served up on any Pizza Hut crust.
  - **Beyond Italian Sausage™ Alfredo Loaded Flatbread:** A crispy flatbread topped with flavor-packed Beyond Italian Sausage Crumbles, roasted red pepper, creamy alfredo sauce, and mozzarella cheese.
  - **Beyond Creamy Alfredo:** A savory pasta alfredo dish layered with Beyond Italian Sausage Crumbles, onions, mushrooms and mozzarella cheese that delivers a creamy, delicious bite.

  Beyond Italian Sausage Crumbles could also be added as a topping to any existing pizza offerings of any size. Canada was the second market to permanently offer the Beyond Meat Crumble menu items nationally. After a successful trial of Beyond Meat Pizzas in the United Kingdom in the first half of 2021, Pizza Hut brought them back as a permanent menu option at all Pizza Hut UK Delivery locations in July 2021. As of early 2023, Beyond Meat products were regular menu items at Pizza Hut restaurants across Canada, the United Kingdom, Singapore, El Salvador, Guatemala, and Sweden.

- **McDonald's Test of New McPlant Burger.** Beyond Meat had worked with McDonald's for years to co-develop a meaty and tasty plant-based burger that McDonald's management believed was worthy of becoming a permanent menu offering and satisfying growing customer desires for a tasty plant-based burger option. In 2021, McDonald's concluded that it, in cooperation with Beyond Meat, had come up with a plant-based burger patty named McPlant that was made of ingredients like peas, rice, and potatoes, that would be exclusive to McDonald's, and that was ready for launch.[2] The McPlant burger included a McPlant patty served on a sesame seed bun with tomato, lettuce, pickles, onions, mayonnaise, ketchup, mustard, and a slice of American cheese—customers who preferred burgers with 100 percent plant-based ingredients could ask to hold the mayonnaise and American cheese, or any other ingredient. In early 2021, after market trials in 250 European locations where new items were frequently offered for limited times to learn customer responses, McDonald's introduced the McPlant burger in locations throughout Sweden, Denmark, the Netherlands, Austria, Ireland, and Great Britain.

  In November 2021, McDonald's tested the McPlant burger in eight locations in the United States, mainly to better understand how offering a burger with a plant-based patty impacted the kitchens in its restaurants in the United States. Because of the success of the trial, beginning in February 2022, McDonalds put the McPlant burger on its menu in over 600 additional locations in the San Francisco Bay and Dallas-Fort Worth areas.[3] At the end of July 2022, McDonald's ended its 622-unit test of the McPlant burger in the United States due to an "underwhelming" number of customer orders for the plant-based burger. In July 2022, McDonalds began a limited time test run of the McPlant burger at 270 locations in Victoria, Australia, but the McPlant burger was discontinued after the test run.

  European customers were generally more receptive to McDonald's plant-based meat products than those in the United States. In early 2023, the McPlant burger was considered as a permanent menu item in the United Kingdom, Ireland, Austria, and the Netherlands—and for a limited time in Portugal. A McDonalds official said the McPlant burger was "wildly successful" in the United Kingdom after four months on the menu.[4] In January 2023, McDonald's rolled out the Double McPlant burger in the United Kingdom and Ireland for a limited time. In February 2023, in Germany McDonalds began selling its new plant-based, chicken-flavored McNuggets product, co-developed with Beyond Meat, as a regular menu item at its 1,400 McDonalds units nationwide—Germany was the first market to get the new chicken-flavored nuggets. A week later, McDonalds began selling the McPlant burger nationwide in Germany as a regular menu item.

Other Announcements of Beyond Meat Partnerships with Fast Food and Restaurant Chains. In November 2018, Dunkin' Brands (formerly Dunkin' Donuts) announced a partnership with Beyond Meat and introduced the Beyond Sausage Breakfast Sandwich on its menu nationwide in the United States; the sandwich was pulled from the Dunkin' menu in June 2021. In January 2019, Carl's Jr., then a 900+-unit chain best known for its burgers and a subsidiary of CKE Restaurants, became the first large quick service restaurant chain in the United States to offer a plant-based burger patty by adding the Beyond Famous Star burger to its menu offerings; some 14 months later in April 2021, it had sold nearly 12 million Beyond burgers.[5] In late 2019, Carl's Jr began serving a Beyond Sausage burrito and a Beyond Sausage egg and cheese biscuit to complement its Beyond Meat Famous Star Burger and Cheeseburger.[6] The Beyond Meat Famous Star Cheeseburger was still on the Carl's Jr menu in 2023. Also, in late 2019, Hardee's (also owned by CKE Restaurants) debuted an Original Beyond Thickburger and a Beyond Breakfast Sausage Biscuit for a limited time, but both products were then discontinued.

Denny's Corp. announced it would give away free Beyond Meat Burgers with the purchase of any beverage on January 30, 2020, from 11 a.m. to 10 p.m. while supplies lasted. The promotion, following on the heels of a highly successful market test of the Beyond Burger in Denny's restaurants in Los Angeles, served to launch the Beyond Burger menu item nationwide at all 1,700-plus Denny's locations in the United States and Canada. However, in March 2023, Denny's said it would replace the Beyond Meat burger with Dr. Praeger's Veggie Burger.

In February 2020, Starbucks added a Beyond Sausage sandwich to its breakfast menu at its store locations in Canada. In April 2020, Starbucks debuted a new menu in its 4,200 stores in China that included three selections of Beyond Meat's plant-based beef products: Beyond Beef Pesto Pasta, Beyond Beef Classic Lasagna, and a Beyond Beef Sour and Spicy Wrap. In September 2020, Starbucks added additional Beyond Meat products (along with several plant-based products by Beyond's chief competitor, Impossible Foods) to its menus at store locations in Hong Kong, Taiwan, Singapore, Thailand, and New Zealand. The new menu items in Taiwan included a Beyond Crumbles Bolognese penne, a Beyond Sausage sandwich, and a Beyond Meatball sandwich. In January 2021, Starbucks began selling two new Beyond Meat sandwiches at its Middle East store locations in the United Arab Emirates and Kuwait. However, none of these Beyond Meat dishes could be found on Starbucks menu in these locations in 2023, having been replaced with other new, innovative vegan products. (It was regular practice at Starbucks to keep its food products lineup fresh and appealing to customers by replacing some items with new and different items as they became available.)

In 2017, TGI Fridays® with 850 locations in 55 countries, became one of the first fast-casual restaurants to offer the Beyond Burger and a Beyond Meat Cheeseburger. In 2020, the company's corporate chef used Beyond Beef to create a proprietary chili recipe and expand TGIF's offerings of plant-based dishes to include Beyond Chili, Beyond Chili Loaded Potato Skins, Beyond Chili Ballpark Nachos, and a Beyond Chili Cheeseburger. In April 2023, only the Beyond Meat Cheeseburger continued to be a menu offering at TGI Fridays.

In October 2021, Panda Express, the largest family-owned and operated Asian dining enterprise in the United States with 2,200 locations in 12 countries, announced that its collaborative partnership with Beyond Meat would introduce "Beyond Orange Chicken™" to menus in 70 locations in 10 states. This lasted until January 2022 when Panda began testing two Beyond Beef menu items at its Innovation Kitchen location in Pasadena, California. In September 2022, Panda Express reintroduced

Beyond Orange Chicken to its menu at all locations in the United States for a limited time, but as of January 2023, the limited time had expired.

Starting in July 2018, A&W Canada introduced the Beyond Meat Burger at all its 925 locations in Canada and sold 90,000 burgers in the first three days.[7] In February 2019, Canada-based Quesada Burritos & Tacos began using Beyond Meat's Feisty Crumbles in its burritos at 120 restaurants.[8] In March 2019, A&W Canada launched the Beyond Meat Sausage & Egger on its breakfast menu nationwide. In August 2021, A&W Canada introduced Beyond Meat's plant-based chicken nuggets as a six- or ten-piece order at all its locations in Canada for a limited time. The A&W locations in the United States tried out the Beyond Burger on its menus for a few weeks in 2021 and then removed it from its menu. In February 2022, A&W Canada began a five-week test of a Jalapeno Lime Beyond Meat® burger at all its 1,000-plus locations across Canada; the burger featured a 7-grain bun, tomato, lettuce, red onion, Beyond Burger® patty and a spicy, tangy Jalapeno lime aioli. In April 2023, the only Beyond Meat product on the A&W Canada menu was a Beyond Meat burger with lettuce, red onion, tomato, pickles, ketchup, mustard, and mayonnaise, served on a sesame seed bun.

As of March 2023, there were six restaurant chains in the United States with a Beyond Meat product on their menus: Peet's Coffee (a breakfast sandwich with Beyond Meat seasoned breakfast sausage patty); Bareburger (a Beyond Burger, along with a black bean burger, a quinoa-based burger, and an Impossible burger); Del Taco (a burrito containing Beyond Meat beef crumbles); TGI Fridays (a Beyond Meat cheeseburger); Carl's Jr. (the Beyond Famous Star Burger and Beyond Famous Star cheeseburger), and BurgerFi (a Beyond Burger).[9]

COMPANY BACKGROUND

Beyond Meat was founded in 2009 by Ethan Brown, and then later incorporated in Delaware in April 2011 under the name "J Green Natural Foods Co." In October 2011, the company changed its corporate name to "Savage River, Inc.," with "Beyond Meat" being its "doing business as" name. In September 2018, the corporate name was changed to "Beyond Meat, Inc." Beyond Meat's principal executive offices were located in El Segundo, California. In 2023, Ethan Brown was president and chief executive officer of Beyond Meat and had served in this capacity throughout all of the corporate transitions since the original company was founded. Brown grew up on a family farm in Maryland that specialized in dairy operations and became fascinated with animal agriculture, meat-raising practices, and animal protein consumption. But he also started to wrestle with a question that continued to nag him for many years to come: Do we need animals to produce meat? During the course of his business and industry career, Brown held a variety of positions in the energy business that provided him with growing familiarity about clean energy technologies, the adverse impacts of animal meat consumption on human health, and the sizeable effects livestock had on greenhouse gas emissions, along with the related burdens cattle-raising had on land, energy, and water.

These experiences expanded his understanding of animal meat. The key thing he learned was that it was not necessary to limit the definition of meat to just cows, pigs, and poultry; rather, meat could just as accurately be defined in terms of its composition and structure—amino acids, lipids, trace minerals, vitamins, and water woven together in the assembly of muscle (or meat). None of these core elements of meat was exclusive to animals; they were abundant in the plant kingdom. While animals served as a bioreactor, consuming vegetation and water and using their digestive system to organize these inputs into meat, it was equally feasible to take the constituent parts of meat from plants and, together with water, organize them into the same basic architecture as animal-based meat, thereby bypassing the need for animals and the cholesterol associated with consuming animal meat.

Then, as climate change issues moved into the public spotlight, Brown became increasingly troubled by studies reporting that the livestock industry was estimated to contribute 18 to 51 percent of global greenhouse gas emissions, depending on the measurement methodology used. And there were numerous studies in medical journals about the adverse impacts of eating red meat on human health, which heightened his concerns about satisfying his children's protein requirements totally with animal meat. In 2009, driven by the health and environmental implications of intensive animal protein production and consumption, Brown decided to found Beyond Meat and begin the process of producing and marketing nutritious and good-tasting plant-based meat products.

Brown's vision for Beyond Meat was to perfectly build a plant-based meat. Believing that there was a better way to feed the planet than by relying so heavily on animal meat, Brown's mission for Beyond Meat was "to create The Future of Protein®—delicious plant-based burgers, beef, sausage, crumbles, and more."[10] The goal was "to deliver a consumer experience that is indistinguishable from that provided by animal-based meats."[11] Brown saw four socially beneficial outcomes associated with Beyond Meat's efforts to try to shift a significant portion of the world's protein requirements from animal to plant-based meat: improving human health, positively impacting climate change, addressing global resource constraints, and improving animal welfare. Beyond Meat's brand commitment, "Eat What You Love," reflected a belief that by eating its plant-based meat offerings, consumers could enjoy more of their favorite protein dishes while helping address concerns related to human health, animal welfare, resource conservation, and climate change.

Beyond Meat's Early Successes

To begin the process of learning how to build a delicious tasting plant-based meat, Brown opened the company's first operation in a small commercial kitchen in Maryland to develop and test recipes for plant-based meat products using (1) proteins from peas, mung beans, fava beans, brown rice, and sunflower seeds; (2) various fats (cocoa butter, coconut oil, sunflower oil, and canola oil); (3) minerals such as calcium, iron, salt, and potassium chloride; and (4) beet juice extract, apple extract, and assorted other natural flavors. Ethan Brown began working extensively with two researchers at the University of Missouri's Bioengineering and Food Science Department and faculty and students in the University of Maryland's Nutrition & Food Science Department. The company ultimately licensed a process developed by the researchers that combined proteins from plants into a basic structure resembling animal muscle, or meat, and used this as an initial foundation for Beyond Meat products.[12] With this basic protein platform and an understanding that parts of meat, namely lipids, trace minerals, and water, were also present in abundance outside the animal, it became clear that with appropriate resources, building meat from plants was indeed possible.

The young company began selling an early plant-based product to Whole Foods Markets in the Mid-Atlantic region. It quickly discovered that traditional veggie burgers and soy-based meat had limited appeal to traditional meat eaters, who commonly criticized their inferior taste.[13] Its own market research with consumers revealed that, when choosing among plant-based meat options, taste was definitely the single most important product attribute for plant-based foods. Legacy vegetarian brands typically aimed to compensate for poor taste appeal by positioning their products as a noble sacrifice—something consumers *should* do for the benefit of their health, the environment, and/or animal welfare.

A "The Future of Protein" marketing campaign was launched in the summer of 2015.[14] The goal was to mobilize brand ambassadors to help raise brand awareness and make Beyond Meat products aspirational. A joint announcement with Leonardo DiCaprio about his becoming a Beyond Meat brand ambassador in October 2017 generated over 378 million earned media impressions, including a viral video that drew more than 8.5 million views.

Beyond Meat launched its flagship Beyond Burger in 2016 and used an unprecedented marketing approach for a vegetarian meat product.[15] Instead of marketing and merchandising the Beyond Burger to vegans and vegetarians (who represented less than five percent of the population in the United States), the company requested that the product be sold in the meat case at grocery retailers where meat-loving consumers were accustomed to shopping for center-of-plate proteins. In May 2016, the Rocky Mountain Division of Whole Foods Market became the first grocery chain to place the Beyond Burger in its meat section alongside animal-based equivalents; soon other Whole Foods Market regions followed. In April 2017, Safeway of Northern California and several Kroger divisions began to do the same. In the Southern California division of Ralph's, a Kroger subsidiary, the Beyond Burger was the number one selling packaged burger patty by unit in the meat case for the 12-week period ending August 4, 2018. Marketing personnel at Beyond Meat believed merchandising the Beyond Burger in the meat case in the retail channel helped drive greater brand awareness with consumers.

During 2017–2019, many restaurant, hotel, and other foodservice customers chose to prominently feature the Beyond Meat/Beyond Burger name on their menu and within item descriptions, in addition to displaying Beyond Meat branded signage.

Beyond Meat used its sales to foodservice businesses as a form of paid trial for its products to help drive additional retail demand and create greater brand awareness for Beyond Meat through the on-menu and in-store publicity it received.[16] Top executives believed that Beyond Meat had established its brand as one with "halo" benefits to its partners as evidenced by the speed of adoption by key partners. For example, Beyond Meat was the fastest new-product launch in the history of TGI Friday's and the millions of Beyond Famous Star burgers sold by Carl's Jr. In A&W's concept and focus group testing to gauge consumers' appetite for a plant-based burger, Beyond Meat's burger received high marks from surprised consumers. A&W CEO, Susan Senecal commented, "We were blown away by the flavor and taste and delicious 'burgerness' of Beyond."[17] On the strength of these results and reports from store managers that guest counts were up, A&W Canada quickly spent a significant sum on television, newspaper, and digital media advertising to call public attention to the addition of the Beyond Burger to its menu.

By late 2018, the Beyond Burger was being merchandised in approximately 17,000 supermarkets and retail groceries across the United States, and food service distributors were delivering the Beyond Burger to approximately 11,000 restaurant and foodservice outlets in the United States. The Beyond Burger launched in Europe in August 2018 through contracts with three major distributors, producing strong expressions of interest from some of Europe's largest grocery and restaurant chains. Beyond Meat's revenues from international markets (excluding Canada) represented 13 percent of net revenues in the first half of 2019, up from 2 percent in the first half of 2018. The company began production of its plant-based products in Europe in 2020 at a new co-manufacturing facility constructed in the Netherlands by Zandbergen World's Finest Meat. In 2018, Zandbergen started distributing Beyond Meat's products throughout Europe across both foodservice and retail grocery channels. Meanwhile, Beyond Meat developed a presence and generated brand awareness in Asia through a local distributor in Hong Kong. Further expansion in Asia occurred in 2020–2021 via the establishment of a co-manufacturing partnership with a firm in a Shanghai suburb and the addition of more local food distributors across China and also in Indonesia.

Throughout 2017–2018 and continuing into 2019, in additions to the efforts of its marketing staff to convince more retail groceries to stock Beyond Meat products and foodservice enterprises to serve dishes containing Beyond Meat products, Beyond Meat relied heavily on its growing number of brand ambassadors (celebrities and influencers), free sampling of its products from food trucks at over 300 special events, a digital newsletter (with over 200,000 subscribers as of September 2018), visits to the company's website, strong social marketing, and consumer word-of-mouth as the cornerstones of a campaign to promote greater consumer awareness of the Beyond Meat brand name. By Spring 2019, the company's website had drawn approximately 5 million visitors; the website featured packages of the company's products, provided information on where they could be purchased (whether retail or served in a food establishment), highlighted nutritional facts and news about the company, and offered an assortment of recipes for using its products. In August 2020, Beyond Meat launched an e-commerce site and began offering its products direct to consumers in Classic Cookout packs with 8 servings, mixed product bundles, and 4-product trial packs. To spur sales, the website occasionally featured limited time price discounts on particular items.

As of 2018, Beyond Meat operated approximately 100,000 square feet of production space in two facilities in Columbia, Missouri, where it manufactured the woven protein that was the key ingredient of its products. This woven protein was then converted according to the company's proprietary formulas and specifications into a packaged product, either at the facilities in Columbia, Missouri, or by a network of comanufacturers. All third-party co-manufacturers signed nondisclosure agreements to ensure that Beyond Meat's proprietary intellectual property and trade secrets were protected. Management believed that the partnering with comanufacturers (who produced Beyond Meat products in facilities alongside their own products) was a capital efficient production model that allowed Beyond Meat to scale production more quickly and cost-effectively to supply the rapidly increasing demand for its products. In 2020, Beyond Meat opened a second facility in Pennsylvania to produce its growing need for woven protein. Plans called for the company to continue expanding its internal woven protein production facilities domestically and abroad to produce the needed volume of woven protein while forming additional strategic relationships with comanufacturers to complete the manufacturing and packaging of the items comprising Beyond Meat's product line.

In 2018, the United Nations officially called attention to the trailblazing accomplishments of Beyond Meat and Ethan Brown, awarding them its highest environmental accolade, "Champion of the Earth."

Beyond Meat Becomes a Public Company

Shortly after the corporate name change to Beyond Meat in September 2018, the company filed Form S-1 with the Securities and Exchange Commission seeking approval to conduct an initial public offering of its common stock. Beyond Meat shares began trading on the Nasdaq Global Select Market on May 2, 2019, under the ticker symbol "BYND." The opening trade for the stock was $46 and trading on the first day closed at $65.75, 163 percent above the $25 per share IPO price. Buoyed by investor enthusiasm over the company's long-term prospects, the stock price climbed steadily higher in the ensuing weeks and months, reaching a peak of $234.90 on July 22, 2019. Various analysts estimated that the market for plant-based protein products could reach $85 billion in sales by 2030. But investor excitement and aggressive buying of Beyond Meat stock quickly started cooling off in the remainder of 2019, as scrappy rival Impossible Foods announced major new grocery and restaurant chain customers for its plant-based Impossible Burger and as such major meat producers as Tyson Foods, Smithfield Foods, Perdue Farms, Nestlé, Hormel Foods, and Maple Leaf Foods all announced introductions of variously formulated plant-based meat alternatives and began shipping an array of plant-based burgers, ground meat, sausage, and chicken products to their supermarket customers for display in both fresh and frozen meat sections. By late October 2019, Beyond Meat's stock price had plummeted to the low 80s and by December 2019 was trading in the mid-70s.

Nonetheless, headed into 2020, Beyond Meat was viewed as one of the fastest growing food companies in the United States. Company revenues had increased from $8.8 million in 2015 to $32.6 million in 2017 to $88 million in 2018 to $298 million in 2019, equal to a compound annual growth rate of 102 percent. The company's revenue growth continued to $407 million in 2020 (36.6 percent over 2019) and to $464.7 in million in 2021 (14.2 percent over 2020); the slower percentage growth in 2021 was partly attributable to a falloff in sales to foodservice enterprises that stemmed from the COVID-19 pandemic, which greatly reduced sales to restaurants and food service institutions due to temporary lockdowns, mask mandates, and consumer reluctance to dine outside the home. However, the company's revenue growth in 2020–2021 was buoyed by increases in grocery channel purchases of Beyond Meat products by consumers for in-home meals and also by rapid growth in the number of grocery stores and supermarkets in Europe and China stocking Beyond Meat products.

EXHIBIT 1 Beyond Meat's Net Revenues by Distribution Channel, 2019–2022 (in thousands)

	Year Ending December 31			
Distribution Channel	**2019**	**2020**	**2021**	**2022**
United States:				
Retail	$129,383	$264,111	$243,360	$234,744
Foodservice	70,372	60,763	76,475	69,289
United States Net Revenues	199,775	324,874	319,835	304,033
International:				
Retail	15,426	36,472	81,483	60,907
Foodservice	82,716	45,439	63,382	53,993
International Net Revenues	98,142	81,911	144,865	114,900
Total Net Revenues	$297,897	$406,785	$464,700	$418,923

Headed into 2022, Beyond Meat's portfolio of plant-based meats had grown to include several flavors/varieties of Beyond Sausages, a Beyond Breakfast Sausage (patties and links), one-pound packages of ground Beyond Beef, 12-count packages of Beyond Meatballs, and two flavors of frozen Beyond Beef crumbles and one flavor of frozen Beyond Chicken Tenders that were located in the frozen meat section at grocery retailers. As year-end 2021, the company's fresh and frozen plant-based protein products were being sold at approximately 130,000 grocery stores, restaurants, hotels, and other foodservice outlets in more than 90 countries worldwide.

Exhibit 2 shows Beyond Meat's quarterly revenues from 2019 forward to Q1 of 2023. Exhibit 3 shows the company's recent financial performance.

BEYOND MEAT'S STRATEGY

During 2016–2021, Beyond Meat's revenue growth was driven largely by three factors:

- Expanding its lineup of plant-based protein products.
- Securing additional retail grocery customers to stock and merchandise its products and additional foodservice firms (chiefly dine-in restaurants and fast-food chains) to include its Beyond Meat burgers and other products on their menus.
- Expanding its geographic coverage to include a growing number of countries/cities/towns across the world.

EXHIBIT 2 Beyond Meat's Quarterly Net Revenues, 2019 through Q2, 2023

	2019	2020	2021	2022	2023
Quarter 1	$ 40.2 million	$ 97.1 million	$ 108.2 million	$ 109.5 million	$ 92.2 million
Quarter 2	67.3 million	113.3 million	149.4 million	147.0 million	102.1 million
Quarter 3	92.0 million	94.4 million	106.4 million	82.5 million	
Quarter 4	98.5 million	101.9 million	100.7 million	79.9 million	
Annual Total	$ 297.9 million	$ 406.8 million	$ 464.7 million	$ 418.9 million	

Sources: Presentation at Barclay's Global Consumer Staples Conference, September 5, 2019, posted in the Investor Relations section at **www.beyondmeat.com** (accessed December 10, 2019); Company 10-K Report 2020, 2021, and 2022; company press releases, May 10, 2023, and August 7, 2023.

EXHIBIT 3 Selected Financial Data for Beyond Meat, 2019–2022 (in thousands)

Selected Income Statement Data	2019	2020	2021	2022
Net Revenues	$297,897	$406,785	$ 464,700	$ 418,933
Cost of goods sold	198,141	284,510	347,419	442,676
Gross profit (loss)	99,756	122,275	117,281	(23,743)
Research and development	20,650	31,535	66,946	62,264
Selling, general, and administrative expenses	74,726	133,655	209,474	
Restructuring expenses	4,869	6,430	15,794	17,259
Total operating expenses	100,245	171,620	292,214	319,028
Loss from operations	(489)	(49,345)	(174,933)	(342,771)
Other income (expense), net				
Interest expense	(3,071)	(2,576)	(3,648)	(3,966)
Remeasurement of warrant liability	(12,503)	-----	------	-----
Other, net	3,629	(759)	(487)	(420)
Total other (income) expense, net	(11,945)	(3,335)	(4,135)	(4,386)

Selected Income Statement Data	2019	2020	2021	2022
Loss before taxes	(12,434)	(52,680)	(179,068)	(347,157)
Income tax (benefit) expense	9	72	60	32
Net profit (loss)	$ (12,443)	(52,752)	(182,105)	(366,127)
Weighted average shares of common stock outstanding	42,275	62,290	63,172	62,290
Selected Balance Sheet Data				
Cash and cash equivalents	$275,988	$159,127	$ 733,294	$ 309,922
Inventory	81,596	121,717	241,870	235,696
Total current assets	403,594	332,226	1,052,048	606,459
Property, plant, and equipment, net	47,474	115,299	226,489	257,002
Total assets	451,923	468,006	1,379,399	1.062,224
Total current liabilities	47,697	88,967	94,189	75,841
Total long-term liabilities	20,136	11,942	1,152,715	1,189,931
Total stockholders' equity (deficit)	$384,090	$367,097	$ 132,495	($203,548)
Selected Cash Flow Data				
Net cash used in operating activities	$ (46,995)	$ (39,995)	$(301,370)	$ (320,244)
Capital expenditures	23,795	57,696	135,961	57,696
Net cash provided by financing activities	294,876	(1,762)	1,022,322	276

Source: Company 10-K Report, 2019, 2020, 2021, and 2022.

The company's plant-based burger patties had been its best-selling product since they were first introduced in 2016; there were two 4-ounce patties per package, and the typical retail price in 2022 was about $5.99. A marbled, meatier-tasting burger patty was introduced in June 2019, replacing two earlier versions; further updated versions of the patty were introduced in 2020–2021. Starting in 2020 Cookout Classic eight-patty packages were introduced; these packages retailed for about $9.99 and were located in the frozen meat cases at grocery retailers. The company's second biggest seller was Beyond Sausage, introduced in 2018, which was available in 2022 in three varieties, Bratwurst, Sweet Italian, and Hot Italian; the normal retail price for a four-link package was $7.99. Frozen Beyond Beef Crumbles, available in two flavors—Beefy and Feisty, became widely available in early 2018 and retailed for about $5.99 per 10-ounce package; these crumbles could be used in chili, tacos, spaghetti, lasagna, pizza toppings, and other recipes calling for ground meat. In mid-2019, the company introduced a one-pound plastic-sealed package of ground plant-based beef that could be used in any ground beef recipe, including chili, spaghetti sauce, meatballs, burgers, and tacos. This product was very similar in appearance to the branded one-pound ground beef packages found in the fresh meat cases at supermarkets and grocery stores. The company's Beyond Breakfast Sausage patties and links began hitting the shelves of large supermarket chains in March 2020; as of 2023, the company was marketing Beyond Breakfast Sausage in three varieties—Classic and Spicy Patties (six patties per package for $4.29) in the fresh meat section and Classic Links (eight links per package for $4.99) in the frozen meat section. In September 2020, the company introduced 12-piece packages of Italian Style Beyond Meatballs at a retail price of $5.99. In 2020, Beyond Meat began marketing Beyond Mince, a product developed especially for consumers in European countries, and in 2021 the company launched Beyond Pork in China because of pork's high popularity in China.

In early 2022, Beyond Chicken breaded tenders began appearing in the frozen meat cases of many supermarket chains in North America at a retail price of $4.99 for an 8-ounce package (six tenders). On March 23, 2022, Beyond Meat and PepsiCo announced the introduction of Beyond Meat Jerky manufactured by the two companies' joint-venture Planet Partnership, LLC. The plant-based product was marinated and slow-roasted in three flavors—Original, Hot & Spicy, and Teriyaki—and was available in three different size plastic packages. Beyond Meat Jerky was the company's first shelf-stable product, and its addition to the product lineup allowed the company's salesforce in the United States to quickly secure 43,000 new points of distribution to gas stations, convenience stores, and drugstores in Q2 of 2022; the plant-based Jerky packages were usually located on shelves next to animal jerky products and other on-the-go snack foods. In October 2022, Beyond Meat debuted frozen Beyond Steak seared tips at a retail price of $7.99 for a 10 oz package. In November 2022, Beyond Meat added Beyond Chicken Nuggets and Popcorn Chicken to its frozen plant-based chicken offerings—these were sold at a retail price of $5.49 for a 10 oz package.

Also, in 2022 Beyond Meat conducted tests of Beyond Carne Asada and Beyond Fried Chicken in the U.S. foodservice channel, Beyond Italian Sausage Crumbles in the Canadian foodservice channel, and Beyond Dumplings and Beyond Meat Plant-based Pork Patties in China ecommerce channels.

R&D Strategy

Research, product development, and product innovation were core elements of Beyond Meat's business strategy, and top management believed its growing R&D capabilities represented a valuable competitive advantage over rival companies seeking to compete in the market for plant-based meat products. Since 2017, Beyond Meat had invested increasing amounts in research, development, and product innovation—spending $5.7 million in 2017, $9.6 million in 2018, $20.7 million in 2019, $31.5 million in 2020, $66.9 million in 2021, and $62.3 million in 2022. In 2018, the company opened a state-of-the-art 30,000 square-foot Manhattan Beach Project Innovation Center as a part of its world headquarters complex in El Segundo, California. The Innovation Center included five laboratories, a pilot plant, and a test kitchen and was staffed with a team of scientists, engineers, and cooking specialists whose principal task was improving the company's existing products and developing new products that better replicated the sensory experience of animal meats.

In 2023, Beyond Meat's recently renamed Rapid and Relentless Innovation Program at the company's El Segundo headquarters had grown to include over 170 scientists from such disciplines as chemistry, biology, materials, food science, and biophysics who collaborated with process engineers and culinary specialists. New product development and testing was focused on three core plant-based product platforms that matched the three largest animal meat categories globally: beef, pork, and poultry. The chief objectives were to expand the company's product offerings, to develop and test to improve the formulations of existing products, and to develop new techniques and recipes for making new plant-based meat products. New learning about taste, texture, and aroma for one product was quickly applied to the formulations of other existing product offerings and tested for use in products still in the development stage. As the company's knowledge and expertise had deepened, its pace of innovation had accelerated, allowing for reduced time between new product launches. It was standard practice for upgrades of existing products and newly developed products to be quickly introduced in the marketplace once they had passed the in-house testing process.

In addition, the innovation team devoted time and effort to exploring and testing the use of additional plant protein options, searching for ingredients that could be sourced more easily or more cheaply than current plant ingredients and/or that would enhance the quality, taste, and flavor appeal of current product offerings.

Growth Strategy

In response to the current difficult environment and the negative impact of certain factors on our business and the overall plant-based category, beginning in the fourth quarter of 2022 Beyond Meat executives pivoted the company's strategy toward sustainable long-term growth supported by three pillars: (1) driving margin recovery and operating expense reduction through the implementation of lean value streams across the company's beef, pork, and poultry platforms; (2) inventory reduction and cash flow generation through more efficient inventory management; and (3) focusing on near-term retail and foodservice growth drivers while supporting strategic key long-term partners and opportunities. By "lean value streams," the company meant organizing teams and operational approaches in such a way that increased cross-functional collaboration, transparency and ownership of key business processes and initiatives, with an overarching objective of eliminating waste throughout the organization. Top management believed, if implemented effectively, the use of a lean value stream approach could increase the speed with which new products could be introduced in the marketplace, which in turn could accelerate sales growth, increase the pace of cutting production costs and other operating expenses, and boost gross profit margins.

In 2023, the company's efforts to reduce costs over time so that it could price its products at parity with animal protein products included implementing competitive bidding for ingredients purchased from suppliers, endeavoring to operate its production facilities more efficiently, streamlining its internal fulfillment network, reformulating products to achieve lower ingredient costs, and reducing the size of its workforce (which occurred in August and October 2022).

Distribution Strategy

Meat was the largest category in food. In terms of dollars, the size of the global market for animal meat in 2023 was estimated to be about $1.3 trillion and was projected to grow 7.5 percent annually through 2027.[18] The most common sources of meat were domesticated animal species such as cattle, pigs, poultry, and, to a lesser extent, buffaloes, sheep, and goats.[19] In some regions of the world, other animal species were also eaten as meat. Pork was the most widely eaten meat in the world accounting for roughly 40 percent of the world meat intake, followed by poultry and beef with about 35 percent and 22 percent respectively.[20]

Because the global market for meat was so large, Beyond Meat executives saw ample room for the company to become and remain the major disruptor in the animal meat category worldwide for some years to come. To achieve this role as a major disruptor and change agent in the market for meat, it was essential for Beyond Meat to sustain its efforts and successes in securing additional distribution points in the North American and international grocery and foodservice channels in 2023 and beyond. However, because the United States had the highest level of animal meat consumption per person of any country in the world, management considered the United States as the company's core target market from a geographical standpoint. The Statista Market Research group forecast that in 2022 China would be the country with the largest sales of plant-based meat substitute products (~$2.1 billion) followed by the United States with sales of $1.5 billion, and the United Kingdom with estimated sales of $847 million; Russia and Germany rounded out the top five.[21] The market for plant-based meat substitutes worldwide was estimated to be $10.1 billion in 2022 and was projected to reach $34 billion in 2027.[22]

As had been the case every year during 2019–2022, the chief component of Beyond Meat's strategy for acquiring new customers and achieving greater penetration of the retail grocery, restaurant, and foodservice channels entailed hiring additional numbers of experienced sales and marketing personnel to establish relationships with strategically important full-service restaurant chains and fast-food chains and to expand its partnerships with foodservice distributors in all of the geographic markets and countries where it had a presence. The goals were to be a "best-in-class" partner in developing plant-based menu items for customers, to drive adoption of Beyond Meat products in the retail grocery, restaurant, and foodservice channels, and to increase the speed and availability with which the company could get its products to all types of domestic and international customers.

During 2019–2022, Beyond Meat succeeded in expanding its market footprint in the retail grocery and foodservice channels from 94,000 points of distribution in grocery, restaurant, and foodservice outlets in 65 countries at year-end 2019 to 190,000 points in about 80 countries at year-end 2022. In early 2023, Beyond Meat executives believed there was still significant opportunity to expand beyond the company's current market footprint in the retail grocery, restaurant, and foodservice channels, both in the countries where its products were currently being marketed and in the countries that the company had not yet entered. However, in the first two quarters of 2023, the company reported it ended quarter 1 with a total of 191,000 distribution points and ended quarter 2 with just 190,000 distribution points.[23]

Major supermarket chains marketing Beyond Meat products during 2019–2022 included Kroger/City Market, Albertson's, Publix, Whole Foods Market, Target, Walmart, Costco, Giant, Hannaford, Stop & Shop, Safeway, Harris Teeter, Natural Grocers, Jewel-Osco, Food Lion, Ralph's, Wegmans, Sprouts Farmer's Market, The Fresh Market, Mariano's, Loblaws, and Sobeys. Restaurant and foodservice outlets offering Beyond Meat products in North America included Dunkin' Brands, Burger King, Del Taco, Pizza Hut, KFC, Panda Express, Carl's Jr. (approximately 1,100 units), TGI Friday's, BurgerFi, Tim Horton's, Chronic Tacos, Hello Fresh, Bareburger, WhiteSpot, A&W, Cinemark Theaters, Disney World, Marriott and Hilton hotels, and foodservice distributor Sysco. The company was aggressively developing more relationships with international grocery chain customers including Tesco (Great Britain and 6 other countries in Central Europe and Asia); Sainsbury's and Waitrose (Great Britain); Kesko (Finland); Edeka, Kaufland, Tegut, Famila, and Real (Germany); Carrefour, Monoprix, Franprix, Casino Supermarchés, and Géant (France); Coop (Denmark, Sweden, and Norway); Spar, Billa, and Billa Plus (Austria); Migros (Switzerland); Lidl (28 European countries), Albert Heijn and Jumbo (Netherlands); Ahold Delhaize (Netherlands, Belgium, five other European countries, Greece, and Indonesia); Coles (Australia, Indonesia); Alibaba (China); IGA, Woolworths, and Coles (Australia); and Countdown (New Zealand).

Exhibit 4 presents the approximate number of distribution outlets by channel by quarter for the period 2021 through Q1 2023.

Grocery Channel Strategy. In the grocery channel, Beyond Meat's strategic objective was to capitalize on the company's success as the first plant-based protein offering in supermarket meat cases not only by growing the number of supermarkets and grocery stores carrying Beyond Meat's products but also (1) by adding more plant-based meat products to its offerings in supermarket fresh and frozen meat cases and (2) by helping drive increases in the overall size of the plant-based protein category, as more consumers shifted their diets away from animal-based proteins.

The Restaurant and Fast-Food Channel. It was a key element of Beyond Meat's strategy to do everything it could to disrupt the animal meat offerings in the restaurant channel by getting its plant-based meat products on more full service and quick service restaurant menus across an ever wider geographic area and in more dishes on these menus. This meant devoting more resources to (1) outcompeting rival Impossible Meats and other new entrants in the plant-based meat category in convincing restaurants to use its branded products in their plant-based meat offerings rather than the brands of other makers of plant-based meats

EXHIBIT 4 The Approximate Number of Retail and Food Service Distribution Points for Beyond Meat Products in the United States and Internationally, by Quarter, 2021 through Q2 of 2023

	Q1 2021	Q2 2021	Q3 2021	Q4 2021	Q1 2022	Q2 2022	Q3 2022	Q4 2022	Q1 2023	Q2 2023
United States:										
Retail[1]	32,000	34,000	34,000	34,000	35,000	78,000	78,000	78,000	78,000	79,000
Foodservice	39,000	34,000	36,000	38,000	39,000	41,000	42,000	43,000	42,000	41,000
International:										
Retail	24,000	29,000	32,000	30,000	31,000	33,000	35,000	35,000	36,000	36,000
Foodservice	23,000	22,000	26,000	28,000	30,000	31,000	33,000	34,000	35,000	34,000
Total distribution points	118,000	119,000	128,000	130,000	135,000	183,000	188,000	190,000	191,000	190,000

(1) Quarters 2, 3, and 4 of 2022 and Quarters 1 and 2 of 2023 include additional distribution points in the United States associated with the recently introduced Beyond Meat Jerky. Excluding Beyond Meat Jerky, total retail distribution outlets in the United States were approximately 35,000 in Q2 and 34,000 in Q3 of 2022. Sales of Beyond Meat Jerky were discontinued briefly in Q4 2022 to implement a reformulation of the product and then quickly reintroduced.

Source: Company press releases, November 9, 2022; February 23, 2023; and August 7, 2023.

and (2) partnering closely with dine-in restaurant chains and fast-food chains to develop customized Beyond Meat products and dishes that were deemed particularly suitable and attractive to the customers of these enterprises. Specialists in the company's Rapid and Relentless Innovation Program were a competitively valuable resource in helping dine-in restaurants chains and fast-food chains create flavorful and appealing dishes with Beyond Meat products, customize them as needed to fit the customer's kitchen and food preparation requirements, test the reaction of customers to the dishes at several locations over a multi-week period, and make adjustments as needed.

The Foodservice Distributor Channel. Growing the sales of Beyond Meat products to food distributors who supplied food products to the food operations at airports, hospitals, schools, hotels, convention centers, country clubs, banquet facilities, concerts and sporting events, and other such venues where food was served was one of the company's important strategic objectives. Management believed that the appearance of Beyond plant-based meat products on the menus of these organizations and at these venues not only helped satisfy growing customer demand for an alternative to animal meat but also was a meaningful source of revenue and a means of broadening consumer awareness of the Beyond Meat brand name. Hence, having a sufficiently large sales staff to call on foodservice distributors and food vendors in those geographic markets where Beyond Meat had a market presence was standard practice.

Sales and Marketing Activities. The company's sales and commercial personnel were organized into four divisions, retail, foodservice, international, and strategic partnerships. Sales team members typically had an extensive range of experience from previous jobs in leading natural food, meat, and plant-based protein companies. They worked in close coordination with a national network of broker and distributor sales teams that gave Beyond Meat access to accounts across the United States and internationally, as well as directly with the purchasing teams of large retail and foodservice customers. Beyond Meat routinely offered sales discounts and promotions to its customers and to consumers. These included rebates, temporary on shelf price reductions, buy-one-get-one-free programs, off invoice discounts, retailer advertisements, and product coupons. Price discounts and special price promotions were used extensively by Beyond Meat during the last three quarters of 2022 in order to help counter the growing tendency of budget-constrained consumers to shift their purchases to lower-priced animal meat substitutes—rising prices for food products in many locations had created situations where the prices of plant-based meats were often from 25 percent to as much as 75 percent higher than animal meat products.

In addition, Beyond Meat had an active field marketing team that used company food trucks to sample Beyond Meat products directly with consumers in stores and at events where food was served. In March 2020 and continuing into 2021–2022 when the COVID-19 pandemic produced stay-at-home orders, distancing, temporary business closings, mask mandates, and vaccine mandates, the company's food truck operations were suspended and diverted to feeding frontline workers through the company's Feed A Million+ campaign and through food banks across the United States. The field marketing staff also supported content creation and certain media campaigns and activities, as well as recruiting influencers and brand ambassadors and activating new customers. As soon as the magnitude and effects of the COVID-19 pandemic allowed, Beyond Meat's field marketing staff resumed their efforts to sample products directly with consumers in stores and at relevant events where food was served.

Beyond Meat extensively used social media platforms such as Facebook, Instagram, Twitter, and LinkedIn to supplement all of its other means of engaging with consumers and in particular to directly reach desirable target demographics such as millennials and "Generation Z." Examples of Beyond Meat's social media activities included the following:

- **Facebook** The company maintained a Facebook page that was utilized to facilitate consumer services, distribute brand information and news, publish videos and pictures promoting the brand, and conduct regular contests and giveaways. As of April 2023, Beyond Meat had about 470,000 Facebook followers.
- **Instagram:** Beyond Meat had an active company Instagram account, @beyondmeat, that was used to publish content related to its products and to the company and to better connect with potential and existing consumers. It frequently published news of celebrities promoting Beyond Meat's products and core values. As of March 2023, the company had roughly 1 million Instagram followers.

- **Twitter** The company used its Twitter account, @ BeyondMeat, to disseminate trending news and information, to publish short format tips, tricks. and shortcuts, and to regularly interact with consumers. As of April 2023, Beyond Meat had 137,000 Twitter followers.
- **LinkedIn:** The company used its LinkedIn account to disseminate news related to Beyond Meat and industry-related media and information. Its LinkedIn account was also used as a job board for individuals interested in working at Beyond Meat. As of April 2023, Beyond Meat had 163,000 LinkedIn followers.

Strategy to Drive Brand Awareness and Interest in Beyond Meat Products

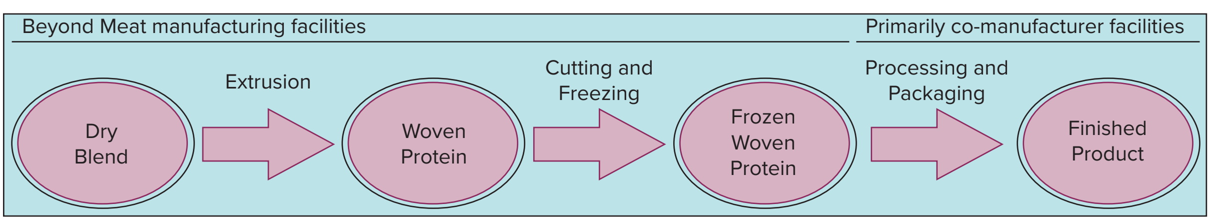
Beyond Meat used five primary means to drive consumer awareness and interest in its products:

- Social media and the variety of information on the company's website.
- Public relations activities (announcements of company news, company awards, and special company activities).
- Recruitment of brand ambassadors and influencers (such as celebrities from the worlds of sports and entertainment who liked the company's products and overall mission or who shared the company's core values about the benefits of eating plant-based substitutes for animal meat, protecting the environment, promoting agricultural sustainability, and helping to ward off climate change). Going into 2023, the company had attracted a large following of celebrities.
- Restaurant promotions about Beyond Meat products on their menus
- Grocery store signage and price promotions for Beyond Meat products displayed in their fresh and frozen meat shelves.
- Strategic partnerships with full-service restaurants and fast-food chains to create and use Beyond Meat products on their menus.

Production Strategy

The core of Beyond Meat's production strategy was to invest in state-of-the art domestic and international production facilities and expand the capacity of these as needed to supply all of the company's requirements for woven protein, the principal ingredient of its plant-based products. Self-manufacture of woven protein allowed the company to keep the details of its manufacturing process for woven protein proprietary, thereby making it harder for rival makers of plant-based protein products to replicate the meat-like texture of Beyond Meat's products—see Exhibit 5. The remainder of the manufacturing process was either done at company-owned and -operated manufacturing facilities devoted to completing the manufacturing process and packaging the finished products for shipment to customers or by partnering with "co-manufacturers" to complete the production process in facilities they operated. While the company initially completed the manufacture of Beyond Burger patties that it sold to the *foodservice* channel at its production facilities in Columbia, Missouri, it depended on its comanufacturing partners to complete the production process for Beyond Burger patties sold through retail grocery channels and for all of its other products at facilities operated by the comanufacturers. All third-party comanufacturers signed nondisclosure agreements to ensure that Beyond Meat's proprietary intellectual property and trade secrets were protected.

EXHIBIT 5 Beyond Meat's Manufacturing Process



Source: Beyond Meat, Form S-1, November 16, 2018, p. 92.

In the first quarter of 2019, Beyond Meat's internal monthly production capacity was triple what it had been in the second quarter of 2018. Further increases in production capacity occurred in the remainder of 2019 and in early 2020. The company had ongoing efforts underway to evaluate and improve the company's supply chain processes for woven protein and to collaborate closely with the growing number of its comanufacturing partners to increase manufacturing efficiencies and product quality, while reducing overall production costs.

Beyond Meat's manufacturing process for woven protein is displayed in Exhibit 5. The first manufacturing step was to mix a dry blend containing pea protein. The dry blend then entered an extruder, where both water and steam were added. A combination of heating, cooling, and variations of pressure were used to weave together the pea protein into formed woven protein, which was used as the basis for all of the company's products.

The formed woven protein not used to produce Beyond Meat patties for foodservice customers in North America was then cut into smaller pieces to expedite the freezing process, and the frozen woven protein was shipped via third-party logistic providers to cold storage facilities or directly to production facilities operated by the company or its comanufacturing partners. At the final production facility, thawed woven protein was further processed by adding binding agents, other ingredients that provided texture, and flavorings, after which the final product was packaged and then shipped frozen to retail grocery stores and foodservice distributors.

All of the flavorings used in Beyond Meat products were custom-developed at the company's Innovation Center by its team of researchers, chefs, and recipe specialists working in close collaboration with its flavoring suppliers. Ingredients in the flavoring were qualified through trials to ensure manufacturability. Flavoring formulas, all for exclusive use only in Beyond Meat products, were extensively tested prior to introduction to ensure finished product attributes such as taste, texture, aroma, and appearance were not negatively impacted. When the company's flavoring suppliers received ingredients for the flavors they were to manufacture for Beyond Meat, they had to submit Certificates of Analysis confirming that Beyond Meat's rigorous standards had been met. Upon receipt of the ingredients, Beyond Meat received Certificates of Analysis from its suppliers to confirm that its rigorous quality control standards had been met.

All Beyond Meat products were made from simple ingredients without GMOs, bioengineered ingredients, hormones, antibiotics, or cholesterol. All of its products were also gluten-free and lower in saturated fats than their animal-based equivalents. With the exception of certain flavors of Beyond Beef Crumbles which were not certified Kosher, all Beyond Meat products were certified Kosher and Halal.

To control the quality of its products throughout the production process, the company utilized a type of Six Sigma quality control process called DMAIC (short for "define, measure, analyze, improve and control") that served to "improve, optimize, and stabilize" its product formulation and production processes. In-process quality checks were performed throughout the manufacturing process, including temperature, physical dimension, and weight. Specific instructions were provided to foodservice vendors and restaurants for storing and cooking the company's products. Cooking instructions for frozen products, which were intended to be prepared from their frozen state, were on the packaging.

As the company's sales in Europe and Asia expanded in 2020 and 2021, the company established facilities for manufacturing woven protein in first Europe and then in Asia. In Europe the final manufacturing and packing was done at a new co-manufacturing facility constructed in the Netherlands by Zandbergen World's Finest Meat. In 2018, Zandbergen started distributing Beyond Meat's products throughout Europe across both foodservice and retail grocery channels. In 2020, Beyond Meat acquired land and a 46,000 square foot manufacturing facility in Enschede, the Netherlands, to produce woven protein for use in Beyond Meat products being sold in Europe and the Middle East. Later in 2020, the company acquired 19.34 acres of land and an approximately 92,000 square-foot manufacturing facility and related improvements from its former comanufacturer, Zandbergen, for the purpose of switching from comanufacturing to in-house finished goods manufacturing and packaging because Beyond Meat believed it would prove it was cheaper and enabled tighter quality control. In Asia, Beyond Meat leased a facility to manufacture woven protein but initially utilized a comanufacturer located in a Shanghai suburb to handle final manufacture and packaging. In 2021, Beyond Meat arranged to lease the Asian co-manufacturer's 38,000 square-foot facility and, after various renovations and improvements, began producing woven protein, performing all of the final manufacturing activities, and packaging for sale to customers in Southeast Asia, Australia, and New Zealand.

In 2022, when Beyond Meat's sales turned sharply downward and top management decided in the third quarter to transition to an operating model focused on positive cash flow and profitability, the decision was made to restructure all of the company's comanufacturing agreements, right-size its production network, in-source a bigger percentage of its production volumes, and more efficiently manage production staffing levels to better match its now smaller production requirements. By February 2023, Beyond Meat had successfully reduced its North American external manufacturing footprint from a peak of eight co-manufacturers in 2022 to three, enabling the company to eliminate its exposure to underutilization or idle time penalties and avoid an estimated $8 million of potential fees in 2023.[24]

Supply Chain Practices

Raw Material Procurement Beyond Meat's products had about 20 ingredients (the Beyond Beef burger had 22)—these included pea protein isolate, canola oil, coconut oil, amino acids, lipids, trace minerals, vitamins, salt, methylcellulose (a binding agent), and assorted flavorings. The company procured raw materials for woven protein that were readily available from a number of different suppliers, except for pea protein, which was purchased from a single supplier under a multiyear agreement that expired at year-end 2023. Most other needed ingredients and supplies were purchased on a purchase order or competitive bid basis. Most of the raw materials used in flavoring Beyond Meat products were readily available in the marketplace from many suppliers; management believed that within a reasonable period of time it could make satisfactory alternative supply arrangements in the event of an interruption of supply from its existing vendors.

All flavorings in the company's products were developed at the company's Innovation Center in collaboration with the suppliers chosen to produce the flavors, and all these flavorings were produced *exclusively* for use in Beyond Meat products. Flavoring ingredients considered for use were qualified through trials at Beyond Meat's Innovation Center to ensure manufacturability. The Innovation Center staff, using only ingredients deemed manufacturable, created a number of alternative formulas for each of the flavors being considered for use in one or more products. Each formula was extensively tested to identify the specific flavoring formula and the specific combination of flavorings that best impacted the final product's taste, texture, and appearance. While supplies of each ingredient in a flavoring were obtained directly by the supplier producing a specific flavoring for Beyond Meat, as new ingredient shipments arrived at a flavoring supplier's production facilities, the supplier was required to submit a Certificate of Analysis to Beyond Meat to confirm that the ingredient quality and flavoring formula used in production runs met the quality control standards previously established at the Innovation Center.

Packaging supplies for products manufactured in the United States were sourced from domestic suppliers with the exception of the Beyond Sausage tray which was sourced from China; the company maintained approximately 10 weeks of inventory of sausage trays to mitigate the risk of supply interruptions. Likewise, packaging supplies for products manufactured in Europe were sourced from European suppliers, and packing products for products manufactured at Beyond Meat's facilities in China were sourced from Chinese suppliers. Packaging specifications for all products were clearly defined and provided to all packaging suppliers.

Shipping All Beyond Meat products were shipped to customers frozen. Retail grocery stores merchandising burgers, beef, sausage, and meatballs in refrigerated fresh meat cases as part of Beyond Meat's "fresh" platform had to apply a "use by date" sticker of seven days for Beyond Sausage or ten days for The Beyond Burger, Beyond Beef. and Beyond Meatballs; at the end of the use-by date, unsold packages in fresh meat cases had to be discarded (or, prior to the use-by date, moved to a freezer case). In addition to or as a substitute for their fresh meat displays of Beyond Meat products, some supermarkets and smaller groceries kept incoming shipments of frozen Beyond Meat products in a frozen state and placed the packages in their frozen meat cases alongside various branded packages of frozen chicken and animal meat patties; this was done partly (often mainly) to avoid spoilage losses of fresh products—the frozen versions required no use-by dates. It was customary for all Beyond Meat products not displayed in fresh meat cases to be stocked in frozen cases adjacent to other frozen meat products.

Foodservice customers receiving shipments of frozen Beyond Meat products were provided instructions either for immediately cooking or for "slacking," which was typically done by moving frozen packages to a refrigerator to allow them to slowly and safely thaw before cooking.

COMPETITORS

Beyond Meat operated in a highly competitive environment that included both animal protein suppliers and plant-based meat suppliers. In North America, the leading suppliers of fresh meats (beef, pork, and poultry) and assorted branded meat products included

- The world's largest meat supplier, JBS, a company headquartered in Brazil whose meat portfolio consisted of Swift® beef and pork products, 19 brands of fresh beef and hamburger, Butterball® brand turkey, and Pilgrim's Pride® chicken.
- Tyson Foods, a global supplier of meats with 2022 sales of $53 billion and a meat portfolio that consisted of Tyson® fresh and frozen chicken products, fresh beef and pork, and such meat brands as Jimmy Dean®, Hillshire Farms®, Ball Park®, Wright®, Aidells®, IBP®, Bryan, and State Fair®.
- China-based WH Group, whose North American brands included Smithfield pork products, Eckrich®, Nathan's®, Farmland®, John Morrell®, Armour®, Gwaltney®, and Cook's® hams. In 2022, Farmland was marketing plant-based burgers, meatballs, breakfast sausage patties, one-pound packages of plant-based ground meat, and four versions of preseasoned, plant-based protein starters under the Pure® brand; all were displayed in grocers' refrigerated meat sections.
- Cargill, a privately owned company and one of the world's biggest global suppliers of fresh beef and poultry products, had 2022 sales of $165 billion, with operations in 70 countries and sales in 125 countries. In 2023, Cargill was a major supplier of plant-based ingredients for use in plant-based food products and the largest private-label supplier of plant-based food products for a wide variety of food enterprises.
- Hormel, with 2022 sales of $12.5 billion, was a well-known company whose meat brands included Hormel® bacon and chili, Applegate® (bacon, breakfast and dinner sausage, chicken burgers and strips, hot dogs, frozen beef and turkey burgers), Jennie-O® turkey, Lloyd's barbecue, and Columbus® deli meats. Hormel began marketing plant-based protein products under the brand name Happy Little Plants® in 2019. In 2023, the company's products being marketed under the Happy Little Plants brand included pepperoni-style, Italian-style, and chorizo-style crumbles, and plant-based meatballs; its three crumbles products were frequently used for pizza toppings. In 2022, the Happy Little Plants brand became the official plant-based pizza topping partner of *The World Pizza Champions™,* a U.S.-based nonprofit, multinational group made up of elite pizza professionals.
- Maple Leaf Foods was a Canadian consumer packaged meat company with 2022 sales of $4.5 billion; its brands included Maple Leaf, Maple Leaf Prime, Schneiders, Greenfield, Swift, Field Roast Grain Meat, and Lightlife. Field Roast and Lightlife specialized in plant-based meat substitutes. These two brands had combined sales of $184 million in 2021, versus sales of $211 million in 2020; the 12.7 percent decline in revenues was driven by lower retail product volumes. Field Roast's product offerings were largely made of wheat and other grains; the main ingredients in Lightlife's plant-based burger patties and ground meat were pea protein, coconut oil, and beet powder. Lightlife's other products were plant-based chicken nuggets (a menu offering at all A&W locations in Canada), chicken-like tenders, hot dogs, bacon, sausages, and tempeh.

There were significant variations among the various commonly available types of animal burger products regarding calorie count, total fat grams, saturated fat grams, protein grams, cholesterol, milligrams of sodium, carbohydrates, dietary fiber, and other nutritional measures—see Exhibit 6.

Competition in the Plant-Based Meat Segment of the Broader Meat Industry

Competition among the plant-based meat rivals revolved around a host of factors:

- Taste, meat-like appearance, and texture.
- Price.
- Ingredients (being gluten-free and avoiding use of genetically modified ingredients) and nutritional

EXHIBIT 6 Comparative Nutrition Facts for Selected Types of Animal Burger Patties, April 2023

Grain Fed Beef 80% Lean		Grain Fed Beef 93% Lean		Ground Bison 90% Lean		Organic 100% Grass Fed Beef 85% Lean	
Amount per 4-oz. serving		Amount per 4-oz. serving		Amount per 4-oz. serving		Amount per 4-oz. serving	
Calories	290	Calories	170	Calories	190	Calories	240
Calories from fat	200	Calories from fat	70	Calories from fat	100	Calories from fat	150
	% of Daily Value		% of Daily Value		% of Daily Value		% of Daily Value
Total fat 23g	35%	Total fat 8%	12%	Total fat 11g	17%	Total fat 17g	26%
Saturated fat 9g	45	Saturated fat 3g	15	Saturated fat 4g	20	Saturated fat 7g	35
Trans fat 0g	0	Trans fat 0g	0	Trans fat 0g	0	Trans fat 1g	—
Cholesterol 80mg	27	Cholesterol 65mg	22	Cholesterol 60mg	20	Cholesterol 75mg	25
Sodium 75mg	3	Sodium 70mg	3	Sodium 60mg	3	Sodium 75mg	3
Total Carbohydrate 0g	0	Total Carbohydrate 0g	0	Total Carbohydrate 0g	0	Total Carbohydrate 0g	0
Dietary fiber 0g	0	Dietary fiber 0g	0	Dietary fiber 0g	0	Dietary fiber 0g	0
Sugars 0g	0	Sugars		Sugars 0g	0	Sugars 0g	0
Protein 19g	38	Protein 23g	46	Protein 23g	46	Protein 21g	42
Vitamin A	0	Vitamin A	0	Vitamin A	50	Vitamin A	0
Vitamin C	0	Vitamin C	0	Vitamin C	6	Potassium 330mg	8
Calcium	2	Calcium	0	Potassium 350mg	8	Calcium 20mg	<1
Iron	10	Iron	15	Iron	25	Iron 2.4mg	15

Source: Brand labels (there is some brand-to-brand variation in percentages) profile (calories, fat content, protein, carbohydrates, sugar, and fiber).

- Distribution capabilities (being able to secure a strong presence in both the retail grocery channel and the restaurant/foodservice channels, including favorable shelf and display locations in the grocery channel and menu offerings in the restaurant/foodservice channel.
- Breadth of product offerings.
- Competitive production costs and product prices.
- Brand awareness and customer loyalty.
- Advertising/media spending.
- Ability to secure intellectual property protection on products (to aid in blocking rivals' efforts to produce and market copycat products).

While Beyond Meat and other companies offering plant-based meat products were alert to all of these competitive elements, most all companies in the animal meat sector had substantially greater financial resources, more comprehensive product lines, broader market presence, longer standing relationships with distributors and suppliers, longer operating histories, greater production and distribution capabilities, stronger brand recognition, and greater marketing resources than any plant-based meat company.

Beyond Meat's Most Important Direct Competitor: Impossible Foods

In addition to competing against the much larger companies providing animal protein products of all types, in 2023 Beyond Meat was embroiled in a fierce competitive battle with the second largest provider of plant-based meats, Impossible Foods, a privately held company headquartered in Redwood City, California, that marketed its products under the Impossible brand name. Founded in 2011 by current CEO Pat Brown, Impossible Foods had an ambitious mission: "To drastically reduce humanity's destructive impact on the global environment by completely replacing the use of animals as a food production technology."[25] The company hoped to accomplish this mission within two decades by creating the world's most delicious, nutritious, affordable and sustainable meat, fish, and dairy foods directly from plants.

During 2015–2019, Impossible Foods, whose main product at the time was the Impossible Burger, gained brand awareness by convincing some 15,000 restaurants to put its Impossible Burger on their menus, and by securing distribution of its burgers and crumbles in growing numbers of supermarkets, grocery stores, and natural food stores. In August 2019, after running market tests in several units, Burger King added the Impossible Whopper to its menu offering at all of its 7,200 Burger King locations in the United States and began featuring the Impossible Whopper in some of its national TV ads (including ads run during NFL games). The Impossible Whopper included everything that came on a regular Whopper: a quarter-pound patty, tomatoes, lettuce, mayonnaise, ketchup, pickles, and white onions on a sesame seed bun. Instead of a flame-grilled beef patty, the Impossible Whopper had a flame-grilled Impossible Burger patty containing a unique ingredient called soy leghemoglobin that made Impossible burgers taste so meat-like. Leghemoglobin was a protein found in many plants and it carried an iron-rich molecule called heme that during the cooking process caused the Impossible Burger to "bleed" and take on the product's signature blood-red color. The patties that Impossible Foods supplied to Burger King were based on the company's new 2.0 formulation that was announced in January 2019.[26] Among other upgrades, this formulation worked well in restaurant environments because version 2.0 burgers held up well in hot holding trays and could withstand the 6-inch drop at the end of Burger King's conveyor that grilled the patty for exactly 2 minutes, 35 seconds at 630 degrees Fahrenheit. The Impossible Whopper was usually priced $1 more than the regular Whopper.

In 2020, after market tests in five locations, Burger King introduced a new Impossible Sausage Croissan'wich to its breakfast menu offerings[27] The Croissan'wich featured an egg, cheese, and Impossible Sausage patty sandwiched in a toasted croissant. A raw two-ounce serving of Impossible Sausage had 7g protein, 1.69mg iron, 0 mg cholesterol, 9g total fat, 4g saturated fat, and 130 calories. It was also gluten-free and designed to be both halal and kosher. Concurrent with Burger King's announcement of the Impossible Sausage Croissan'wich, Impossible Foods announced its official launch of Impossible Sausage for distribution through retail grocery and foodservice/restaurants channels. In 2021, Burger King discontinued its menu offering of the Impossible Whopper and the Impossible Sausage Croissan'wich.

In 2019, Impossible Foods had collaborated with Little Caesar's to test its new Impossible Pork crumbles product as a pizza topping. Impossible Pork crumbles was suitable for use in a wider assortment of applications and recipes for ground pork as compared to Impossible Sausage. Pork was especially popular in China, making Impossible Pork an important product for the company's global expansion.

In March 2020, Impossible Foods announced a 15 percent price cut on its plant-based products, and requested that its foodservice distributors pass the price cuts on to their restaurant customers. Impossible Foods CEO Patrick Brown said[28]

> Our stated goal since the founding of the company has always been to drive down prices through economies of scale, reach price parity, and then undercut the price of conventional ground beef from cows.

In 2022, Impossible Foods reported a 50 percent increase in retail sales of its Impossible brand of plant-based products, despite declining retail sales in the plant-based products category. This outsized sales increase enabled Impossible Foods to replace Beyond Meat as the fastest growing company in the plant-based meat category. Impossible Foods product line in 2023 included 12-ounce packages of plant-based ground beef, frozen chicken tenders, frozen spicy chicken nuggets, frozen wild (chicken) "nuggies," chicken patties, frozen pork crumbles, bratwurst sausage links (4-pack), Italian sausage links (4-pack), spicy sausage links (4-pack), sausage patties (8-pack) in savory and spicy flavors, 14-ounce packages of ground sausage in savory and spicy flavors, fresh burger patties in 2-packs, frozen burger patties in 6- and 10-packs, and 14-ounce packages of meatballs in Italian and Homestyle flavors. While Impossible Foods products were delivered to grocery retailers in a frozen state, many of the company's products could be sold either frozen or thawed. It was left up to each retailer to determine which Impossible products to display in the fresh meat case and which to display on the shelves of a frozen meat case,

In September 2022, Impossible Foods launched its first frozen plant-based entrees, called Impossible Bowls, featuring beef, pork, and chicken options complemented with assorted vegetables, spices, and flavorings. The single-serving frozen meals came in eight varieties, featured an array of cuisines, and could be microwaved and ready-to-eat in five minutes or less. The eight different Impossible Bowl meals included Sweet & Sour Impossible Pork, Teriyaki Impossible Chicken, Chili Mac with Impossible Pork, Barbeque Impossible Pork, Spaghetti & Impossible Meatballs, Pasta Bolognese with Impossible Beef & Pork, Burrito Bowl with Impossible Beef, and Spicy Enchilada Bowl with Impossible Chicken.

Other Plant-Based Meat and Vegan Competitors

Beyond Meat also faced competitive pressures from Farmland's plant-based Lightlife brand, Hormel's brand Happy Little Plant brand, Cargill's private-label products, and several makers of meatless vegan products, such as Boca Foods, Field Roast Grain Meat Co., Gardein, Morningstar Farms, and Tofurky. The products of the meatless vegan companies were commonly available throughout the supermarket and grocery store channel, including most national and regional supermarket chains, specialty grocer Trader Joe's, such natural foods and health food chains as Whole Foods, Natural Grocers, Sprouts Farmer Markets, Fresh Market, and Earth Fare, plus thousands of mostly local natural/health food stores.

These different brands of meatless vegan products used soy protein or pea protein or potato protein or wheat protein, or other grains as the main ingredient; lesser ingredients could include coconut oil, sunflower oil, canola oil, or some other type of vegetable oil, binding agents (food starch, potato starch, methylcellulose, xanthan gum), yeast extract, maltodextrin, beet powder or beet juice extract, salt, water, and a varying assortment of spices, vitamins (B6, B12, niacin, thiamin, riboflavin), minerals (potassium, iron, zinc, calcium, phosphorus), and natural flavorings. There were sometimes significant variations from brand-to-brand and product-to product regarding calorie count, total fat grams, saturated fat grams, protein grams, cholesterol, milligrams of sodium, carbohydrates, dietary fiber, and other nutritional measures—see Exhibit 7. Most plant-based meats had protein levels comparable to their animal counterparts but had lower cholesterol, less saturated fat, higher dietary fiber, and no antibiotics or hormones. Both 4-ounce plant burger patties and 4-ounce animal burger patties typically contained about 20 grams of protein.

Lightlife Food Company. Lightlife Food, a subsidiary of Greenleaf Foods (which was an independent subsidiary of Canada-based Maple Leaf Foods), produced foods for plant-based diets and had estimated sales of $80 million. It was best known for its plant-based

EXHIBIT 7 Comparative Nutrition Facts for Three Brands of Plant-Based Burger Patties, April 2023

Beyond Meat		Impossible Foods		Lightlife	
Amount per 4-oz. serving		Amount per 4-oz. serving		Amount per 4-oz. serving	
Calories	260	Calories	240	Calories	270
	% of Daily Value		% of Daily Value		% of Daily Value
Total fat 16g	23%	Total fat 13g	17%	Total fat 17g	21%
Saturated fat 5g	25	Saturated fat 8g	40	Saturated fat 2.5g	13
Trans fat 0g	0	Trans fat 0g	0	Trans fat 0g	0
Cholesterol 0mg	0	Cholesterol 0mg	0	Cholesterol 0mg	0
Sodium 350mg	15	Sodium 370mg	16	Sodium 530mg	23
Total Carbohydrate 5g	2	Total Carbohydrate 9g	3	Total Carbohydrate 10g	4
Dietary fiber 2g	7	Dietary fiber 3g	11	Dietary fiber 2g	8
Sugars 0g		Sugars <1g	2	Sugars 1g	0.5
Protein 20g	40	Protein 19g	31	Protein 20g	40
Vitamin B6 0mg	0	Vitamin B6	20	Vitamin B6	0
Potassium 260mg	6	Vitamin B12	130	Potassium 200mg	4
Calcium 100mg	8	Calcium 170mg	15	Calcium 70mg	6
Iron 4.0mg	20	Iron 4.2mg	25	Iron 3.8mg	20

Source: Brand labels.

veggie dog, Smart Dog, which launched in 1993; other products included Lightlife plant-based burger patties (launched in 2019 to compete with the patties being offered by Beyond Meat and Impossible Foods), beef crumbles (for use in tacos, pasta, and chili), plant-based beef meatballs, plant-based bacon and Italian sausage, plant-based chicken tenders and chicken fillets, organic tempeh, and plant-based deli options (that had no saturated fat or cholesterol).

In January 2022, Mary Brown's Chicken, a growing company which had 200 locations across Canada renowned for its Big Mary® chicken sandwich and Signature Chicken and Taters made from farm fresh Canadian ingredients, agreed to put Lightlfe plant-based chicken tenders on its menu as well as Lightlife plant-based Chicken Sidekick Snack sandwiches in two flavor profiles. Also in January 2022, 7-Eleven® Canada added Lightlife® Plant-Based Chick'n Tenders to its Healthy To Go menu platform at more than 600 Canadian locations. 7-Eleven, based in Irving, Texas, had a network of more than 77,000 company-operated, franchised, or licensed 7-Eleven locations in 19 countries, including nearly 16,000 in North America.

Morningstar Farms Morningstar Farms was a division of Kellogg that produced vegetarian foods; its product line in 2023 consisted of 40 items that included eight varieties of burgers (made with vegetables, grains, and seeds); veggie bacon strips; four varieties of breakfast sausage patties and sausage links; a sausage, egg, and cheese breakfast sandwich; six varieties of Veggie Chik'n nuggets and patties; vegetarian hot dogs and corn dogs; four varieties of Veggie crumbles (called Meal Starters); eight varieties of Veggie appetizers; four Incogmeato® breakfast products; an Incogmeato® plant-based burger; and Incogmeato® plant-based ground meat All products sold to the grocery channel were frozen and displayed in grocery freezer cases. Morningstar had crafted a special line-up of its products sold in the foodservice channel.

Until 2020, one key difference between Morningstar and the other plant-based meat brands was that most

Morningstar products had egg ingredients and thus did not qualify as vegan. But in 2019 management decided to discontinue production and marketing of Morningstar egg products, abandon use of egg ingredients, and begin phasing in new vegan and plant-based versions of the company's entire lineup of vegetarian products. Going into 2021 Morningstar had completed the process of transitioning the products it sold through the retail grocery and foodservice channels to vegan and plant-based.

Field Roast Grain Meat Co. Since its founding in 1997 as a privately owned company, Field Roast had been a pioneer in the plant-based industry by creating flavorful, high-quality products using fresh whole-food ingredients–grains, vegetables, legumes and spices–to craft artisanal plant-based meats and cheeses. Field Roast was acquired by Maple Leaf Foods in 2018. Its product line in 2023 were sausages (seven varieties–smoked apple and sage, Italian garlic and fennel, caramelized onion and beer plant-based bratwursts, spicy Mexican chipotle, plant-based breakfast sausage patties, apple and maple plant-based breakfast sausages, and a classic style sausage, egg, and cheese plant-based breakfast sandwich); a Chef's Signature plant-based burger, three types of appetizers–Classic Nuggets, miniature corn dogs, plant-based buffalo wings; Signature Plant-Based Stadium Dogs; Classic Smoked Plant-Based Frankfurters; three varieties of plant-based deli slices (mushroom & balsamic, lentil & sage, smoked tomato); Classic Pizzeria plant-based pepperoni; three varieties of roasts (sage & garlic, hazelnut & cranberry, and celebration); four varieties of dairy-free Creamy Chao slices; two varieties of Chao Creamery shreds; a block of Creamy Chao; a Chao Queso dip; and two varieties of Mac'n Chao. Most of the products were a blend of vegetables, grains, legumes, fresh herbs, and spices.

The company's products were available in most supermarket chains, medium and large natural foods stores, and a few online food retailers in both the United States and Canada. Except for its three varieties of roasts which were displayed in grocery freezer sections, Field Roast meat products were located in the refrigerated section of grocery stores and had a "use-by" date. However, their freshness could be extended by freezing them for up to a year; once thawed, they were good for about 65 days.

ENDNOTES

[1] Amy McCarthy, "KFC's Beyond Meat Nuggets Taste like Chicken, Eat Like Rubber'" posted at **www.eater.com**, January 10, 2022 (accessed February 4, 2022).
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[3] Amelia Lucas, "McDonald's expands test of McPlant burger created with Beyond Meat," posted at **www.cnbc.com** January 20, 2022, accessed February 4. 2022.
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CASE 10

McPherson Cellars in 2023: Setting The Stage for Texas Wine

Kristen Rinck
University of Houston, Doctoral Candidate

Armand Gilinsky, Jr.
Sonoma State University

Clinton "Doc" McPherson pioneered the Texas wine industry when he began planting grapes in Lubbock in the 1960s. In 2008, Doc's son, Kim, converted a Coca-Cola bottling plant in downtown Lubbock into McPherson Cellars, a winery dedicated to his father. Since its establishment in 2000, McPherson Cellars had developed into a successful and award-winning winery that focused on sustainably farmed wines from the Texas High Plains appellation. Passion, humor, and innovation were markers of the McPherson family as they aimed to uplift the Texas wine industry.

As the next generation of wine drinking consumers came of age, Kim McPherson hoped to take advantage of a new and open-minded crowd and introduce them to Texas wine. Kim's goals for McPherson Cellars included: (1) increase sales and grow the customer base beyond the loyal locals; (2) change the minds of those who did not believe Texas could produce quality wine through growing the best suited grapes for the region; and (3) enhance educational opportunities for Texas residents to learn about quality wine.

The future appeared bright for the Texas wine industry in 2023, as the increase of quality wine production in that state began to capture the attention of wine industry observers. What were the best strategies for Texas wineries like McPherson Cellars in order to gain the attention of out-of-state wine consumers? Could the honest vision and hands-on approach of Kim McPherson lead the Texas wine industry forward?

THE UNITED STATES WINE INDUSTRY IN 2023

The United States was perceived as the most attractive wine market as rated by industry members around the globe.[1] This rating was not surprising when looking at the leading wine industry indices in the United States. Exhibit 1 presents the top ten wine producing countries in 2022.

EXHIBIT 1 Comparison of Top Ten Countries by Leading Industry Indices, 2022

Rank	Vineyard Acreage	Wine Production	Wine Consumption	Consumption Per Capita (2018)	Wine Export Volume	Wine Import Volume
1	Spain	Italy	United States	Portugal	Italy	United Kingdom
2	France	France	France	Luxembourg	Spain	Germany
3	China	Spain	Italy	France	France	United States
4	Italy	United States	Germany	Italy	Chile	France
5	Turkey	Chile	UK	Slovenia	Australia	Netherlands
6	United States	Australia	Spain	Belgium	Argentina	Canada
7	Argentina	Argentina	China	Austria	United States	China
8	Chile	South Africa	Russia	Croatia	South Africa	Russia
9	Portugal	Germany	Argentina	São Tomé and Príncipe	Germany	Belgium
10	Romania	China	Australia	Australia	Portugal	Portugal

Source: International Organization of Vine and Wine (OIV), *Worldwide Wine Production,* 2022.

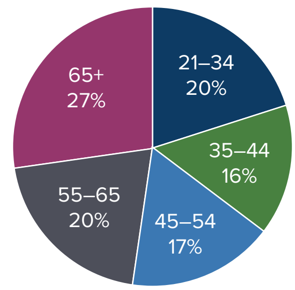
In 2023, there are nearly 12,000 wineries in the United States, with at least one winery established in each of the states.[2] The largest wine companies by volume included E&J Gallo, The Wine Group, Trinchero Family Estates, Delicato Family Wines, Constellation Brands, Treasury Wine, Bronco Wine Company, and Treasury Wine.[3] While the top-selling brands (by volume) in the United States were Franzia, followed by Barefoot, Robert Mondavi, Sutter Home, and Carlo Rossi.[4]

Wine consumers in the United States have often used grape variety as a discriminating factor when deciding which bottle of wine to purchase. A Nielsen Scan Data of U.S. Wine Sales in 2022 viewed the most popular wines in the U.S. market by volume. Chardonnay was at the top of the list followed by Cabernet Sauvignon, Pinot Grigio, Red Blends, Sauvignon Blanc, Pinot Noir, Muscat, Merlot, Rose Blends, and White Zinfandel.

U.S. wine production in 2022 was estimated at 23.1 mhl (million hectoliters).[5] For perspective, the 2022 global volume of wine produced was 260 mhl, the equivalent of approximately 2.9 billion cases of wine. Despite a few exceptions, the annual global production of wine had remained fairly consistent since 2004, falling between the volumes of 260 mhl and 270 mhl. Although behind the European Union in acreage and production, the United States continued to lead the globe in wine consumption in 2022. However, the United States was not considered to be a leading country for wine consumption per capita.

According to a Wine Market Council report, 43 percent of Americans drank wine, 29 percent drank other alcohol, and 28 percent abstained from drinking alcohol. In addition, only 18 percent of U.S. wine drinkers consumed wine more than once a week. While 25 percent of wine consumers identified with only being an occasional wine drinker. 59 percent of wine drinkers identified as female and 41 percent identified as male. When broken down by age group with data from a Nielsen Homescan those 21–34 years of age represented 19.8 percent of wine consumers, 35–44 (15.5 percent), 45–54 (17.4 percent), 55–64 (20.1 percent), and 65+ (27.2 percent). In other words, the baby boomer generation alongside the millennial generation made up well over half of the wine-drinking population. Exhibit 2 provides the share of wine consumers by age category in 2020.

EXHIBIT 2 Share of U.S. Wine Consumers by Age Category, 2020



Source: Nielsen *Homescan,* 52 weeks ending December 26, 2020.

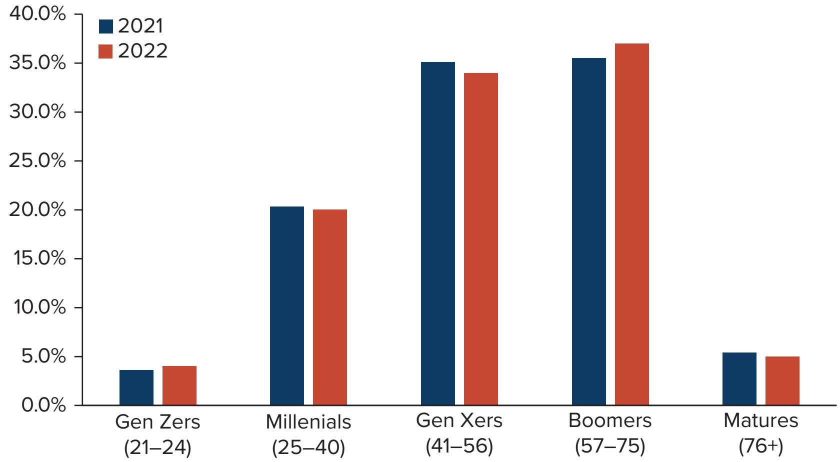
A 2023 Silicon Valley Bank (SVB) *State of the Wine Industry Report Consumer Expenditure Survey* showcased the amount of annual per capita spending on alcohol. Those in the 35–55 age group were highlighted as the highest spenders. Starting in 2013, the 21–25 cohort had been spending less, with 2020 having been the lowest data point. The 2020 fiscal year marked a drop in per capita spending for all age groups. In 2022, Generation X and Baby Boomers both had about 35 percent of the wine club member composition. See Exhibit 3 provides wine club composition by age category in 2020 and 2021.

Ethnicity of wine consumers was another important factor. A 2020 Nielsen Homescan Panel revealed that Caucasians represented 67 percent of wine consumers. Hispanics represented 14.7 percent of wine consumers, followed by African Americans (10.9 percent), and Asians (five percent).

U.S. wine consumers had come to be characterized by a higher education level, higher income, experience-seeking, information-seeking, enjoying food and wine together, traveling abroad more frequently, and being open to new experiences. According to a Sonoma State Wine Business Institute survey of 1,072 Americans from all 50 states, the top reasons U.S. consumers drank wine were taste, relaxation, food pairing, socialization, romance, health reasons, and as a sleeping aid.[6]

In general, approximately two-thirds of the wine sold globally was priced at less than $10 per bottle. In 2023, it was measured[7] that the average bottle price was valued at $45.16, the sweet spot for direct-to-consumer (DTC) sales price were between $30–$45,

EXHIBIT 3 Wine Club Composition by Age Category, 2020–2021



Source: Silicon Valley Bank, *State of the Wine Industry 2023.*

and the sweet spot for off-premise selling prices was \$10.50–\$12. Approximately 8–10 percent of wine sold in the United States was direct from wineries. DTC is often utilized by smaller wineries. Furthermore, it was reported that the Covid-19 pandemic led to record-breaking DTC sales; 2021 sales increased by 48 percent in volume when compared to 2019.[8] Tasting rooms have been a common way to facilitate DTC sales. In the United States, the average tasting fee was \$25.[9] Wine clubs were another profitable way to gain DTC sales. The total annual revenue per wine club member was on average \$750 across the United States.

Marketing, and digital marketing, in particular, were key when carrying the message of one's brand. Using online platforms such as Facebook, Twitter, and Instagram could assist in growing a brand. In addition, wine tourism and the promotion of environmental issues were other popular ways to promote a wine region.

The United States' three-tier system created for the channel of alcoholic beverage distribution was designed to separate suppliers from wholesalers, distributors, and retailers. Where applicable, regulations required that wine pass through all three steps listed above but differed in each state. The major channels for wine sold in the United States included on-premise, off-premise, and direct to consumer. On-premise sales referred to a place where alcoholic beverages were consumed at the retail location, such as restaurants, hotels, bars, clubs, and other similar settings. Off-premise sales referred to a place where alcoholic beverages were sold, such as wine stores, liquor shops, grocery stores, drug stores, and other similar settings. Direct to consumer (DTC) sales designated that producers are selling directly to consumers.

Trends in the U.S. Wine Industry

Several consumer trends influenced beverage production, marketing, and management. Furthermore, it was crucial to consider the myriad of choices consumers were faced with when they selected an alcoholic (or nonalcoholic) beverage to consume. Although cross-consumption of alcohol categories had been increasing over time, wine still faced much competition in the marketplace. According to the Silicon Valley Banks State of the Wine Industry 2023 report, wine was not posed as the next generation's alcoholic beverage of choice. Those aged between 21 and 34 spread their loyalties fairly even between wine, beer, spirits, flavored malt beverages, hard seltzer, cider, and ready-to-drink beverages.

Core consumer trends included wellness, experience-seeking, and convenience. Consumers viewed health and wellness as a determining factor when they looked at what products and services to purchase. A 2020 Nielsen and Harris Poll survey revealed that approximately 50 percent of U.S. alcohol drinkers aimed to reduce their alcohol consumption. Accordingly, many alcohol brands created low or no alcohol options including ingredient labeling, and pivoted their focus to the health of the environment.

Furthermore, it was found that American consumers looked for qualities such as authenticity, relatability, and luxury reflected in their product choices. In 2016, it was reported that over 50 percent of Americans participated in e-commerce. In the wine industry, purchasing wine online greatly increased as well.[10]

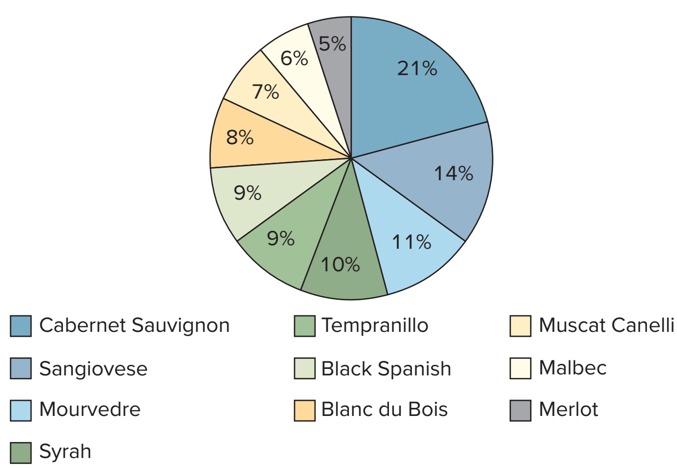
The COVID-19 pandemic drastically altered the United States Wine industry. Wineries were tasked with learning how to pivot their strategies to conform to this new reality. Alongside this shift, some sale trends that were observed over the past two years include increased premium wine sales, declined on-premise wine sales, and an increase in e-commerce sales. Looking forward, analysts forecasted that the wine industry would need to encourage growth through the expansion of innovation and adaptation.[11]

TEXAS WINE INDUSTRY IN 2022

The "Lone Star State" had a long history of viticulture. The first vines were planted in Texas in 1662, with more vine cuttings entering the country alongside settlers in the 1800s. Texas was home to more indigenous grapevine species than any other region on earth. This fact proved to be beneficial to the state when the root louse Phylloxera ravaged the vines of Europe in the late nineteenth century. Texas horticulturalist Thomas V Munson was credited with helping save Europe from this parasite. The rootstocks of his created hybrids of *Vitis Vinifera* and indigenous vines were immune to Phylloxera and were successfully able to be grafted onto European vines, thus saving much of the world's wine industry. Unfortunately, the Texas wine industry was severely scaled back during Prohibition and did not see a comeback until the 1970s.

In 2022, Texas had over 4,000 acres planted to vines and over 500 wineries. It was reported that the total economic impact of the Texas wine industry was over $13 billion and that the industry supported over 140,000 Texas jobs.[12] These numbers helped support the fact that the Texas wine industry was moving in upward momentum. In 1979 Texas produced 14,000 gallons of wine and the last reported statistic showed that Texas produced two million gallons. Approximately 70 percent of production was devoted to red wine. The state's total acreage was planted to 73 percent red varieties and 27 percent white grape varieties. Cabernet Sauvignon was the most widely planted grape. Followed by Tempranillo. Other notable grapes included Merlot, Mourvèdre, Sangiovese, Blanc du Bois, Black Spanish, Malbec, Viognier, Muscat Canelli, Syrah, and Cabernet Franc. The breakdown of the most popular Texas grapes by production are shown in Exhibit 4. After much experimentation, it was discovered that certain varieties, specifically those grown in the Mediterranean - Southern France, Spain, and Italy, were much better adapted for Texas. These grapes included Tempranillo, Mourvèdre, Syrah, Sangiovese, Viognier, Roussanne, Vermentino, Picpoul, Chenin Blanc, and Albariño.

EXHIBIT 4 Texas Wine Production by Variety (in tons), 2022



Source: United States Department of Agriculture.

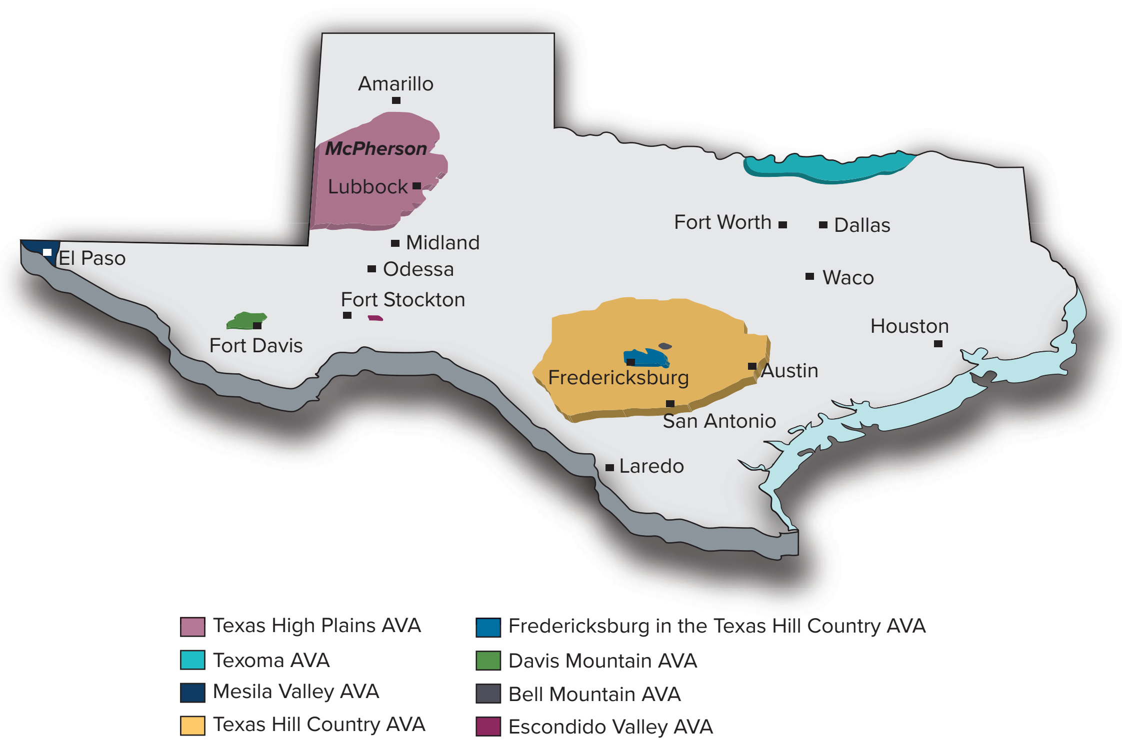
As of 2023, the state of Texas was home to eight American Viticultural Areas, AVAs. They were Mesilla Valley (1985), Bell Mountain (1986), Fredericksburg (1988), Texas Hill Country (1991), Escondido Valley (1992), Texas High Plains (1993), Texas Davis Mountains (1998), and Texoma (2005).[13] These Texas AVAs are highlighted in the map shown in Exhibit 5.

The Texas High Plains, where McPherson Cellars was established, was the largest Texas AVA in terms of production volume. The High Plains was one of the main suppliers of grapes to wineries throughout the state. The climate of this area was continental with hot days and cool evenings. The persistent dry winds kept many diseases at bay. The McPhersons felt that "the higher elevation and semi-continental weather patterns here provided the best growing environment for grape growing in Texas." Late spring frosts were the biggest climate threat.

The Texas wine industry was seeing immense growth, but compared to California, Washington, New York, and several other states, the Texas wine industry could still be considered in its infancy. Furthermore, a large portion of the wine-drinking population did not know that Texas produced quality wine. Texas wineries had their work cut out for them to build mental and physical awareness in the American consumer's mind. Key challenges faced by Texas wineries included combatting harsh climates, increased competition–both statewide and national, changing the minds of consumers who did not view Texas as a region that produced high-quality wines, and capitalizing on the growth of wine tourism that came along with the industry growth.

Many Texas winemakers were attempting to spread awareness of their quality vines, but there was much more to explore and expand. Texas winemakers faced a choice between (1) planting popular grapes and making wine that was known across the globe, such as Cabernet Sauvignon or Chardonnay in hopes to attract consumers with familiarity, or (2) planting varieties that were better suited to the terroir of Texas and promoting the quality of those particular varieties. McPherson Cellars followed the latter strategy. According to Kim, the problem with a lot of other Texas wineries was that they went business instead of wine first. "They went into the

EXHIBIT 5 Grape Growing Regions in Texas



Source: McPherson Cellars' website.

wine business thinking let's produce what people are familiar with, which would be Cabernet Sauvignon and Chardonnay. Well, those varieties don't do well here. We are not Napa!" he exclaimed.

Competition in the Texas wine industry

The Texas wine industry had been growing in size and popularity since the 1970s. Congruently Texas wines had been growing in quality. This indicated greater competition in the Texas wine marketplace. In 1995 the Texas Wine and Grape Growers Association was formed. In 2015, the Texas Wine and Grape Growers Association partnered with the Texas Wine Marketing Research Institute at Texas Tech University to conduct studies about the wine industry. Two years later, they became a member of the Wine Origins Alliance which led to the requirement that wines labeled with Texas American Viticultural Areas (AVAs) must be made from 100 percent Texas-grown grapes. Now home to over 500 wineries, Texas had seen exponential growth in the number of producers. "The Texas Wine Industry is in an exciting phase of exponential growth, innovation, and discovery," stated Karen Bonarrigo, co-owner of Messina Hof Winery. Messina Hof alongside McPherson Cellars, English Newsom, William Chris Vineyards, Becker Vineyards, Lost Draw Vineyards, and Kalasi Cellars represented prominent Texas wineries that led the advancement of the Texas wine industry. These wineries aimed to build a wider consumer audience.

A boom in quality winemaking had led to an increase in wine tourism as more consumers sought out a wine-focused experience. The city of Frederickson, where many Texas wineries were based, attracted over 1.5 million tourists per year alone. The Texas Hill Wine Country received over five million tourists annually and was the second most visited wine region in the U.S. following Napa, California. Beyond the average tasting room visit, visitors could expect additional offerings from these Texas wineries. Special events, virtual tastings, and offering a venue for weddings were all common activities.

The majority of Texas wineries also operated a wine club with membership measuring between several hundred to several thousand club members. For small and medium-sized wineries much of their sales were reliant on wine club membership with a good portion of their case production devoted to club shipments. *Wine Business Monthly* reported that in 2020 the total annual revenue per wine club member was $678.

DR. CLINTON "DOC" MCPHERSON

Clinton "Doc" McPherson was a pioneer of the Texas wine industry and was considered an ambassador of the region until his passing. McPherson worked as a chemistry professor at Texas Tech University. During this time McPherson and his business colleague, horticulture and entomology professor Robert Reed began to plant grapes in Reed's backyard. The pair were the first to plant experimental grapes in Lubbock during the 1960s. McPherson and Reed brought Sangiovese cuttings to the "Sagmor Vineyard," which was at the time considered only cotton-farming land. In 1976 they established Llano Estacado Winery as their love of growing grapes expanded. The next generation of McPhersons followed in Doc's footsteps. One of his sons Jon became a winemaker in Temecula, California. While another son came back to his family roots after studying winemaking at UC Davis and started his own winery in Lubbock, Texas–, McPherson Cellars. Sagmor vineyards eventually became the home of the vines for McPherson Cellars. Exhibit 6 provides a timeline highlighting important milestones for McPherson Cellars.

Mission

"Though Texas viticulture and winemaking are still very young and adolescent compared to the West Coast, we aim to develop and improve the face of quality Texas wine. With

EXHIBIT 6 McPherson Cellars' Milestones

The late 1960s—Dr. Clinton "Doc" McPherson and Robert "Bob" Reed began planting grapes to see if a vineyard could survive on the High Plains

1976—Dr. Clinton "Doc" McPherson and Bob Reed established Llano Estacado Winery

1993—Texas High Plains American Viticultural Area (AVA) was established thanks to the assistance of Dr. Clinton "Doc" McPherson's research on the area

2000—Kim launched McPherson Cellars in dedication to his father

2008—Kim converted a 1930s era Coca-Cola bottling plant in downtown Lubbock into a winery

Source: McPherson Cellars.

grapes that suit our climate and soils, improved farming methods, and an appreciation for the land, we believe the next decade has much in store for Texas. It's our mission to grow and make wines with a real sense of place. Welcome to the Texas High Plains." Kim McPherson

McPherson Cellars took an honest and hands-on approach when it came to following its mission. Since its founding, the winery had demonstrated its commitment to cultivating and escalating the modern Texas wine industry. Such actions as growing the best-suited grape varieties for the region, following sustainable farming practices, and collaborating with the local community were all done to bring attention to the true Texas terroir.

Management team

McPherson Cellars embraced mentorship and valued employee empowerment. Many of their employees were current or past students at Texas Tech University further connecting the winery to the University. Tasting room employees were encouraged to pursue wine education and were offered funding to earn wine certifications, such as exams through the Court of Master Sommeliers (CMS) or the Wine Spirits and Education Trust (WSET). Key personnel are listed in Exhibit 7.

Challenges

McPherson Cellars was faced with the same challenges other wineries were dealing with in the region. When running and operating a winery, a winemaker was already faced with many challenges—such as combatting harsh weather conditions and fighting for market share. Not only did a winemaker have to focus on resolving these challenges, but in Texas there was also the fight against preconceived bias. Wine consumers outside of the state of Texas and even many Texas natives had a poor view of Texas wine. It became quite difficult to sell wine when they already had a negative opinion of it. A common argument was posed by consumers who would say "if I had one Texas wine, I have tried them all." For example, winemakers could be seen as hindering the Texas name by producing subpar Cabernet Sauvignon. With consumers familiar with California Cabernet Sauvignon, they may have tasted a Texas Cabernet Sauvignon and expected the same profile. When the wine did not meet their expectations, the value of Texas wine dropped.

Financial performance

McPherson Cellars' estimated financial data for 2019–2022 is provided in Exhibit 8. McPherson

EXHIBIT 7 McPherson Cellars' Key Personnel

Kim McPherson—owner and winemaker	Firmly believing in the quality of wines that could come from his home state, Kim led his team with immense passion.
Sylvia McPherson—behind every successful man is a great woman	Sylvia is an interior designer and was pivotal in transforming the Coca-Cola bottling plant into a modern winery and tasting room.
Thomas Thurman—his man Friday	Thomas works as the executive director (Hospitality & Event Director) at McPherson Cellars.
Krystin Herrera	Operations manager at McPherson Cellars Winery
Emily Simpson	Winery operations manager at McPherson Cellars

Source: Employee information provided by McPherson Cellars.

EXHIBIT 8 McPherson Cellars' Income Statement Data (estimated), 2019–2022

	2022	2021	2020	2019
Sales (Tasting room sales)	$ 500,000	$ 400,000	$ 350,000	$ 325,000
Sales (Wholesale sales)	3,000,000	2,700,000	2,600,000	2,500,000
Total sales	3,500,000	3,100,000	2,950,000	2,825,000
Cost of goods sold	1,500,000	1,200,000	1,150,000	1,100,000
Gross profit	$2,000,000	$1,900,000	$1,800,000	$1,725,000

Source: Financial information provided by McPherson Cellars.

Cellars saw an increase in total sales from the years 2019–2022. This was directly related to an increase in tasting room sales and slight increase in wholesale sales. Cases produced and wine club members also saw increases in numbers over these years. If McPherson Cellars wanted to continue their upwards trajectory in their gross margins, the company would need increase its wine club membership as well as sales via distributors.

WINERY OPERATIONS AND HOSPITALITY MANAGEMENT

The winery welcomed all guests into their facility as if they were family. Their event center provided a space to showcase the winery and host various events. The winery hosted tastings, events, dinners, and weddings. Visitors could stand up at the tasting room bar, sit at indoor tables, or enjoy the sun on the outdoor patio. Thursday nights were reserved for "patio night" in which local musicians and food trucks were welcomed to the facility and guests could enjoy their wine outdoors. The location of the barrel room warehouse was located down the street from the tasting room. Texans were looking for a story and McPherson Cellars aimed to give them just that.

Wine production and supply chain

McPherson Cellars wanted their wines to be high quality and display a high level of elegance but also be affordable and easily attainable. With this in mind, McPherson Cellars produced wines from grapes that best fit the Texas terroir and were culturally correct. McPherson Cellars was identified as an urban winery since they were located in downtown Lubbock. At their facility, they completed the steps of winemaking from crushing the grapes to bottling the wine. They owned a barrel warehouse down the street. They sold their wines in the tasting room and retail. Tasting room sales contributed a substantial amount of sales revenue for the company. In general, McPherson Cellars' wine would not be found in a grocery store, but their wines sold well in a retail setting. Exhibit 9 shows the total estimated case production for McPherson Cellars for 2019–2022.

EXHIBIT 9 McPherson Cellars' Annual Production of Wines (estimated), 2019–2022

Year	Cases produced
2022	34,000
2021	28,000
2020	25,000
2019	32,000

Source: Annual case production data estimates provided by McPherson Cellars.

Wine portfolio

McPherson Cellars had concentrated on planting grapes that were best suited to the surrounded land and their wines represented that sense of place. Their focus was on Italian, Southern Rhone, and Spanish varietals — grapes that loved the heat. Kim McPherson had claimed that Texas wineries needed to stop shotgun firing and see what would stick when it came to planting grape varieties. They already knew what grew well there. However, there were still many wineries that decided to grow grape varieties that could be considered in style instead. Exhibit 10 highlights the most popular wines produced at McPherson Cellars.

EXHIBIT 10 McPherson Cellars' Popular Wines

Wine	Description
Viognier ($18)	*Our Viognier is fuller bodied, with an aromatic and sophisticated white wine brimming with floral notes. A light chill will accentuate its opulent texture and bring Viognier's lush fruits into focus for an exotic treat.*
Chenin Blanc ($24)	*Leading with notes of yellow pear, fleshy sun-kissed lemon, glazed pineapple, and crystalline honeycomb, this wine is rich and concentrated with a broad, dry palate that finishes with a vibrant lift.*
Muscat Canelli ($5)	*This distinctly aromatic wine jumps out of the glass with enticing aromas of fresh pineapple, lemon curd, orange blossom, and lychee lead way to a crisp citrus and spicy palate. A dry wine ideal for your salad course or aperitif!*

Wine	Description
Picpoul Blanc ($18)	*Piquepoul is a French Mediterranean variety that grows well in Texas! Its naturally high acidity, bright citrus and melon flavors make it a perfect gulper poolside, but it's equally at home with oysters or seafood.*
Roussanne ($18)	*Roussanne, originally from France's Rhône Valley, blossoms into a robust white wine on the Texas High Plains. Savor a rich mouthfeel, delicate herbaceous flavors, and fresh mineral finish.*
La Herencia ($18)	*Spicy, deep, and bright, 'La Herencia' is built on a foundation of Spanish Tempranillo carefully bolstered by Mourvedre, Syrah, and Carignan for additional depth. Cool earth and incense form the core of an otherwise crimson-fruited glass—woodsmoke, cherry jam, and the barest hint of gaminess become more persistent after twenty minutes of air. Tannins are supple and rounded, while acidity holds the wine upright with delicate juiciness. 'La Herencia' is best matched with brisket, and hot baked beans in no short supply.*
Sangiovese ($28)	*Tuscany's foundational grape has long had a place at the table in the Old World, and becomes a supple, medium-bodied red on the sun-drenched High Plains. Sangiovese was one of the first varieties planted in the late 1960s by Clinton "Doc" McPherson. Reminiscent of the rolling hills of Tuscany, but decidedly reflective of the Texas terroir, this wine offers aromas of ripe dark cherry, dark plum, and boysenberry framed by dusty earth, powdered cocoa, and dry, savory herbs. The palate reveals an elegant structure with gentle grip and a long, savory finish.*

Source: McPherson Cellars' website.

Wine club

McPherson Cellars offered three different wine clubs. Each wine club offered several benefits to customers such as gaining access to their smaller production wines and receiving 15 percent off all wines purchased. Other benefits offered to club members included complimentary tastings, reserved tasting room seating, and invitations to member-exclusive events such as full plate dinners. Local members had the option to pick up their wines at the winery during hosted pick-up parties. Shipping was also offered for those unable to get to the winery. The majority of the wine club members were locals. An overview of McPherson Cellars' wine club options" is presented in Exhibit 11, while Exhibit 12 shows the number of wine club members for the years 2019–2022.

EXHIBIT 11 McPherson Cellars' Wine Club Membership, 2022

Year	Number of members
2022	900
2021	750
2020	650
2019	500

Source: Wine club membership provided by McPherson Cellars.

MARKETING STRATEGIES

"Let's start with the Texans," explained Kim McPherson when speaking about the marketing strategies of McPherson Cellars. In terms of dry wines, Texans didn't know what to think of these wines. For example, if they saw the word "Muscat" they would assume the wine was sweet. McPherson Cellars only produced a dry Muscat and despite initial customer

EXHIBIT 12 McPherson Cellars' Wine Club Membership Options

The Sagmor Club	*This club includes three exclusive releases per year. Selections include red, white, and rosé wines—something for every time and place!*
Block Select Club	*A wine club for those who consider "a bottle of red" their usual preference! From our small lots highlighting single-vineyards to our classic red blends, this selection contains tannins and structure.*
Favorites of the Month	*Each shipment is completely customizable! Members are notified before a shipment goes out, and can make any customization desired. This gives members the opportunity to taste through our portfolio while staying well-stocked at home.*

Source: McPherson Cellars' website.

confusion, it was one of their most popular wines. This was a constant conflict with many wines in the McPherson Cellars portfolio. At first, Kim was shocked that people still had a preference for sweet wines. In general, Kim observed that more people seemed to like red wine, but even when you looked at consumers who said they drink red wine, it is sweet.

One marketing strategy that McPherson Cellars followed was using fun labels to pull in consumers. For example, the Picpoul label had the image of two pools and was intended to give off Palm Springs vibes. Consumers considered that wine as a "patio-party favorite." A similar sense of fun was also conveyed in McPherson Cellars' social media postings. Posts often would feature a group of friends or family enjoying themselves at the tasting room. Instagram was their most-used platform.

In terms of consumers visiting the tasting room, Kim optimistically believed that "if you build it, they will come." However, market research showed that it was key to market your product. Sharp (2021) described that to build one's brand, it was key for that brand to build both mental and physical awareness in consumers' minds.

Due to their long history in Texas viticulture, McPherson Cellars, selling wine in the Texas market made sense. However, the decision to expand into other states took more debate. At the time of this case, McPherson Cellars was being sold in fourteen states. The majority of their wine was sold direct-to-consumer, primarily through the tasting room, but also via their website.

FUTURE OPPORTUNITIES

With the ultimate goal of increasing the knowledge of quality Texas wine, the following strategic actions were available to Kim McPherson.

Community collaboration

Collaboration with the community was considered to be a key opportunity for McPherson Cellars. McPherson Cellars had decided to collaborate with wine business students at Texas Tech University in Lubbock in order to bridge the gap between their textbook learning and the reality of the marketplace. The McPhersons had historically strong ties with Texas Tech. "Doc" was a professor of chemistry and Kim had earned his B.S. in Food and Technology at Texas Tech.

A future project was proposed to create a student-designed label. The easiest connection for collaboration would be with the department of retail management and hospitality, but other departments such as agricultural sciences and design should be involved. A dynamic collaborative project could be created to benefit both the winery and the University. A further project was also suggested in which students would participate in the entire winemaking process. As the vineyard is just seven miles from the tasting room, students would be able to assist in both the vineyard and the winery. Students could be offered lab credit for their efforts. The hope was that the students would have their hands involved in the whole winemaking process from picking the grapes to labeling the bottles to marketing the wine. The collaborative goal would be to support and grow more winemakers and industry professionals.

McPherson Cellars also considered partnering with local artists and local chefs for wine club exclusives. Wine club packages could include suggested menus to prepare to complement the wines. During wine club pick-up parties, food would be provided by local chefs.

Educational opportunities

Kim wanted to be a leading pioneer of wine education in Texas. Kim found that there was an immaturity level when it came to wine education in Texas. Thomas Turman intended to take the lead on educational opportunities offered to consumers. He would lead wine tastings and would have the interns and staff assist. Increasing staff wine education is also recommended. A great avenue for expanding staff training would be the WSET courses offered at Texas Tech University.

Wine competitions

Wine competitions and awards played a big role in the Texas wine industry. Kim McPherson has judged in various local and national wine competitions. McPherson Cellars used competition as its grade scale to ensure that they were still producing good wine. McPherson Cellars was also a semifinalist for a James Beard Award two years in a row. These awards and competitions could be used to further exemplify the quality of Texas wine.

Social media

McPherson had utilized Instagram to communicate with their customers. It is recommended that McPherson Cellar increase their social media presence and use other platforms as well. For example, the wine region of Frederick was making an impact on TikTok followers who were highlighting their experiences at the wineries.

DECISION TIME

As wine connoisseurs took notice and praised the state of Texas for its wine-making quality, it appeared that the Texas wine industry was well-positioned to grow in the U.S. wine market. *Wine Spectator Magazine* had previously opined in 2019 that "the future is bright for Texas wine."

In May 2022, Kim McPherson wondered if his company should utilize new strategies to get its brand recognized outside of the state of Texas, or focus efforts on capturing the Texas wine market. Given the emergence of new wine consumers and the changing trends that were likely to follow the COVID-19 pandemic in 2020–2022, Kim felt that he needed to make the decision relatively quickly. Among the potential benefits of expanding into other states included being one of the first Texas wineries to fill that niche in the American market and thus able to take advantage of the positioning of McPherson Cellars, though there were no guarantees that doing so would be the most successful route to profitable growth and market share. Although the benefits of solely focusing on wine sales in Texas meant encountering weak competition for market share in that state, taking this step and remaining at the same levels of production was thought to result in lackluster growth in sales and profitability. Could McPherson Cellars take on the task of bringing quality Texas wine to the other 49 states in America?

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CASE 11

Peloton Interactive, Inc.: The Road Ahead

Sabine E. Turnley
Kansas State University

William H. Turnley
Kansas State University

Peloton Interactive, Inc. became a household name brand during the COVID-2019 pandemic as individuals sought ways to maintain healthy lifestyles despite social distancing requirements. Peloton's platform included connected fitness equipment such as bikes and treadmills with a monthly fitness subscription, which streamed instructor-led boutique classes to its users.[1] The company's managers believed that it disrupted the fitness industry by positioning themselves at the nexus of fitness, technology, and media.[2]

Coming out of 2020, Peloton seemed primed to take over the fitness world. Both their customers and investors were infatuated. The company's stock rose to an all-time high of $171 during trading on January 14, 2021, and their market cap was close to $50 billion. Exhibit 1 provides key operational and business metrics for 2020 through 2022 that show the company's dramatic growth during the 2020–2021 period. Unfortunately, Peloton miscalculated how the end of the pandemic would affect their business. They fell prey to the "bullwhip effect"[3] and spent too much on scaling up manufacturing and logistics while expecting that the demand for their products would remain high. With sales slowing down in 2021 and 2022, Peloton was in need of a complete turnaround. The company had slashed thousands of jobs, ousted its CEO and cofounder, and halted in-house manufacturing and delivery. Yet, it still experienced an enormous $2.8 billion loss in 2022.[4] The company's income statements for 2020–2022 are presented in Exhibit 2. Peloton Interactive's balance sheets for 2021 and 2022 are presented in Exhibit 3.

In 2023m Peloton was focused on the execution of strategic moves to stop the financial bleeding. They launched a Fitness as a Service (FAAS) program where customers could rent the equipment instead of purchasing it. They also refurbished previously owned equipment, with the PCR initiative and entered into a partnership with Dick's Sporting Goods, Amazon, and Hilton.

By the end of the third quarter for fiscal 2023, the company started to show some progress, especially with operating expenses and lower inventory. Peloton also beat revenue expectations and increased its gross profit by 47 percent year to year. Peloton was getting close to free-cash-flow positive, only burning $55 million that quarter versus $747 million a year ago. However, by having a net loss for nine straight quarters, Peloton still had not yet demonstrated a successful turnaround.

COMPANY BACKGROUND

Peloton Interactive, Inc. was a connected fitness equipment company headquartered in New York City. It was founded in 2012 by John Foley, Hisao Kushi, Tom Cortese, Graham Stanton, and Yony Feng.[5]

Peloton's main products were Internet-based stationary bikes, treadmills, rowers that enable monthly subscribers to remotely participate in streamed fitness classes. Their newest offering, called Peloton Guide,[6] was an AI-enabled device for strength training. Peloton differentiates itself from the traditional exercise equipment businesses through online services. To that effect, Peloton has been called the

EXHIBIT 1 Key Operational and Business Metrics for Peloton Interactive, Inc., 2020–2022

	Fiscal Year Ended June 30,		
	2022	2021	2020
Ending Connected Fitness Subscriptions	2,965,677	2,330,700	1,091,100
Average Net Monthly Connected Fitness Churn	0.96 %	0.61 %	0.62 %
Total Workouts (in millions)	540.0	459.7	164.5
Average Monthly Workouts per Connected Fitness Subscription	16.4	22.0	17.9
Subscription Gross Profit (in millions)	$ 944.7	$ 541.7	$ 208.0
Subscription Contribution (in millions)	$ 994.2	$ 586.5	$ 232.1
Subscription Gross Margin	67.7 %	62.1 %	57.2 %
Subscription Contribution Margin	71.3 %	67.2 %	63.8 %
Net loss (in millions)	$ (2,827.7)	$ (189.0)	$ (71.6)
Adjusted EBITDA (in millions)	(982.7)	$ 253.7	$ 117.7
Adjusted EBITDA Margin	(27.4)%	6.3 %	6.4 %
Net Cash (Used in) Provided by Operating Activities (in millions)	$ (2,020.0)	$ (239.7)	$ 376.4
Free Cash Flow (in millions)	$ (2,357.4)	$ (491.9)	$ 220.0

Source: Peloton Interactive, Inc. 2022 Annual Report.

EXHIBIT 2 Peloton Interactive, Inc.'s Consolidated Results of Operations, 2020–2022 ($ in millions, except per share amounts)

	Fiscal Year Ended June 30,		
	2022	2021	2020
Revenue:			
Connected Fitness Products	$2,187.5	$3,149.6	$1,462.2
Subscription	1,394.7	872.2	363.7
Total revenue	3,582.1	4,021.8	1,825.9
Cost of revenue:			
Connected Fitness Products	2,433.8	2,236.9	832.5
Subscription	450.0	330.5	155.7
Total cost of revenue	2,883.8	2,567.4	988.2
Gross profit	698.4	1,454.4	837.7
Operating expenses:			
Sales and marketing	1,018.9	728.3	476.7
General and administrative	963.4	661.8	351.4
Research and development	359.5	247.6	89.1
Goodwill impairment	181.9	—	—
Impairment expense	390.5	4.5	1.2
Restructuring expense	180.7	—	—
Supplier settlements	337.6	—	—
Total operating expenses	3,432.4	1,642.2	918.4

	Fiscal Year Ended June 30,		
	2022	2021	2020
Loss from operations	(2,734.0)	(187.8)	(80.7)
Other (expense) income, net:			
Interest expense	(43.0)	(14.8)	(2.0)
Interest income	2.3	7.9	18.2
Foreign exchange losses	(31.8)	(3.5)	(4.0)
Other (expense) income, net	(1.5)	0.1	0.1
Total other (expense) income, net	(74.1)	(10.4)	12.3
Loss before provision for income taxes	(2,808.1)	(198.2)	(68.4)
Income tax expense (benefit)	19.6	(9.2)	3.3
Net loss	$ (2,827.7)	$ (189.0)	$ (71.6)
Net loss per share attributable to common stockholders, basic and diluted	$ (8.77)	$ (0.64)	$ (0.32)
Weighted-average Class A and Class B common shares outstanding, basic and diluted	322,368,818	293,892,643	220,952,237

Source: Peloton Interactive, Inc. 2022 Annual Report.

EXHIBIT 3 Peloton Interactive, Inc.'s Consolidated Balance Sheets, 2021–2022 ($ in millions, except per share amounts)

	June 30, 2022	June 30, 2021
ASSETS		
Current assets:		
Cash and cash equivalents	$1,253.9	$1,134.8
Marketable securities	—	472.0
Accounts receivable, net	83.6	71.4
Inventories, net	1,104.5	937.1
Prepaid expenses and other current assets	192.5	202.8
Total current assets	2,634.6	2,818.1
Property and equipment, net	610.9	591.9
Intangible assets, net	41.3	247.9
Goodwill	41.2	210.1
Restricted cash	3.8	0.9
Operating lease right-of-use assets, net	662.5	580.1
Other assets	34.3	36.7
Total assets	$4,028.5	$4,485.6
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable and accrued expenses	$797.4	$ 989.1
Current portion of long term debt	7.5	—
Customer deposits and deferred revenue	201.1	164.8

(*continued*)

EXHIBIT 3 *(continued)*

	June 30, 2022	June 30, 2021
Operating lease liabilities, current	86.4	61.9
Other current liabilities	13.2	27.2
Total current liabilities	1,105.5	1,243.0
0% Convertible senior notes, net	864.0	829.8
Term loan, net	690.0	—
Operating lease liabilities, non-current	725.4	620.4
Other non-current liabilities	50.7	38.3
Total liabilities	3,435.6	2,731.5
Commitments and contingencies (Note 13)		
Stockholders' equity		
Common stock, $0.000025 par value; 2,500,000,000 and 2,500,000,000 Class A shares authorized, 308,241,938 and 270,855,356 shares issued and outstanding as of June 30, 2022 and June 30, 2021, respectively; 2,500,000,000 and 2,500,000,000 Class B shares authorized, 30,032,078 and 29,291,774 shares issued and outstanding as of June 30, 2022 and June 30, 2021, respectively.	—	—
Additional paid-in capital	4,291.3	2,618.9
Accumulated other comprehensive income	12.2	18.2
Accumulated deficit	(3,710.6)	(883.0)
Total stockholders' equity	592.9	1,754.1
Total liabilities and stockholders' equity	$4,028.5	4,485.6

Source: Peloton Interactive, Inc. 2022 Annual Report.

"Netflix for Fitness".[7] Over 50 instructors run live classes each week, at different intensities, alongside a big library of pre-recorded content. The fitness pioneer employed 3,723 people in 2023,[8] down from its peak of over 6,700 in June 2021. It generated annual revenue of $3.58 billion in 2022, representing a decrease of about 11 percent from the prior year.[9] An overview of Peloton's product line, fitness modalities, membership levels, and instructor-led boutique classes are provided in Exhibit 4. Exhibit 5 presents Peloton's Revenue Contribution by Product Category for 2021 and 2022.

The company ended its third quarter of fiscal 2023 with about 3.1 million connected fitness subscriptions and forecast its first-ever decline in subscribers for Q4 of FY 2023.[10] Connected fitness subscribers were people who owned a Peloton product and paid a monthly fee for access to live and on-demand workout classes. The third quarter of 2023 was the fourth quarter in a row when subscription revenue surpassed hardware revenue. Exhibit 5 presents Peloton's Revenue Contribution by Product Category for 2020 through 2022.

Peloton's business mission was to "use technology and design to connect the world through fitness, empowering people to be the best version of themselves anywhere, anytime".[11] The founders' vision, even before the pandemic, was to democratize the fitness world. However, reaching customers in all income demographics has been difficult. It appears that the premium brand appeals more to wealthy consumers who can afford Peloton's high-end fitness equipment and who were eager to subscribe to their 24/7 service. The brand was aspirational and has created a whole new lifestyle for customers who were obsessed with Peloton's content.

EXHIBIT 4 Overview of Peloton Interactive's Product Line, Fitness Modalities, Membership Levels, and Instructor-Led Fitness Classes, 2023

Peloton Products	Peloton Bike, Peloton Bike+, Peloton Tread, Peloton Guide, Rower, iOS App, Android App
Fitness Modalities	Cycling, Strength, Stretching, Scenic/Just GO, Meditation, Yoga, Running, Outdoor, Walking, Bike Bootcamp, Cardio, Meditation/AO, Tread Bootcamp
Instructors	51
Monthly classes produced	1,000+
Memberships	All-Access @$45/month: for owners of Peloton equipment (access to all Peloton's content and enabling real-time performance tracking). All Digital @12.99/month: for those without Peloton equipment (access to Peloton library)

Source: Peloton Interactive company information.

EXHIBIT 5 Peloton Interactive, Inc.'s Cost of Revenue, Growth Profit, and Gross Margin by Revenue Source, 2021–2022 ($ in millions)

	Fiscal Year Ended June 30,	
	2022	**2021**
Cost of Revenue:		
Connected Fitness Products	$2,433.8	$ 2,236.9
Subscription	450.0	330.5
Total cost of revenue	2,883.8	$ 2,567.4
Gross Profit:		
Connected Fitness Products	(246.3)	$ 912.7
Subscription	944.7	541.7
Total gross profit	$698.4	$1,454.4
Gross Margin:		
Connected fitness products	(11.3)%	29.0 %
Subscription	67.7 %	62.1 %

Source: Peloton Interactive, Inc. 2022 Annual Report.

Peloton's culture was shaped by the following core values:

- Put members first, always remembering that when our members win, we win.
- Operate with a bias for action by continuously innovating, learning, and improving.
- Empower teams of smart creatives.
- Together we go far, working shoulder-to-shoulder.
- Be the best place to work.

The fitness industry has been booming in recent years, as more and more people invest in their health.[12] Still, Peloton operates in a challenging environment. It must compete with health clubs, fitness clubs and gyms, as well as companies that sell at-home fitness equipment and health and wellness apps.[13] Some of Peloton's main competitors include Life Fitness, Equinox, SoulCycle, ClassPass, Orange Theory, NordicTrack, Echelon, Stryde, Bowflex, Myx Fitness, Proform, and Wahoo.[14] Peloton also competes with smart home gym workouts such as Mirror and Tempo.[15] The most popular gyms were LA Fitness, LifeTime Fitness, 24 Hour Fitness, Planet Fitness, and Anytime Fitness LLC.[16] Since one in five Americans uses a smartwatch or a fitness tracker when exercising, Peloton should also view wearable technology as a rival. Some players in the wearable technology include Fitbit, Garmin, and Apple Watch.

CLIMBING TO THE TOP

Peloton was established in 2012. It took several years and quite a few rounds of funding to solve design, production, and delivery issues. In fact, live and on-demand classes only began in 2016[17] and Peloton did not introduce its treadmill until 2018.[18] Altogether, Peloton received a whopping $443.7 million in start-up funding.[19] The fitness company went public in 2019 ($29 a share) in what was at the time the third-worst trading debut for a major IPO since the 2008 financial crisis.[20] Still, the IPO allowed them to raise $1.16 billion in equity.[21]

Peloton's vertical strategy was to bring its manufacturing in-house to better address supply chain disruptions, which saw customers waiting weeks, if not months, for their equipment to be delivered.[22] In October 2019, Peloton expanded its manufacturing capacity by acquiring bike manufacturer, Tonic Fitness Technology. In April 2021, it paid $420 million for Precor, a manufacturer of commercial exercise equipment with two U.S. factories.[23]

The fitness innovator experienced a quick ascension to stardom thanks to the pandemic. COVID forced gyms and fitness centers to temporarily close their doors and everybody was stuck at home. This led Peloton to experience a huge surge in demand for its at-home fitness equipment. In June 2020, Peloton had its first profitable quarter, with sales spiking 172 percent since the same quarter the year prior and rising to $607 million.[24] In December 2020, Peloton reported its first-ever billion-dollar quarter, driven by holiday sales and high demand for at-home fitness as the pandemic raged on.[25] On January 14, 2021, its stock reached its all-time high of $171.09 per share (440% increase from its IPO price[26]) and its market cap hovered around $50 billion.[27] Six and a half million people were using its products and taking its high-intensity online classes. Those classes were even plot points in tv dramas and parodied on Saturday Night Live. Peloton's instructors became celebrities, with thousands of social media followers, wellness consultancies, and clothing lines. Peloton was on top of the world.

The pandemic enabled Peloton to seize a big share of the fitness craze, build a cultlike following among its loyal customers, and become a stock everybody wanted to own. Success was achieved despite several mistakes along the way, from the infamous "Peloton Wife" commercial that was viewed as being sexist, late product deliveries, a 30,000-bike recall, and a child death requiring a 125,000-tread+ recall. The company was fined $19 million for failing to promptly report treadmill hazards and for distributing recalled treadmills.[28] In 2019, Peloton also faced a $150 million lawsuit over alleged copyright violations for the music used in its workout videos. They later settled the case.

DESCENDING FROM ITS PEAK

As the global pandemic started to recede, so did demand for Peloton's products. Sales of Peloton's equipment fell more than 40 percent from the previous year as people returned to the gym and their pre-COVID routines. Tumbling demand led to $1.4 billion in excess inventory and Peloton experienced a net earning loss of $313.2 million during the fourth quarter of 2021 and a loss of $379 million for the first quarter of fiscal 2022. Peloton was also the target of several unexpected product placements, which tarnished its brand image and sunk its stock price. HBO's "Sex and the City" reboot featured a main character dying of a heart attack after a Peloton workout, sending the company's stock plummeting. Then, Showtime's "Billions" became the second show to have a character suffer a Peloton induced heart attack. In May 2022, Peloton reported its biggest quarterly loss as a public company ($757.1 million) but said that it had borrowed $750 million, payable over 5 years, from JPMorgan Chase Co. and Goldman Sachs Group to keep its operations running. The company's share price hit an all-time low of $8.22 in mid-July 2022.

REVERSING COURSE

In order to address its gross miscalculation of post-COVID demand and reduce its costs, Peloton proposed a restructuring plan that would include

1. Headcount reduction including manufacturing, delivery, and support workforce.
2. Closure of manufacturing, assembly, and warehousing facilities.
3. Shift to third-party manufacturers and logistics providers.

Peloton started implementing this restructuring plan in 2022, by laying off 2,800 employees (about 20 percent of its corporate workforce), pausing productions as its warehouses were filled with excess bikes and treadmills, and halting its plans to open a brand-new factory in Ohio. On February 8, 2022, John Foley, Peloton's cofounder and first CEO was replaced by Barry McCarthy, a former CFO of Netflix and Spotify. McCarthy then hired former Amazon executive, Liz Coddington as CFO and Andy Rendich, formerly COO at Grove Collaborative, as chief supply chain officer.

In July 2022, reversing its vertical strategy to manufacture its equipment in-house, Peloton announced that it would stop all manufacturing and would instead outsource it to Taiwanese manufacturer Rexon Industrial Corp. Peloton also cut about 570 employees at its Tonic facilities but retained 100 existing staffers in Taiwan to work with outside partners such as Quanta Computer Inc., which makes its touchscreens, and Pegatron Corp, which will make its upcoming rowing machine. Peloton also declared that its $400 million Ohio-based factory called "Peloton Output Park" would be sold upon completion. However, it has been more difficult than anticipated for Peloton to shrink its operating footprint. Peloton Output Park has not been sold yet and a deal for Precor, which was purchased in 2020 to boost its manufacturing footprint, recently felt through. This led McCarthy to decide to grow Precor as a free-standing subsidiary in order to make it more attractive for a potential buyer down the line.

The struggling company also decided to lower the price of its bikes and treadmills to get rid of its huge inventory and increase its cash flow. At the same time, it raised the price of its monthly subscriptions from $39 to $44. Just a few months later, Peloton reversed its strategy and increased the price of its Bike+ by $500 to $2,495 and its Tread by $800 to $3495, while it kept the price of its original Bike and its strength-training product Guide unchanged.

On August 24, 2022, Peloton announced a wholesale partnership with Amazon and Dick's Sporting Goods to sell its connected fitness equipment and branded clothing and accessories to U.S. customers. It was the first time Peloton teamed up with another company to sell its products. Previously, products were sold directly to consumers through Peloton's website or its stores. The struggling company even offered its customers the option to self-assemble the equipment shipped by Amazon. All these decisions marked a reversal of Peloton's vertical strategy to control manufacturing, sales, distribution, and support in order to reduce their costs, especially their fixed costs.

Peloton also entered into a partnership with Hilton to enable existing members to continue their Peloton routines while traveling. Hilton agreed to place bikes across its portfolio of 5,400 hotels in the United States as well as in their properties in Puerto Rico, Canada, the UK, and Germany.

As part of a "Fitness as a Service" strategic shift, Peloton launched a rent-to-own service where customers can rent Peloton bikes on a month-to-month basis without any long-term commitments and at a cost of $89/month for a Bike and $119/month for a Bike+. These rates include the monthly subscription.

As its sales have continued to plummet, the fitness company has also introduced pre-owned Peloton equipment sales as well as a "Freemium" strategy where its app would work on non-Peloton equipment. Those moves illustrate how Peloton was focusing much more on their monthly subscription service rather than on selling fitness equipment. Indeed, subscribers were paying Peloton the same recurring, high-margin fee whether they were riding a new model, a used one, or a competitor's equipment.

Yet, even though Peloton wants to focus more on its high-margin subscription, it still launched in 2022 a high-end rowing machine called Peloton Row at a price of around $3,195.

In September 2022, Peloton faced another wave of leadership shakeups. John Foley, cofounder and former CEO, resigned from his position as executive chairman of the board. Foley's position was taken by Karen Boone, the former president of Restoration Hardware. Fellow cofounder Hisao Kushi, who was Peloton's chief legal officer, also resigned and was replaced by Tammy Albarran, Uber's chief deputy general counsel. Kevin Cornils, Peloton's chief commercial officer resigned as well. Chief strategy officer, Dion Sanders took on the new title of chief emerging business officer as he assumed most of Cornils' responsibilities.

Peloton posted a momentous $2.8 billion net loss for 2022, which was 1,400 percent larger than FY2021's loss of $189 million. The restructuring plan amounted to a $611.3 million in total charges. More significantly, it appeared that customer acquisition costs were spinning out of control. Peloton spent over $1 billion in sales and marketing in 2022, gaining roughly 600,000 connected fitness subscribers in the process. That customer acquisition cost for 2022 averaged about $1,500 per net connected fitness subscription addition. Even in good times, the company never made much money selling equipment, so the company needs subscribers to stick around for quite a while for the math to work out for them.

Total revenue for the first 9 months of fiscal 2023 was a little over $2.1 billion, which was lower than the $2.9 billion in the same period of the previous year. For the first time in the company history, revenue from subscriptions was larger than from equipment sales.[29] Unfortunately, the company was still not profitable and its cash used by operating activities was growing exponentially. In fact, Peloton had burned through its cash balances for nine quarters in a row from Q3 fiscal 2021 through Q3 of FY23.[30] Peloton disclosed a $75 million patent-infringement settlement with DISH Technologies, which they expected will significantly pressure free-cash flow for fourth quarter 2023. Exhibit 6 presents a Summary of Cash Flows for 2020 through 2022.

In May 2023, Peloton recalled 2.2 million Bikes over safety concerns, the second major recall the fitness company has faced.[31] Even though, the company was providing its customers with a free seat post that can be self-installed, it led its stock into a downward spiral. The PTON stock hit $6.80 on May 11, 2023, below its prior closing low of $6.93 on September 30, 2022. Exhibit 7 provides trend data for Peloton Interactive, Inc.'s common shares for September 2019–May 2023.

RIDING INTO THE FUTURE

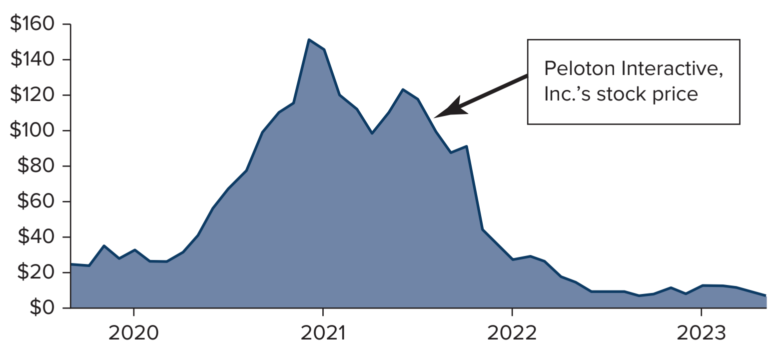
With major moves such as its Fitness as a Service (FAAS) offers, its Peloton Certified Refurbished (PCR) initiative, its entry into new channels through third-party retailers Dick's and Amazon and through its partnership with hotel chain Hilton, the company's managers had attempted to think outside the box to turn Peloton around after two years of spiraling down.

EXHIBIT 6 Summary of Cash Flows for Peloton Interactive, Inc., 2020–2022 ($ in millions)

	Fiscal Year Ended June 30,		
	2022	2021	2020
Net cash (used in) provided by operating activities	$(2,020.0)	$(239.7)	$376.4
Net cash provided by (used in) investing activities	153.3	(585.1)	(741.3)
Net cash provided by financing activities	2,015.1	916.8	1,240.2

Source: Peloton Interactive, Inc. 2022 Annual Report.

EXHIBIT 7 Market Performance of Peloton Interactive, Inc.'s Common Stock, September 2019–May 2023



Source: bigcharts.marketwatch.com

Peloton has also announced a major rebranding initiative to demonstrate that they were more than just a bike company. The company planned to focus more on fitness content than hardware and was rolling out a multitiered membership structure instead of a one-size-fits all membership for people who purchase its equipment. The app would serve as a mobile access point for its fitness content, including strength training, meditation, and outdoor running. It was unclear how this open ecosystem would affect Peloton's equipment business but the company believed that was the open ecosystem strategy was necessary. According to Barry McCarthy, in Q3 FY2023, 57 percent of all workouts were not cycling related, 62 percent of active members participated in noncycling activities such as strength, yoga, or meditation, and 38 percent involved non-Peloton hardware.

Peloton had accumulated losses of $1.019 billion during the first nine months of 2023 and was predicting a Q4 decline in revenue. The company also anticipated connected fitness subscriptions to fall into a range of 3.08–3.09 million, lower than the 3.11 million reported in the third quarter. That would be Peloton's first-ever subscriber decline, raising concerns about their growth and their turnaround strategy. It was clear that the road ahead for Peloton would be a steep uphill climb and investors would be justified to ponder whether Peloton could still chase its dream of fitness dominance. The company's Results of Operations for the first nine months of fiscal 2023 are presented in Exhibit 8.

EXHIBIT 8 Peloton Interactive, Inc.'s Consolidated Results of Operations, 2020–2020 ($ in millions, except per share amounts)

	Nine Months Ended March 31,	
	2023	2022
Revenue:		
Connected Fitness Products	$ 909.8	$ 1,891.9
Subscription	1,248.3	1,011.6
Total revenue	2,158.1	2,903.4
Cost of revenue:		
Connected fitness products	1,025.8	1,848.1
Subscription	409.8	327.2
Total cost of revenue	1,435.6	2,175.3
Gross profit	722.4	728.2
Operating expenses:		
Sales and marketing	510.4	860.8
General and administrative	635.3	731.3
Research and development	246.3	274.6
Goodwill impairment	—	181.9
Impairment expense	111.9	42.5
Restructuring expense	167.9	158.5
Supplier settlements	22.0	—
Total operating expenses	1,693.8	2,249.4
Loss from operations	(971.3)	(1,521.2)
Other (expense) income, net:		
Interest expense	(69.7)	(26.5)
Interest income	17.7	1.1

(*continued*)

EXHIBIT 8 *(continued)*

	Nine Months Ended March 31,	
	2023	2022
Foreign exchange gains (losses)	3.9	(19.1)
Other income, net	3.0	0.7
Total other expense, net	(45.1)	(43.8)
Loss before provision for income taxes	(1,016.4)	(1,565.0)
Income tax expense	3.5	7.5
Net loss	$ (1,019.9)	$ (1,572.4)

Source: Peloton Interactive, Inc. Quarterly Report for the Fiscal 2023 Nine Month Period Ending March 31, 2022.

ENDNOTES

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CASE 12

Electronic Arts: It's Strategy in the Video Game Industry

Diana R. Garza
Our Lady of the Lake University

Video gaming had become a vibrant and fast-growing industry in 2023, with over 3 billion enthusiasts playing at any time, on different devices, and in multiple spaces. Gamers from around the world, who may not speak the same language or be in the same time zone, utilize a common platform to explore new worlds, complete quests, survive a hoard of zombie outlaws, or test athletic abilities in a number of esports. Competition was continuing to intensify as video game publishers attempted to convert casual gamers into long-term customers and gain ongoing sales from additional features offering an immersive gaming experience.

Electronic Arts (EA) developed, marketed, and distributed video game software with a particularly strong position in the sports category. Its *Madden NFL 23* and *FIFA 2023* video games were ranked numbers three and seven, respectively in 2023 video game sales. The company had become a dominant player in this industry with a strong brand name, a strong financial position, a diverse portfolio, and experienced leadership. Despite these strengths, the company faced strong competition from companies such as Activision Blizzard, producer of *Call of Duty,* Sony; producer of *God of War, MLB,* and *Gran Turismo;* Ubisoft, developer of *Assassin's Creed* and *Far Cry 6;* and others. The quest to create more visually stunning and technologically complex games had resulted in escalating game development costs and was challenging the ability of rivals to earn attractive profits. Competition from free-to-play games, which were becoming increasingly popular in the early-2020s, could reduce demand for premium-priced games and profitability for EA and its chief rivals. To defend against such threats, EA would need to continue developing cutting-edge video games, dominate the sports market, and further expand into mobile gaming and virtual reality technology. Electronic Arts management team would need to address these strategically important issues and practice sound financial management to sustain its competitive position and profitability.

COMPANY OVERVIEW

Electronic Arts (EA) was an American video game company headquartered in Redwood City, California. The company was founded in May 1982 by Apple employee Trip Hawkins. EA developed and delivered games, content, and online services for Internet-connected consoles, mobile devices, and personal computers. The company boasts of delivering infinite possibilities, cutting-edge games, innovative services, and powerful technologies to over 600 million active players and fans from around the globe. The company was recognized for highly acclaimed games such as *EA Sports™ FIFA, Battlefield™*, *The Sims™*, *Need for Speed™*, *Apex Legends™*, *Madden NFL, Titanfall®*, and *F1®*. As of 2022, EA was considered third among the leading gaming companies worldwide.

The company held a 13.5 percent share of video game software publishing industry sales and was considered a Rising Star due to its strong profitability and revenue growth potential. During the 2021–2022 fiscal year, Electronic Art's (EA) video game downloads were the fastest-growing business segment growing by 40 percent compared to the year prior. Its live service segment, which included extra content, subscription offerings, and revenue generated outside of game sales, grew 24 percent year-over-year.

THE VIDEO GAME INDUSTRY IN 2023

The video game industry had become a mainstream entertainment option across developed and emerging economies across the world, with the COVID-19 pandemic boosting its growth to a billion-dollar market. In 2022, the video games market in the United States generated more than $85 billion and was projected to grow to $128 billion annually by 2028. Digital video game sales have surpassed physical sales becoming the primary driver of video game revenue. This industry included the broader operations of all video game industries in the United States. Gaming consoles, games made for the consoles, and games produced for personal computers make up the retail segment. The development and manufacturing of games, consoles, and accessories constitute a notable share of the market, with added revenue coming from online gaming subscriptions.

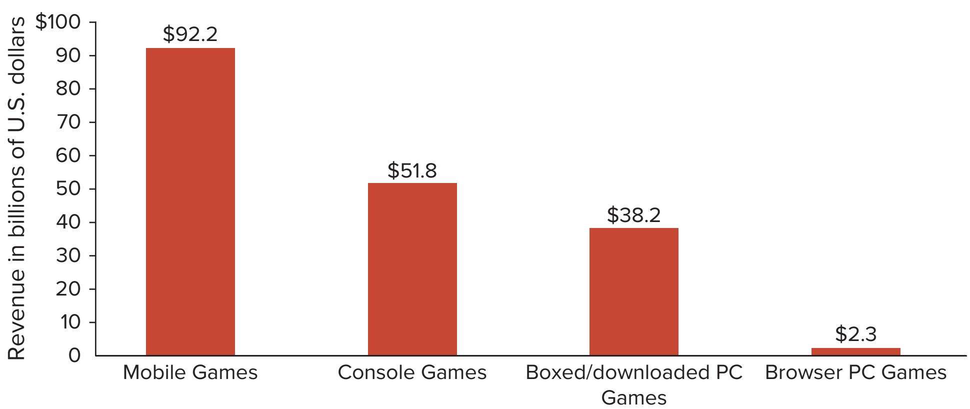
Although the largest regional market in sales and number of gamers was Asia Pacific, the United States was also an important player in the global video games industry. The United States was considered the birthplace of gaming, fueled by the arcade games in the '60s and the introduction of the first personal computers and consoles in the '70s. Fast forward to 2022, game developers have driven the movement to more enhanced software solutions, graphics, better sound, and more advanced interaction for video games.

The video game industry was not only growing but also changing. Internet accessibility and new development in technologies are strong forces for change, causing more and more players to switch from single-player console or PC video games to multiplayer games, social networking games, and mobile games. Mobile games have become a new trend accounting for 51 percent of the revenue of the games market worldwide, surpassing console games and downloaded games or boxed PC games. Mobile games were classified on the basis of location, the number of maximum players, and the gaming experience.

Video Game Software Publishing

The video game industry was segmented into different activities, with Video Game Software Publishing as one of the fastest-growing segments. Companies in this segment primarily publish video game software; they produce and distribute video games, including design, documentation, installation, and support services. The main activities in this industry include video game publishing, video game development for video game consoles, mobile operations, and computers. Other industry operations include the sale of

EXHIBIT 1 Worldwide Video Game Market by Segment, 2022 ($ in billions)



Source: "Video game market revenue worldwide in 2022, by segment," *Statista,* **https://www.statista.com/statistics/292751/mobile-gaming-revenue-worldwide-device/** (accessed June 12, 2023).

in-game software, add-ons, and other downloadable content, as well as endgame advertising. Exhibit 1 provides worldwide video game market revenue by segment in 2022.

Growth in Mobile Gaming

Mobile gaming had become a driving force behind the growth of the global video game market. Due in large part to technological advances and digital innovation the number of video game users was higher than ever, reaching a record of $41.7 billion. Video games represent one of the most popular forms of entertainment. This industry had proven more lucrative than other popular entertainment, such as movies and music.

The mobile games industry experienced a massive influx of demand during the pandemic leading to projected revenue growth of $286.5 billion in 2023 and a projected CAGR of 7.08 percent for the 2023–2027 period. Demand had been primarily from young male gamers, with most games tailored to this demographic, leaving the female gamer group as an underrepresented segment. Gaming companies have taken note of this opportunity and begun making games that are more gender-neutral in terms of themes and stories.

With most people returning to a normal lifestyle following the pandemic, consumers have less time to spend gaming. This had pushed game developers to develop mobile and online games that can be played on the go. In 2022, mobile gaming became the top-grossing segment, ahead of console and PC. With 1.75 billion mobile gamers worldwide in 2022, this number was expected to surpass 2.2 billion in 2026. With a growing audience and the popularity of mobile games, the mobile gaming market revenues are expected to see an increase from $152.5 billion to $211.9 billion over the same period. Mobile gaming had become the largest market share within the gaming industry.

Top mobile gaming publishers in North America include established publishers such as Disney, Activision, Electronic Arts, and Warner Bros, cross-platform developers such as Zynga and Roblox, and other players with significant hits, content licenses, and wide-ranging mobile portfolios. In 2022, Star Wars: Galaxy of Heroes was a top-grossing mobile game for Electronic Arts (EA) in the Google Play Store, generating almost $110 million in revenues and accounting for EA's largest share of app revenues. EA's second-ranked *FIFA Soccer* game grossed $75.98 million in gaming app revenues.

Video Game Industry Acquisitions

To understand the competitive landscape of video game companies, it was important to highlight the value of mergers and acquisitions. Mergers and acquisitions are a strategic option to strengthen a company's market position. Acquisitions allow for the combination of operations of similar companies to increase the scope of their business, create more cost-efficient operations, expand geographic coverage, expand a company's product categories, gain access to new technologies, and increase market opportunities.

Mergers and acquisitions were a cornerstone of EA's growth strategy. In April 2021, EA acquired Glu Mobile, a global developer and publisher of mobile games, for $2.0 billion. The acquisition of Glu Mobile was expected to accelerate the company's growth by creating a combined organization with ongoing live services. *Playdemic* was acquired in September 2021 for $1.4 billion with the goal of continued leadership in sports and mobile expansion.

One of the biggest video game industry acquisitions was Tencent's purchase of Finnish gaming publisher Supercell for $8.6 billion in January 2022. Supercell was a mobile game company known for the top-grossing title *Clash of Clans.* Tencent was a Chinese Tech Company that started as PC-based messaging software in 1999 and evolved into an Internet giant with a market value of $452 billion. Tencent's business model was focused on increasing customer reach before app monetization. Earnings come from value-added services, a third of which are generated by online games. A 2019 partnership with Nintendo had extended its offerings in the Chinese console market.

Take-Two Interactive purchased the social gaming company Zynga with the goal of increasing synergies and revenue opportunities. Take-Two Interactive was based in New York and owns Rockstar Games and 2K publishing labels. The company was a leading developer, publisher, and marketer of interactive entertainment for consumers around the globe. Its products are designed for console gaming systems, PC, and Mobile including smartphones and tablets, delivered through physical retail, digital download, online platforms, and cloud streaming services.

ELECTRONIC ARTS' STRATEGY IN THE VIDEO GAME SOFTWARE PUBLISHING INDUSTRY

EA's mission was to inspire the world to play. They did this by developing, licensing, marketing, and publishing games that can be played on different devices. EA's revenue-generating products and services include physical games and software. The company's strategies had produced consistent revenue gains between 2020 and 2022, but the increasing cost of goods sold, research and development, and marketing and sales expenses had resulted in a 74.1 percent decline in net income between 2020 and 2022. Exhibit 2 presents Electronic Arts' consolidated statements of operations for 2020 through 2022. The company's consolidated balance sheets for 2021 and 2022 are shown in Exhibit 3.

The company produced and published games for all major gaming platforms, with two-thirds of its revenue coming from console games. Live services, one of EA's fastest-growing revenue segments, reported an increase of 24 percent year-on-year compared to 2021. In 2022, *FIFA 21* and *20* became the revenue drivers for live service, followed by sports franchises such as *Madden NFL*. In 2022, EA released full-game downloads and released new titles such as *Battlefield 2042, It Takes Two,* and the remastered *Mass Effect Trilogy,* making this segment the largest revenue driver.

EA followed a hybrid strategy by developing, licensing, and distributing its own games using a cross-platform approach. Part of the strategy was ensuring that games can be iterated or sequeled; for example, *Madden NFL* releases a new edition every

EXHIBIT 2 Electronic Arts, Inc. and Subsidiaries Consolidated Statements of Operations, 2020–2022 ($ in millions, except per share data)

	2022	2021	2020
Net revenue	$6,991	$ 5,629	$5,537
Cost of revenue	1,859	1,494	1,369
Gross profit	5,132	4,135	4,168
Operating expenses:			
Research and development	2,186	1,778	1,559
Marketing and sales	961	689	631
General and administrative	673	592	506
Acquisition-related contingent consideration	—	—	5
Amortization and impairment of intangibles	183	30	22
Total operating expenses	4,003	3,089	2,723
Operating income	1,129	1,046	1,445
Interest and other income (expense), net	(48)	(29)	63
Income before provision for (benefit from) income taxes	1,081	1,017	1,508
Provision for (benefit from) income taxes	292	180	(1,531)
Net income	$ 789	$ 837	$3,039
Earnings per share:			
Basic	$2.78	$2.90	$10.37
Diluted	$2.76	$2.87	$10.30
Number of shares used in computation:			
Basic	284	289	293
Diluted	286	292	29

Source: Electronic Arts, Inc. Annual Report, SEC Form 10-K, 2022.

EXHIBIT 3 Electronic Arts, Inc. and Subsidiaries Consolidated Balance Sheets, 2021–2022 ($ in millions except par value data)

	March 31, 2022	March 31, 2021
ASSETS		
Current assets:		
Cash and cash equivalents	$ 2,732	$ 5,260
Short-term investments	330	1,106
Receivables, net	650	521
Other current assets	439	326
Total current assets	4,151	7,213
Property and equipment, net	550	491
Goodwill	5,387	2,868
Acquisition-related intangibles, net	962	309
Deferred income taxes, net	2,243	2,045
Other assets	507	362
TOTAL ASSETS	$13,800	$ 13,288
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 101	$ 96
Accrued and other current liabilities	1,388	1,341
Deferred net revenue (online-enabled games)	2,024	1,527
Total current liabilities	3,513	2,964
Senior notes, net	1,878	1,876
Income tax obligations	386	315
Deferred income taxes, net	1	43
Other liabilities	397	250
Total liabilities	6,175	5,448
Stockholders' equity:		
Preferred stock, $0.01 par value. 10 shares authorized	—	—
Common stock, $0.01 par value. 1,000 shares authorized; 280 and 286 shares issued and outstanding, respectively	3	3
Additional paid-in capital	—	—
Retained earnings	7,607	7,887
Accumulated other comprehensive income (loss)	15	(50)
Total stockholders' equity	7,625	7,840
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$13,800	$ 13,288

Source: Electronic Arts, Inc. Annual Report, SEC Form 10-K, 2022.

year. Game themes include action-adventure, casual, family, fantasy, racing, music, multiplayer online role-playing, and simulation. The company had a strong portfolio of wholly owned properties that include brands such as *EA SPORTS™ FC, Battlefield™, Apex Legends™, The Sims™, Madden NFL, Need for Speed™, Titanfall™*, and *Plants vs. Zombies™*. EA's portfolio also included licensed intellectual property, such as *Madden NFL Football, FIFA Soccer,* and *F1®*.

EA's strategy included acquisitions of companies, businesses, intellectual property, and other assets, as well as investing in strategic partnerships. The company was focused on expanding its reach and engaging players through a variety of channels. Investments in digital distribution have allowed EA to reach a global audience and monetize its content through in-game transactions and subscription models.

EA owns and operated gaming studios and subsidiaries such as Bioware, Codemasters, DICE, PopCap Games, and Respawn Entertainment. *Madden NFL* and *FIFA* are EA's flagship franchises releasing new versions yearly.

Electronic Arts' corporate social responsibility and sustainability strategy

EA's global impact on communities for the fiscal year 2022 includes $9.5 million in total giving, $7.7 million in company grants, sponsorships, and matching gifts, $1.8 million in employee gifts, 6,428 total volunteer hours, 4,359 nonprofits supported, and 3.764 donated game codes. EA created the John Madden Legacy Commitment to Education by committing $5 million over five years to support nonprofit organizations focused on STEAM education. EA had also sponsored students affiliated with The Jackie Robinson Foundation Scholarship by providing multiple internship opportunities since 2012. EA believed in the power of positive play and in making the gaming community and platforms a fun, fair, and safe experience for all.

PROFILES OF LEADING VIDEO GAME SOFTWARE PUBLISHERS

Activision Blizzard

As of October 2021, Activision Blizzard was ranked second with a market cap of nearly $46.98 billion. The company had benefited from rising mobile and ancillary revenue. The mobile and ancillary platform revenue increased to 24.0 percent in 2021, due primarily to higher revenues from in-game player purchases and advertising on games such as *Candy Crush* and *Call of Duty.* The publisher of popular video games like *Call of Duty, Diablo,* and *StarCraft* was focused on the development of mobile versions of some of their core brands. They have a notable market share in Video Game Software Publishing, holding an estimated 10.8 percent of the total industry revenue.

Microsoft

Several mergers and acquisitions have made this playing field even more competitive. One of the biggest video game acquisitions in 2022 was the purchase of Activision by Microsoft for $68.7 billion. Microsoft had already made news in 2020 when it acquired video game company ZeniMax for $7.5 billion. In September 2014, Microsoft acquired the Swedish Minecraft studio Mojang for $2.5 billion. Microsoft's strategic move demonstrated its intent to purchase studios and gaming publishers and develop new games. As of fiscal quarter 2022, revenues of Microsoft Xbox content and service agreements increased by 2 percent compared to previous years.

Sony Corporation

Sony was a private company in the United States with a notable market share in at least four industries: recordable media manufacturing, movie and video production, video game software publishing, and video games and video game software publishing. Their largest market share was in the recordable media manufacturing industry. Sony, Microsoft, and Nintendo are formidable competitors in the console segment leading to a high industry concentration.

Nintendo

Nintendo was a private company with a notable market share in video game software publishing and video games and video game software publishing industries. Their largest market share was in video game software publishing, accounting for an estimated 9.7 percent of the total industry revenue. In 2022, Nintendo Co. LTD entered into an agreement to acquire the Tokyo-based company SRD Co LTD. SRD had been providing support in the programming and development of Nintendo games such as *Donkey Kong, Super Mario Bros,* and *The Legend of Zelda.* The agreement between Nintendo and SRD will secure development resources for Nintendo and strengthen the management structure for SRD. An added benefit of this vertical integration included an improvement in software efficiency.

Roblox

More than 60 million people engaged in Roblox games and simulations using tablets, smartphones or computers in 2023. The company was ranked among the leaders of the gaming industry, with its tremendous growth during 2021 had been attributed to the metaverse hype at the time. However, the market cap declined to $24.55 billion as of April 2023.

Epic Games

Epic Games was a software and video game publisher based in the United States. The company was known for the success of *Fortnite Battle Royale,* which accounts for the most significant share of the company's estimated $6.27 billion in annual gross revenues. The company was also the developer of *Unreal Engine,* a game engine for video game development. Aside from video game publishing, the company launched the Epic Game Store in 2018. As of 2021, PC gamers had spent 840 million on gaming content in the Epic Game Store.

Ubisoft

Ubisoft was a leading global producer, publisher, and distributor of interactive entertainment products. In fiscal year 2021–2023, the company generated €1.8 billion in sales. Eighty-five percent of Ubisoft's sales were attributed to the digital format—the U.S. subsidiary accounts for the majority of sales revenues of the parent company. The company plans to develop free-to-play and mobile games for the 2023–2024 financial year. Ubisoft was known for games such as *Mirage, Assassin's Creed, Avatar: Frontiers of Pandora,* and *Tom Clancy's Rainbow Six Mobile*

Take-Two Interactive

Take-Two Interactive was a developer, publisher, and marketer of interactive software games. The company generated total revenue of $5.3 billion, up from $3.5 billion in 2022. Take-Two Interactive was the parent company of the publishing labels Rockstar and 2K. In 2022, TT Interactive purchased Zynga for $12.7 billion, making this one of the biggest video game purchases of all time. Some of Take Two Interactive most popular games include *Grand Theft Auto, 2K Sports, Borderlands, Max Payne,* and *Red Dead Redemption.*

A 2022 survey found that more than seven out of ten gamers in the United States were familiar with Nintendo, making this company the most well-known; Epic Games, the publisher of *Fortnit*e, ranked second, with Electronic Arts (EA) ranking third. The brand awareness of competing video game studios and publishers in 2022 is presented in Exhibit 4.

CHALLENGES AND OPPORTUNITIES IN MID-2023

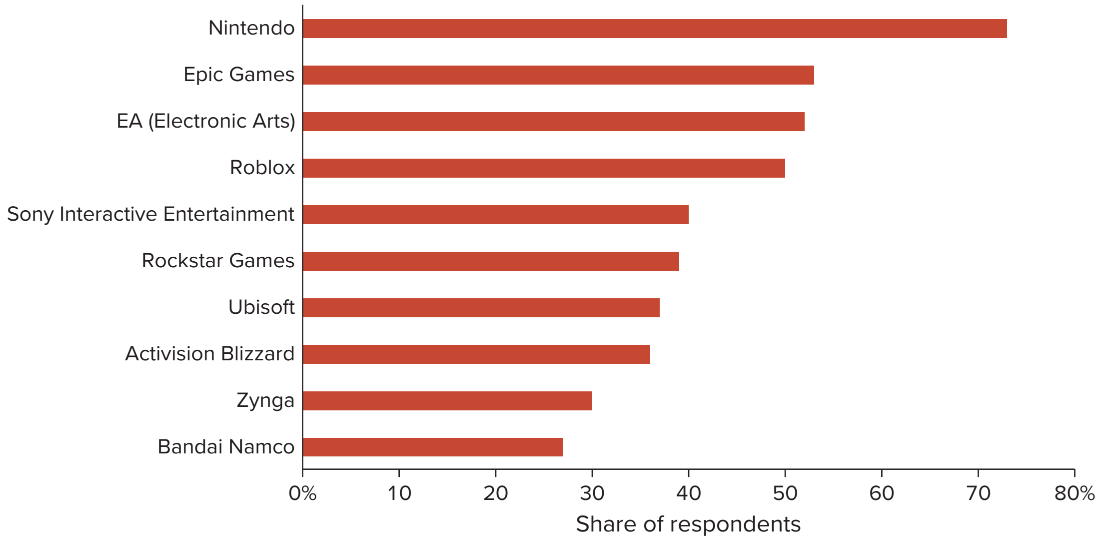
The next steps for EA included expanding its mobile business with the EA SPORTS portfolio and creating a more interactive and social platform where players could stay connected to friends. EA's growth strategy also included providing creation tools for their gamer community to engage more deeply with content and experiences; the company planned to distribute content and experiences to more players on more platforms and in more geographies while harnessing the power of social ecosystems.

EA had built significant relationships with Sony and Microsoft to distribute digital products and services compatible with PlayStation and Xbox consoles. An agreement with Apple, Google, and other app stores allows the distribution of mobile applications and additional content would be important. The company's senior management must also consider the impact of publishers such as Tencent and Nexon who produced mobile and PC free-to-play games in many Asian countries, including China and Korea.

EA's Strategic Risks

Electronic Arts faced several strategic issues at mid-2023, including the right to use intellectual property, which required forecasting, sometimes years in advance, and competitive pressures from well-funded technology companies such as Amazon.com, Alphabet Inc., Meta Platforms, Microsoft, and Netflix, who are able to strengthen their interactive entertainment capabilities by providing larger budgets to develop and market tools, technologies, products, and services and shift player time to different platforms. Other issues included continuously evolving laws; the increase in mergers and acquisitions, which posed a threat and put added competitive pressure as interactive entertainment companies grow through acquisitions. Also,

EXHIBIT 4: Video Game Studio and Publisher Brand Awareness in the United States, August 2022



Source: "Video game studio and publisher brand awareness according to games in the United States, as of August 2022," *Statista,* **https://www.statista.com/statistics/1341633/video-game-studio-publisher-brand-awareness-us/** (accessed June 12, 2023).

the company's managers recognized that while many new products and services were introduced to gamers, only a relatively small number drove significant engagement and accounted for a significant portion of total revenues.

Electronic Arts leadership would need to forecast and anticipate the rivals' moves and successfully implement new or evolving technologies. Expansion opportunities included expansion of its mobile business and building a more extensive EA SPORTS portfolio. In addition, a commitment of resources allocated to product development was necessary to advance the availability of games compatible with new consoles, systems, and devices. Also of interest was how acquisitions or strategic alliances in new technologies such as artificial intelligence, virtual reality, and the Metaverse might lead to growth in revenues and shareholder value.

CASE 13

Under Armour in 2023: What Should the New CEO Do to Boost the Company's Performance?

Arthur A. Thompson
The University of Alabama

Going into 2023, Under Armour was headed into its seventh consecutive year of sales and profit difficulties in its core North American market. The troubles began in 2016 and undermined Under Armour's reputation as an up-and-coming growth company in the sports apparel business. Starting in the second-quarter of 2010 and continuing through the second-quarter of 2016, Under Armour achieved revenue growth of 20+ percent for 24 consecutive quarters. But UA's quarterly revenue growth slowed to 15.6 percent in Q3 of 2016 and to 11.7 percent in Q4. Full-year operating income in North America dropped from $461 million in 2015 to just $411.3 million in 2016. Even so, UA's North American revenues in 2016 reached $4.0 billion, and its global revenues were $4.8 billion. But since 2016, Under Armour's revenues in North America had yet to reach the $4 billion mark again, falling to a low of $2.95 billion in 2020 during the COVID-19 pandemic and recovering in the post-pandemic years to $3.81 billion in 2021 to $3.85 billion in the 12 months ending March 31, 2022, and to $3.82 billion in the 12 months ending March 2023. Company profitability had suffered also, particularly during 2017–2020, dropping from $257.0 million in 2016 to a net loss of $48.3 million in 2017, a net loss of $46.3 million in 2018, a net profit of $92.1 million in 2019, and a net loss of $549.2 million in 2020. The losses in 2017 and 2018 were due chiefly to two restructuring programs to address operating inefficiencies, transition to a product category management structure, and reengineer the company's go-to-market process (product innovation and design, vendor relationships, delivery times of seasonal products, inventory management, profit margin control, and speed of response to shifting consumer preferences and market conditions). The company's horrendous performance in 2020 was due in part to an $800 million drop in sales revenues caused by the COVID-10 pandemic and in part to the size and timing of a third even larger restructuring initiative to further improve profitability and cash flow generation and to forgo opening a flagship store in New York City while pursuing options to sublease the space under the long-term lease already in place—this resulted in restructuring and impairment charges of $613.4 million. Company profitability improved to $360.1 million in 2021 and to $386.8 million in fiscal 2023 ending March 31, 2023.

Under Armour's struggles to grow its sales revenues in North America, to consistently achieve attractive bottom-line profitability, and to reward shareholders with an upward-trending stock price during 2017–2022 prompted changes at the top executive level. In 2019, founder and CEO Kevin Plank, who had been devoting a sizeable portion of his time on outside interests, decided to relinquish his position as CEO and step into the roles of Executive Chairman and Chief Brand Officer. Patrik Frisk, who joined Under Armour in 2017 and was serving as the company's President and Chief Operating Officer was elevated to President and CEO. Both changes were effective January 1, 2020.

As president and COO, Frisk had responsibility for Under Armour's go-to-market strategy and the successful execution of its long-term growth plan. When he became CEO, Frisk worked to limit the amount of discounting that Under Armour was doing with third-party retailers in an attempt to buoy profits. He also tried to make the brand appear more premium next to peers like Nike and lululemon. And he had to wrestle with a host of global supply chain challenges that emerged during the COVID-19 pandemic and that were still lingering in 2022.

In May 2022, Under Armour unexpectedly announced that Frisk would be stepping down as President and CEO and as a member of the Board of Directors, effective June 1, 2022. Under Armour's board initiated a comprehensive internal and external search process to identify a permanent President and CEO. Until a successor was named, the board appointed Colin Browne, the company's Chief Operating Officer (COO), as interim President and CEO, effective June 1, 2022. In December 2022, Under Armour announced that Stephanie Linnartz would join the company as President, CEO, and member of the company's board of directors effective February 27, 2023. Linnartz was currently the president of Marriott International, the world's largest hospitality company, with 8,200 properties across 138 countries and territories and a portfolio of 30 brands that included The Ritz-Carlton®, St, Regis®, Marriott Hotels®, W® Hotels, and Westin® plus the industry's most extensive customer-loyalty program, Marriott Bonvoy®, which had 173 million members. Colin Browne was to resume his position as Chief Operating Officer.

Exhibit 1 shows selected financial statement data for Under Armour for fiscal years 2019–2023.

Company Background

Founded in 1996 by former University of Maryland football player Kevin Plank, Under Armour was the originator of sports apparel made with performance-enhancing fabrics—gear engineered to wick moisture from the body, regulate body temperature, and enhance comfort regardless of weather conditions and activity levels. Plank's initial plan was to make a T-shirt that provided compression and wicked perspiration off the wearer's skin, thereby avoiding the discomfort of sweat-absorbed apparel—and sell the T-shirt to athletes and sports teams.

He worked the phone and, with a trunk full of shirts in the back of his car, visited schools and training camps in person to show his products. Plank's sales successes were soon good enough that he convinced Kip Fulks, who played lacrosse at Maryland, to become a partner in his enterprise. Operations were conducted on a shoestring budget out of the basement of Plank's grandmother's house in Georgetown, a Washington, D.C. suburb. In 1998, the company's sales revenues and growth prospects were sufficient to secure a $250,000 small-business loan, enabling the company to move operations to a facility in Baltimore. Ryan Wood, one of Plank's acquaintances from high school, joined the company in 1999 and became a partner.

KP Sports' sales grew briskly as it expanded its product line to include high-tech undergarments tailored for athletes in different sports and for cold as well as hot temperatures, plus jerseys, team uniforms, socks, and other accessories. Increasingly, the company was able to secure deals not just to provide gear for one team at a particular school but for most or all of a school's sports teams. However, the company's partners came to recognize the merits of tapping the retail market for high-performance apparel and began making sales calls on sports apparel retailers. In 2000, Scott Plank, Kevin's older brother, joined the company as Vice President of Finance (with certain other operational and strategic responsibilities). When Galyan's, a large retail chain later acquired by Dick's Sporting Goods, signed on to carry KP Sports' expanding line of performance apparel for men, women, and youth in 2000, sales to other sports apparel retailers began to explode. By the end of 2000, the company's products were available in some 500 retail locations.

Prompted by growing operational complexity, increased financial requirements, and plans for further geographic expansion, KP Sports revoked its "S" corporation status and became a "C" corporation on January 1, 2002. The company opened a Canadian sales office in 2003 and began selling its products in the United Kingdom in 2005. At year-end 2005, about 90 percent of the company's revenues came from sales to some 6,000 retail stores in the United States and 2,000 stores in Canada, Japan, and the United Kingdom. In addition, sales were being made to high profile professional athletes and teams, most notably in the National Football League, Major League Baseball, the National Hockey League, and some 400 men's and women's sports teams at NCAA Division 1-A colleges and universities.

EXHIBIT 1 Selected Financial Data for Under Armour, Inc., 2019–2023* (in millions)

	2019	2020	2021	2023*
Selected Income Statement Data				
Net revenues	$ 5,267.1	$4,474.7	$5,683.5	$5,903.6
Cost of goods sold	2,796.6	2,314.6	2,822.0	3,254.3
Gross profit	2,470.5	2,160.1	2,861.5	2,649.3
Selling, general and administrative expenses	2,233.8	2,171.9	2,334.7	2,365.5
Restructuring and impairment charges	—	601.6	40.5	—
Income (loss) from operations	236.8	(613.4)	486.3	283.8
Interest income (expense), net	(21.2)	(47.3)	(44.3)	(12.8)
Other income (expense), net	(5.7)	168.2	(51.1)	16.8
Income (loss) before income taxes	209.8	(492.5)	390.9	287.8
Income tax expense (benefit)	70.0	49.4	32.1	101.0
Income (loss) from equity method investment	(47.7)	(7.2)	1.3	(2.0)
Net income (loss)	$ 92.1	$ (549.2)	$ 360.1	$ 386.8
Basic net income (loss) per share of Class A, B, and C common stock	$ 0.20	$ (1.21)	$ 0.77	$ 0.86
Selected Balance Sheet Data				
Cash and cash equivalents	$ 788.1	$1,517.3	$ 1,669.5	$ 711.9
Working capital**	1,280.2	1,809.7	1,886.1	1,602.7
Inventories at year-end	892.3	896.0	811.4	1,190.3
Total assets	4,843.5	5,030.6	4,991.4	4,875.8
Long-term debt, net of current maturities	592.7	1,003.5	662.5	674.5
Total liabilities	2,623.9	3,354.6	2,902.4	2,858.7
Total stockholders' equity	2,150.1	1,676.0	2,089.0	1,998.4
Selected Cash Flow Data				
Net cash provided by (used in) operating activities	$ 509.0	$ 212.9	$ 664.8	($9.9)

*In February 2021, Under Armour changed its fiscal year from December 31 to March 31. Following a three-month transition period (January 1 – March 31, 2022), Under Armour's fiscal year 2023 will run from April 1, 2022, through March 31, 2023. Consequently, Under Armour did not have a fiscal year 2022. Under Armour's data for 2023 is from the company's press release on May 9, 2023 and the company's 10-K Report for the fiscal year ended March 31, 2023.

**Working capital is defined as current assets minus current liabilities.

Note: Some totals may not add up due to rounding and to the omission of some line items in the company's income statement and consolidated balance sheet.

Source: Company 10-K reports, 2019 and 2021; company press release, May 9, 2023; and 10-K Report for the fiscal year ended March 31, 2023.

In late 2005, KP Sports changed its name to Under Armour and became a public company with an initial public offering of common stock that generated net proceeds of nearly $115 million. Under Armour immediately began to pursue a long-term strategy to grow its product line, to establish a market presence in a growing number of countries across the world, and to build public awareness of the Under Armour brand and its interlocking "U" and "A" logo.

In 2008, Plank voluntarily reduced his salary from $500,000 to $26,000 which was his approximate salary when he founded Under Armour. As UA's largest stockholder, Plank believed he should be compensated for his services based primarily on the company's annual incentive plan tied to the company's performance and on annual performance-based equity awards. Plank's $26,000 salary remained in place until 2021 when his salary was adjusted to $372,385 (the lowest of the company's five most highly compensated executive officers); as before, Plank's primary compensation continued to be tied to the company's performance and annual performance-based equity awards.

Under Armour's growth proceeded nicely through 2015, with its stock price reaching an all-time high of $105 in July 2015 and year-end 2015 sales revenues reaching $3.96 billion, up from $3.08 billion at the end of 2014. But as UA's sales growth in North America versus the same quarter of the prior year slid progressively lower from 25.7 percent in the first quarter of 2016 to 11.7 percent in the last quarter of 2016, the stock price fell even faster to $27 at yearend 2016.

Early Signs of Problems at Under Armour. Then in 2017 as sales revenues in North America began falling dropped by $200 million after slowing down in the last half of 2016 and reaching what turned out to be a peak of just over $4.0 billion at year-end 2016, investors became increasingly concerned; the stock price was down to $12.50 by October 1, 2017. Investors became further unnerved in November 2017 when analysts at 24/7 Wall St. ranked Kevin Plank as No. 4 on its list of "20 Worst CEOs in America 2017."[1] The continuing falloff in North American revenues in 2018 and 2019 deepened investor concerns about whether the Under Armour brand was in deep trouble in North America—the experiences of other troubled brands had demonstrated it was extremely difficult to rebuild a brand once it had fallen out of favor with the public. Kevin Plank had been under the microscope since a controversial split of the company's stock in April 2016 into Class A (vote-entitled), Class B, and Class C (no voting power) shares resulted in Kevin Plank having 65 percent of the total shareholder voting power on every shareholder vote taken.

Since the stock split, Plank had sold some of his Class C shares to fund the creation of Plank Industries, a privately held investment company with ownership interests in commercial real estate, hospitality, food and beverage, venture capital, and thoroughbred horse racing. Plank's critics had claimed the new venture was absorbing too much of his time. In addition, Plank's time in dealing with UA's operating issues and sales slowdown was constrained by his involvement in helping spearhead a 25-year, $5.5 billion project (being partially financed with bonds issued by the City of Baltimore's Baltimore Development Corp.) to develop waterfront property in South Baltimore into a mini-city called Port Covington that would create thousands of jobs and drive demand for office buildings, houses, shops and restaurants. Plank Industries' Sycamore Development Co. was the lead private developer of the Port Covington project. Sycamore had completed a number of properties in the project, including a $24 million renovation of a former Sam's Club into a 170,000 square-foot facility for Under Armour, tentatively named Building 37 (Plank's number on his University of Maryland football jersey was 37). Building 37 was on acreage Under Armour had purchased for $70.3 million in 2014 and was being leased by Sycamore to Under Armour for $1.1 million annually. Building 37 was the first phase of Under Armour's plan to create a 50-acre global headquarters campus that would include a new headquarters building on the site of Building 37, additional Under Armour facilities and manufacturing space, a man-made lake, and a small stadium—a layout designed to house as many as 10,000 Under Armour employees (UA employed approximately 2,100 people in Baltimore in early 2018, some 600 of which were housed in Building 37).

To compensate for the time he was spending on outside interests, Plank had engineered the appointment of Patrik Frisk, formerly CEO of the ALDO Group, a global footwear and accessories company, to serve as President and Chief Operating Officer in June 2017. Frisk had 30 years of experience in the apparel, footwear, and retail industry, holding top management positions with responsibility for such brands as The North Face®, Timberland®, JanSport®, lucy®, and SmartWool®. At the time, Kevin Plank's titles were Chairman of the Board and CEO. Then came the October 2019 announcement that Frisk would become president, CEO, and a member of the company's board with Frisk reporting to Kevin Plank as UA's executive chairman of the board.

UNDER ARMOUR'S STRATEGY IN 2023

Until 2018, Under Armour's mission was "to make all athletes better through passion, design, and the relentless pursuit of innovation." A reworded mission—"Under Armour Makes You Better"—was publicly announced in early 2018 and continued in effect in 2023. Kevin Plank said the new wording was meant to better convey that "in every way we connect, through the products we create, the experience we deliver and the inspiration we provide, we simply make you better."[2] In early 2016, Kevin Plank told a gathering of Wall Street analysts in a conference call discussing the company's fourth quarter 2015 results that Under Armour's vision was "to inspire you with performance solutions you never knew you needed and can't imagine living without."[3] This vision was reiterated on several occasions thereafter and remained in place in 2023.

The company's principal business activities in 2023 were the development, marketing, and distribution of branded performance apparel, footwear, and related sports accessories for men, women, and youth. The brand's moisture-wicking apparel and footwear products were engineered in many designs and styles for wear in nearly every climate to provide a performance alternative to traditional products. Under Armour sports apparel was worn by athletes at all levels, from youth to professional, and by consumers with active lifestyles. The company generated revenues from the sale of its products globally through two primary channels: (1) sales to national, regional, independent and specialty wholesalers and distributors in many countries across the world and (2) direct-to-consumer sales (sales at the company's e-commerce websites in the four geographic regions where its products were marketed and at its company-owned brick-and-mortar Brand Houses and factory outlet stores at locations across the world).

In the company's earlier years, revenue growth was achieved primarily by growing wholesale sales to retailers of sports apparel, athletic footwear, and sports equipment and accessories in North America. Starting in 2010, Under Armour began increasing its global footprint by expanding its wholesale and e-commerce sales to countries in Latin America, the Asia-Pacific, and Europe, the Middle East, and Africa (EMEA).

In 2013, Under Armour acquired MapMyFitness for $150 million, a provider of website services and mobile apps to fitness-minded consumers across the world; Under Armour used this acquisition, along with several follow-on acquisitions, including MyFitnessPal for $475 million (which had about 30 million users) and Denmark-based Endomondo for $85 million (which claimed 20 million fitness users), to create what it termed a "connected fitness" business offering digital fitness subscriptions and licenses, mobile apps, and other fitness-tracking and nutritional-tracking solutions to athletes and fitness-conscious individuals across the world. During 2016–2020, the company's connected fitness business experienced strong revenue growth and built a user base of some 200 million individuals. However, in November 2020, Under Armour announced it was selling MyFitnessPal for $345 million and shutting down its Endomondo social network sometime in 2021. But Under Armour retained the MapMyFitness software platform which included the MapMyRide and MapMyRun apps. Revenues and expenses associated with the company's connected fitness business were no longer reported separately as of 2021 but, instead, were included as part of the company's "corporate administration" account.

Growth Strategy

In announcing Under Armour's fiscal 2023 revenues and earnings results, the company's new CEO Stephanie Linnartz said,"[4]

> Fiscal 2024 will be a year of building for the brand. I am prioritizing significantly amplifying global brand heat; delivering elevated design and products, with a focus on Sportstyle, footwear, and women; and positioning us to drive better sales growth in the United States. We will leverage our strong portfolio of franchises. . . . .to drive innovation across new products and markets. We must deliver better for athletes and our customers and meaningfully increase returns for shareholders in the years ahead.

Product Line Strategy

For a number of years, expanding the company's product offerings and marketing them at multiple price points had been a key element of Under Armour's strategy. The goal for each new item added to the line-up of offerings was to provide consumers with a product that was a *superior* alternative to the traditional products of rivals—striving to always introduce a superior product that management believed would help foster and nourish a culture of innovation among all company personnel.

Apparel The company designed and merchandised three lines of apparel gear intended to regulate body temperature and enhance comfort, mobility, and performance regardless of weather conditions: HEATGEAR® for hot weather conditions; COLDGEAR® for cold weather conditions; and ALLSEASONGEAR® for temperature conditions between the extremes.

HeatGear. HeatGear was designed to be worn in warm to hot temperatures under equipment or as a single layer. In sharp contrast to a sweat soaked cotton T-shirt that could weigh two to three pounds, HeatGear was engineered with a microfiber blend featuring what Under Armour termed a "Moisture Transport System" that ensured the body would stay cool, dry, and light. HeatGear was offered in a variety of tops and bottoms in a broad array of colors and styles for wear in the gym or outside in warm weather.

ColdGear. Under Armour high performance fabrics were appealing to people participating in cold-weather sports and vigorous recreational activities like snow skiing who needed both warmth and moisture-wicking protection from becoming overheated. ColdGear was designed to wick moisture from the body while circulating body heat from hotspots to maintain core body temperature. All ColdGear apparel provided dryness and warmth in a single light layer that could be worn beneath a jersey, uniform, protective gear or ski-vest, or other cold weather outerwear. ColdGear products generally were sold at higher price points than other Under Armour gear lines.

AllSeasonGear. AllSeasonGear was designed to be worn in temperatures between the extremes of hot and cold and used technical fabrics to keep the wearer cool and dry in warmer temperatures while preventing a chill in cooler temperatures.

Each of the three apparel lines contained three fit types: compression (tight fit), fitted (athletic fit), and loose (relaxed). Some of Under Armour's apparel and footwear products contained MicroThread, a fabric technology that used elastomeric (stretchable) thread to create a cool moisture-wicking microclimate, prevented clinging and chafing, and allowed garments to dry 30 percent faster and be 70 percent more breathable than similar Lycra construction. Under Armour had also introduced a collection of workout gear, headwear, and footwear with an exclusive CoolSwitch coating on the inside of the fabric that pulled heat away from the skin, allowing the wearer to feel cooler and perform longer. More recently, Under Armour had introduced Rush™ or Recover™ products designed to increase blood flow. It also had recently introduced garments embedded with such innovations and technologies as ColdGear Infrared®, UA Isochill™, UA Smartform™, and UA Storm™.

Footwear Under Armour began marketing athletic footwear for men, women, and youth in 2006 and had expanded its footwear line every year since. New footwear collections for men, women, and youth were introduced annually, sometimes seasonally. Most new models and styles incorporated fresh technological features of one kind or another. Its 2023 offerings included footwear models specifically designed for performance training, running, footwear, basketball, golf, outdoor wear, and cleated footwear for football, baseball, lacrosse, softball, and soccer. Under Armour's footwear models were light, breathable, and built with performance attributes specific to their intended use. Over the past seven years, a stream of innovative technologies had been incorporated in the ongoing generations of footwear models/styles to improve stabilization, cushioning, moisture management, comfort, directional control, and performance.

To capitalize on a recently signed long-term endorsement contract with pro basketball superstar Stephen Curry, in 2014 Under Armour began marketing a Stephen Curry Signature line of basketball shoes; the so-called Curry One models had a price point of $120. This was followed by an ongoing series of new Curry collections introduced periodically at steadily rising price points. In 2023, the latest Curry 10 collection had a $160 price point. In March 2023, Under Armour announced it was strengthening its partnership with Curry and elevating him to President of the Curry brand. This was expected to result in extending Curry-branded products from basketball to golf, women, youth, and sportstyle product categories, plus featuring Curry in new media campaigns to enhance Under Armour's brand image and gaining Curry's help in expanding UA's roster of athlete endorsements.

After signing pro golfer Jordan Spieth to a 10-year endorsement contract in early 2015—Spieth had a spectacular year on the Professional Golf Association (PGA) tour in 2015 and was named 2015 PGA Tour Player of the Year—Under Armour promptly sought to leverage the signing by introducing an all-new 2016 golf shoe collection in April 2016; the collection had 3 styles, ranging in price from $160 to $220. A new Spieth One Signature collection was introduced in early 2017 with much the same price points, followed by a Spieth Two collection in early 2018, which was accompanied by a Spieth Tour™ golf glove, and a Spieth 3 collection in early 2019. In 2023, Under Armour was marketing golf shoes, golf pants and shorts, short- and long-sleeve Playoff polos, UA Tech polos, UA Performance polos, UA Storm fleeced quarter-zip sweaters, half-zip UA Storm waterproof pullovers, Spieth golf hats and assorted other golfing accessories.

Growing numbers of Under Armour's footwear models in 2018–2023 featured such recently developed technologies as Anafoam (which provided a chafe-free, body-mapped fit and lightweight structure and support) and Charged Cushioning® (which provided stabilization, directional cushioning, and moisture management, engineered to maximize comfort and control). In 2018, Under Armour debuted a new, multi-featured HOVR™ running shoe, which Kevin Plank hailed as a new product that hit what he called "the trifecta—style, performance, and fit." HOVR models used compression mesh and a special molded foam that provided a "zero gravity feel," gave the runner return energy with each step to reduce impact, and delivered "unmatched comfort." Plank believed the HOVR was "a home run" and a reflection of the company's growing capabilities to churn out innovative products. In 2020–2023, HOVR models were available for running, training, basketball, golf, and casual wear. UA's Clutch Fit® technology used in some footwear models flexed and responded "like your second skin."[5] Under Armour used to make cleats for football, baseball, softball and soccer shoes (which were sold as part of its Accessories business segment), but had shifted to making cleated footwear for these sports instead.

As of 2023, Under Armour was touting newly introduced models featuring a variety of under-foot cushioning technologies labeled UA HOVR™, UA TriBase™, Charged Cushioning®, UA Micro G®, and UA Flow™. These cushioning platforms provided athletes with plush underfoot and improved ground feel, enhanced responsiveness and lightweight solutions, and advanced outsole construction, engineered to fit the needs of a specific sport or high-performance activity. The company's most recent footwear models introduced in 2023 featured UA's new SlipSpeed™ heel-folding technology, combined with UA Flow lightweight cushioning, ISO-CHILL heel-to-toe foam padded interiors, and UA's new BOA Fit System that employed advanced lacing capabilities that produced "a personalized fit."

As growing numbers of footwear buyers became attracted to designing their own athletic and casual footwear (which Nike was first to introduce), Under Armour quickly followed Nike's lead and introduced software that allowed shoppers to design their own customized footwear, using uploaded images, customizable patterns, an assortment of styles and technologies, and a giant array of color options and logos.

Accessories Under Armour's accessory line in 2023 included gloves, socks, hats and headwear, belts, backpacks and bags, eyewear, protective gear, headphones, phone cases and mounts, water bottles and coolers, and an assortment of sports equipment. All of these accessories featured performance advantages and functionality similar to other Under Armour products. For instance, the company's baseball, football, golf, and running gloves included HEATGEAR®, COLDGEAR®, and Clutch Fit® technologies and were designed with advanced fabrics to provide various high-performance attributes that differentiated Under Armour gloves from those of rival brands.

Under Armour's Entry into "Connected Fitness" In December 2013, Under Armour acquired MapMyFitness, which served one of the largest fitness communities in the world at its website and offered a diverse suite of websites and mobile applications under its flagship brands, MapMyRun and MapMyRide. Utilizing GPS and other advanced technologies, MapMyFitness provided users with the ability to map, record, and share their workouts. Under Armour acquired European fitness app Endomondo and food-logging app MyFitnessPal in 2015, enabling UA to create a multifaceted connected fitness dashboard that used four independently functioning apps (MapMyFitness, MyFitnessPal, Endomondo, and UA Record™) to enable subscribers to log workouts, runs, and foods eaten, and to use a digital dashboard to review measures relating to their sleep, fitness, activity, and nutrition. Next, UA introduced a Connected Fitness System called Under Armour HealthBox™ that consisted of a multifunctional wristband (that measured sleep, resting heart rate, steps taken, and workout intensity), heart rate strap, and a smart scale (that tracked bodyweight, body fat percentage, and progress toward a weight goal); the wristband was water resistant, could be worn 24/7, and had Bluetooth connectivity with UA Record.

Kevin Plank was so enthusiastic about the long-term potential of Under Armour's Connected Fitness business that he had boosted the company's team of engineers and software developers from 20 to over 350 during 2014 and 2015. In 2016, Under Armour organized all of its digital and fitness technologies and products into a new business division called Connected Fitness, under the leadership of a senior vice president of digital revenue. By December 2018, Under Armour believed it had created the world's largest digital health and fitness community. More than 250 million people had downloaded one of the company's digital fitness apps. Many users were quite active, with more than 2 million workouts and 30 million foods being logged daily across the world. Under Armour had learned that members of its digital ecosystem purchased 36 percent more Under Armour products than other consumers and that their brand preference for Under Armour products was significantly higher.[6]

While Connected Fitness sales grew rapidly, the business initially lost millions of dollars annually but achieved profitability in 2018. As part of the 2017 restructuring program, Under Armour merged its core connect fitness digital products, digital engineering, and digital media under the direction of a chief technology officer; this management arrangement evolved further in early 2018 with the appointment of a new senior vice president, digital product, who reported to the chief technology officer and had responsibility for leading the strategy for all digital product development in collaboration with executive management, product category heads, marketing, and creative/design. In Under Armour's February 2018 earnings announcement, the Connected Fitness business reported its first-ever positive operating income (almost $800,000) for the fourth quarter of 2017; for full-year 2018, the connected fitness business reported operating income of $5.9 million. Under Armour reported that premium subscription revenue for its Connected Fitness business grew about 56 percent during 2018. UA's MyFitnessPal was the number one grossing health and fitness app in the Apple App Store; in 2018, users of this app had over 9 billion foods and burned more than 440 billion calories. Users of various Connected Fitness apps participated in social media communities on Instagram, WeChat, Snap, YouTube, Facebook, and other platforms. At the end of 2021, Under Armour sold its Connected Fitness business for an undisclosed sum, except for its Map My Fitness digital platform (which included Map My Ride and MapMyRun); UA's MapMyFitness app was still available for download and use in 2023.

Licensing Under Armour had licensing agreements with a number of firms to produce and market Under Armour apparel, accessories, and equipment. Under Armour product, marketing, and sales teams were actively involved in all steps of the design process for licensed products in order to maintain brand standards and consistency. Under Armour pre-approved all products manufactured and sold by its licensees, and the company's quality assurance team strived to ensure that licensed products met the same quality and compliance standards as company-sold products. During fiscal 2023, UA licensees offered collegiate apparel and accessories, baby and youth apparel, team uniforms, socks, water bottles, eyewear, and other specific hard goods equipment that featured performance advantages and functionality like other UA product offerings.

Exhibit 2 shows Under Armour's revenues for its three main product categories plus revenues associated with its licensing arrangements for 2019 through 2023.

DISTRIBUTION STRATEGY

The majority of Under Armour's sales were generated through wholesale channels, including national and regional sporting goods chains, independent and specialty retailers, discount retailers (Walmart and Target), and department store chains. Under Armour products were available in roughly 20,000 retail store locations worldwide in 2018–2022. In many foreign countries, Under Armour relied on independent marketing and sales agents, instead of its own marketing staff, to recruit retail accounts and solicit orders from retailers for UA merchandise. Under Armour also sold its products directly to consumers through its own Brand House stores, factory outlet stores, and e-commerce websites.

EXHIBIT 2 Under Armour's Revenues, by Product Category, 2019–2023* (in millions of $)

	2019		2020		2021		2023*	
Product/Revenue Category	Dollars	Percent	Dollars	Percent	Dollars	Percent	Dollars	Percent
Apparel	$3,470.3	67.9%	$2,882.6	66.5%	$3,841.2	67.6%	$ 3,871.6	66.2%
Footwear	1,086.6	21.3%	934.3	21.5%	1,264.1	22.3%	1,455.3	24.9%
Accessories	416.4	8.1%	414.1	9.5%	461.9	8.1%	408.5	7.0%
Total net sales	4,973.2	94.4%	4,231.0	97.6%	5,567.2	98.0%	$ 5,735.4	98.1%
License revenues	138.8	2.7%	105.8	2.4%	112.6	2.0%	116.7	2.0%
Total net revenues	$5,112.0	100.0%	$4,336.8	100.0%	$5,679.8	100.0%	$ 5,852.1	100.0%

Note 1: Percentages may not add to 100% because of rounding.

**In* February 2021, Under Armour changed its fiscal year from December 31 to March 31. Following a three-month transition period (January 1 – March 31, 2022), Under Armour's fiscal year 2023 ran from April 1, 2022, through March 31, 2023. Consequently, Under Armour did not report a fiscal year 2022. Under Armour's data for 2023 is from the company's press release on May 9, 2023, and the company's 10-K Report for the fiscal year ended March 31, 2023.

Source: Company 10-K reports, 2019 and 2021; company press release, May 9, 2023; and 10-K Report for the fiscal year ended March 31, 2023.

Wholesale Distribution In 2018, Under Armour had about 13,500 points of distribution in North America, just under 40 percent of the 35,000 places that consumers could buy athletic apparel and footwear.[7] The company's biggest retail account was Dick's Sporting Goods, which in 2023 accounted for just under 10 percent of the company's net revenues. Until its bankruptcy and subsequent store liquidation in 2016, The Sports Authority had been UA's second largest retail account; the loss of this account was a principal factor in Under Armour's struggle to grow wholesale sales to retailers in North America. Other important retail accounts included Academy Sports and Outdoors, Hibbett Sporting Goods, Modell's Sporting Goods, Bass Pro Shops, Cabela's, Footlocker, The Army and Air Force Exchange Service, Walmart, and Target and such well-known department store chains as Macy's, Nordstrom, Belk, Dillard's, and Kohl's. In Canada, the company's important retail accounts included Sport Chek and Hudson's Bay. Roughly 75 percent of all sales made to retailers were to large-format national and regional retail chains. The remaining 25 percent of wholesale sales were to lesser-sized outdoor and specialty retailers, institutional athletic departments, leagues, teams, and fitness specialists. Independent and specialty retailers were serviced by a combination of in-house sales personnel and third-party commissioned manufacturer's representatives.

Direct-to-Consumer Sales In 2023, about 38 percent of Under Armour's net revenues were generated through direct-to-consumer sales, versus 23 percent in 2010 and 6 percent in 2005; the direct-to-consumer channel included sales of discounted merchandise at Under Armour's factory outlet stores and full-price sales at Under Armour Brand Houses, and various country websites. The factory outlet stores gave Under Armour added brand exposure and helped familiarize consumers with Under Armour's product lineup while also functioning as an important channel for selling discontinued, out-of-season, and/or overstocked products at discount prices without undermining the prices of Under Armour merchandise being sold at retail stores, Brand Houses, and company websites. Going into fiscal 2024, Under Armour was operating 176 stores in factory outlet malls in North America.

During the past several years, Under Armour had opened company-owned Brand House stores in high-traffic retail locations in the United States to showcase its branded apparel and sell its products direct-to-consumers at retail prices. As of March 31, 2023, the company was operating 18 Under Armour Brand House stores in North America.

UA management's e-commerce strategy called for sales at www.underarmour.com (and 26 other in-country websites as of 2016) to be one of the company's principal vehicles for sales growth in upcoming years. To help spur e-commerce sales, the company had enhanced its efforts to drive traffic to its websites, improve its online merchandising techniques, and do a better job of storytelling about the many different Under Armour products sold on its sites. In 2017–2019, UA had made frequent use of discounted price promotions to spur online sales, but top executives decided that discount-pricing had been overdone and damaged the company's image as a premium brand. In 2020, the strategy at UA websites was to cut back on discounted price promotions and, instead, utilize marketing and advertising efforts that portrayed Under Armour as a premium brand with an attractive line-up of top-quality, high-performance products well worth paying a premium price to own.

To begin reshaping its marketing approaches, in 2019 and early 2020 Under Armour started including much more user-generated content on its e-commerce website to help tell the story about UA products. This user-generated content included customer ratings and reviews, Instagram snapshots and videos of shoppers and well-known athletes wearing UA products, feedback from pre-launch "wear-testers," and quotes from athletes and spokespeople like Stephen Curry, Dwayne Johnson, and other endorsers of the company's products. Management believed that the opinions of what shoppers and athletes said about Under Armour's performance-driven products carried more weight with prospective buyers than what Under Armour said in its product descriptions.

To better compete with Amazon and other online sellers of performance sports apparel and athletic footwear, in 2023 the company offered free standard shipping (3–5 business days) on orders over $99. From time-to-time, free limited-time shipping was offered on overstocked items. Free shipping on returns within 60 days was standard.

Distribution outside North America Under Armour's first strategic move to gain international distribution occurred in 2002 when it established a relationship with a Japanese licensee, Dome Corporation, to be the exclusive distributor of Under Armour products in Japan. The relationship evolved, with Under Armour making a minority equity investment in Dome Corporation in 2011 and Dome gaining distribution rights for South Korea. Dome sold Under Armour branded apparel, footwear, and accessories to professional sports teams, large sporting goods retailers, and several thousand independent retailers of sports apparel in Japan and South Korea. Under Armour worked closely with Dome to develop variations of Under Armour products to better accommodate the different sports interests and preferences of Japanese and Korean consumers.

In 2006, Under Armour opened a headquarters in Amsterdam, The Netherlands, to conduct and oversee sales, marketing, and logistics activities across Europe. The strategy was to first sell Under Armour products directly to teams and athletes and then leverage visibility in the sports segment to access broader audiences of potential consumers. By 2011, Under Armour had succeeded in selling products to Premier League Football clubs and multiple running, golf, and cricket clubs in the United Kingdom; soccer teams in France, Germany, Greece, Ireland, Italy, Spain, and Sweden; as well as First Division Rugby clubs in France, Ireland, Italy, and the United Kingdom. Sales to European retailers quickly followed on the heels of gains being made in the sports team segment. By year-end 2012, Under Armour had 4,000 retail customers in Austria, France, Germany, Ireland, and the United Kingdom and was generating revenues from sales to independent distributors who resold Under Armour products to retailers in Italy, Greece, Scandinavia, and Spain.

In 2023, Under Armour sold its apparel, footwear and accessories in Europe primarily through wholesale customers and independent distributors; these sales were supplemented with the sales made at the e-commerce websites and Brand and Factory House stores it operated within Europe. Under Armour also sold branded products directly to various sports clubs and teams in Europe. Generally, Under Armour distributed its products to retail customers and e-commerce consumers in Europe through a third-party logistics provider in the Netherlands and a bonded warehouse in the United Kingdom. In the Middle East and Africa Under Armour products were sold through independent distributors. Adidas strongly defended its industry-leading position with European retailers, and Under Armour frequently found itself embroiled in hotly contested price-cutting battles with adidas and Nike to win orders from retailers in many EMEA locations.

In 2010 and 2011, Under Armour began selling its products in parts of Latin America and Asia. In Latin America, Under Armour sold directly to retailers in some countries and in other countries sold its products to independent distributors who then were responsible for securing sales to retailers. In 2014, Under Armour launched efforts to make Under Armour products available in over 70 of Brazil's premium points of sale and e-commerce hubs; expanded sales efforts were also initiated in Chile and Mexico. By 2018, Under Armour had about 4,000 points of distribution in Latin America. While sales had trended upward in Latin America except for 2020 when the COVID-19 was at its peak, the company had reported operating losses in the region every year until 2021. In fiscal 2021, Under Armour transitioned away from direct sales operations to distributors in several countries within the Latin America region. In 2023, Under Armour sold apparel, footwear, and accessories in Mexico through wholesale and direct-to-consumer channels. In countries where it no longer had direct sales operations, such as Chile, Argentina, Colombia and Brazil, Under Armour distributed its products through independent distributors, sourced primarily through its international distribution hub in Panama. In fiscal 2023, UA reported record net revenues of $213.2 million and record operating profits of $23.5 million in Latin America (see Exhibit 3).

In 2011, Under Armour opened a retail showroom in Shanghai, China—the first of a series of steps to begin the long-term process of introducing Chinese athletes and consumers to the Under Armour brand, showcase Under Armour products, and learn about Chinese consumers. Additional retail locations in Shanghai and Beijing soon followed (some operated by local partners). By April 2014, there were five company-owned and franchised retail locations in mainland China that merchandised Under Armour products; additionally, the Under Armour brand was first introduced in Hong Kong through a partnership with leading retail chain GigaSports. Under Armour

EXHIBIT 3 Under Armour's Revenues and Operating Income for Its Four Geographic Regions 2019–2023*

A. Net revenues by geographic region (in millions of $)

	2019	2020	2021	2023*
North America	$3,658.4	$2,945.0	$3,810.4	$3,821.0
Europe–Middle East–Africa (EMEA)	621.1	598.3	842.5	992.6
Asia-Pacific	636.3	628.7	831.8	825.3
Latin America	196.1	164.8	195.3	213.2
Total net revenues	$5,111.9	$4,336.8	$5,683.5	$5,852.1

B. Operating income (loss) by geographic region (in millions of $)

	2019	2020	2021	2023*
North America	$733.4	$474.6	$ 972.1	$734.9
Europe–Middle East–Africa (EMEA)	53.7	60.6	132.6	112.2
Asia-Pacific	97.6	2.0	132.9	100.3
Latin America	(3.2)	(42.8)	22.4	23.5
Total operating income	$881.5	$494.4	$1,260.0	$970.9

*In February 2021, Under Armour changed its fiscal year from December 31 to March 31. Following a three-month transition period (January 1 – March 31, 2022), Under Armour's fiscal year 2023 ran from April 1, 2022, through March 31, 2023. Consequently, Under Armour did not have a fiscal year 2022. Under Armour's data for 2023 is from the company's press release on May 9, 2023, and 10-K Report for the fiscal year ended March 31, 2023.

Source: Company 10-K reports, 2019 and 2021; company press release, May 9, 2023; and 10-K Report for the fiscal year ended March 31, 2023.

began selling its branded apparel, footwear, and accessories to independent distributors in Australia, New Zealand, and Taiwan in 2014. As of March 2032, Under Armour sold its products in China, South Korea, Australia, Singapore, Malaysia, and Thailand through stores operated by distribution and wholesale partners, along with e-commerce websites and its Brand and Factory House stores that operated in these countries. In New Zealand, Taiwan, Hong Kong, India and other countries in Southeast Asia where UA did not have direct sales operations, it sold products to distributors. UA Armour products sold in Asia-Pacific were distributed through third-party logistics providers based in Hong Kong, China, South Korea, Australia, and Singapore.

In 2023, Under Armour still had a licensing agreement with its partner in Japan, Dome Inc., to produce, market and sell UA-branded apparel, footwear, and accessories to large sporting goods retailers, independent specialty stores, professional sports teams, and licensee-owned retail stores in Japan and South Korea. Under Armour's non-controlling stake in Dome remained in place.

In 2013, Under Armour organized its international activities into four geographic regions—North America (the United States and Canada), Latin America, Asia-Pacific, and Europe/Middle East/Africa (EMEA). In the company's 2013 Annual Report, Kevin Plank said, "We are committed to being a global brand with global stories to tell, and we are on our way."[8] Sales of Under Armour products in EMEA, the Asia-Pacific, and Latin America in fiscal 2023 accounted for 34 percent of Under Armour's total net revenues, up from 15.3 percent in 2016, and 8.7 percent in 2014. Exhibit 3 shows Under Armour's revenues and operating income for each of its four geographic regions for fiscal years 2019–2023.

Under Armour saw growth in foreign sales as the company's biggest market opportunity going forward, chiefly because of the sheer number of people residing outside the United States who could be attracted to patronize the Under Armour brand. In 2019 Nike generated just over 57 percent of its revenues outside North America, and adidas got about 77 percent outside of North America—these big international sales percentages for Nike and adidas were a big reason why Under Armour executives were confident that growing UA's international sales represented an enormous market opportunity for the company, despite the stiff competition it could expect from its two bigger global rivals.

One of Under Armour's chief initiatives to build greater international awareness of the Under Armour brand and grow its sales internationally was to continue to open more factory outlet stores in popular factory outlet malls and to open more Brand Houses in visible, high-traffic locations in major international cities. UA had 165 factory outlet stores and 80 Brand House stores in international locations as of year-end 2023, up from 37 factory outlet and 35 Brand House stores in various international locations at year-end 2017.

Marketing, Promotion, and Brand Management Strategies

Under Armour's marketing efforts were focused on driving consumer demand for its performance-enhancing products, communicating how Under Armour products delivered advantages to make athletes perform better, and building greater awareness of Under Armour as a leading performance athletic brand. The company's marketing expenses were not reported separately but were included as part of selling, general, and administrative expenses (see Exhibit 1).

Sports Marketing Under Armour's sports marketing and promotion strategy began with promoting the sales and use of its products to high-performing athletes and teams on the high school, collegiate, and professional levels. This strategy was executed by entering into outfitting agreements with a variety of collegiate and professional sports teams, sponsoring and hosting an assortment of collegiate and professional sports events, entering into endorsement agreements with individual athletes, and selling Under Armour products directly to team equipment managers and to individual athletes. Under Armour had been the official supplier of competition suits, uniforms, and training resources for a number of U.S. Olympic teams in the 2014 Winter Olympics, 2016 Summer Olympics, 2018 Winter Olympics, 2020 Summer Olympics, and 2022 Winter Olympics and for teams in eight NCAA conferences. In addition, UA hosted combines, camps, and clinics for young athletes in many sports at regional sites across the United States. Internationally, Under Armour sponsored and sold its products to several Canadian, European, and Latin American soccer and rugby teams to help drive brand awareness in various countries and regions across the world.

Going into 2023, Under Armour was the official outfitter of men's and women's athletic teams at such collegiate institutions as Notre Dame, Boston College, Northwestern, Texas Tech, Maryland, South Carolina, Cincinnati, the U.S. Naval Academy, Wisconsin, Indiana, California, Utah, and Auburn. All told, it was the official outfitter of some 200 men's and women's collegiate athletic teams, growing numbers of high school athletic teams, and it supplied sideline apparel and fan gear for many collegiate teams as well.

Under Armour was quite active in negotiating agreements to supply products to high profile professional athletes and professional sports teams, most notably in the National Football League (NFL) and the National Basketball Association (NBA). It was active in being the official supplier and/or the official sponsor for a number of sports organizations, and it sponsored and hosted a variety of sports and consumer events in countries across the world. The company frequently worked with an assortment of manufacturing and distribution partners to sell licensed fan wear at retail in various regions and countries.

As a result, UA products were seen on the playing field (typically with the Under Armour logo prominently displayed), giving them exposure to various consumer audiences attending live sports events or watching these events on television and through other media (pictures and videos accessed via the internet, social media, magazines, and print). Management believed such exposure helped the company establish the on-field authenticity of the Under Armour brand with consumers.

In addition to sponsoring teams and events, a key component of Under Armour's brand-building strategy was to secure endorsement of the company's products by successful individual athletes in a variety of sports. One facet of this strategy was to sign endorsement contracts with newly emerging sports stars—examples included Jacksonville Jaguars running back Leonard Fournette, Milwaukee Bucks point guard Brandon Jennings, Philadelphia 76ers center Joel Embiid, Charlotte Bobcats point guard Kemba Walker, Manchester United soccer star Jayde Riviere, WNBA star Kelsey Plum, tennis phenom Sloane Stephens, WBC super-welterweight boxing champion Camelo Alvarez, and PGA golfer Jordan Spieth. But the company's endorsement roster also included established stars: NFL football players Tom Brady (retired), and Anquan Boldin; Golden State Warriors point guard Stephen Curry; professional baseball players Ryan Zimmerman and Clayton Kershaw; U.S. Women's National Soccer Team players Heather Mitts and Lauren Cheney; U.S. Olympic and professional volleyball player Nicole Branagh; and U.S. Olympic swimmer Michael Phelps. In 2015, Under Armour negotiated 10-year extensions of its endorsement contracts with Stephen Curry and Jordan Spieth; both deals included grants of stock in the company. Recently, Under Armour had signed celebrities outside the sports world to multi-year contracts, including ballerina soloist Misty Copeland and fashion model Giselle Bündchen; wrestler, actor, and producer Dwayne "The Rock" Johnson; and rapper A$AP Rocky (Rakim Mayers). Copeland was featured in one of Under Armour's largest advertising campaigns for women's apparel offerings. Johnson was playing an integral role in promoting UA's connected fitness, apparel, footwear, and accessory products. Mayers was expected to have his own line of premium clothing in a forthcoming Under Armour Sportswear collection. In addition to signing endorsement agreements with prominent sports figures and celebrities in the United States and Europe, Under Armour had become increasingly active in using endorsement agreements with well-known athletes to help build public awareness of the Under Armour brand in those foreign countries where it was striving to build a strong market presence. As of early 2023, Under Armour had signed endorsement agreements with several hundred international athletes in a wide variety of sports.

Under Armour's strategy of signing high-profile sports figures to endorsement contracts, sponsoring a variety of sports events, and supplying products to sports teams emblazoned with the company's logo had long been used by Nike and The adidas Group. Both rivals had far larger rosters of sports figure endorsements than Under Armour and supplied their products to more collegiate and professional sports teams than Under Armour.

Nonetheless, Under Armour's aggressive entry into the market for securing endorsement agreements had spawned intense competition among the three rivals to win the endorsement of athletes and teams with high profiles and high perceived public appeal had caused the costs of winning such agreements to spiral upward. In 2014, Under Armour reportedly offered between $265 million and $285 million to entice NBA star Kevin Durant away from Nike; Nike matched the offer and Durant elected to stay with Nike.[9] In 2015, adidas bested Nike in a bidding war to sign Houston Rockets star and runner-up NBA most valuable player James Harden to a 13-year endorsement deal, when Nike opted not to match adidas' offer of $200 million. The deal with Harden was said to be a move by adidas to reclaim its number two spot in sports apparel sales in North America behind Nike, months after being surpassed by Under Armour.[10] In 2016, it took $280 million for Under Armour to secure a 16-year deal with UCLA to outfit all of UCLA's men's and women's athletic teams (this deal was later terminated). In 2018, Under Armour enticed Joel Embiid to switch from adidas to Under Armour for a five-year apparel and footwear endorsement deal that made him the highest-earning center in the NBA (the exact terms were not disclosed); Joel Embrid won the NBA Most Valuable Player award for the 2022–2023 season.

In 2019, Under Armour spent roughly $120 million for athlete and superstar endorsements, various team and league sponsorships, athletic events, and other marketing commitments, compared to about $126.2 million in 2018, $150.4 million in 2017, and $176.1 million in 2016.[11] At the end of fiscal 2021, the company was contractually obligated to spend almost $350 million for endorsements, sponsorships, events, and other marketing commitments from 2021 to 2025.[12] At the end of fiscal 2023, the company was contractually obligated to spend almost $314 million for endorsements, sponsorships, events, and other marketing commitments from 2024 to 2028.[13] Under Armour did not know precisely what its future endorsement and sponsorship costs would be because its contractual agreements with most athletes were subject to certain performance-based metrics and because it was constantly engaged in efforts to sign additional endorsement contracts and sponsor additional sports teams and athletic events.

Retail Marketing and Product Presentation The primary thrust of Under Armour's retail marketing strategy was to increase the floor space *exclusively* dedicated to Under Armour products in the stores of its major retail accounts. The key initiative here was to design and fund point of sale displays and Under Armour "concept shops"—including flooring, lighting, walls, displays, and images—within the stores of its major retail customers. This shop-in-shop approach was seen as an effective way to gain the placement of Under Armour products in prime floor space and create a more engaging and sales-producing way for consumers to shop for Under Armour products.

In stores that did not have Under Armour concept shops, Under Armour worked with retailers to establish sales-enhancing placement of its products and various point-of-sale displays. In "big-box" sporting goods stores, it was important for Under Armour's growing variety of products to be readily visible in all of the various departments where UA products were displayed (polos and shorts in the sportswear department, footwear and socks in the footwear department, and so on). Except for the retail stores with Under Armour concept shops, company personnel worked with retailers to employ in-store fixtures, life-size mannequins, and displays that highlighted the UA logo and conveyed a performance-oriented, athletic look. The merchandising strategy was not only to enhance the visibility of Under Armour products and drive sales but also grow consumer awareness that Under Armour products delivered performance-enhancing advantages.

Media and Promotion Under Armour advertised in a variety of national digital, broadcast, and print media outlets. It utilized social media to engage consumers and promote connectivity with the Under Armour brand and Under Armour products. The company's advertising campaigns were of varying lengths and formats and frequently included prominent athletes and personalities. Under Armour's total advertising expenses were $618.3 million in fiscal 2023, $173.2 million during the Q1–Q3 fiscal transition period, $649.2 million in fiscal 2021, $550.4 million in 2020, and $578.9 million in 2019.[14] These expenses included media placement costs for ads, the costs of sponsorship agreements with teams and athletes on the collegiate and professional levels, official supplier agreements, and athletic event sponsorships.

Product Design and Development

UA executives believed that product innovation—as concerns both technical design and aesthetic design—was the key to driving Under Armour's sales growth and building a stronger brand name. UA products were manufactured with technically advanced specialty fabrics produced by third parties. The company's product development team collaborated closely with its fabric suppliers to develop innovative technical high performance fabrics and materials and use them to create UA's products having the desired performance and fit attributes. In December 2022, Under Armour announced a new partnership with North Carolina State University to speed the discovery and commercialization of new fabrics with better performance characteristics by teaming its experts and university researchers in collaborative projects at NCSU's Nonwoven Institute (NWI), which operated the world's first academic program for the field of engineered fabrics.

Under Armour regularly upgraded its products as next-generation fabrics with better performance characteristics became available and as the needs of athletes changed. Product development efforts also aimed at broadening the company's product offerings in both new and existing product categories and market segments. An effort was made to design products with "visible technology," utilizing color, texture, and fabrication that would enhance customers' perception and understanding of the use and benefits of Under Armour products.

Under Armour's product development team had significant prior industry experience at leading fabric and other raw material suppliers and branded athletic apparel and footwear companies throughout the world. The team worked closely with Under Armour's sports marketing and sales teams as well as professional and collegiate athletes to identify product trends and determine market needs. Collaboration among the company's product development, sales, and sports marketing team had proved important in identifying the opportunity and market for three recently launched product lines and fabric technologies:

- CHARGED COTTON™ products, which were made from natural cotton but performed like the products made from technically advanced synthetic fabrics, drying faster and wicking moisture away from the body.
- COLDGEAR® Infrared, a ceramic print technology applied to the inside of garments that provided wearers with lightweight warmth and heat retention, breathability, and wind protection.
- UA HOVR™, a proprietary underfoot cushioning wrapped in a mesh web, equipped with a MapMyRun powered sensor designed to deliver energy return and real-time coaching.

In 2017, Under Armour opened a center for footwear performance innovation located in Portland, Oregon, bringing together footwear design and development teams in a centralized location.

Sourcing, Manufacturing, and Quality Assurance

Many of the high-tech specialty fabrics and other raw materials used in UA products were developed by third parties and sourced from a limited number of pre-approved specialty fabric manufacturers; no fabrics were manufactured in-house. Under Armour executives believed outsourcing fabric production enabled the company to seek out and utilize whichever fabric suppliers were able to produce the latest and best performance-oriented fabrics to Under Armour's specifications, while also freeing more time for UA's product development staff to concentrate on upgrading the performance, styling, and overall appeal of existing products and expanding the company's overall lineup of product offerings.

In fiscal 2023, approximately 38 percent of the fabric used in UA products came from five suppliers, with primary locations in Taiwan, China, Turkey , and Malaysia. Because a big fraction of the materials used in UA products were synthetics that included petroleum-based products, fabric costs were subject to crude oil price fluctuations and supply shortages. The cotton used as a blended fabrics used in some of UA's apparel products was subject to price fluctuations and varying availability based on cotton harvests. Under Armour footwear used raw materials sourced from a diverse base of third-party suppliers. These raw materials included chemicals and petroleum-based components such as rubber that were also subject to price fluctuations and supply shortages.

In fiscal 2023, substantially all UA products were made by 33 primary contract manufacturers, operating in 20 countries; 10 manufacturers produced approximately 62 percent of UA's apparel and accessory products. Approximately 59 percent of UA's apparel and accessories products were manufactured in Jordan, Vietnam, Cambodia, and Malaysia. Under Armour's footwear products were made by eight primary contract manufacturers operating primarily in Vietnam, Indonesia, and China.

All contract manufacturers making Under Armour apparel products purchased the fabrics they needed from fabric suppliers pre-approved by Under Armour. All of the makers of UA products across all divisions were evaluated for quality systems, social compliance, and financial strength by Under Armour's quality assurance team, prior to being selected and also on an ongoing basis. The company strived to qualify multiple manufacturers for particular product types and fabrications and to seek out contractors that could perform multiple manufacturing stages, such as procuring raw materials and providing finished products, which helped UA control its cost of goods sold. All contract manufacturers were required to adhere to a code of conduct regarding quality of manufacturing, working conditions, and other social concerns. However, the company had no long-term agreements requiring it to continue to use the services of any manufacturer, and no manufacturer was obligated to make products for UA on a long-term basis. UA had subsidiaries strategically located near its manufacturing partners to support its manufacturing, quality assurance, and sourcing efforts.

Under Armour had a 17,000 square-foot Special Make-Up Shop located at one of its distribution facilities in Maryland where it had the capability to make and ship customized apparel products on tight deadlines for high-profile athletes and teams. While these apparel products represented a tiny fraction of Under Armour's revenues, management believed the facility helped provide superior service to select customers.

Inventory Management

Under Armour based the amount of inventory it needed to have on hand for each item in its product line on existing orders, anticipated sales, and the rapid delivery requirements of customers. Its inventory strategy was focused on (1) having sufficient inventory to fill incoming orders promptly and (2) putting strong systems and procedures in place to improve the efficiency with which it managed its inventories of individual products and total inventory. The amounts of seasonal products it ordered from manufacturers were based on current bookings, the need to ship seasonal items at the start of the shipping window in order to maximize the floor space productivity of retail customers, the need to adequately stock its Factory House and Brand House stores, and the need to fill customer orders at its website. Excess inventories of particular products were either shipped to its Factory House stores or earmarked for sale to third-party liquidators.

However, the growing number of individual items in UA's product line and uncertainties surrounding upcoming consumer demand for individual items made it difficult to accurately forecast how many units to order from manufacturers and what the appropriate stocking requirements were for many items. New inventory management practices were instituted in 2012 and again in 2017 to better cope with stocking requirements for individual items and avoid excessive inventory buildups. However, at the end of fiscal 2023, lululemon had a record $1.1 billion in ending inventory (Exhibit 1).

COMPETITION

The $280 billion global market for sports apparel, athletic footwear, and related accessories was fragmented among some 25 brand-name competitors with diverse product lines and varying geographic coverage and numerous small competitors with specialized-use apparel lines that usually operated within a single country or geographic region. Industry participants included athletic and leisure shoe companies, athletic and leisure apparel companies, sports equipment companies, and large companies having diversified lines of athletic and leisure shoes, apparel, and equipment. The athletic footwear market was valued at $133.1 billion in 2022, and was projected to reach $196.1 billion by 2030, equal to a CAGR of 4.9 percent from 2022 to 2030.[15] The global sports equipment and apparel market was valued at $340.6 billion in 2020, and was projected to hit $930.5 billion by 2031, equal to a CAGR of 8.3 percent from 2022 to 2031.[16] In 2022, demand globally benefitted from large-scale sport events, such as the 2022 Beijing Winter Olympics, the UEFA Women's EURO 2022 in England, and the 2022 FIFA World Cup in Qatar. Exhibit 4 shows a representative sample of the best-known companies and brands in selected segments of the sports apparel, athletic footwear, and sports equipment industry.

Consumers across the world shopped for the industry's products digitally (online) or physically in stores. And they shopped either for a favorite brand or for multiple brands. The trend was for more consumers to shop digitally and for a brand deemed to be the best or their favorite. Multi-brand shoppers typically wanted to explore and compare the options,

EXHIBIT 4 Major Competitors and Brands in Selected Segments of the Sports Apparel, Athletic Footwear, and Accessory Industry, 2023

Performance Apparel for Sports (baseball, football, basketball, softball, volleyball, hockey, lacrosse, soccer, track & field, and other action sports)	Performance-Driven Athletic Footwear	Training/Fitness Clothing
• Nike • Under Armour • Adidas • Eastbay • Russell	• Nike • Adidas • New Balance • Under Armour • Reebok • Puma • Rockport • Converse • Ryka • Asics • Sketchers USA • Li Ning	• Nike • Under Armour • Adidas • Puma • Fila • lululemon athletica • Champion • Asics • Eastbay • SUGOI • Li Ning
Performance Activewear and Sports-Inspired Lifestyle Apparel	**Performance Skiwear**	**Performance Golf Apparel**
• Polo Ralph Lauren • lululemon athletica • Lacoste • Izod • Cutter & Buck • Timberland • Columbia • Puma • Li Ning • Many others	• Salomon • North Face • Descente • Columbia • Patagonia • Marmot • Helly Hansen • Bogner • Spyder • Many others	• Footjoy • Nike • Adidas • Under Armour • Polo Golf • Ashworth • Cutter & Buck • Greg Norman • Yonex • Puma • Many others

either through a **dot.com** experience or in stores where they could view the products firsthand, get advice or personalized assistance, and/or get the product immediately.

As Exhibit 4 indicates, the sporting goods industry consisted of many distinct product categories and market segments. Because the product mixes of different companies varied considerably, it was common for the product offerings of industry participants to be extensive in some segments, moderate in others, and limited to nonexistent in still others. Consequently, the leading competitors and the intensity of competition varied significantly from market segment to market segment and from geographic location to geographic location. Nonetheless, competition tended to be intense in most every segment with substantial sales volume and typically revolved around performance and reliability, the breadth of product selection, new product development, price, brand name strength and identity through marketing and promotion, the ability of companies to convince retailers to stock and effectively merchandise their brands, and the capabilities of the various industry participants to sell directly to consumers through their own retail/factory outlet stores and/or at their company websites. It was common for the leading companies selling athletic footwear, sports uniforms, and sports equipment to actively sponsor sporting events and clinics and to contract with prominent and influential athletes, coaches, professional sports teams, colleges, and sports leagues to endorse their brands and use their products.

Nike was the clear global market leader in the sporting goods industry, with a global market share in athletic footwear of about 25 percent and a sports apparel share of 5 percent. Germany-based Adidas with businesses that produced athletic footwear, sports uniforms, fitness apparel, sportswear, and a variety of sports equipment and marketed them across the world, was the second-largest global competitor. These two major competitors of Under Armour are profiled as follows.

Nike, Inc.

Incorporated in 1968, Nike was the dominant global leader in the design, development, and worldwide marketing and selling of footwear, sports apparel, sports equipment, and accessory products. Nike was a truly global brand, with a broader and deeper portfolio of products, models, and styles than any other industry participant. The company had global sales of $46.7 billion and net income of $6.0 billion in fiscal year ending May 31, 2022. Nike was the world's largest seller of footwear with Nike-branded sales of $29.1 billion and Converse-branded sales of $2.3 billion; it held the number 1 market share in all markets and in all categories of athletic footwear. Nike's footwear line included some 1,500 models/styles. Nike was also the world's largest sports apparel brand, with 2022 sales of $13.6 billion.

Nike's strategy in 2022–2023 was driven by three core beliefs. One was that the growing popularity of sports and active lifestyles reflected a desire to lead healthier lives. As a result, companies like Nike were becoming more relevant for more moments in people's lives because of their growing participation in calorie-burning, wellness, and fitness activities and because active lifestyles stimulated greater interest in sports-related activities and sports events. Moreover, streaming of sports events and social media were changing the ways people consumed sports content. The NBA, for example, had over 1.3 billion social media followers across the league, teams, and player pages. The growth of watching streamed events on mobile phones was exploding. Second, in a connected, mobile-led world, consumers had become infinitely better informed and, thus, more powerful because of the information they could access in seconds and the options this opened up—"powered consumers" were prone to consult their phones (or conduct Internet searches on other devices) for price comparisons and availability before deciding where to shop or what to purchase online. Third, the world was operating at faster speeds and the numbers of powered consumers was about to explode. Nike's CEO expected over 2 billion digitally connected people in markets in China, India, and Latin America would join the middle class by 2030. In North America, Nike estimated that its primary consumer base was 50 million people, but that if population trends in China continued at the expected rate, Nike's projected consumer base in China would be more than 500 million people by 2030.

For years, the heart and soul of Nike's strategy had been creating innovative products and powerful storytelling that produced an emotional connection with consumers and caused them to gravitate to purchase Nike products. But at the same time Nike executives understood that brand strength had to be earned every day by satisfying consumer needs and meeting, if not exceeding, their expectations. Exhibit 5 shows Nike's worldwide retail and distribution network at the end of fiscal 2022.

In October 2017, at Nike's most recent Investor's Day presentation, Nike's CEO at the time Mark Parker provided a brief overview of the company's "Triple Double" strategy that had three components: 2X Innovation, 2X Speed, and 2X Direct:[17]

The 2X Innovation component called for the company to lead with more distinct platforms that transitioned from seeding to scaling much faster and that gave consumers better choices to match their preferences. In addition, this strategy element called for Nike to set a new expectation for style, creating a new aesthetic that buyers could wear on

EXHIBIT 5 Nike's Worldwide Retail and Distribution Network, 2022

United States	Foreign Countries
• ~15,000 retail accounts	• ~15,000 retail accounts
• 209 Nike factory outlet stores	• 597 Nike factory outlet stores
• 48 Nike and NIKETOWN stores	• 47 Nike and NIKETOWN stores
• 87 Converse retail and factory outlet stores	• 58 Converse retail and factory outlet stores
• 8 Primary distribution centers	• 72 Distribution centers
• Company website (www.nike.com)	• Independent distributors and licensees in over 190 countries
	• Websites in 45 countries

many different occasions. Management believed that from a consumer's perspective, there was no trade-off between sport and style. Nike research data indicated that more than half of the athletic footwear and apparel consumers bought was for non-sport activities, and management believed that was much opportunity for Nike to grow its sales of footwear and apparel for non-sport activities.

The role of the 2X Speed strategy component was to be faster in meeting the insatiable consumer demand for new and fresh products. As management put it, "you can't run an up-tempo offense if only half your plays are designed for speed." Hence 2X Speed called for building new capabilities and analytics to deliver new products to consumers quicker. Doing this entailed engaging with more partners company-wide to move faster to get new products into the marketplace quicker. To achieve this, Nike wanted to join forces with leading robotics and automation companies to cut the time between new product design and having manufactured products ready to ship to the marketplace. 2X peed also entailed serving millions of athletes and sports fans faster through manufacturing bases that were closer to North American consumers. The goal of the 2X strategy element was to deliver the right product in the moment, 100 percent of the time.

With 2X Direct [to Consumer], the strategic objective was to have as many Nike touch points as possible live up to the intended outcome of delivering "the right product in the moment." To help this happen, Mark Parker believed that Nike had to invest heavily in identifying and implementing digital solutions in its supply chain and collaborations with its supply chain and distribution partners. Parker's 2X Direct plan was to move resources away from dependence on undifferentiated retail distributors of Nike products to environments where Nike could better control providing shoppers with distinct buyer experiences.

Since 2017, Nike under new CEO John Donahue had launched a Consumer Direct Acceleration initiative in 2020 to ramp up its investments in e-commerce technology aimed at providing more agility in directly serving consumer needs, achieving better engagement with customers, and creating a digital-led marketplace of the future. However, rapid product innovation in both footwear and performance apparel continued to be the primary driver of Nike's strategy to grow revenues and market share, boost earnings, and separate itself from rivals.

Principal Products Nike's roughly 1,500 athletic footwear models and styles were designed primarily for specific athletic use, although many were worn for casual or leisure purposes. Running, training, basketball, soccer, sport-inspired casual shoes, and kids' shoes were the company's top-selling footwear categories. It also marketed footwear designed for baseball, football, golf, lacrosse, cricket, outdoor activities, tennis, volleyball, walking, and wrestling. The company designed and marketed Nike-branded sports apparel and accessories for most all of these same sports categories, as well as sports-inspired lifestyle apparel, athletic bags, and accessory items. Footwear, apparel, and accessories were often marketed in "collections" of similar design or for specific purposes. It also marketed apparel with licensed college and professional team and league logos. Nike-brand offerings in sports equipment included bags, socks, sport balls, eyewear, timepieces, electronic devices, bats, gloves, protective equipment, and golf clubs. Nike was also the owner of the Converse brand of athletic footwear and the Jordan Brand of athletic and casual footwear, apparel, and accessories products; Nike designed products specifically for these two brands.

Exhibit 6 shows a breakdown of Nike's sales of footwear, apparel, and equipment by geographic region for fiscal years 2020 to 2022.

Marketing, Promotions, and Endorsements Nike responded to trends and shifts in consumer preferences by (1) adjusting the mix of existing product offerings; (2) developing new products, styles, and categories; and (3) striving to influence sports and fitness preferences through aggressive marketing, promotional activities, sponsorships, and athlete endorsements. Nike spent $3.75 billion in fiscal 2019 (as compared to $2.75 billion in 2013 for) what it termed "demand creation expense" that included the costs of advertising, promotional activities, and endorsement contracts. Well over 500 professional, collegiate, club, and Olympic sports teams in football, basketball, baseball, ice hockey, soccer, rugby, speed skating, tennis, swimming, and other sports wore Nike uniforms with the Nike swoosh prominently visible. There were over 1,000 prominent professional athletes with Nike endorsement contracts in 2011-2023, including former basketball great Michael Jordan, former NFL player Drew Brees, NBA players LeBron James, Kobe Bryant, Kevin Durant, and

EXHIBIT 6 Nike's Sales of Nike Brand Footwear, Apparel, and Equipment, by Geographic Region and by Wholesale and Nike Direct, Fiscal Years 2020–2022

	Fiscal Year Ending May 31		
Sales Revenues and Earnings (in millions)	**2022**	**2021**	**2020**
North America			
Revenues—Footwear	$12,228	$11,644	$ 9,329
Apparel	5,492	5,038	4,639
Equipment	633	507	516
Total Revenues	$18,353	$17,179	$14,484
Sales to Wholesale Customers	9,621	10,186	9,371
Sales through Nike Direct	8,732	6,993	5,113
Earnings before interest and taxes	$ 5,114	$ 5,089	$ 2,899
EBIT Profit margin	27.9%	29.6%	20.0%
Europe, Middle East, and Africa			
Revenues—Nike Brand footwear	$ 7,388	$ 6,970	$ 5,892
Nike Brand apparel	4,527	3,996	3,053
Nike Brand equipment	567	490	402
Total Nike Brand revenues	12,479	11,456	$ 9,347
Sales to Wholesale Customers	8,377	7,812	6,574
Sales through Nike Direct	4,102	3,644	2,773
Earnings before interest and taxes	3,393	2,435	$ 1,541
EBIT Profit margin	27.2%	21.3%	16.5%
Greater China			
Revenues—Nike Brand footwear	$ 5,416	$ 5,748	$ 4,635
Nike Brand apparel	1,938	2,347	1,896
Nike Brand equipment	193	195	148
Total Nike Brand revenues	$ 7,547	$ 8,290	$ 6,679
Sales to Wholesale Customers	4.041	4,513	3,803
Sales through Nike Direct	3,466	3,777	2,876
Earnings before interest and taxes	$ 2,365	$ 3,243	$ 2,490
EBIT Profit margin	31.3%	39.1%	37.3%
Asia Pacific and Latin America			
Revenues—Nike Brand footwear	$ 4,111	$ 3,659	$ 3,449
Nike Brand apparel	1,610	1,434	1,365
Nike Brand equipment	234	190	214
Total Nike Brand revenues	$ 5,955	$ 5,343	$ 5,028
Sales to Wholesale Customers	3,529	3,387	3,408
Sales through Nike Direct	2,426	1,956	1,620
Earnings before interest and taxes	$ 1,896	$ 1,530	$ 1,184
EBIT Profit margin	31.8%	28.6%	23.5%

	Fiscal Year Ending May 31		
Sales Revenues and Earnings (in millions)	**2022**	**2021**	**2020**
All Regions			
Revenues—Nike Brand footwear	$29,143	$28,021	$23,305
Nike Brand apparel	13,567	12,865	10,953
Nike Brand equipment	1,624	1,382	1,280
Global Brand Divisions	102	25	30
Total Nike Brand revenues	$44,436	$42,293	$35,568
Sales to Wholesale Customers	25,608	23,969	23,156
Sales through Nike Direct	18,726	6,332	12,382
Corporate expenses	(1,810)	(1,456)	(724)
Total Nike earnings before interest and taxes	$ 6,856	$ 6,923	$ 2,976
EBIT Profit margin	15.4%	16.4%	8.4%
Converse			
Revenues	$ 2,346	$ 2,205	$ 1,846
Earnings before interest and taxes	669	543	297
EBIT Profit margin	15.9%	16.4%	23.4%

Note: The revenue and earnings figures for all geographic regions include the effects of currency exchange fluctuations. The Nike Brand revenues for equipment include the Jordan brand. The earnings before interest and taxes figures associated with Total Nike Brand Revenues include those for the Jordan brand.

Source: Nike's 10-K Report for Fiscal Year 2022, pp. 32–41.

Dwayne Wade; professional golfers Tiger Woods and Michelle Wie; soccer player Cristiano Ronaldo; and professional tennis players Venus and Serena Williams, Roger Federer, and Rafael Nadal. When Tiger Woods turned pro, Nike signed him to a 5-year $100 million endorsement contract and made him the centerpiece of its campaign to make Nike a factor in the golf equipment and golf apparel marketplace. Nike's long-standing endorsement relationship with Michael Jordan led to the introduction of the highly popular line of Air Jordan footwear and, more recently, to the launch of the Jordan brand of athletic shoes, clothing, and gear. In 2003, LeBron James signed an endorsement deal with Nike worth $90 million over 7 years, and in 2015 he signed a lifetime deal with Nike. Because soccer was such a popular sport globally, Nike had more endorsement contracts with soccer athletes than with athletes in any other sport; track and field athletes had the second largest number of endorsement contracts.

Nike's payments for media, print, and digital advertising, endorsement contracts, brand events and sponsorships, and retail brand presentation were $3.85 billion, $3.31 billion, and $3.59 billion for the fiscal years ended May 31, 2022, 2021, and 2020, respectively. Prepaid advertising and promotional expenses (which included the costs of endorsements contracts containing provisions for royalty payments, upfront payments, and performance incentives) totaled $773 million in 2022 and $630 million in 2021. Except for prepayment expenses, the costs of endorsement payments were expensed on a straight-line basis over the life of the contract.

Resources and Capabilities Nike had an incredibly deep pool of valuable resources and capabilities that enhanced its competitive power in the marketplace and helped spur product innovation, shorten speed-to-market, enable customers to use digital tools to customize the colors and styling of growing numbers of Nike products, and thereby drive strong brand attachment and sales growth. Examples of these included the following:[18]

- The creation and ongoing enhancement of the NikePlus membership program which in 2017 connected 100 million consumers to Nike—NikePlus members who used the company's mobile apps spent more than three times as much time on **nike.com** as other site visitors. Starting in 2018, NikePlus members were entitled to "reserved-for-you service" that used machine learning-powered algorithms to set aside products in a member's size that the algorithms predicted members would like. Members could also use a "reserved-by-you" service to gain guaranteed access to products they wanted; this newly developed capability was deemed especially valuable to members wanting a recently-introduced product in high demand. In 2018, Nike began accelerating invitations to NikePlus members to personalized events and experiences. In 2019, Nike discontinued its NikePlus app and rebranded NikePlus membership into simply being a Nike Member, which was free and came with several benefits to those who joined; the benefits in 2023 included:

- Discounts on select Nike and Jordan products.
- Exclusive access to new product releases and limited-edition items.
- Personalized shopping experience.
- Advice from Nike's team of experts.
- Free shipping and returns on select orders.
- Early access to special events and sales.

• The establishment of an Advanced Product Creation Center charged with keeping the pipeline flowing with product innovations, new digital products, and manufacturing innovations to make 2X Speed a reality. Nike was aggressively investing in 3D modeling and other related technology to quickly create prototypes of new products; with traditional technology, it often took four-to-six months to go from new idea to design to product prototype. So far, Nike had been able to go from design, to prototyping, to manufacturing, to delivery in less than 6 months, as compared to 9 to12 months. Nike's goal was to improve its rapid prototyping capabilities to the point where 100 percent of new product innovations could be rapid-prototyped at the Advanced Product Creation Center in Portland, Oregon. Employee athletes, athletes engaged under sports marketing contracts, and other athletes wear-tested and evaluated products during the development and prototyping process.

• A relaunch of all 40+ **nike.com** websites in late 2017 that featured a new design with better visual appeal and functionality, more storytelling, eye-catching product displays, and better product descriptions—all aimed at generating more visitor traffic, longer shopping times, increased online sales, and achieving 2X Direct and Consumer Direct Acceleration performance targets.

• Implementing robot-assisted manufacturing capabilities and other recently-developed manufacturing innovations (such as oscillating knives, laser cutting and trimming, phylon mold transfer, and computerized stitching) on a broad scale. In one instance, the use of advanced robotics and digitization techniques was generating a continuous, automated flow of the upper portion of a footwear model with 30 percent fewer steps, 50 percent less labor, and less waste in just 30 seconds per shoe—a total of 1,200 automated robots had been installed to perform an assortment of activities at various manufacturing facilities in 2017. In another instance, Nike had made manufacturing breakthroughs in producing the bottoms of its footwear (the midsoles and outsoles) using innovative techniques capable of delivering a pair of midsoles and outsoles, on average, in 2.5 minutes, compared to more than 50 minutes with previously-used techniques. This new process used 75 percent less energy, entailed 50 percent less tooling cost, and enabled a 60 percent reduction in labor.

• Revamped supply chain practices that had shortened the lead times from manufacturing to market availability from 60 days to 10 days in one instance and from six to nine months to three months in other instances. Nike had recently made supply chain adjustments to better manage its inventory levels, particularly in late 2022 and early 2023 when sales of many products did not meet expectations.

• Creating a digital technology called Nike By You, whereby customers could go to **Nike.com**, click on Nike By You, design their own customized version of a pair of shoes online, view a prototype, have the shoes made to order, and get them delivered (for free in the case of Nike Members) or, in some cases, pick them up on the same day at a nearby store.

All of Nike's competitively valuable resources and capabilities were being dynamically managed; enhancements were made as fast as ways to improve could be developed and instituted and new capabilities were being added in an effort (1) to provide customers with a better "Nike Experience" and (2) to respond faster to ongoing changes in consumer preferences and expectations. Collaborative efforts were underway in Nike's organizational units to transfer new or enhanced resources and capabilities to all seven of the company's product categories and also extend them to all of geographic regions and countries where Nike had a market presence. The goal was to mobilize Nike's resources and capabilities to produce an enduring competitive advantage over rivals and give customers the best possible experience in purchasing and using Nike products.

Manufacturing In fiscal year 2022, Nike sourced its athletic footwear from 120 factories in 11 countries. About 94 percent of Nike's footwear was produced by independent contract manufacturers in Vietnam (44 percent), Indonesia (30 percent), and China (20 percent). During fiscal 2022, Air Manufacturing Innovation, a wholly owned subsidiary, with facilities near Beaverton, Oregon, in Dong Nai Province, Vietnam, and St. Charles, Missouri, as well as contract manufacturers in China and Vietnam, supplied NIKE Air-Sole cushioning components used in Nike's footwear.

In fiscal 2022, Nike-branded apparel was manufactured by 279 independent contract manufacturers located in 33 countries; about 62 percent of the apparel production occurred in Vietnam (26 percent), China (20 percent), and Cambodia (16 percent). The top five contract manufacturers accounted for approximately 54 percent of NIKE Brand apparel production.

Adidas

The mission of adidas was to be the best sports brand in the world. Its stated purpose was "through sport we have the power to change lives."[19] Headquartered in Germany, its primary business in 2023 was designing and marketing active sportswear, uniforms, footwear, and sports products in football, basketball, soccer, running, training, outdoor, and six other categories.

adidas had four main objectives:

1. Grow sales significantly faster than the industry average.
2. Win additional market share across key product categories and geographic markets.
3. Substantially improve the company's profitability.
4. Increase returns to shareholders.

Exhibit 7 shows the company's financial highlights for 2020–2022. In 2016–2017, the company divested five businesses—TaylorMade Golf, Adams Golf, Ashworth brand sports apparel, CCR Hockey, and Rockport brand shoes, and in 2022 it divested its Reebok brand. The divestitures were made to focus the company's full resources on achieving faster and more profitable sales growth in its adidas product offerings and strengthening its adidas brand name.

adidas sold products in virtually every country of the world. In 2023, its extensive product offerings were marketed through thousands of third-party retailers (sporting goods chains, department stores, independent sporting goods retailer buying groups, and lifestyle retailing chains—with a combined total of 150,000 locations worldwide, and Internet retailers) and nearly 2,000 company-owned retail stores, plus the company's own e-commerce website. There was an adidas app reaching some 65 countries across all major markets that linked directly to the adidas e-commerce store. The company's own e-commerce sales were €4.6 billion in 2022, up from €4.2 billion in 2021. Adidas had a global network of 66 distribution centers.

Like Under Armour and Nike, adidas was actively engaged in sponsoring major sporting events, teams, and leagues and in using athlete endorsements to promote their products. Recent high-profile sponsorships and promotional partnerships included numerous professional soccer and rugby teams; sports teams at the University of Miami, Arizona State University, University of Washington, Mississippi State University, and Texas A&M University; FIFA World Cup events; the Summer and Winter Olympics; the Boston and Berlin Marathons; and the Arsenal Football Club. It was the official outfitter of items for assorted professional sports leagues and the national soccer teams of seven countries. High-profile athletes that were under contract to endorse adidas products included NBA players James Harden, Derrick Rose, Trae Young, Donovan Mitchell, and Damian Lillard; WNBA star Candace Parker; soccer players David Beckham and Lionel Messi; NFL players Aaron Rodgers, Patrick Mahomes, JuJu Smith-Schuster, and Trevor Lawrence; MLB players Chase Utley, brothers B.J. and Justin Upton, Carlos Correa, Josh Harrison, and Chris Bryant; and tennis star Naomi Osaka. It had also signed non-sports celebrities Beyoncé and Pharrell Williams. In 2003, soccer star David Beckham, who had been wearing

EXHIBIT 7 Financial Highlights for adidas, 2020–2022 (in millions of €)

Income Statement Data	2020	2021	2022
Net sales	€18,435	€21,234	€22,511
Gross profit	9,222	10,765	10,644
Gross profit margin	50.0%	50.7%	47.3%
Operating profit	746	1,986	669
Operating profit margin	4.0%	9.4%	3.0%
Net income	432	2,116	612
Net profit margin	2.3%	10.0%	2.7%
Balance Sheet Data			
Inventories	€ 4,397	€ 4,009	€ 5,973
Working capital	3,890	3,960	4,033
Cash Flow Data			
Capital expenditures	€ 442	€ 667	€ 695
Net cash generated by (used in) operating activities	1,366	2,873	(58)
Net sales by product			
Footwear	€10,129	€11,336	€12,286
Apparel	7,315	8,223	8,732
Accessories and Gear	991	1,187	1,493
Net sales and operating profit by region			
Europe/Middle East/Africa	€ 6,308	€ 7,770	€ 8,550
Operating profit	1,003	1,658	1,679
North America	4,519	5,105	6,398
Operating profit	506	960	989
Greater China	4,342	4,597	3,179
Operating profit	1,137	1,194	322
Asia-Pacific	2,083	2,189	2,241
Operating profit	382	457	486
Latin America	1,035	1,446	2,110
Operating profit	33	265	473
Number of stores	2,185	2,184	1,990
Concept stores	1,029	987	834
Concession corners	112	111	99
Factory outlets	1,044	1,086	1,057
Net sales, all retail stores	€ 7,471	€ 8,172	€ 8,838

Source: Company Fact Sheet, 2021 and 2022.

adidas products since the age of 12, signed a $160 million lifetime endorsement deal with adidas that called for an immediate payment of $80 million and subsequent payments said to be worth an average of $2 million annually for the next 40 years.[20] Adidas was anxious to sign Beckham to a lifetime deal not only to prevent Nike from trying to sign him but also because soccer was considered the world's most lucrative sport and adidas management believed that Beckham's endorsement of adidas products resulted in more sales than all of the company's other athlete endorsements combined. Companywide expenditures for marketing (advertising, event sponsorships, athlete endorsements, public relations, and point-of-sale activities) were €2.76 billion in 2022 (12.3 percent of net sales), €2.55 billion in 2021 (12.0 percent of net sales), and €2.57 billion in 2020 (13.0 percent of net sales).

In 2015–2017, adidas launched a number of initiatives to become more America-centric and regain its #2 market position lost to Under Armour in 2015. This included a campaign to sign up to 250 National Football League players and 250 Major League Baseball players over the next three years. It had secured 1,100 new retail accounts that involved prominent displays of freshly styled adidas products and newly introduced running shoes with high-tech features. The adidas brand regained its #2 position in the United States in 2017.

Research and development activities commanded considerable emphasis at adidas. Management had long stressed the critical importance of innovation in improving the performance characteristics of its products. New apparel and footwear collections featuring new fabrics, colors, and the latest fashion were introduced on an ongoing basis to heighten consumer interest, as well as to provide performance enhancements—indeed, 77 percent of sales at adidas came from products launched in 2019 (versus 74 percent in 2018 and 79 percent in 2017), while only 3 percent of sales were generated by products introduced three or more years earlier. In 2020-2022, adidas continued to improve the performance characteristics of its products by introducing the use of innovative technologies, the latest fabric enhancements, environmentally sustainable concepts, and various material and design innovations in manufacturing its footwear, apparel, and equipment. In 2020, adidas introduced (1) the adidas 4D concept featuring midsoles crafted with light and oxygen using Digital Light Synthesis, a unique technology developed by Carbon (a partner supplier) for producing high performance footwear that eliminated the necessity of traditional prototyping or molding; this technology enabled adidas to economically manufacture multiple variations of its running shoes in large quantities, (2) EnergyRODS—a running shoe technology that used EnergyRODS, combined with a responsive foam and a lightweight upper mesh (as a substitute for traditional carbon plates) to deliver an anatomically driven transition from heel to toe, thereby limiting energy loss and providing a propulsive feeling, (3) Futurecraft.Strung—an industry-first textile and creation process that allowed adidas to input athlete data into the precision placement of each thread on the upper of shoes to provide a new feeling and experience of fast short-distance running specifically, (4) Lightstrike, a super-light EVA foam cushioning technology that provided extreme comfort and the perfect balance between light weight and responsiveness; was featured in multiple adidas running shoe models, (5) the use of Parley Ocean Plastic (created from upcycled plastic waste intercepted from beaches and coastal communities before it reached the oceans) as a replacement for virgin plastic in making 15 million pairs of adidas footwear, (6) the use of Primeblue, a recycled technical material made in part with Parley Ocean Plastic that was used in making adidas' Ultaboost apparel and in making the jerseys of some of the biggest sports leagues and teams in the world, (7) Primegreen, made from recycled ingredients, was a series high performance materials for various adidas products, and (8) RDY—a performance material that combined a series for technologies to manufacture garments for all types of weather conditions, including such adidas products lines as moisture-managing COLD.RDY; breathable, air-cooling HEAT.RDY; wind-resistant, water-repellent WIND.RDY; waterproof, windproof RAIN.RDY; and moisture-absorbing AEROREADY.[21]

In 2021, adidas introduced (1) 4DFWD footwear manufacturing featuring midsoles that were 3D-printed with light and oxygen using Digital Light Synthesis and 40-percent biodegradable materials and a FWDcell that resulted in a 15 percent reduction of peaking braking force experienced by the athlete, (2) a new iteration of the Adizero Adios Pro 2 high performance running shoe featuring two layers of re-sculpted Lightstrike Pro midsole, signature carbon-infused EnergyRODS, and a Continental rubber outsole (athletes wearing this shoe were able to break six world records), (3) a one-piece Futurenatural shoe mold that delivered an anatomically correct representation of an individual athlete's foot which offered superior stability and full ground contact—the first iteration of this technology was then applied by adidas to James Harden's fifth signature basketball sneaker, the Harden Vol. 5), (4) adidas' first 100-percent vegan football shoe, the Predator Freak Vegan, designed in collaboration with Paul Pogba and Stella McCartney; the shoe had adidas Demonskin rubber spikes in signal orange calibrated by a computer algorithm to afford improved ball control and swerve.[22]

In 2022, adidas redesigned its entire bra line with 42 styles in 72 sizes, introduced (1) new Adizero footwear with a "strung" upper fused to a Prime X outsole packed with Energy RODS and three layers of Lightstrike Pro for a more responsive run, (2) an industry-first shoe with a bowtie-shaped lattice 4DFWD 2 midsole, a new Continental outsole, and all-new Primeknit+ and engineered mesh upper construction using recycled materials that provided an extra supportive and snug fit, reduced braking forces, transformed the impact energy into forward motion, and provided extra grip, (3) an Adizero Adios Pro 3 running shoe featuring EnergyRODS 2.0 embedded in the midsole, Lightstrike Pro foam, a Continental rubber outsole with traction to help take corners at a faster pace (in 2022 half of the 12 major marathons worldwide were won by athletes wearing Adizero), (4) a new "Al Rihla" soccer ball designed to support the highest in-flight game speeds as compared to any other World Cup ball, and (5) a Stella McCartney tracksuit that was "Made to Be Remade," allowing consumers to wear down products and then return them by scanning a QR code on the product for it to be remade.[23]

Some 1,031 people (1.7 percent of total employees) were engaged in research and development (R&D) activities in 2022; in addition, the company drew upon the services of well-regarded researchers at universities in Canada, the United States, England, and Germany. R&D expenditures in 2019 were €152 versus €153 million in 2018, €187 million in 2017, €149 million in 2016, and €139 million in 2015 (R&D expenditures for 2022 and 2021 were not publicly reported in the company's financial documents).

In 2022, almost 100 percent of production was outsourced to 117 independent contract manufacturers that were producing in 259 manufacturing facilities. In 2022, 97 percent of the company's footwear was sourced in Asia (34 percent of the total volume was sourced in Indonesia, followed by 32 percent in Vietnam, and 16 percent in China); the annual volume sourced from footwear suppliers was 419 million pairs in 2022, down from a record 429 million pairs in 2019. In 2022, 91 percent of total apparel volume was produced in Asia, with Cambodia being the largest sourcing country (22 percent) followed by Vietnam and China with 17 percent each. In 2019, apparel production was 482 million units, down from a record 528 million units in 2019. The production of accessories and gear was 117 million units in 2022, with 72 percent being sourced in Asia and China being the largest sourcing country (28 percent), followed by Turkey (25 percent) and Pakistan (21 percent).

The company was stepping up its investments in company-owned, robot-intensive micro-factories to speed certain products to key geographic markets in Europe and the United States much faster and to also lower production costs and boost gross profit margins. At the same time, the company had begun reengineering its existing supply chain and production processes to enable the company to respond quicker to shifts in buyer preferences, to be able to reorder seasonal products and sell them to buyers within the season, and to reduce the time it took to get freshly designed products manufactured and into the marketplace.

ENDNOTES

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CASE 14

lululemon athletica in 2023: Full Speed Ahead?

Arthur A. Thompson,
The University of Alabama

Randall D. Harris,
Texas A&M University–Corpus Christi

In early 2019, about five months after being appointed lululemon's CEO in August 2018, Calvin McDonald announced a new five-year plan to grow the company's revenues from $3.3 billion in fiscal year 2018 (ending February 3, 2019) to $6.25 billion. His five-year "Power of Three" strategic plan was built around three growth initiatives:

- **Product Innovation.** This initiative featured using high-performance proprietary fabrics and innovative design and apparel construction techniques to create a disruptive innovation strategy that would lure large numbers of new customers to lululemon's retail stores and ecommerce website by offering them apparel products with unparalleled feel-good comfort, fit, and enhanced technical performance. The objective was to use the principle of disruptive innovation to achieve rapidly sales growth by offering sports apparel buyers an appealing and ever-evolving stream of innovative new products and a fresh and expanding lineup of yoga, running, and training apparel products for both women and men.
- **Omni Guest Experiences.** The company sought to become "an experiential brand" and use all of the company's marketing channels to grow and deepen its relationship with the guests who patronized its stores and shopped its website. The vision was to create an expanding digital ecosystem where local community members striving to live the "sweatlife" and lead a healthy, mindful lifestyle could connect and come together via attendance at a variety of local community events, partnerships with local yoga studios and running clubs, sharing information about fitness and wellness posted by various digital sources, and further developing unique store formats (like a 25,000 square-foot store in Chicago which had a yoga studio, meditation space, a healthy food and juice bar, and areas for community gatherings). Management intended for the company's digital ecosystem to become a greater source of information and communication and a means of inspiring and igniting community building. Then in June 2020, lululemon significantly expanded its omni guest experiences concept by acquiring at-home exercise fitness company Mirror. Mirror offered live online exercise classes every day, access to a large library of 10,000+ workouts across 50 fitness categories (such as sculpt, cardio, strength, stretch, Pilates, Barre, yoga, tai chi, and boxing) conducted by world-class experts, and one-on-one personal training sessions—all delivered by a wall-mounted smart gym Mirror device connected to the internet which Mirror sold for $1,495. Mirror buyers paid a monthly membership fee for unlimited exercise classes on-demand. Calvin McDonald believed that the COVID-19 pandemic would prompt many gym-goers to shift to exercising at their homes and that the use of in-home Mirror devices would appeal to in-home exercisers.
- **Expanded Geographic Coverage.** Outside North America, the company's primary focus for new store openings would be the People's Republic of China, supplemented with annual openings

of several new company-operated stores in such European countries as Germany, the United Kingdom, France, Ireland, the Netherlands, and Norway, and in such Asia-Pacific countries as Australia, South Korea, New Zealand, Japan, Singapore, and Malaysia.

In addition to growing lululemon revenues to $6.25 billion by fiscal year 2023, the 2019 Power of Three plan called for the company to double digital revenues, double revenues from sales of men's apparel, grow the number of lululemon retail stores in the United States and internationally, and quadruple revenues outside North America.

Despite the in-store shopping headwinds posed by government-mandated COVID-19 restrictions to remain at home and avoid crowds in 2020 and parts of 2021, the "Power of Three" strategy McDonald crafted for lululemon proved hugely successful. The objective to boost lululemon's revenues to $6.25 billion was achieved by the end of fiscal 2021 (ending January 20, 2022), two years ahead of schedule. Moreover, digital sales in 2021 were $2.78 billion, $1 billion above the amount needed to double the company's 2019 digital sales. Sales revenues from men's apparel were 22 percent above the targeted doubling of 2019 sales of men's apparel. The number of company-operated lululemon retail stores grew from 440 in 14 countries at the end of fiscal 2019 to 574 in 17 countries at the end of fiscal 2022. The number of stores in China grew from 16 at the end of fiscal 2019 to 86 at the end of fiscal 2022. Of the 53 new stores opened in fiscal 2022, 43 were outside of North America. However, international sales outside North America, while up 266 percent over 2019, were $0.5 billion short of quadrupling the company's 2019 sales outside of North America. The company's stock price had risen from $150 in early 2019 when the Power of Three plan was first announced to an all-time high of $477 in November 2021, before dropping to $316 when full-year results for fiscal 2021 were announced.

The company's strong performance in 2020–2022 reinforced CEO McDonald's belief that lululemon was in the early innings of capturing its full growth potential—its current sales represented only 1 percent of the total addressable market of $650 billion. Hence, he saw great opportunity going forward for the company to continue to attract new guests, grow revenues in its core product lines, open more stores in existing and new geographic markets, and expand international revenues.

Five days after announcing the company's fiscal 2021 results in March 2022, Calvin McDonald outlined a new five-year growth plan and a new Power of Three x2 strategy for lululemon at the company's 2022 Investor Day session with industry analysts. The overall performance target of the new 5-year Power of Three x2 growth plan was to double lululemon's revenues to $12.5 billion by year-end 2026. To reach the $12.5 billion revenue target, the Power of Three x2 plan called for

- Doubling revenues from the sale of men's products by the end of fiscal 2026.
- Doubling digital revenues by 2026. McDonald's vision was to add the sales of Mirror devices and subscriber-based online exercise workouts to its menu of omni guest experiences and thereby create the most immersive direct-to-consumer fitness marketplace in the industry.
- Quadrupling international revenues by the end of fiscal 2026 and delivering annual double-digit revenue growth in North America.

When lululemon's results for fiscal 2022 were announced on March 28, 2023, the company's performance for the first year of its second 5-year plan was quite encouraging. Net revenues rose 29.6 percent to $8.1 billion. Direct-to-consumer (digital) sales rose 33.2 percent; sales of men's apparel were up 27.4 percent; and international sales outside North America were up 35.2 percent. The company opened 81 new retail stores, including 31 new stores in China and 18 others outside North America, bringing the number of company-operated retail stores to a total of 655 locations. lululemon's strong performance continued in the first quarter of fiscal 2023.[1] Net revenues, compared to Q1 of 2022, increased 17 percent in North America and 60 percent internationally; direct-to-consumer revenue increased 16 percent. Retail sales at lululemon stores open at least 12 months increased 13 percent, and a net of seven new stores were opened during the quarter. The company said it planned to open 30 to 35 new stores in global markets in 2023, mostly in China. For full-year 2023, lululemon said it expected net revenues to be in the range of $9.44 billion to $9.51 billion and for diluted earnings per share to be in the range of $11.74 to $11.94.

Exhibit 1 presents highlights of the company's performance for fiscal years 2018–2022. Exhibit 2 shows lululemon's revenues by business segment and geographic region for the same period.

EXHIBIT 1 Financial and Operating Highlights, lululemon athletica, Fiscal Years 2018–2022 (Millions of $, except per share data)

Selected Income Statement Data	Fiscal Year 2022 (Ending Jan. 29, 2023)	Fiscal Year 2021 (Ending Jan. 30, 2022)	Fiscal Year 2020 (Ending Jan. 31, 2021)	Fiscal Year 2019 (Ending Feb. 2, 2020)	Fiscal Year 2018 (Ending Feb. 3, 2019)
Net revenues	$8,110.5	$6,256.6	$4,401.9	$3,979.3	$3,288.3
Cost of goods sold	3,618.2	2,648.0	1,937.9	1,755.9	1,472.0
Gross profit	4,492.3	3,608.6	2,464.0	2,223.4	1,816.3
Selling, general, and administrative expenses	2,757.4	2,225.0	1,609.0	1,334.3	1,110.5
Operating profit	1,328.4	1,333.4	820.0	889.1	705.8
Net profit (loss)	854.8	$ 975.3	$ 588.9	$ 645.6	$ 483.8
Foreign currency translation adjustment	—	(18.8)	47.4	(7.8)	(73.9)
Earnings per share—basic	$ 6.70	$ 7.52	$ 4.52	$ 4.95	$ 3.63
Earnings per share—diluted	$ 6.68	$ 7.49	$ 4.50	$ 4.93	$ 3.61
Balance Sheet Data					
Cash and cash equivalents	$1,154.9	$1,259.9	$1,150.5	$1,093.5	$ 881.3
Inventories	1,572.0	966.5	647.3	518.5	404.8
Total assets	5,607.0	4,942.5	4,185.2	3,281.4	2,084.7
Stockholders' equity	3,148.8	2,740.0	2,558.6	1,952.2	1,446.0
Cash Flow and Other Data					
Net cash provided by operating activities	$ 966.5	$1,389.1	$ 803.3	$ 669.3	$ 742.8
Capital expenditures	638.7	394.5	229.2	283.1	225.8
Store Data					
Number of corporate-owned stores open at end of period	655	574	521	491	440
Sales per gross square foot at corporate-owned stores open at least one full year	$ 1,580	$ 1,443	Not reported*	$ 1,657	$ 1,579

*This performance metric was not reported due to temporary store closings and the in-store shopping restrictions associated with the COVID-19 pandemic.

Source: Company 10-K reports for fiscal years 2018, 2019, 2020, 2021, and 2022.

Lululemon's Issues and Challenges Going Forward. Despite the strong results for fiscal 2022, however, McDonald had a number of internal and external issues that merited front-burner managerial attention. Among the internal issues was the MIRROR exercise equipment unit, which had been acquired for $500 million in June 2020. Mirror offered live exercise classes every day, access to a large library of 10,000+ workouts across 50 fitness categories (such as sculpt, cardio, strength, stretch, Pilates, Barre, yoga, tai chi, and boxing) conducted by world-class experts, and one-on-one personal training

EXHIBIT 2 lululemon athletica's Revenues and Income from Operations, by Business Segment and by Geographical Region, Fiscal Years 2018–2022 (dollars in millions)

Revenues by Business Segment	Fiscal Year 2022 (Ending Jan. 29, 2023)	Fiscal Year 2021 (Ending Jan. 30, 2022)	Fiscal Year 2020 (Ending Jan. 31, 2021)	Fiscal Year 2019 (Ending Feb. 2, 2020)	Fiscal Year 2018 (Ending Feb. 3, 2019)
Corporate-owned stores	$3,648.1	$2,821.5	$1,658.8	$2,501.1	$2,126.4
Direct-to-consumer (e-commerce sales)	3,699.8	2,777.9	2,284.1	1,137.8	858.9
Other*	762.6	657.2	459.0	340.4	303.1
Total	$8,110.5	$6,256.6	$4,401.9	$3,979.3	$3,288.3
Percentage Distribution of Revenues by Business Segment					
Corporate-owned stores	45.0%	45.1%	37.7%	62.9%	64.7%
Direct-to-consumer (e-commerce sales)	45.6%	44.4%	51.8%	28.6%	26.1%
Other*	9.4%	10.5%	10.4%	8.5%	9.2%
Total	100%	100%	99.9%	100.0%	100.0%
Income from Operations (before general corporate expenses), by Business Segment					
Corporate-owned stores	$ 991.1	$ 727.7	$ 212.6	$ 689.3	$ 575.5
Direct-to-consumer (e-commerce sales)	1,562.5	1,216.5	1,029.1	482.4	354.1
Other*	107.1	77.3	10.5	72.6	62.6
Total income from operations	$2,660.7	$2,021.5	$1,252.2	$1,244.3	$ 992.2
Revenues by Geographic Region					
United States	$5,654.3	$4,345.7	$3,105.1	$2,854.4	$2,363.4
Canada	1,163.1	954.2	672.6	649.1	565.1
People's Republic of China	681.6	520.4	297.7		
Rest of World	611.4	436.3	326.4		
Outside of North America**				475.8	359.8
Total	$8,110.5	$6,256.6	$4,401.9	$3,979.3	$3,288.3
Percentage Distribution of Revenues by Geographic Region					
United States	69.72%	69.46%	70.54%	71.73%	71.87%
Canada	14.34%	15.25%	15.28%	16.31%	17.19%
People's Republic of China**	8.40%	8.32%	6.76%		
Rest of World	7.54%	6.97%	7.41%		
Outside of North America†				11.96%	10.94%
Total	100%	100%	99.99%	100.0%	100.0%

(continued)

Revenues by Business Segment	Fiscal Year 2022 (Ending Jan. 29, 2023)	Fiscal Year 2021 (Ending Jan. 30, 2022)	Fiscal Year 2020 (Ending Jan. 31, 2021)	Fiscal Year 2019 (Ending Feb. 2, 2020)	Fiscal Year 2018 (Ending Feb. 3, 2019)
Revenues by Product Category					
Women's products	$5,259.8	$4,171.8	$3,049.9	$2,767.8	$2,334.6
Men's products	1,956.6	1,535.8	953.2	927.2	690.5
Other categories	894.1	549.0	398.8	284.2	263.2
Total	$8,110.5	$6,256.6	$4,401.9	$3,979.3	$3,288.3
Percentage Distribution of Revenues by Product Category					
Women's products	64.9%	66.7%	69.3%	69.6%	71.0%
Men's products	24.1%	24.5%	21.7%	23.3%	21.0%
Other categories	11.0%	8.8%	9.1%	7.1%	8.0%
	100.0%	100.0%	100.1%	100.0%	100.0%

*The "Other" category included outlets, temporary locations, Mirror, sales to wholesale accounts, and license and supply arrangements.

†lululemon athletica began reporting segment revenue for China separate from rest of the world segment revenue in fiscal 2020.

Source: Company 10-K Reports, Fiscal Years 2018, 2019, 2020, 2021, and 2022.

sessions—all delivered by a wall-mounted smart gym Mirror device connected to the internet which Mirror sold for $1,495. Mirror buyers paid a monthly membership fee for unlimited exercise classes on-demand. However, sales of MIRROR home exercise equipment had underperformed during the 2022 holiday season and subscription revenues for online exercise classes had lagged, prompting lululemon to take a $443 million impairment charge on its MIRROR business unit at the end of the 2022 fourth quarter; in addition, lululemon reduced the price of the Mirror device to $995.

Company gross margins were also under pressure. While supply chain costs, particularly for shipping, had abated with the end of the COVID-19 pandemic, markdowns on lululemon merchandise had increased during Q4 2022 because sales of some items were lower than expected. Nonetheless, the company ended Q4 with ending inventories at a record high of $1.57 billion. Several stock analysts had also issued neutral ratings on the company's stock, with some analysts forecasting only limited upside for lululemon's stock price in the short to medium term, partly because of the need to work off the excess inventory in the first quarter of 2023, partly because monetary authorities in many countries had rapidly raised interest rates to combat price inflation, and partly because an economic slowdown and potential global recession in the second half of 2023 was widely anticipated. In addition, a number of market analysts were skeptical about whether lululemon could continue to achieve double-digit sales growth in lieu of the bleak global economic outlook for retail sales across most of the countries where it had retail stores.

In short, was it full speed ahead for lululemon or would there be some bumps in the road? Could the company continue to take market share away from competitively potent rivals like Nike and Adidas who were the long-time global market leaders in sports apparel and high-performance athletic garments? In 2022, Nike had global sports apparel sales of $13.6 billion and Adidas had global apparel sales of nearly $9.5 billion; both companies had formidable sales and marketing capabilities. The prices lululemon charged for its apparel products were substantially above those charged by Nike and Adidas as well as the prices of fourth place Under Armour.

COMPANY BACKGROUND

A year after selling his eight-store surf-, skate-, and snowboard-apparel chain called Westbeach Sports, Chip Wilson took the first commercial yoga class offered in Vancouver, British Columbia, and found the result exhilarating. But he found the cotton clothing used for sweaty, stretchy power yoga completely inappropriate. Wilson's passion was form-fitting performance fabrics and in 1998 he opened a design studio for yoga clothing that also served as a yoga studio at night to help pay the rent. He designed several yoga apparel items made of moisture-wicking fabrics that were light, form-fitting, and comfortable and asked local yoga instructors to wear the products and give him feedback. Gratified by the positive response, Wilson opened lululemon's first real store in the beach area of Vancouver in November of 2000.

While the store featured yoga clothing designed by Chip Wilson and his wife Shannon, Chip Wilson's vision was for the store to be a community hub where people could learn and discuss the physical aspects of healthy living—from yoga and diet to running and cycling, plus the yoga-related mental aspects of living a powerful life of possibilities. But the store's clothing proved so popular that dealing with customers crowded out the community-based discussions and training about the merits of living healthy lifestyles. Nonetheless, Chip Wilson and store personnel were firmly committed to healthy, active lifestyles, and Wilson soon concluded that for the store to provide staff members with the salaries and opportunities to experience fulfilling lives, the one-store company needed to expand into a multi-store enterprise. Wilson believed that the increasing number of women participating in sports, and specifically yoga, provided ample room for expansion, and he saw an opportunity for lululemon athletica's yoga-inspired performance apparel to capitalize on the absence of yoga-specific garments in the women's athletic apparel market. Wilson also saw the company's mission as one of providing people with the components to live a longer, healthier, and more fun life.

Several new lululemon stores were opened in the Vancouver area, with operations conducted through a Canadian operating company, initially named lululemon athletica, Inc. and later renamed lululemon Canada, Inc. In 2002, the company expanded into the United States and formed a sibling operating company, lululemon athletica USA, Inc. (later renamed as lululemon USA, inc.), to conduct its operations in the United States. Both operating companies were wholly owned by affiliates of Chip Wilson. In 2004, the company contracted with a franchisee to open a store in Australia as a means of more quickly disseminating the lululemon athletica brand name, conserving on capital expenditures for store expansion (since the franchisee was responsible for the costs of operating the store), and boosting revenues and profits. The company wound up its fiscal year ending January 31, 2005, with 14 company-owned stores, 1 franchised store, and net revenues of $40.7 million. A second franchised store was opened in Japan later in 2005. Franchisees paid lululemon a one-time franchise fee and an ongoing royalty based on a specified percentage of net revenues; lululemon supplied franchised stores with garments at a discount to the suggested retail price.

Five years after opening the first retail store, it was apparent that lululemon apparel was fast becoming something of a cult phenomenon and a status symbol among yoga fans in areas where lululemon stores had opened. Avid yoga exercisers were not hesitating to purchase $120 color-coordinated lululemon yoga outfits that felt comfortable and made them look good. Mall developers and mall operators quickly learned about lululemon's success and began actively recruiting lululemon to lease space for stores in their malls.

In December 2005, with 27 company-owned stores, 2 franchised stores, and record sales approaching $85 million annually, Chip Wilson sold 48 percent of his interest in the company's capital stock to two private equity investors: Advent International Corporation, which purchased 38.1 percent of the stock, and Highland Capital Partners, which purchased a 9.6 percent ownership interest. In connection with the transaction, the owners formed lululemon athletica inc. to serve as a holding company for all the company's related entities, including the two operating subsidiaries, lululemon Canada Inc. and lululemon USA, Inc. Robert Meers, who had 15 years' experience at Reebok and was head of Reebok's Specialty Group 1996–1999, joined lululemon as CEO in December 2005. Chip Wilson remained as chairman of the company's board of directors, but he became head of the company's design team and continued to play a central role in developing the company's strategy and nurturing the company's distinctive corporate culture. Wilson and Meers assembled a management team with a mix of retail, design, operations, product sourcing, and marketing experience from such leading apparel and retail companies as Abercrombie & Fitch, Limited Brands, Nike, and Reebok.

Brisk expansion ensued. The company ended fiscal 2006 with 41 company-owned stores, 10 franchised stores, net revenues of $149 million, and net income of $7.7 million. In 2007, the company's owners elected to take the company public. The initial public offering took place on August 2, 2007, with the company selling 2,290,909 shares to the public and various stockholders selling 15,909,091 shares of their personal holdings. Shares began trading on the NASDAQ under the symbol LULU and on the Toronto Exchange under the symbol LLL.

The company grew rapidly over the next decade. Fitness-conscious women began flocking to the company's stores not only because of the fashionable products but also because of the store ambience and attentive, knowledgeable store personnel. Dozens of new lululemon athletic retail stores were opened annually, and the company pursued a strategy of embellishing its product offerings to create a comprehensive line of apparel and accessories designed for athletic pursuits such as yoga; running and general fitness; technical clothing for active female youths; and a selection of fitness and recreational items for men. Revenues topped $1 billion in fiscal 2011, $2 billion in fiscal 2016, and $3 billion in fiscal 2018.

Sales reached $3.9 billion in fiscal 2019, and continued to grow to $4.4 billion in fiscal 2020, despite the worldwide COVID-19 pandemic that caused the company to shut down many of its stores for portions of 2020; the reason for lululemon's revenue gain was that many of the company's customers shifted from shopping lululemon's retail stores to shopping online at the company's website (**https://shop.lululemon.com**) that was accessible worldwide. In 2020, sales at the company's retail stores dropped from $2.5 billion in fiscal 2019 to just under $1.7 billion, while e-commerce sales more than doubled from $1.14 billion in 2019 to $2.4 billion in 2020. In the company's most recent fiscal year ending January 29, 2023, retail store sales accounted for 45 percent of the company's $8.1 billion in net revenues; direct-to-consumer sales accounted for 45.6 percent; and sales in other channels (discount outlets, temporary locations, Mirror, sales to wholesale accounts, and licensing and supply arrangements) accounted for 9.4 percent.

lululemon's Evolving Senior Leadership Team

In January 2008, Christine M. Day joined the company as Executive Vice President, Retail Operations. Previously, she had worked at Starbucks, functioning in a variety of capacities and positions, including President of the Asia Pacific Group (July 2004- February 2007); Co-President for Starbucks Coffee International (July 2003 to October 2003); Senior Vice President, North American Finance & Administration; and Vice President of Sales and Operations for Business Alliances. In early 2008, Robert Meers, whose command-and-control leadership style did not mesh well with Chip Wilson's preference for collaboration and cooperation, left the company. Christine Day was appointed as lululemon's President and Chief Operating Officer and was elevated to Chief Executive Officer and member of the Board of Directors in July 2008. During her tenure as CEO, Day expanded and strengthened the company's management team to support its expanding operating activities and geographic scope, favoring the addition of people with relevant backgrounds and experiences at such companies as Nike, Abercrombie & Fitch, The Gap, and Speedo International. She also spent several hours each week in the company's stores observing how customers shopped, listening to their comments and complaints, and using the information to tweak product offerings, merchandising, and store operations.

Company founder Chip Wilson resigned from his position as lululemon's Chief Innovation and Branding Officer effective January 29, 2012, and moved his family to Australia; however, he continued on as Chairman of the company's Board of Directors and focused on becoming a better board chairman, even going so far as to take a four-day course on board-governance at Northwestern University.[2]

Christine Day promoted Sheree Waterson, who had joined the company in 2008 and had over 25 years of consumer and retail industry experience, as Chief Product Officer to assume responsibility for product design, product development, and other executive tasks that Wilson had been performing. Shortly after quality problems with lululemon black Luon bottoms (too sheer) occurred that resulted in a product recall, Sheree Waterson resigned her position and left the company. In October 2013, lululemon announced that Tara Poseley had been appointed to its Senior Leadership Team as Chief Product Officer and would have responsibility for overseeing lululemon's design team, product design activities, merchandising, inventory activities, and strategic planning.

In the aftermath of the pants recall in March 2013, the working relationship between Christine Day and Chip Wilson deteriorated. Wilson made it clear that he would have handled the product recall incident differently and that he did not think there were problems with the design of the product or the quality of the fabric. But the differences between Day and Wilson went beyond the events of March 2013, especially when some consumers began to complain about the quality of the replacement pants. Wilson returned from Australia in May 2013, and weeks later Christine Day announced she would step down as CEO when her successor was named. A lengthy search for Day's replacement ensued.

In the meantime, Chip Wilson triggered a firestorm when, in an interview with Bloomberg TV in November 2013, he defended the company's design of the black Luon bottoms, saying "Quite frankly, some women's bodies just actually don't work" with the pants. Although a few days later he publicly apologized for his remarks suggesting that the company's product quality issues back in March 2013 were the fault of overweight women, his apology was not well received. In December 2013, Wilson resigned his position as Chairman of lululemon's board of directors and took on the lesser role of nonexecutive Chairman. A few months later, Wilson announced that he intended to give up his position as nonexecutive Chairman prior to the company's annual stockholders meeting in June 2014 but continue as a member of the company's Board of Directors (in 2013–2014, Wilson was the company's largest stockholder and controlled 29.2 percent of the company's common stock).

In early December 2013, lululemon announced that its Board of Directors had appointed Laurent Potdevin as the company's Chief Executive Officer and a member of its Board of Directors; Potdevin stepped into his role in January 2014. Potdevin came to lululemon having most recently served as President of TOMS Shoes; a company founded on the mission that it would match every pair of shoes purchased with a pair of new shoes given to a child in need. Prior to TOMS, he held numerous positions at Burton Snowboards for more than 15 years, including President and CEO from 2005 to 2010; Burton Snowboards, headquartered in Burlington, Vermont, was considered to be the world's premier snowboard company, with a product line that included snowboards and accessories (bindings, boots, socks, gloves, mitts, and beanies); men's, women's, and youth snowboarding apparel; and bags and luggage. Burton's grew significantly under Potdevin's leadership, expanding across product categories and opening additional retail stores.

Tension between Chip Wilson and lululemon's board of directors erupted at the company's annual shareholders' meeting in June 2014 when he voted his entire shares against re-election of the company's chairman and another director. In February 2015, after continuing to disagree with lululemon executives and board members over the company's strategic direction and ongoing dissatisfaction with how certain lululemon activities were being managed, Wilson resigned his position on lululemon's board of directors. In August 2014, he sold half of his ownership stake to a private equity firm. In June 2015, lululemon filed documents with the Securities and Exchange Commission enabling Wilson to sell his remaining 20.1 million shares (equal to a 14.6 percent ownership stake worth about $1.3 billion) in the event he wished to do so. As of April 2023, Chip Wilson was lululemon's second largest stockholder, with 10.7 million shares equal to an ownership stake of about 8.4 percent.[3]

In 2018, lululemon CEO Laurent Potdevin resigned as CEO following allegations of misconduct; he was replaced by Calvin McDonald as Chief Executive Officer effective August 2018. McDonald had previously served for five years as the President and CEO of Sephora America, a division of the LVMH Group. Mr. McDonald had been very successful in his previous position, a period during which Sephora America grew annually by double digits. McDonald was also an endurance athlete who had competed in both triathlons and marathons.[4] In April 2020, the Chief Financial Officer (CFO) for lululemon, Patrick Guido, resigned as CFO. Patrick Guido was replaced by Ms. Meghan Frank, who served as interim co-CFO from April 2020 to November 2020, and was appointed CFO for lululemon in November 2020.

Exhibit 3 presents the Executive Officers of lululemon athletica as of April 2023.

EXHIBIT 3 Executive Officers, lululemon athletica, April 2023

Name	Title	Brief Biography
Calvin McDonald	Chief Executive Officer	Joined lululemon in August 2018. Prior to joining lululemon, he served for five years as President and CEO of Sephora Americas, a division of the LVMH group of luxury brands. Before that, he was President and CEO of Sears Canada for two years and spent 17 years at Loblaw Companies Limited, the largest retailer in Canada. He was on the board of directors of lululemon and The Walt Disney Company. McDonald had an MBA from University of Toronto and a Bachelor of Science degree from the University of Western Ontario.
Michael Aragon	Chief Executive Officer, lululemon Digital Fitness	Joined lululemon in January 2022. Previously at Amazon, where he was Chief Content Officer at Twitch. Also served as General Manager VRV at Ellation, Inc. and spent more than 10 years at Sony where he expanded the PlayStation Network beyond gaming and into more than 30 countries. Earned an MBA from Tuck School of Business, Dartmouth College.
Julie Averill	Executive Vice President and Chief Technology Officer	Joined lululemon in 2017. Previously worked at REI, where she was the first-ever Chief Information Officer and spent more than a decade at Nordstrom where she held several key positions on its IT leadership team. MBA from the University of Washington.
Celeste Burgoyne	President, Americas, and Global Guest Innovation	Joined lululemon in 2006 and was previously General Manager of U.S. Operations, among other roles. Started career at Abercrombie & Fitch. B.A. Degree from the University of San Diego.

Name	Title	Brief Biography
Sun Choe	Chief Product Officer	Joined lululemon in 2016. Prior to lululemon, served as Chief Global Product Merchant at Marc Jacobs. Also worked at Urban Outfitters, Levi's, and The Gap. B.A. Degree from University of Maryland, College Park.
Ted Dagnese	Chief Supply Chain Officer	Joined lululemon in 2016. Prior to lululemon, served as Vice President, Supply Chain at VF Corporation. M.S. in Engineering Economics from Northeastern University.
Meghan Frank	Chief Financial Officer	Joined lululemon in 2016. Interim co-CFO from April 2020 until appointment as CFO in November 2020. Previously held senior finance and merchandise planning roles at Ross Stores and J. Crew. BA in Economics from Colgate University.
Susan Gelinas	Senior Vice President, People & Culture	Ms. Gelinas joined lululemon in 2011. Prior to joining the company, she was a Senior Consultant at Towers Watson.
Shannon Higginson	Senior Vice President, General Counsel & Chief Compliance Officer	Ms. Higginson joined lululemon in 2011. Prior to joining the company, she served as Senior Counsel for Canadian telecommunications company TELUS. Holds a J.D. degree from the University of Victoria.
André Maestrini	Executive Vice President, International	Joined lululemon in January 2021. Prior to lululemon, spent 14 years at adidas in various senior roles. Also held marketing roles at the Coca-Cola Company and Danone. Master's degree in marketing from ESSEC in Paris, France.
Nikki Neuberger	Chief Brand Officer	Ms. Neuberger joined lululemon in 2020. Prior to lululemon, served as Global Head of Marketing for Uber Eats. Also spent 14 years at Nike, where she served as Global Vice President of Nike Running. B.S. in Business Administration from Oregon State University.

Source: Information posted at **www.corporate.lululemon.com,** (accessed May 12, 2023).

THE YOGA MARKETPLACE

The origins of Yoga are obscure but was generally considered to have been developed in Northern India at least 5,000 years ago.[5] Yoga arrived in the United States in 1893 through a series of lectures given by Swami Vivekananda in Chicago, Il.[6] The number of people who participated in yoga in the United States in 2023 was estimated to be roughly 35 million.[7] Worldwide, it was estimated by one source that there were about 300 million yoga practitioners.[8] The level of yoga expertise varied considerably: 56 percent of yoga practitioners considered themselves as beginners, 42 percent considered themselves as "intermediate," and 2 percent considered themselves to be in the expert/advanced category. Yoga practitioners enrolled in yoga classes for a number of different reasons, including improving flexibility, reducing stress, improving sleep, and improving health and physical fitness.[9] Apart from in-person yoga classes, 24 percent of people were estimated to use yoga apps or yoga guided videos as part of their yoga routines.[10] About 72 percent of the people who engaged in group or class yoga exercises were women; 30–49 year-olds were the most active age group (43 percent), followed by 50+ year olds (38 percent) and 19–29 year-olds (19 percent); close to 62 percent of all yoga practitioners were in the age range of 18–49.[11]

Worldwide, the annual spend on yoga classes, clothing, equipment, and accessories yoga industry was estimated to be about $88 billion, with spending in the United States an estimated $16 billion.[12] Those aged between 25 and 34 spent the most on activewear, including yoga clothing. In 2022, there were about 7,000 registered yoga studios in the United States, and more than 100,000 yoga teachers registered with the Yoga Alliance.[13]

The global market for sports and fitness apparel in 2023 was expected to reach $207 billion.[14] During the 2023–2033 period, the compound average growth rate was expected to be 6.9 percent and reach $400 billion by 2033. Yoga apparel was but one part of a larger apparel market, however. Sales of various types of sports apparel was among the fastest-growing segments in the $3 trillion global apparel market. In the United States, sales of activewear and all types of gym and fitness apparel, which included both items made with high-tech performance fabrics that wicked away moisture and had other high-performance features were the fastest growing segment of the sports apparel industry.[15]

LULULEMON'S BUSINESS AND STRATEGY IN 2023

In its 2022 10-K report, the company described its vision and business purpose as follows:

> lululemon athletica inc. is principally a designer, distributor, and retailer of technical athletic apparel, footwear, and accessories. We have a vision to create transformative products and experiences that build meaningful connections, unlocking greater possibility and wellbeing for all. Since our inception, we have fostered a distinctive corporate culture; we promote a set of core values in our business which include taking personal responsibility, acting with courage, valuing connection and inclusion, and choosing to have fun. These core values attract passionate and motivated employees who are driven to achieve personal and professional goals and share our purpose "to elevate human potential by helping people feel their best."[16]

The company elaborated further on its business:

> Our guests seek a combination of performance, style, and sensation in their athletic apparel, choosing products that allow them to feel great however they exercise. Since consumer purchase decisions are driven by both an actual need for functional products and a desire to live a particular lifestyle, we believe the credibility of our brand and the authentic community experiences we offer expand our potential market beyond just athletes to those who pursue an active, mindful, and balanced life.
>
> Although our largest customer group is made up of guests who shop our women's range, representing 65% of our 2022 net revenue, we also design a comprehensive men's line and have a targeted strategy in place. Revenue from our men's range is growing as more guests discover the technical rigor and premium quality of our men's products and are attracted by our distinctive brand.[17]

Product Line Strategy

In 2023, lululemon offered a diverse and growing selection of premium-priced performance apparel and accessories for women, female youths, and men that were designed for healthy lifestyle activities such as yoga, swimming, running, cycling, and general fitness. The company's range of offerings in 2023 are shown in Exhibit 4.

EXHIBIT 4 A Representative Sample of lululemon athletica's Product Offerings for Women and Men, 2023

Women		Men
• Leggings	• Swimsuits	• Joggers
• Coats & Jackets	• Tank Tops	• Hoodies & Sweatshirts
• Dresses	• Underwear	• Pants
• Joggers	• Footwear	• Polo Shirts
• Shirts	• Gloves & Mittens	• Shorts
• Pants	• Hats	• Swim Trunks
• Shorts	• Scarves & Wraps	• Trousers
• Sports Bras	• Water Bottles	• Footwear
• Sweaters	• Yoga Mats & Accessories	• Yoga mats & Accessories

If you are not familiar with lululemon products, it would be useful to spend a few minutes browsing the company's e-store at **https://shop.lululemon.com/.**

lululemon's Strategy of Offering Only a Limited Range of Apparel Sizes In the months following the product recall of the too-sheer bottom pants in March 2013, lululemon officially revealed in a posting on its Facebook page that it did not offer clothing in plus-sizes because focusing on sizes 12 and below was an integral part of its business strategy; according to the company's posting and to the postings of lululemon personnel who responded to comments made by Facebook members who read the lululemon posting:[18]

> Our product and design strategy are built around creating products for our target guest in our size range of 2–12. While we know that doesn't work for everyone and recognize fitness and health come in all shapes and sizes, we've built our business, brand, and relationship with our guests on this formula.
>
> We agree that a beautiful healthy life is not measured by the size you wear. We want to be excellent at what we do, so this means that we can't be everything to everybody and need to focus on specific areas. Our current focuses are in innovating our women's design, men's brand, and building our international market.
>
> At this time, we don't have plans to change our current sizing structure which is 2–12 for women.

In 2016, the largest size appearing in the size guide for women on lululemon's website was 12, which was said to be suitable for a 40″ bust, 32.5″ waist, and 43″ hips. However, in 2022, the size range had been expanded, with 20 being the largest women's size appearing on the company's website. Some women's products in 2023 were offered in sizes ranging from XXXS to XXL but most website products were sized XS to XL.

Lululemon's Entry into the Athletic Footwear Segment On March 8, 2022, lululemon CEO Calvin McDonald announced the company was entering the athletic footwear market.[19] Its first product, Blissfeel, was a women's running shoe line and that became available in late March 2022. Additional styles, including Chargefeel (cross-training), Restfeel (post-workout), and Strongfeel (athletic training), were released later in 2022. A men's footwear collection was scheduled for rollout during 2023.[20] According to McDonald, "Each shoe within the lululemon footwear collection is designed to deliver a specific feeling . . . and to help ensure a zero-distraction experience for guests enjoying the right fit from the first trial."[21]

Company-Operated Stores and Store Expansion Strategy

After several years of experience in establishing and working with franchised stores in the United States, Australia, Japan, and Canada, top management in

2010 determined that having franchised stores was not in lululemon's best long-term strategic interests. A strategic initiative was begun to either acquire the current stores of franchisees and operate them as company stores or convert the franchised stores to a joint venture arrangement where lululemon owned the controlling interest in the store and the former franchisee owned a minority interest. By year-end 2011, all franchised lululemon stores had been converted to company-operated.

As of February 2023, lululemon had 655 company-operated retail stores in 18 countries:[22]

- 350 stores in the United States.
- 69 stores in Canada.
- 117 stores in the People's Republic of China, inclusive of nine stores in Hong Kong, two stores in Macau, and seven stores in Taiwan.
- 32 stores in Australia.
- 20 stores in the United Kingdom.
- Sixteen stores in South Korea, ten stores in Germany, eight stores in New Zealand, eight stores in Japan, eight stores in Singapore, four stores in France, four stores in Ireland, three stores in Spain, two stores each in Malaysia and Switzerland, and one store each in Norway, Switzerland, and the Netherlands.

In addition, lululemon had 26 retail locations operated by third parties under license and supply arrangements, including 12 in Mexico, seven in the United Arab Emirates, three in Qatar, three in Saudi Arabia, and one in Kuwait. As of January 29, 2023, there was also an e-commerce website operated through the license and supply arrangements for lululemon branded locations in the United Arab Emirates, Kuwait, Qatar, Oman, Bahrain, Saudi Arabia, and Mexico.

For fiscal year 2023, management indicated that new store growth would come primarily from company-operated store openings in the United States and the People's Republic of China. CEO McDonald was optimistic about lululemon's further expansion in China, in particular. Revenues in China had increased over 50 percent on a three-year CAGR basis.[23] Lululemon management saw China as being the company's biggest growth opportunity, where the number of yoga studios had tripled from about 14,000 in 2016 to approximately 42,000 in 2021 and where the size of the yoga market was expected to grow about 12 percent and reach sales of $7.9 billion in 2022, of which about 59 percent would be spent on yoga classes and 41 percent on apparel, equipment, and accessories.[24]

lululemon sales per gross square foot in its company-owned retail stores were $1,443 and $1,580 in fiscal 2021 and fiscal 2022, respectively. While strong, these metrics did not reach the levels seen for lululemon retail stores sales per gross square foot of $1,657 in fiscal 2019, pre-pandemic. Further, direct-to-consumer sales were increasingly driving revenues for the company, and likely diverting revenues away from retail store operations. Still, sales per gross square foot at corporate-owned stores open at least one full year had exceeded $1,500 per square foot in fiscal years 2018 and 2019 (see Exhibit 1). By way of comparison, the stores of specialty fashion retailers like Old Navy, Banana Republic, The Gap, and Abercrombie & Fitch historically had annual sales averaging less than $500 per square foot of store space.

lululemon's Retail Stores: Locations, Layout, and Merchandising The company's retail stores were located primarily on street locations, in upscale strip shopping centers, in lifestyle centers, and in malls. Typically, stores were leased and ranged from 2,500 to 3,500 square feet in size. Most stores included space for product display and merchandising, checkout, fitting rooms, a restroom, and an office/storage area. While the leased nature of the store spaces meant that each store had its own customized layout and arrangement of fixtures and displays, each store was carefully decorated and laid out in a manner that projected the ambience and feel of a homespun local apparel boutique rather than the more impersonal, cookie-cutter atmosphere of many apparel-chain stores.

The company's merchandising strategy was to sell all items in its retail stores at full price.[25] Special colors and seasonal items were in stores for only a limited time—such products were on 3-, 6-, or 12-week life cycles so that frequent shoppers could always find something new. Store inventories of short-cycle products were deliberately limited to help foster a sense of scarcity, condition customers to buy when they saw an item rather than wait and avoid any need to discount unsold items. In one instance, a hot-pink color that launched in December was supposed to have a two-month shelf life but supplies sold out in the first week. However, supplies of core products that did not change much from season to season were more ample to minimize the risk of lost sales due to items being out-of-stock. Approximately 95 percent of the merchandise in lululemon retail stores was typically sold at full price.[26] When certain styles, colors, and sizes of apparel items at lululemon retail stores were selling too slowly to clear out the inventories of items ordered from contract manufacturers, lululemon typically shipped the excess inventories to one or more of the 39 lululemon Factory Outlet stores to be sold at discounted prices.

One unique feature of lululemon's retail stores was that the floor space allocated to merchandising displays and customer shopping could be sufficiently cleared to enable the store to hold an in-store yoga class before or after regular shopping hours. Pre-pandemic, every store had hosted a complimentary yoga class each week that was conducted by a professional yoga instructor from the local community. However, these classes were canceled when the COVID-19 pandemic began and had not been reinstituted as of March 2023. Instead, the company was actively promoting subscriptions for the use of online exercise classes delivered via its lululemon Studio workout platform (formerly MIRROR). Live demonstrations of the company's interactive workout platform were available at select lululemon retail locations.

Lululemon's New Trade-in and Buy Like New Program

Following a successful pilot test across 80+ stores in Texas and California in 2021 that met enthusiastic customer response, lululemon in April 2022 announced that the company's first trade-in and resale program "lululemon Like New" would be available to guests in 390+ participating stores in the United States and online (trade-ins were not accepted at lululemon factory outlet stores). Store guests could bring in "gently used" lululemon pants, tops, shorts, jackets and other items to any U.S. store, trade them in for amounts ranging from $5 to $25 per item, and receive an e-gift card (or credit) that could be used to shop resale products online at **www.likenew.lululemon.com** or to purchase new lululemon gear at stores or online. New trade-in items were added for resale daily at the like new section of lululemon's website. Examples of the prices of used items included men's slim-fit pants priced from $65 to $75 which sold new for $128, women's Align™ high-rise leggings priced at $59 which sold new for $98, women's Wunder Puff wool jacket priced at $239 which sold new for $398, women's Rest Less Pullover priced at $69 which sold new for $108, and women's Oh So Sherpa Jacket priced at $99 which sold new for $168—resale prices varied according to whether the item was in "good-as-new" condition or "gently used." The company had not ruled out selling secondhand items in a section of its retail stores; management believed the new trade-in and resale program would help attract customers looking for deals. A lululemon executive said "The guest who's buying from Like New really . . . skews younger and is a value-based shopper."[27] The company said its lululemon's Like New program would reinvest 100 percent of the program's profits to support the brand's commitments, which included giving all of its guests the option to repair and/or recycle its products and making all of its products with sustainable materials and end-of-use solutions by 2025.

Direct-to-Consumer Sales and Strategy

Direct-to-consumer sales was an integral part of lululemon's Omni Guest Experience. As part of the company's 2022 Power of Three x2 strategic growth plan, the company had committed to doubling direct-to-consumer revenues by 2026. The company launched its e-commerce website, **https://shop.lululemon.com/**, in 2009. In 2023, the company used its e-commerce website, other country and region-specific websites, and mobile app to enable customers to make online purchases, enable in-store shoppers to make purchases that could be fulfilled via inventories at other retail locations or the company's distribution centers, and extend the company's geographic market reach.

Management saw online sales as having three strategic benefits: (1) providing added convenience for core customers, (2) securing sales in geographic markets where there were no lululemon stores, and (3) helping build brand awarevness, especially in new markets, especially those outside of North America. As of March 2023, the company website shipped lululemon merchandise to 6 continents and 78 separate countries in North America, South America, Africa, Asia, Europe, and the Middle East. lululemon processed and shipped online orders within 1 to 2 business days of the order date and provided free standard shipping (2–6 business day delivery) to all lululemon customers in North America—customers could upgrade to express shipping for a fee of $20 (2–4 business days) or to priority shipping for a fee of $30 (2–3 business days); buyers outside North America paid a standard $30 shipping fee, with delivery in 5–10 business days after the package was shipped.

The merchandise selection that lululemon offered to online buyers differed somewhat from what was available in the company's retail stores. Several of the items available in stores were not sold online; a few online selections were not available in the stores. Styles and colors available for sale online were updated weekly. On occasion, the company marked down the prices of some styles and colors sold online to help clear out the inventories of items soon to be out-of-season and make way for newly arriving merchandise—online customers could view the discounted merchandise by clicking on a "we made too much" link.

Direct-to-consumer sales at the company's websites had grown dramatically, with e-commerce sales climbing from $106.3 million in fiscal 2011 (10.6 percent of total net revenues) to $3.70 billion in fiscal 2022 (45.6 percent of total revenues)—equal to a compound annual growth rate (CAGR) of 38.1 percent. In 2020 and 2021, when the majority of lululemon's retail stores in North America and elsewhere were closed for 2–3 months or longer due to COVID-19, e-commerce became a vital link between the company and its customers. Exhibit 5 shows the growth in quarterly e-commerce sales for fiscal years 2018 through 2022.

Other Company Segments

lululemon also engaged in several other company operations, discussed below.

- **Outlets** – The company operated factory outlet stores to sell slow-moving inventory and inventory from prior seasons at discounted prices.[28] In 2022, lululemon operated 39 factory outlet locations, with most of them located in North America.
- **Wholesale Accounts** – lululemon also marketed its products to select premium yoga studios, health clubs, university campus retailers and fitness centers to gain the implicit endorsement of local fitness personnel for lululemon branded apparel, familiarize their customers with the lululemon brand, and give them an opportunity to conveniently purchase lululemon apparel. lululemon management did not want to grow wholesale sales to these types of establishments into a significant revenue contributor. Rather, the strategic objective of selling lululemon apparel to yoga studios, health clubs, and other locations centers was to build brand awareness,

EXHIBIT 5 lululemon's Quarterly E-commerce Sales, Q1 2018 through Q4 2022

Online Sales	Quarter 1	Quarter 2	Quarter 3	Quarter 4
2018	$157.8 million	$167.4 million	$189.4 million	$ 344.2 million
2019	209.8 million	217.6 million	246.7 million	463.7 million
2020	352.0 million	554.3 million	478.3 million	899.5 million
2021	545.1 million	597.4 million	586.5 million	1,000.0 million
2022	721.3 million	775.4 million	767.4 million	1,400.0 million

Source: Quarterly Financial Results, posted in the Investor Relations section at **www.lululemon.com.**

especially in new geographic markets both in North America and international locations where the company intended to open new stores.

- **License and supply arrangements —** lululemon had entered license and supply arrangements with partners in the Middle East and Mexico to operate lululemon athletica branded retail locations in the United Arab Emirates, Kuwait, Qatar, Oman, Bahrain, Saudi Arabia, and Mexico. Under the arrangement, lululemon supplied their partners with lululemon products, training, and other support.
- **Recommerce —** lululemon's recommerce segment covered the sale of repurchased products via the company's "Like New" program. Recommerce allowed customers to exchange their gently used lululemon products for credit. Among other benefits, lululemon hoped that this program contributed toward lowering the company's environmental footprint.
- **Temporary Locations—lululemon's "Pop Ups" and Showroom Strategy.** Over the years, lululemon had opened temporary "showrooms" and "pop ups" in numerous locations both inside and outside North America. Pop ups were typically for short periods of time, either to serve guests during peak shopping periods in markets where lululemon did not ordinarily have a physical location, or to better serve guests in local markets with high demand at existing locations. From time to time, lululemon had operated temporary showrooms in certain locations as a means of introducing the lululemon brand and culture to a community, developing relationships with local fitness instructors and fitness enthusiasts, and hosting community-related fitness events, all in preparation for the grand opening of a new lululemon athletica retail store in that general location. Showroom personnel
  - Hosted get-acquainted parties for fitness instructors and fitness enthusiasts.
  - Recruited a few well-regarded fitness instructors in the local area to be "store ambassadors" for lululemon products and periodically conduct in-store yoga classes when the local lululemon retail store opened.
  - Advised people visiting the showroom on where to find great yoga or Pilates classes, fitness centers, and health and wellness information and events.
  - Solicited a select number of local yoga studios, health clubs, and fitness centers to stock and retail a small assortment of lululemon's products.

  Showrooms were only open part of the week so that showroom personnel could be out in the community meeting people, building relationships with yoga and fitness instructors, participating in local yoga and fitness classes, and talking with attendees before and after class, promoting attendance at local fitness and wellness events, and stimulating interest in the soon-to-open retail store. lululemon used showrooms as a means of "pre-seeding" the opening of a lululemon retail store primarily in those locations where no other lululemon retail stores were nearby.
- **lululemon Studio (formerly Mirror)**—Renamed lululemon Studio in October 2022, the Mirror division had been acquired by lululemon in July 2020. Described as the "perfect package to transform your home into a complete home gym," Studio Mirror was an in-home fitness package that used an interactive workout platform, or Mirror, to allow guests to subscribe to live and on-demand classes.[29] The lululemon Studio Mirror basic package sold for $995 on the lululemon website in March 2023 and required a $39/month subscription fee with a one-year minimum commitment—the company planned to lower its monthly subscription fee in summer 2023. Apart from the basic Mirror, there were three higher-priced Mirror models with a number of added features. Subscribers could access 10,000+ classes on-demand and new live classes daily taught by world-class fitness experts. Studio members also received 10 percent off lululemon gear, free classes at lululemon Experiential stores, and 20 percent off workouts at partner studios. Management believed the lululemon Studio program offered the at-home yoga and fitness enthusiast not only a wide choice of workouts but also convenience of working out on their own schedule

with whatever time they had available and at a level that met their ability, the opportunity to engage with a whole fitness community, quick access to great Studio customer service, and the aesthetics of added good looks, taking up little space, and blending right in with the surroundings. In addition to the lululemon Studio subscription tier, the company in 2023 launched an Essentials free membership tier and signed up nine million members in the first five months.[30]

Acquired for $426.5 million in July 2020, the unit quickly ran into trouble. The original Mirror CEO, Brynn Putnam, stepped down in September 2021.[31] Revenues dropped at the Mirror unit in 2021, and company earnings were impaired by $26.7 million in fiscal 2020 and $40 million in fiscal 2021 due to the Mirror acquisition.[32] Michael Aragon was named CEO of Mirror in January 2022.[33] Aragon's title was changed to CEO, lululemon Digital Fitness in October 2022. Lululemon took an additional $433 million earnings impairment against the MIRROR unit at the end of 2022.

Taken together, the company's other operations accounted for $762 million in net revenues, or 9.4 percent of total net revenues in fiscal 2022, versus $657 million and 10.5 percent of net revenues in fiscal 2021.

COMPANY OPERATIONS AND CULTURE

Product Design and Development Strategy

lululemon's product design and development efforts were led by a team of researchers, scientists, engineers, and designers. The design team included athletes and users of the company's products who embraced lululemon's design philosophy and dedication to premium quality. Design team members regularly visited retail stores in a proactive effort to solicit feedback on existing products from store customers and fitness ambassadors and to gather their ideas for product improvements and new products. In addition, the design team used various market intelligence sources to identify and track market trends. The design team incorporated all this input to make fabric selections, develop new products, and adjust the fit, style, and function of existing products.

The design team worked closely with its apparel manufacturers to incorporate innovative fabrics that gave lululemon garments such characteristics as stretch ability, moisture-wicking capability, color fastness, feel-good comfort, and durability. Fabric quality was evaluated via actual wear tests and by a leading testing facility. lululemon partnered with independent inspection, verification, and testing companies who conducted a battery of tests on fabrics for such performance characteristics as pilling, shrinkage, abrasion resistance, and colorfastness. Lastly, lululemon design personnel worked with leading fabric suppliers to develop proprietary fabrics and collaborated with fabric and trim suppliers to manufacture fabrics and trims that lululemon could protect through trademarks, agreements, and trade-secrets and thereby gain added brand recognition and brand differentiation.

Where appropriate, product designs incorporated convenience features, such as pockets to hold credit cards, keys, digital audio players, and clips for heart rate monitors and long sleeves that covered the hands for cold weather exercising. Product specifications called for the use of advanced sewing techniques, such as flat seaming, which increased comfort and functionality, reduced chafing and skin irritation, and strengthened important seams. All these design elements and fabric technologies were factors that management believed enabled lululemon to price its high-quality technical athletic apparel at prices above those of traditional athletic apparel.

Typically, it took 8 to 10 months for lululemon products to move from the design stage to availability in its retail stores; however, the company had the capability to bring select new products to market in as little as two months. Management believed its lead times were shorter than those of most apparel brands due to the company's streamlined design and development process, the real-time input received from customers and ambassadors at its store locations, and the short times it took to receive and approve samples from manufacturing suppliers. Short lead times facilitated quick responses to emerging trends or shifting market conditions. lululemon management believed that its product design and development process enhanced the company's capabilities to develop top quality products and was a competitive strength.

Sourcing and Manufacturing

Production was the only value chain activity that lululemon did not perform internally. Lululemon did not own or operate any manufacturing facilities to produce fabrics or make garments. In 2022, fabrics were sourced from a group of approximately 60 fabric manufacturers, with five fabric manufacturers supplying 56 percent of the total and the largest single fabric manufacturer supplying 21 percent of the fabric the company utilized. During fiscal year 2022, approximately 43 percent of the required fabrics were sourced from suppliers in Taiwan, 19 percent from suppliers in mainland China, 16 percent from manufacturers in Sri Lanka, and the remainder from other regions. Other raw materials used in lululemon products, such as content labels, elastics, buttons, clasps, and drawcords, were obtained from suppliers located predominantly in the Asia Pacific region.

Garments were sourced from approximately 45 contract manufacturers, five of which produced approximately 56 percent of the company's products in fiscal 2022, with the largest of these producing about 15 percent of the total. During fiscal 2022, approximately 39 percent of the company's products were produced in Vietnam, 14 percent in Cambodia, 12 percent in Sri Lanka, 8 percent in Bangladesh, 7 percent in Indonesia, and the remainder in other countries. The company deliberately refrained from entering into long-term contracts with any of its fabric suppliers or manufacturing sources, preferring instead to transact business on an order-by-order basis and rely on the close working relationships it had developed with its various suppliers over the years. lululemon maintained production relationships with several manufacturers in North America that provided the company with the capability to speed select products to market and respond quickly to changing trends and unexpectedly high buyer demand for certain products.

lululemon took great care to ensure that its manufacturing suppliers shared lululemon's commitment to quality and ethical business conduct. All manufacturers were required to adhere to a Vendor Code of Ethics regarding quality of manufacturing, safe and healthy working conditions, operation of a respectful and inclusive workplace, environmental stewardship, fair wage practices, fair dealings and avoidance of corruption, and compliance with child labor laws, among others. Vendors were required to post lululemon's code of ethics in the language of employees in all major workplaces and dormitories and train their employees on its contents. lululemon utilized the services of a leading inspection and verification firm to closely monitor each supplier's compliance with applicable law, lululemon's vendor code of ethics, and other business practices that could reflect badly on lululemon's choice of suppliers.

Distribution Facilities

lululemon shipped products to its stores from owned or leased distribution facilities in the United States and Canada. The company owned a 310,000 square-foot distribution center in Columbus, Ohio, and leased six additional distribution centers. The company leased four distribution centers in Canada (Two in Delta, British Columbia, one in Milton, Ontario, and one in Mississauga, Ontario), one distribution center in the United States (Sumner, Washington), and one distribution center in Australia (Derrimut, Victoria). lululemon also entered into three new lease agreements in 2021 and 2022 for three additional distribution centers in the United States, Canada, and Australia. All three new distribution centers were expected to be opened for business in fiscal 2024.

Third-party logistics providers in the United States, China, and the Netherlands were also used to warehouse and distribute finished products from the company's distribution centers to supply the company's retail stores in the United States, People's Republic of China, and Europe. Merchandise was typically shipped to retail stores through third-party delivery services multiple times per week, thus providing stores with a steady flow of new inventory.

lululemon's Community-Based Marketing Approach and Brand-Building Strategy

One of lululemon's differentiating characteristics was its community-based approach to building brand awareness and customer loyalty. It pursued a multi-faceted approach that included leveraging its local store personnel and local ambassadors, digital marketing and social media, in-store community boards, and a variety of local grassroots activities, all complemented and amplified by its global brand-building efforts. Each store recruited local fitness practitioners to be brand ambassadors. Ambassadors introduced their fitness class attendees to the lululemon brand and sometimes marketed lululemon products in their studios, which led to interest in the brand, store visits, and word-of-mouth marketing. In return for helping drive business to lululemon stores and conducting classes, ambassadors were periodically given bags of free products, and large portraits of each ambassador wearing lululemon products and engaging in physical activity at a local landmark were prominently displayed on the walls of their local lululemon store as a means of helping ambassadors expand their clientele.

Every lululemon store had a dedicated community coordinator who developed a customized plan for organizing, sponsoring, and participating in local athletic, fitness, and philanthropic events. In addition, each store had a community events bulletin board for posting announcements of upcoming activities, providing fitness education information and brochures, and promoting the local yoga studios and fitness centers of ambassadors. There was also a chalkboard in each store's fitting room area where customers could scribble comments about lululemon products, or their yoga class experiences, or their appreciation of the assistance/service provided by certain store personnel; these comments were relayed to lululemon headquarters every two weeks.

lululemon made little use of traditional advertising print or television advertisements, preferring instead to rely on its various grassroots, community-based marketing efforts and the use of social media (like Facebook and Twitter) to increase brand awareness, reinforce its premium brand image, and broaden the appeal of its products.

Store Personnel

As part of the company's commitment to providing customers with an inviting and educational store environment, lululemon's store sales associates, who the company referred to as "educators," were coached to personally engage and connect with each guest who entered the store. Educators, many of whom had prior experience as a fitness practitioner or were avid runners or yoga enthusiasts, received approximately 30 hours of in-house training within the first three months of their employment. Training was focused on (1) teaching educators about leading a healthy and balanced life, exercising self-responsibility, and setting lifestyle goals; (2) preparing them to explain the technical and innovative design aspects of all lululemon products; and (3) providing the information needed for educators to serve as knowledgeable references for customers seeking information on fitness classes, instructors, and events in the community. New hires that lacked knowledge about the intricacies of yoga were given subsidies to attend yoga classes so they could understand the activity and better explain the benefits of lululemon's yoga apparel.

People who shopped at lululemon stores were called "guests," and store personnel were expected to "educate" guests about lululemon apparel, not sell to them. To provide a personalized, welcoming, and relaxed experience, store educators referred to their guests on a first name basis in the fitting and changing area, allowed them to use store restrooms, and offered them complimentary fresh-filtered water. Management believed that such a soft-sell, customer-centric environment encouraged product trial, purchases, and repeat visits.

Core Values and Culture

lululemon's stated purpose was "We elevate human potential by helping people feel their best."[34] lululemon executives sought to promote and ingrain a set of core values centered on developing the highest-quality products, operating with integrity and inclusion, leading a healthy balanced life, and instilling in its employees a sense of self responsibility and the value of goal setting. The company sought to provide employees with a supportive and goal-oriented work environment; all employees were encouraged to set goals aimed at reaching their full professional, health, and personal potential. The company offered personal development workshops and goal-coaching to assist employees in achieving their goals. Many lululemon employees had a written set of professional, health, and personal goals. All employees had access to a "learning library" of personal development books that included Steven Covey's *The Seven Habits of Highly Effective People,* Rhonda Byrne's *The Secret,* and Brian Tracy's *The Psychology of Achievement.* The core values of lululemon are presented in Exhibit 6.

Chip Wilson had been the principal architect of the company's original culture and core values, and the company's work climate through 2013 reflected his business and lifestyle philosophy. Wilson had digested much of his philosophy about life in general and personal development into a set of statements and prescriptions that he called "the lululemon manifesto." The manifesto was considered to be a core element of lululemon's culture. Senior executives believed the company's work climate and core values helped it attract passionate and motivated employees who were driven to succeed and who would support the company's vision of "elevating the world from mediocrity to greatness"—a phrase coined by Chip Wilson in the company's early years. For several years, the company's shopping bags were emblazoned with a full print of the manifesto, as a means of sharing its culture and beliefs about life in general with customers, the local community, and the public at large.

The death of George Floyd in May 2020, the resulting social unrest and the Black Lives Matter movement had a powerful impact on lululemon. Following a broad conversation within the organization, and with the support of lululemon leadership, the company made a significant commitment to fund Inclusion, Diversity, Equity and Action (IDEA) within the lululemon organization. Among the initiatives was a commitment to create an ongoing dialogue with underrepresented members of the company, expand training, learning and development, and to increase diverse representation among lululemon employees. In June 2020, lululemon committed to invest $5 million a year to fund the company's global IDEA activities.[35] The company offered all employees IDEA education, training, and guided conversations on a variety of topics, including anti-racism, anti-discrimination, and inclusive leadership behaviors; the goal was to foster a culture of inclusion by making IDEA part of employees' everyday conversation and by frequently reviewing company policies, programs, and practices to identify ways to be more inclusive and equitable.

In October 2020, the company released its first Impact Agenda, detailing the company's long-term commitment to build a more sustainable and equitable business. The Impact Agenda was organized around three interconnected areas of focus goals—Be Human, Be Well, and Be Planet, along with 12 underlying goals to measure progress.[36] The company updated its Impact Agenda in 2021.[37]

EXHIBIT 6 lululemon core values, 2023

- **Personal Responsibility.** We act with honesty and integrity, taking full accountability for our choices and their impact.
- **Connection.** We build trusting relationships by valuing and celebrating each human's uniqueness.
- **Inclusion.** We remove barriers so that everyone has a sense of belonging.
- **Courage.** We have the heart and strength to do big, challenging, and important things for each other and our planet.
- **Fun.** We infuse joy and laughter into all we do, which in turn allows us to turn work into play.

Source: Posted in the "About Us" section at www.lululemon.com (accessed May 23, 2023).

COMPETITION IN ATHLETIC APPAREL

Competition in the market for athletic and fitness apparel was fierce. Companies competed principally on product quality, performance features, innovation, fit and style, distribution capabilities, brand image and recognition, and price. Rivalry among the competing brands was global, vigorous, and involved both established companies who were expanding their production and marketing of performance products and recent entrants attracted by the growth opportunities. lululemon competed with wholesalers, retailers, and direct sellers of premium performance athletic apparel made of high-tech fabrics, most especially Nike, adidas Group AG, Under Armour, and Athleta (a subsidiary of The Gap, Inc). Other important competitors included Puma, Columbia

Sportswear, Urban Outfitters, Victoria's Secret, and Nordstrom.

Nike Nike had a powerful and well-known global brand name, an extensive and diverse line of athletic and sports apparel, and 2022 global sales of $46.7 billion ($18.4 billion in North America). Nike's sales outside of North America accounted for just over 60 percent of its worldwide revenues in fiscal 2022. Not only was Nike the world's largest seller of athletic footwear (its footwear sales exceeded $29 billion in fiscal 2022), but it was also the world's largest sports apparel brand, with 2022 sales of $13.5 billion. The company had selling arrangements with independent distributors and licensees around the world; its retail account base for sports apparel in the United States included a mix of sporting goods stores, athletic specialty stores, department stores, and tennis and golf shops, plus it had a network of factory outlet stores (209 in the United States and 597 across the rest of the world) and Nike and NIKETOWN retail stores (48 in the United States and 47 in the rest of the world). Nike also had a strong online sales presence via web and apps in 45 countries around the world (**www.nike.com**); in fiscal year 2022, Nike Direct revenues grew 14 percent to $18.7 billion worldwide.

Adidas The adidas Group was a global company headquartered in Germany that had worldwide sales of €22.5 billion ($24.8 billion) in 2022. Worldwide sports apparel revenues for the company were €8.7 billion ($9.6 billion) in 2022; its product lines consisted of high-tech performance garments for a wide variety of sports and fitness activities, as well as recreational sportswear. The adidas Group sold products in almost every country of the world. In 2022, its extensive product offerings were marketed through third-party retailers (sporting goods chains, department stores, independent sporting goods retailer buying groups, lifestyle retailing chains, and Internet retailers), 2,000 company-owned adidas retail and franchised stores, and through the company's e-commerce website at **www.adidas.com.** In August 2021, adidas signed an agreement to sell its Reebok brand and retail store operations to Authentic Brands Group.[38] The Reebok divestiture was completed in February of 2022.

Under Armour Under Armour, a designer and marketer of performance sportswear, had total sales of $5.9 billion in fiscal 2023, of which $3.9 billion was in apparel. Like lululemon, Under Armour's apparel products were made entirely of technically advanced, high-performance fabrics and were designed to be aesthetically appealing, as well as highly functional and comfortable. Under Armour regularly upgraded its products as next-generation fabrics with better performance characteristics became available. Under Armour's product line included apparel for men, women, and children. Under Armour's sales and net income had been uneven between 2019 and 2023; the company booked a $549 million loss in 2020. The company reported significant disruptions in their operations during the COVID-19 pandemic. The majority of Under Armour's sales were made through wholesale channels, including sporting goods stores, independent and specialty retailers, department stores, institutional athletic departments, and sports leagues and teams. As of March 2023, the company operated 176 factory outlet stores and 18 Brand House stores in North America, as well as 165 factory outlet stores and 80 Brand House stores in international locations. Under Armour had direct-to-consumer sales of $2.27 billion in fiscal 2023, which included sales at its factory outlet stores and the company's e-commerce website, **www.underarmour.com**.

Nike, adidas Group, and Under Armour all aggressively marketed and promoted their high-performance apparel products to women and men and spent heavily to grow consumer awareness of their brands and build brand loyalty. All three companies sponsored athletic events, provided uniforms and equipment with their logos to collegiate and professional sports teams, and paid millions of dollars annually to numerous high-profile male and female athletes to endorse their products. Like lululemon, these companies designed their own products but outsourced the production of their garments to contract manufacturers.

Athleta A relative newcomer to women's athletic and fitness apparel, Athleta was a subsidiary unit of The Gap, Inc. The Gap acquired Athleta in 2008 for $150 million. After the acquisition, The Gap converted Athleta into a retail chain to compete head-on against lululemon in the market for comfortable, fashionable, high-performance women's and girl's apparel for workouts and training, sports (tennis, golf, soccer, gymnastics), physically active recreational activities (swimming, surfing), dance, sleep, camp essentials, and leisure wear. Athleta's garment lineup included tops, sweaters, shorts, skirts and skorts, tights and leggings, pants, dresses and rompers, jackets, bras, swimwear, sleepwear, and accessories (hats and hair accessories, shoes, socks, sun protection and sunglasses, bags and wallets, and workout accessories) in sizes ranging from XXS to 3X. In addition to Athleta's sales at its retail stores, it also derived from periodic mailouts of Athleta catalogs, and revenues from online sales at **https://athleta.gap.com**. Athleta also had a social media website, **https://community.athletawell.com/**, that was dedicated to women's well-being.

In 2016, Athleta launched its Athleta Girl collection and in 2020 introduced its first sleep collection. Also in 2020, Athleta expanded its offerings to include large sizes (1X to 3X) and launched franchised Athleta stores in the United Kingdom. In 2022, Athleta opened 40 new stores in the United States and closed 10. Going into 2023, Athleta had grown to 257 retail stores in North America, with an average store size of approximately 4,000 square feet. The Gap planned to continue opening Athleta stores in 2023 and beyond, both domestically and internationally. Athleta had net sales of $1.48 billion in fiscal 2022 (up 2 percent from $1.45 billion in fiscal 2021); Athleta stores open at least 12 months had sales growth of negative 5 percent in fiscal year 2022. To spur sales of Athleta branded garments and achieve its strategic objective of $2 billion in net sales by the end of fiscal 2023, Athleta entered into a distribution partnership with REI (Recreational Products, Inc.) in late 2021 to begin selling a selection of Athleta products in REI's retail stores and on its website.

The Gap also competed directly in the market for sports and athletic apparel. Its GapFit line of women and girls apparel products included breathable, high-performance garments for running, training, yoga, Pilates, tennis, hiking, and swimming as well as sweatshirts, hoodies, sweaters, dresses, pants, leggings, rompers and jumpsuits, jackets, and outerwear in a wide range of styles and in sizes XXS to XXL. Its product line for men and boys included activewear (workouts, training, jogging), T-shirts, polos, shorts, pants, sweaters, hoodies, sweatshirts, sweatpants, jackets, and outerwear in assorted styles and in sizes ranging from XS to XXXL.

Other Competitors in the Sports and Fitness Apparel Market for Women and Men Apparel retailers responded to the growing market for women's and men's sports and fitness apparel by introducing brands and new collections to compete in this segment. Entrants into this segment of the apparel market included Nordstrom, Urban Outfitters, and Victoria's Secret.

Nordstrom, a respected department store retailer, merchandised its Zella line of attire for yoga, cross-training, workouts, swimming, and "beyond the workout." Many of the initial products in the Zella collection were designed by a former member of lululemon's design team. Nordstrom also marketed several other brands of activewear for women, men, and juniors, including Nike, Under Armour, Patagonia, Reebok, and Adidas. In 2022, Nordstrom's activewear offerings could be purchased at 94 Nordstrom full-line department stores (typically 140,000 to 250,000 square-feet in size) and 241 Nordstrom Rack stores (typically 30,000 to 50,000 square-feet in size) in 40 states, at Nordstrom's website (**www.nordstrom.com**), and at the Nordstrom Rack website, **www.nordstromrack.com**.

Urban Outfitters operated three different retail store brands: Urban Outfitters, Anthropologie Group, and Free People Group. The Urban Outfitters stores carried an extensive line of women's activewear and workout apparel. As of January 2023, Urban Outfitters operated 263 stores, of which 183 were in the United States.[39] Product offerings included active wear bottoms, sneakers, active wear tops, sports bras, and workout equipment. Products were sold both in-store and on the Urban Outfitters website at **https://www.urbanoutfitters.com/**.

Victoria's Secret also marketed its own line of women's fitness apparel under the Victoria's Secret label. As of March 2023, Victoria's Secret offered hundreds of fitness apparel items in its stores and on the company's website, **www.victoriassecret.com**. Offerings included sports bras, bottoms, yoga pants, sweatshirts, and hoodies.

Typically, the items in the Zella, Urban Outfitters, and Victoria's Secret collections were priced 10 percent to 25 percent under similar types of lululemon products. Likewise, Nike, adidas and Under Armour apparel products were typically priced 25–40 percent below comparable lululemon branded items.

Dealing with the Global Pandemic and Recovery

Outbreaks of COVID-19 (also known as the coronavirus) began in China in December 2019, spread to other countries in the first months of 2020, and was declared a global pandemic by the World Health Organization in March 2020. Mounting concerns about the potential for the coronavirus to infect a large percentage of the global population and overwhelm hospitals prompted government officials in many countries during February–April 2020 to issue "stay-at-home" orders to the general public, urge companies to allow employees to work from home where feasible, and mandate the closure of retail stores and all "non-essential" local businesses until the daily/weekly number of people in their locales being newly diagnosed with COVID-19 began to flatten out or subside. People were urged to practice "social distancing" and wear face masks when grocery-shopping, picking up to "to-go orders" from local food establishments, or otherwise venturing out beyond the confines of their homes to run errands. As of March 2023, there had been over 650 million diagnosed cases of COVID-19, resulting in over 6.8 million deaths worldwide.[40]

The global pandemic had a devastating impact on most apparel retailers. In North America, luxury retailer Neiman Marcus, apparel retailer J Crew, and department store retailer J.C. Penney filed for bankruptcy in May 2020. Other retailers and businesses struggled to survive in 2020 and 2021 as well. As of March 2023, most apparel retailers worldwide were beginning to resume normal operations.

Apparel retailers whose customers could readily transition to online shopping at their websites were better able to weather the pandemic-related downturn in store sales. Nike, the global sports apparel leader, had a strong digital presence and experienced only a modest and short-lived downturn in sports apparel revenues.[41] The People's Republic of China struggled to contain a COVID-19 outbreak in February–May 2022, and this affected shoe and apparel manufacturing as well as retail operations in Mainland China. The adidas Group, number two globally and financially strong, also came through the pandemic in a competitively strong position, with sales improving sharply in fiscal 2021 and about 6 percent in fiscal 2022. Under Armour suffered a global sales decline of 15 percent in 2020, but global revenues snapped back quickly and reached record levels in the following two years.

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CASE 15

Tesla's Strategy in 2023: Can It Deliver Sustained Revenue Growth and Profitability?

Arthur A. Thompson
The University of Alabama

Tesla's strong financial and operating performance in 2022 put the company on a trajectory to be competitively successful and increasingly profitable despite the 2023 introduction of 123 new models of battery-powered electric vehicles by rival automobile manufacturers across the world. These new 2023 models followed on the heels of 60 new battery-powered models introduced by traditional automobile manufacturers and aspiring new electric vehicle start-up companies in 2022.

There were a number of competitively significant highlights surrounding Tesla's 2022 performance:

- Tesla delivered a record 1,313,851 new vehicles to customers in 2022, a 40.3 percent increase over the record 936,222 vehicles delivered in 2021. Buyer demand for Tesla's models was so strong that the company spent zero dollars on advertising to achieve its record sales volumes.
- The company's automotive revenues rose to $71.5 billion in 2022, up from $47.2 billion in 2021, and Tesla's 2022 net income was a record $12.6 billion, up from $5.5 billion in 2021.
- Tesla generated $7.6 billion of free cash flow in 2022—after spending $7.2 billion to build out new factories and on other capital expenditures.
- Going into 2023, the company had annualized production capacity of close to 2.0 million vehicles at its two plants in California and Texas, one near Shanghai, and one on the outskirts of Berlin. In January 2023, Tesla announced the construction of a new plant in Nevada that would be dedicated to producing the new Tesla Semi truck. Management was also planning the construction of a second plant in Asia, to be located either near the plant in Shanghai or in Indonesia.
- Due to continuing improvements in operating efficiencies and the ability to spread fixed costs over a much higher production and sales volumes, Tesla's operating profit margin went from −0.03 percent in 2019 to 6.3 percent in 2020 to 12.1 percent in 2021 to 16.8 percent in 2022.
- Tesla's software engineering team continued to make significant headway in achieving full self-driving capability for Tesla vehicles. The company's latest full self-driving (FSD) Beta software had been released to 400,000 customers in the United States and Canada who had bought the FSD software option, and close to 6 million Tesla vehicles worldwide had autopilot capability. CEO Elon Musk expected that Tesla would achieve full self-driving capability for Tesla vehicles equipped with FSD software sometime in 2025.

Exhibit 1 shows sales of Tesla's four models from 2012 when the Models S was first introduced through the third quarter of 2023. Exhibit 2 presents selected financial statement data for Tesla for 2018 through 2022.

EXHIBIT 1 Tesla's Deliveries of the Model S, Model X, Model 3, and Model Y to Customers, 2012 through the First Three Quarters of 2023

Period	Model S Deliveries	Model S plus Model X Deliveries	Model 3 Deliveries	Model 3 plus Model Y Deliveries	Total Deliveries
2012	2,653				2,653
2013	22,477				22,477
2014	31,655				31,655
2015	50,332				50,332
2016		76,230			76,230
2017		101,420	1,734		103,181
2018		99,475	146,055		245,506
2019		66,771	300,885		367,656
2020*		57,085		442,562	499,647
2021		24,980		911,242	936,222
2022		66,705		1,247,146	1,313,851
Q1 2023		10,695		412,180	422,875
Q2 2023		19,225		446,915	466,140
Q3 2023**		15,985		419,074	435,059

**Deliveries in Q1 and Q2 of 2020 were negatively impacted by the spread of the Coronavirus, which resulted in government-mandated shutdowns of the company's two assembly plants for portions of the first six months and a sharp falloff in buyer purchases of new motor vehicles due to stay-at-home restrictions in China, the United States, and many other countries.*

*** Delivery volumes in Q3 of 2023 were adversely impacted by planned downtimes for factory upgrades.*

Source: Company 10K reports, 2012–2022 and Tesla press releases April 2, 2023, July 20, 2023, and October 2, 2023.

EXHIBIT 2 Selected Financial Data for Tesla, Inc., Years Ended December 31, 2018–2022 (in millions, except per share data)

	Years Ended December 31				
	2018	2019	2020	2021	2022
Income Statement Data:					
Revenues:					
Automotive sales	$17,632	$19,952	$24,604	$44,125	$67,210
Automotive regulatory credits	419	598	1,580	1,465	1.776
Automotive leasing	883	869	1,052	1,642	2,476
Total automotive revenues	18,515	20,821	27,236	47,232	71,462
Energy generation and storage	1,555	1,531	1,994	2,789	3,909

(*continued*)

	Years Ended December 31				
	2018	2019	2020	2021	2022
Services and other	972	1,628	2,306	3,802	6,091
Total revenues	21,461	24,578	31,536	53,823	81,462
Cost of revenues:					
Automotive sales	13,686	15,939	19,696	32,415	49,599
Automotive leasing	488	459	563	978	1,509
Total automotive cost of revenues	14,174	16,398	20,259	33,393	51,108
Energy generation and storage	1365	1,341	1,976	2,918	3,621
Services and other	1,880	2,770	2,671	3,906	5,880
Total cost of revenues	17,419	20,509	24,906	40,217	60,609
Gross profit (loss)	4,042	4,069	6,630	13,606	20,853
Operating expenses:					
Research and development	1,460	1,343	1,491	2,593	3,075
Selling, general and administrative	2,834	2,646	3,145	4,517	3,946
. . . Restructuring and other	135	149	-----	(27)	176
Total operating expenses	4,430	4,138	4,636	7,083	7,197
Income (loss) from operations	(388)	(69)	1,994	6,523	13,656
Interest income	24	44	30	56	297
Interest expense	(663)	(685)	(748)	(371)	(191)
Other income (expense), net	22	45	(122)	135	(43)
Income (loss) before income taxes	(1,005)	(665)	1,154	6,343	13,179
Provision for income taxes	58	110	292	669	1,132
Net income (loss)	$ (1,063)	$ (775)	$ 862	$ 5,644	$12,587
Net profit (loss) attributable to noncontrolling interests and subsidiaries	(87)	87	141	125	31
Net profit (loss) attributable to common shareholders	$ (976)	$ (862)	$ 721	$ 5,519	$12,556

	Years Ended December 31				
	2018	2019	2020	2021	2022
Net profit (loss) per share of common stock					
Basic	See Note 1	See Note 1	$ 0.25	$ 1.87	$ 4.02
Diluted	See Note 1	See Note 1	0.21	1.63	3.62
Weighted average shares used in computing net income (loss) per share of common stock					
Basic	See Note 1	See Note 1	2,798	2,959	3,130
Diluted	See Note 1	See Note 1	3,249	3,386	3,475
Selected Balance Sheet Data:					
Cash and cash equivalents	$ 3,686	$ 6,286	$19,384	$17,576	$16,253
Inventory	3,113	3,552	4,101	5,757	12,839
Total current assets	8,307	12,103	26,717	27,100	40,917
Property, plant, and equipment, net	11,330	10,396	12,747	18,884	23,548
Total assets	29,740	34,309	52,148	62,131	82,338
Total current liabilities	9,992	10,667	14,248	19,705	26,709
Long-term debt and capital leases, net of current portion	9,404	11,634	9,556	5,245	1,597
Total stockholders' equity	4,923	6,618	22,225	30,189	44,704
Selected Cash Flow Data:					
Cash flows provided by (used in) operating activities	$ 2,098	$ 2,405	$ 5,943	$11,497	$14,724
Proceeds from issuance of common stock in public offerings	-----	848	12,269	----	----
Proceeds from issuance of convertible and other debt	6,176	10,669	9,713	8,883	----
Purchases of property and equipment excluding capital leases	(2,101)	(1,327)	(3,157)	(6,482)	(7,158)
Net cash used in investing activities	(2,337)	(1,436)	(3,132)	(7,868)	(11,973)
Net cash (used in) provided by financing activities	574	1,529	9,973	(5,203)	(3,527)

Note 1: Comparable data was not available due to a 5 for 1 stock split in August 2020 and a 3-for-1 stock split in August 2022.

Sources: Company 10-K reports for 2018, 2019, 2021, and 2022.

COMPANY BACKGROUND

Tesla Motors was incorporated in July 2003 by Martin Eberhard and Marc Tarpenning, two Silicon Valley engineers who believed it was feasible to produce an "awesome" electric vehicle. Tesla's namesake was the genius Nikola Tesla (1856–1943), an electrical engineer and scientist known for his impressive inventions (of which more than 700 were patented) and his contributions to the design of modern alternating-current (AC) power transmission systems and electric motors. Tesla's first vehicle, the Tesla Roadster (an all-electric sports car) introduced in early 2008, was powered by an AC motor that descended directly from Nikola Tesla's original 1882 design.

Financing Early Operations

Eberhard and Tarpenning financed the company until Tesla's first round of investor funding in February 2004. Elon Musk contributed $6.35 million of the $6.5 million in initial funding and, as the company's majority investor, assumed the position of chairman of the company's board of directors. Martin Eberhard put up $75,000 of the initial $6.5 million, with two private equity investment groups and a number of private investors contributing the remainder.[1] Several rounds of investor funding ensued, with Elon Musk emerging as the company's biggest shareholder. Other notable investors included Google cofounders Sergey Brin and Larry Page, former eBay President Jeff Skoll, and Hyatt heir Nick Pritzker.

In 2009, Germany's Daimler AG, the maker of Mercedes-Benz vehicles, acquired an equity stake of almost 10 percent in Tesla for a reported $50 million.[2] Daimler's investment was motivated by a desire to partner with Tesla to accelerate the development of Tesla's lithium-ion battery technology and electric drive train technology and to collaborate on electric cars being developed at Daimler. Later in 2009, Tesla was awarded a $465 million low-interest loan by the U.S. Department of Energy to accelerate the production of affordable, fuel-efficient electric vehicles; Tesla used $365 million for production engineering and assembly of its forthcoming Model S and $100 million for a powertrain manufacturing plant employing about 650 people that would supply all-electric powertrain solutions to other automakers and help accelerate the availability of relatively low-cost, mass-market electric vehicles.

In June 2010, Tesla Motors became a public company, raising $226 million with an initial public offering of common stock. It was the first American car company to go public since Ford Motor Company in 1956.

Management Changes at Tesla

In August 2007, with the company plagued by delays in getting its first model—the Tesla Roadster—into production, cofounder Martin Eberhard was ousted as Tesla's chief executive officer (CEO). While his successor managed to get the Tesla Roadster into production in March 2008 and begin delivering Roadsters to customers in October 2008, internal turmoil in the executive ranks prompted Elon Musk to decide it made more sense for him to take on the role as Tesla's chief executive officer—while continuing to serve as chairman of the board—because he was making all the major decisions anyway.

Elon Musk

Elon Musk was born in South Africa, taught himself computer programming and, at age 12, made $500 by selling the computer code for a video game he invented.[3] In 1992, after spending two years at Queen's University in Ontario, Canada, Musk transferred to the University of Pennsylvania where he earned an undergraduate degree in business and a second degree in physics. During his college days, Musk spent some time thinking about two important matters: one was that the world needed an environmentally clean method of transportation; the other was that it would be good if humans could colonize another planet.[4] After graduating from the University of Pennsylvania, he decided to move to California and pursue a PhD in applied physics at Stanford; however, he left the program after two days to pursue his entrepreneurial aspirations instead.

Musk's first entrepreneurial venture was to join up with his brother, Kimbal, and establish Zip2, an Internet software company that developed, hosted, and maintained some 200 websites involving "city guides" for media companies. In 1999 Zip2 was sold to a wholly owned subsidiary of Compaq Computer for $307 million in cash and $34 million in stock options; Musk received a reported $22 million from the sale.[5]

In March 1999, Musk cofounded X.com, a Silicon Valley online financial services and email payment company. One year later, X.com acquired Confinity, which operated a subsidiary called PayPal. Musk was instrumental in the development of the person-to-person payment platform and, seeing big market opportunity for such an online payment platform, decided to rename X.com as PayPal. Musk pocketed about $150 million in eBay shares when PayPal was acquired by eBay for $1.5 billion in eBay stock in October 2002.

Musk's Founding of SpaceX and Starlink In June 2002, Elon Musk, with an investment of $100 million of his own money, founded his third company, Space Exploration Technologies (SpaceX), to develop and manufacture space launch vehicles with a goal of revolutionizing the state of rocket technology and ultimately enabling people to live on other planets. Upon hearing of Musk's new venture into the space flight business, David Sacks, one of Musk's former colleagues at PayPal, said, "Elon thinks bigger than just about anyone else I've ever met. He sets lofty goals and sets out to achieve them with great speed."[6] In 2011, Musk vowed to put a man on Mars in 10 years.[7] In May 2012, a SpaceX Dragon cargo capsule powered by a SpaceX Falcon Rocket completed a near flawless test flight to and from the International Space Station; since then, under contracts with NASA, the SpaceX Dragon had delivered cargo to and from the Space Station multiple times. Starting in early 2020, SpaceX began working toward launching a rocket and spacecraft in May 2029 carrying two American astronauts to the International Space Station.

But, far more significantly, SpaceX was progressing rapidly to expand Elon Musk's ambitious Starlink project to utilize SpaceX rockets to launch a constellation of 500-pound satellites roughly the size of an office desk orbiting about 375 miles above the earth that were equipped with the capability to provide high-speed broadband service worldwide. Musk envisioned it might take perhaps 12,000 Starlink satellites to provide dense enough coverage for broadband service to reach every nook and cranny on earth. As of February 2023, SpaceX had a constellation of 3,981 satellites providing broadband Internet service to 48 countries. Starlink had authorization to launch 12,000 satellites and the Federal Communications Commission was considering upping its authorization to 30,000 satellites. Starlink was formulating plans to begin offering global mobile phone service after 2023.

Musk believed that if the Starlink network could capture as little as five percent of the global telecommunications market with its high-speed broadband Internet service, SpaceX could net annual revenues of $30 billion to $50 billion. SpaceX had developed a fully and rapidly reusable Falcon rocket to power the Starlink launches (as well as other types of launches). Headquartered in Hawthorne, California, SpaceX had 12,000 employees in 2022 and was owned by management, employees, and private equity firms; Elon Musk was the company's CEO and largest stockholder.

Several days after Russia launched its 2022 invasion of Ukraine, following a public plea by Ukraine's vice prime minister to Elon Musk for help in maintaining Internet service in the Ukraine, Musk announced he would provide Ukraine with 5,000 Starlink Internet terminals and antennas that could be deployed to connect to Starlink's satellites and provide Internet communications across most of Ukraine. The first truckloads of terminals and antennas arrived five days after the Russian invasion began. Beginning in March 2022, the Starlink Internet service was the primary means of Internet communication in the Ukraine; however, the Russian military was engaged in disrupting Starlink's Internet service with weapons aimed at destroying as many of the terminals and antennas as it could locate.

Musk's SolarCity Venture Another of Elon Musk's business ventures was SolarCity Inc., a full-service provider of solar system design, financing, solar panel installation, and ongoing system monitoring for homeowners, municipalities, businesses (including Intel, Walmart, Walgreens, and eBay), universities, nonprofit organizations, and military bases. Initially, investors were generally bullish on SolarCity's future prospects, and the company's stock price rose from about $10.50 in late December 2012 to an all-time high of $85 in March 2013. But when the company's losses continued to grow, investor sentiment cooled and SolarCity's stock price dropped to the $16–$20 range in February 2016. While Solar City had installed many solar energy systems and managed more solar systems for homes than any other solar company in the United States, its business model of recovering the capital and operating costs of the installed systems through leasing fees and power purchase agreements had resulted in negative cash flows and ever-larger net losses. In November 2016, to rescue SolarCity from probable bankruptcy, Tesla acquired the company for $2.6 billion (the deal was approved by an 85 percent shareholder vote); SolarCity's operations were folded into a new division named Tesla Energy. However, the business model was changed to one where customers financed their new solar power installations with cash and loans, thus producing a healthier mix of upfront and recurring revenue; moreover, the costs of installing solar-powered installations were declining, partly because of improvements in solar technology, greater efficiencies in manufacturing solar-generation systems, and cost savings achieved by operating Tesla's automotive and energy divisions as sister companies.

Elon Musk and Twitter For several years prior to 2022, Elon Musk had been a frequent user of Twitter, most often to make comments about his upcoming plans for Tesla and to announce new developments or achievements at Tesla. His Twitter remarks, partly because of Tesla's big following among investors and admirers of his business achievements, had made him one of the most influential users of the Twitter website. In a filing with the Securities and Exchange Commission on April 4, 2022, Musk reported owning about 73.5 million shares of Twitter, making him Twitter's biggest shareholder with 9.2 percent of the shares outstanding, worth about $2.89 billion at the most recent closing price. Earlier, on March 25, Musk had slammed Twitter for its tendency to suspend (temporarily or permanently) the accounts of users whose Twitter comments it disagreed with or otherwise deemed offensive. In his tweet, Musk said

> Given that Twitter serves as the de facto public town square, failing to adhere to free speech principles fundamentally undermines democracy. What should be done?

Over the weekend of April 2–3, Musk posted a poll on his Twitter account in which he said: "Free speech is essential to a functioning democracy. Do you believe Twitter rigorously adheres to this principle?" He further said, "The consequences of this poll will be important. Please vote carefully." Some 2,035,924 people responded to Musk's poll, with 70.4 percent voting "no." One of Musk's followers asked him if he would consider establishing a new social media platform "that would consist of an open source algorithm, one where free speech and adhering to free speech is given top priority, one where propaganda is very minimal." Musk quickly responded, "Am giving serious thought to this."

Over the next several weeks, Musk decided to try to acquire Twitter; on April 22, 2022, Musk offered to purchase Twitter for $54.20 per share (equal to about $43 billion) and take the company private. Twitter's board of directors unanimously agreed to accept the offer on April 25. Several weeks later, Musk put the deal on hold because Twitter could not confirm that spam/fake accounts represented less than 5 percent of its users—there were indications that spam/fake accounts could represent as much as 20 percent of Twitter users. Back-and-forth discussions and negotiations ensued for several months. Ultimately, the issue was resolved, and Musk's acquisition of Twitter was completed on October 27, 2022.

Musk immediately terminated Twitter's board of directors and top executives and proceeded to begin the process of altering how Twitter employees unilaterally decided to delete "unacceptable" twitters and to suspend the accounts of users whose opinions they disagreed with. He also closed down

Twitter's San Francisco's headquarters because it was empty due to employees preferring to work at home. He also promptly fired about 5,200 of the company's 7,500 employees because the company was grossly overstaffed. An additional 200 were laid off in late February 2023. Musk put in new policies regarding what types of posts were acceptable, revamped the staff that monitored posts, and directed the company's software engineers to rework the algorithms that identified "unacceptable" posts and "fake accounts/bots."

However, a number of Tesla's biggest investors became concerned that Musk was spending too much time at Twitter and neglecting his duties at Tesla. They made it known he should appoint someone else as Twitter's CEO. Musk did not dispute that he was spending much of his time at Twitter and said he would look for a suitable replacement, but he was openly skeptical that he could find someone qualified who was "foolish enough to take the job." As it turned out, Musk did not immediately identify a good replacement, and he announced he would remain as Twitter's CEO until the end of 2023 so he could get the company on track to grow its user base and revenues enough to achieve acceptable profitability. However, on May 12, 2023, Musk announced that he had hired a new CEO for Twitter. His choice was Linda Yaccarino, a seasoned media executive at NBCUniversal who as chairwoman for global advertising and partnerships headed a 2,000-person global team and who had generated $100 billion in advertising sales since joining NBCUniversal in 2011.[8]

Musk's Vision and Strategy for Tesla

Elon Musk's strategic vision for the automotive segment of Tesla's operations featured three major elements:

1. Bring a full-range of affordable electric-powered vehicles to market and become the world's foremost manufacturer of premium quality, high-performance electric vehicles.
2. Convince motor vehicle owners worldwide that electric-powered motor vehicles were an appealing alternative to gasoline-powered vehicles.
3. Accelerate the world's transition from carbon-producing, gasoline-powered motor vehicles to zero emission electric vehicles.

His strategic intent was for Tesla to be the world's biggest and most highly regarded producer of electric-powered motor vehicles, dramatically increasing the share of electric vehicles on roads across the world and causing global use of gasoline-powered motor vehicles to fall into permanent long-term decline. At its core, therefore, Tesla's strategy was aimed squarely at utilizing the company's battery and electric drivetrain technology to disrupt the world automotive industry in ways that were sweeping and transformative. If Tesla's strategy proved to be as successful as Elon Musk believed it would be, industry observers expected that Tesla's competitive position and market standing vis-à-vis the world's best-known automotive manufacturers would grow significantly stronger in the years to come.

In 2019, Elon Musk's base salary as Tesla's CEO was $62,400, an amount required by California's minimum wage law; however, he never accepted the salary. Commencing in May 2019, at Elon Musk's request, the company's board of directors eliminated the salary provision. The company's board of directors in 2017 established an executive compensation plan for Musk tied to Tesla's performance on various metrics; compensation was in the form of stock option awards subject to various vesting conditions. At the end of February 2023, Musk owned an estimated 13.4 percent of Tesla's common stock, down from about 17 percent in early 2022—owing to his sales of about 25.5 million shares in the second half of 2022 to pay taxes and help fund the Twitter acquisition. Bloomberg estimated that Musk's net worth was $187 billion, and *Forbes* estimated his net worth at $196 billion.[9]

Musk's Vision and Strategy for Tesla Elon Musk's strategic vision for the automotive segment of Tesla's operations featured three major elements:

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TESLA IN 2023

In 2023, Tesla's business consisted of designing, developing, manufacturing, and leasing high-performance fully electric vehicles, and producing and marketing energy generation and storage systems; the company also offered services related to these products.[10] Tesla products were generally sold directly to customers at the company's website and selected retail locations and, in some cases, by an internal salesforce. To better serve customers who had bought Tesla vehicles, going into 2023, Tesla had invested in a global network of 764 store and service locations, a fleet of 1,584 Mobile Service vehicles manned by technicians who traveled to customers to perform onsite maintenance and repairs, and some 4,700 Supercharger stations with 42,400 charging connections to accelerate the widespread adoption of its battery-powered electric vehicles and help promote the transition from gasoline-powered motor vehicles to zero emission electric vehicles. Vehicle owners could also obtain away-from-home recharging using Tesla Wall Chargers installed at shopping malls, hotels, supermarkets, parking lots and garages, travel centers, and restaurants.

Tesla's long-range plan for its motor vehicle business was to offer a wide range of technologically advanced, attractively styled, high-performance consumer and commercial vehicles. To differentiate its vehicle business from other vehicle manufacturers, Tesla was aggressively striving to be the leader, or at worst among the leaders, in introducing full self-driving capability for all of its models to complement such existing features as leading mileage range on a single charge, superior acceleration, handling and safety performance, user convenience and infotainment packages, and built-in ability to have additional features enabled in previously sold vehicles through over-the-air software updates. In addition, Tesla was striving to lower the cost of ownership for its customers through continuous efforts to reduce the manufacturing, charging, maintenance, and other costs of its vehicles.

In furtherance of its mission to accelerate the world's transition to sustainable energy, Tesla had also developed an expertise in solar energy systems. It sold and leased solar energy systems for residential and commercial customers, and it offered a Solar Roof product, which featured attractive and durable glass roof tiles integrated with solar energy generation. Tesla's approach to the solar business emphasized simplicity, standardization, and accessibility to make it easy and cost-effective for customers to install and utilize solar energy products.

Finally, Tesla had leveraged its technological expertise in batteries, energy management, power electronics, and integrated systems associated with its vehicle powertrain systems to develop and manufacture two lithium-ion battery energy storage products—Powerwall and Megapack. Powerwall was designed to store energy at a home or small commercial facility. Megapack was an energy storage solution for commercial, industrial, utility, and energy-generation customers, multiples of which could be grouped together to form larger energy-generation installations. Tesla also developed software for remotely controlling and dispatching its energy storage systems to serve a wide range of markets and applications, including real-time energy control and optimization platforms. As with Tesla's vehicles, the company's energy storage products could be remotely updated over-the-air with software or firmware improvements.

Tesla's solar energy offerings also included selling retrofit solar energy systems directly to customers and channel partners and also making them available through power purchase agreement ("PPA") arrangements. Tesla Energy purchased most of the components for its retrofit solar energy systems from multiple sources to ensure competitive pricing and adequate supply. It also designed and manufactured certain components for its solar energy products. Tesla sold its Solar Roof, which combined premium glass roof tiles with energy generation, directly to customers, as well as through distribution channel customers. To help spur sales, Tesla Energy was continuing to improve its Solar Roof installation capability and efficiency, in collaboration with real estate developers and builders of new homes.

TESLA'S STRATEGY TO BECOME THE WORLD'S BIGGEST AND MOST HIGHLY REGARDED PRODUCER OF ELECTRIC VEHICLES

Product Line Strategy

A key element of Tesla's long-term strategy was to offer vehicle buyers a full line of electric vehicle options. As of 2023, Tesla had introduced six models—the Tesla Roadster, Model S, Model X, Model 3, Model Y, and Tesla Semi. These were scheduled to be followed by a new pickup truck called the Cybertruck and a fresh Roadster 2 model.

Tesla's First Vehicle—The Tesla Roadster Following Tesla's initial funding in 2004, Musk took an active role within the company. Although he was not involved in day-to-day business operations, he nonetheless exerted strong influence in the design of the Tesla Roadster, a two-seat convertible that could accelerate from 0 to 60 miles per hour in as little as 3.7 seconds, had a maximum speed of about 120 miles per hour, could travel about 245 miles on a single charge, and had a base price of $109,000. Musk insisted from the beginning that the Roadster have a lightweight, high-strength carbon fiber body, and he influenced the design of components of the Roadster ranging from the power electronics module to the headlamps and other styling features.[11] Prototypes of the Roadster were introduced to the public in July 2006. The first "Signature One Hundred" set of fully equipped Roadsters sold out in less than three weeks; the second hundred sold out by October 2007. General production began in March 2008. New models of the Roadster were introduced in July 2009 (including the Roadster Sport with a base price of $128,500) and in July 2010. Sales of Roadster models to countries in Europe and Asia began in 2010. From 2008 through 2012, Tesla sold more than 2,450 Roadsters in 31 countries.[12] Sales of Roadster models ended in December 2012 so that the company could concentrate exclusively on producing and marketing the Model S. However, Tesla announced in early 2015 that Roadster owners would be able to obtain a Roadster 3.0 package that enabled a 40 to 50 percent improvement in driving range to as much as 400 miles on a single charge; management indicated additional updates for Roadsters would be forthcoming.

Tesla's Second Vehicle—The Model S Customer deliveries of Tesla's second vehicle—the sleek, eye-catching Model S sedan—began in July 2012. The Model S was a fully electric, four-door, five-passenger luxury sedan featuring all-wheel drive with dual front and rear motors (mounted on the front and rear axles), an all-glass panoramic roof, a top speed of 155 mph, the ability to accelerate from 0 to 60 mph in as little as 2.4 seconds, an estimated driving range of up to 390 miles on a single charge, a high definition backup camera, a 17-inch touchscreen that controlled most of the car's functions, and keyless entry. New standard and optional features were soon added, including a sub-zero weather package, parking sensors, upgraded leather interior, several new wheel options, a yacht-style center console, Xenon headlights, emergency braking, collision warning, blind-spot monitoring, and various autopilot and self-driving capabilities. In the years since its introduction, the Model S powertrain options had been modified several times, as had the various optional equipment and features offered to buyers. All Model

S vehicles (as well as all other Tesla models) previously delivered to customers were equipped to receive software updates from Tesla that included new and updated features. Autopilot and self-driving software features were updated and upgraded as fast as they were developed and tested.

To counter the "range anxiety" that Tesla owners sometimes experienced, in 2018 Tesla introduced a standard software feature called "Range Assurance," an always-running application within the car's navigation system that kept tabs on the vehicle's battery charge level and the locations of Tesla Supercharging stations and parking-spot chargers in the vicinity. When the vehicle's battery began running low, an alert appeared on the navigation screen, along with a list of nearby Tesla Supercharger stations and public charging facilities; a second warning appeared when the vehicle was about to go beyond the radius of nearby chargers without enough juice to get to the next facility, at which point drivers were directed to the nearest charge point. There was also a Trip Planner feature that enabled drivers to plan long-distance trips based on the best locations for recharging both enroute and at the destination; during travel, the software was programmed to pull in new data about every 30 seconds, updating to show which upcoming charging facilities had vacancies or were full.

The Model S was the most-awarded car of 2013, including *Motor Trend's* 2013 Car of the Year award and *Automobile* magazine's 2013 Car of the Year award. The National Highway Traffic Safety Administration (NTSHA) in 2013, 2014, and 2015 awarded the Tesla Model S a five-star safety rating, both overall and in every subcategory (a score achieved by approximately one percent of all cars tested by the NHTSA). *Consumer Reports* gave the Model S a score of 99 out of 100 points in 2013, 2014, and 2015, saying it was "better than anything we've ever tested." But the Model S did not make *Consumer Reports* list of the "10 Top Picks" in any of the years during 2016 through 2023. However, it did earn a perfect 100 score on its 2018 road test drive and *Consumer Reports* gave the Model S an 88 on its 2023 road test drive and a predicted reliability rating of 2 out of 5.

Tesla's Third Vehicle—The Model X Crossover SUV To reduce the development costs of the Model X, Tesla had designed the Model X so that it could share about 60 percent of the Model S platform. The Model X was a sport utility vehicle with 5, 6, or 7 passenger seating configurations, a top speed of 149 mph, the ability to accelerate from 0 to 60 mph in 3.8 seconds, and a unique "falcon wing" door system for easy access to the second and third seating rows. The falcon-wing doors gave the Model X a profile that resembled a sedan more than an SUV. As with the Model S, Tesla had modified the drivetrain options, the standard features on the base Model X, and the additional equipment and features options that buyers could select.

The sleek styling and politically correct power source of Tesla's Model S and Model X were thought to explain why thousands of wealthy individuals in countries where the two models were being sold—anxious to be a part of the migration from gasoline-powered vehicles to electric-powered vehicles and to publicly display support for a cleaner environment—had become early purchasers and advocates for Tesla's vehicles. Indeed, in a presentation to investors, a Tesla officer said "Tesla owners are our best salespeople."[13]

Tesla's Fourth Vehicle—The Model 3 The goal of the Model 3 was to incorporate all the company had learned from the development and production of the Roadster, Model S, and Model X to create the world's first mass market electric vehicle priced on par with its gasoline-powered equivalents. The Model 3 was attractively styled, with seating for five adults, a choice of three drivetrain versions, and a five-star safety rating. While the stated base price for the rear-wheel drive version in 2023 was $42,990, the range of available upgrades and options could up the base price to $53,990 for the dual motor all-wheel-drive Performance version of the Model 3. In 2022, the price of the rear-wheel drive and Long-Range versions of the Model 3 actually delivered to buyers was typically in the $45,000 to $55,000 range. Buyers could also purchase the FSD software option that included all forthcoming updates—the added price for FSD software was raised from $10,000 to $12,000 in early 2022 and to $15,000 in the last half of 2022 and applied to all of Tesla's currently available models.

Tesla's Fifth Vehicle—The Model Y Crossover SUV In 2017, Elon Musk announced that Tesla had begun developing plans for the development and production of an all-electric crossover SUV that would be built on the same platform as the Model 3, but would have seating for up to 7 adults. Tesla unveiled a prototype of its Model Y SUV in March 2019 and deliveries to customers began in 2020. In early 2023, the Model Y vehicles being offered for sale included dual motor all-wheel-drive Long-Range and Performance versions.

Exhibit 3 shows the prices and specifications for the Model S, Model X, Model 3, and Model Y. In the first 5 months of 2023, Tesla had made price adjustments in its models as many as eight times, sometimes lowering prices to stimulate new orders in certain countries/regions and sometimes raising prices to take advantage of strong demand in certain locations. Most of the price adjustments were downward to stimulate new orders and help combat fears of an upcoming recession due to the aggressive efforts of monetary authorities to raise interest rates and thereby stamp out inflationary pressures, particularly in North America and Europe. But in May 2023 there were also indications that the growing number of price cuts by electric vehicle manufacturers across the world, while boosting weak buyer demand, might trigger a profit-killing price war.

EXHIBIT 3 Comparative Prices* and Specifications of Tesla's Model S, Model X, Model 3, and Model Y, as of May 12, 2023

	Model S	Model X	Model 3		Model Y	
Base Price						
Base model	$88,490	$98,490	Long range model	$47,240	Base model	$47,990
Plaid model	$108,490	$108,490	Performance model	$53,240	Long range model	$50,490
			Rear wheel drive model	$40,240	Performance model	$54,490
Range						
Base model	405 miles (EPA est.)	348 miles (EPA est.)	Long range model	325 miles (EPA est.)	Base model	273 miles (EPA est.)
Plaid model	396 miles (EPA est.)	333 miles (EPA est.)	Performance model	315 miles (EPA est.)	Long Range model	330 (EPA est.)
			Rear wheel Drive model	272 miles (EPA est.)	Performance model	310 (EPA est.)
Seating						
Base model	5 seats	Up to 7 seats	Long range model	5 seats	Base model	Up to 7 seats
Plaid model	5 seats	Up to 6 seats	Performance model	5 seats	Long range model	Up to 7 seats
			Rear wheel Drive model		Performance model	Up to 7 seats
Cargo Capacity	28 cu. ft.	88 cu. ft.		23 cu. ft.		76 cu. ft
Drivetrain						
Base model	AWD Dual Motor	AWD Dual Motor	Long range model	AWD dual motor	Base model	AWD dual motor
Plaid model	AWD Tri-Motor	AWD Tri-Motor	Performance model	AWD dual motor	Long range model	AWD dual motor
			Rear wheel drive model	Single motor rear axle	Performance model	AWD dual motor
Acceleration 0-60 mph						
Base model	3.1 sec.	3.8 sec.	Long range model	4.2 sec.	Base model	5.0 sec.

(*continued*)

(*continued*)

	Model S	Model X	Model 3		Model Y	
Plaid model	1.99 sec.	2.5 sec.	Performance model	3.1 sec.	Long range model	4.8 sec.
			Rear wheel drive model	5.8 sec.	Performance model	3.5 sec.
Top Speed						
Base Model	149 mph	149 mph	Long range model	145 mph	Base model	135 mph
Plaid Model	200 mph	200 mph	Performance model	162 mph	Long range model	135 mph
			Rear wheel drive model	140 mph	Performance model	155 mph
Peak power						
Base Model	670 hp	670 hp	Long range model	455 hp	Base model	420 hp
Plaid Model	1,020 hp	1,020 hp	Performance model	455 hp	Long range model	455 hp
			Rear wheel drive model	271 hp	Performance model	455 hp

**Prices are for the United States. Tesla's prices varied from country to country, due to cross-country differences in market and competitive conditions (particularly the prices of rival brands of electric vehicles and the prices of gasoline) and different country subsidies for buyer purchases of electric vehicles.*

Source: Information posted at **www.tesla.com**, accessed May 12, 2023.

Production of the Model Y was something of a "manufacturing revolution" for Tesla, entailing a much-simplified manufacturing process and greater use of robots[14] Because the Model Y was expected to appeal to a large market segment, Elon Musk believed that the Model Y would ultimately have higher annual sales than Model S, Model X, and Model 3 combined.

The Tesla Semi Truck Mention was made of a semi-truck in Tesla's 2016 master plan. But behind the scenes Tesla had moved swiftly to come up with not only a design but also prototypes. The Semi was unveiled with much fanfare at a press conference on November 16, 2017. The company described the Semi as a Class 8 semi-trailer truck prototype that would be powered by four independent electric motors on rear axles; have a driving range of either 300 miles or 500 miles on a full charge; and have a centered driver's seat in the cockpit, with touch screen controls on either side of the steering wheel. Standard equipment on all models would include Autopilot capabilities, automatic emergency braking, automatic lane keeping, forward collision warning, and ability to enter an energy-saving "convoy mode" with other semis on the road. Elon Musk said the 500-mile version, equipped with Tesla's latest battery design, would be able to run for 400 miles after an 80 percent charge in 30 minutes using a solar-powered Tesla Megacharger charging station. He also said the Semi would be able to accelerate from 0 to 60 mph in fewer than 10 seconds unloaded and in 20 seconds fully loaded. Tesla expected to offer a warranty for a million miles and said maintenance would be simpler than for a diesel truck.

A week later, Musk said that the regular production versions for the 300-mile range version of the Semi would be priced at $150,000 and the 500-mile range version would be priced at $180,000; the company also said it planned to offer a Founder's Series Semi at $200,000—however, these 2017-announced prices had not been publicly confirmed by Tesla as of late 2022. Scores of companies, including Walmart, United Parcel Service, Anheuser-Busch, J.B. Hunt, and PepsiCo, immediately lined up to place pre-orders for 5 to 150 Semis (at an initial reservation price of $5,000, which was quickly raised to $20,000 per reservation) so they could conduct tests of how well the Semi would perform in their operations. Reservations were soon discontinued and had not been re-opened as of late February 2023 (perhaps because orders exceeded production capabilities in early 2023). In March 2018, Tesla began testing the Semi with real cargo, hauling battery packs from Gigafactory 1 in Nevada to the Tesla Factory in Fremont, California. Pictures of the Semi being loaded with cargo at the Nevada Gigafactory and traveling on the highways were immediately publicized in the media and posted on the Internet and social media.

Production of the Semi was originally scheduled to begin in 2019, but in early 2022 it appeared that production of the Semi was on pause until late 2022 at best because mileage tests showed the battery pack originally planned for use in the truck was not able to achieve the targeted range of 300 to 500 miles on a single charge. More powerful battery packs capable of achieving the targeted range were under development. In the second half of 2022, Tesla announced that the Tesla Semi would be manufactured at the Austin plant beginning in December, with initial deliveries beginning in late December. Shortly after this announcement, Musk decided to begin low-volume production of the Semi at a new building near its Gigafactory 1 battery plant outside Reno, Nevada, and to construct a new high-volume plant to manufacture the Semi adjacent to Gigafactory 1, along with a new factory to produce enough of Tesla's new-style 4680 batteries for 1.5 million light-duty vehicles. Tesla officially unveiled its plans to invest $3.6 billion in these two facilities at an onsite presentation by Elon Musk on January 24, 2023. Musk said the two facilities would add about 4 million square feet of manufacturing footprint to the 5.4 million square-foot Gigafactory 1 plant and employ 3,000 people. Tesla's Gigafactory 1 battery plant employed 11,000 people and made lithium-ion batteries for about 500,000 vehicles annually. Initial deliveries of the Tesla Semi from the Nevada plant began in late December 2022; scaled up production was planned for the first two quarters of 2023.

The Tesla Pickup Truck While Elon Musk began talking about Tesla making an all-electric pickup truck (and an all-electric cargo van on the same chassis) in 2016, the company in early 2023 was still finalizing its design and production specifications for what it was calling the Cybertruck. Elon Musk said in a June 2019 podcast that Tesla wanted to keep the Cybertruck's starting price below $50,000 and make sure the truck was highly functional from a load-carrying standpoint, saying[15]

> It's going to be a truck that is more capable than other trucks. The goal is to be a better truck than a [Ford] F-150 in terms of truck-like functionality and be a better sports car than a standard [Porsche] 911. That's the aspiration.

Musk went on to say that the truck's appearance would be pretty sci-fi and not be for everyone. Further, buyers of the truck would have a range of optional extras that could push the price up close to $70,000 (on a par with current roomy, luxurious pickups with powerful engines). Prototypes of the Tesla Cybertruck were unveiled at the company's Tesla Design Studio in California in November 2019. Some people loved the futuristic design, others hated it, and many thought it was too far over the top. Tesla did not respond to questions about whether the truck's design would change before it went into production. In March 2020, Elon Musk announced that Tesla had selected Austin, Texas, as the site for a new plant to manufacture and assemble its new Cybertruck and the recently introduced Model Y. The plant began production of the Model Y in early 2022. In March 2022, Elon Musk announced the development of the Cybertruck would be completed in 2022 and that production would begin in Austin in 2023.[16]

Distribution Strategy: A Company-Owned and Operated Network of Retail Stores and Service Centers

Tesla sold its vehicles directly to buyers and also provided them with after-sale service through a network of company-owned showrooms and service centers. This contrasted sharply with the strategy of rival motor vehicle manufacturers, all of whom sold vehicles and replacement parts at wholesale prices to their networks of franchised dealerships that in turn handled retail sales, maintenance and service, and warranty repairs. Tesla executives believed that integrating forward into the business of traditional automobile dealers and operating the company's own retail sales and service network had three important advantages:

1. *The ability to create and control its own version of a compelling buying customer experience,* one that was differentiated from the buying experience consumers had with sales and service locations of franchised automobile dealers. Having customers deal directly with Tesla-employed sales and service personnel enabled Tesla to (a) engage and inform potential customers about electric vehicles in general and the advantages of owning a Tesla in particular and (b) build a more personal relationship with customers and, hopefully, instill a lasting and favorable impression of Tesla, its mission, and the caliber and performance of its vehicles.
2. *The ability to achieve greater operating economies in performing sales and service activities.* Elon Musk and other top company executives believed that a company-operated sales and service network offered substantial opportunities to better control inventory costs of both vehicles and replacement parts, manage warranty service and pricing, maintain and strengthen the Tesla brand, and obtain firsthand customer feedback.
3. *The opportunity to capture the sales and service revenues of traditional automobile dealerships.* When Tesla buyers purchased a vehicle at Tesla's website or a Tesla-owned sales gallery, Tesla captured the full retail sales price, roughly 10 percent greater than the wholesale price realized by vehicle manufacturers selling through franchised dealers. And, by operating its own service centers, it captured service revenues not available to vehicle manufacturers who relied upon their franchised dealers to provide needed maintenance and repairs. Furthermore, Tesla management believed that company-owned service centers avoided the conflict of interest between vehicle manufacturers and their franchised dealers where the sale of warranty parts and repairs by a dealer were a key source of revenue and profit for the dealer but where warranty-related costs were typically a substantial expense for the vehicle manufacturer.

Initially, Tesla's distribution strategy was to create separate global networks of sales galleries and service centers, but in 2013 Tesla began combining its sales and service activities at a single location because combination sales and service locations were more cost-efficient and facilitated faster expansion of the company's retail footprint. At the end of 2022, Tesla had 764 sales and service locations, mostly in or near major metropolitan areas in the United States, Europe, China, and selected other countries. Most were on highly visible sites along busy thoroughfares. Typically, sales locations had only several vehicles in stock that were available for immediate sale; this was because the vast majority of Tesla buyers preferred to customize their vehicle with their preferred add-on equipment and features options by placing an order via the Internet, sometimes while at a Tesla sales/service location where a salesperson could educate customers about optional equipment and provide ordering assistance.

In the United States, there was a lurking threat to Tesla's strategy to bypass distributing through franchised Tesla dealers and sell directly to consumers. Going back many years, franchised automobile dealers in the United States had feared that automotive manufacturers might one day decide to integrate forward into selling and servicing the vehicles they produced. To foreclose any attempts by manufacturers to compete directly against their franchised dealers, automobile dealers in every state in the United States had formed statewide franchised dealer associations to lobby for legislation blocking motor vehicle manufacturers from becoming retailers of new and used cars and providing maintenance and repair services to vehicle owners. Legislation either forbidding or severely restricting the ability of automakers to sell vehicles directly to the public had been passed in 48 states; these laws had been in effect for many years, and franchised dealer associations were diligent in pushing for strict enforcement of these laws.

As sales of the Model S rose briskly from 2013 to 2015 and Tesla continued opening more combination sales/service centers, both franchised dealers and statewide dealer associations became increasingly anxious about "the Tesla problem" and what actions to take to block Tesla's sell-and-service-direct strategy. Dealers and dealer trade associations in a number of states were openly vocal about their concerns and actively began lobbying state legislatures to consider either enforcement actions against Tesla or amendments to existing legislation that would bring a halt to Tesla's customer-direct strategy. A host of skirmishes ensued in 12 states. In several cases, settlements were reached that allowed Tesla to operate a select few sales locations, but the numbers were capped. In states where manufacturer-direct sales to consumers were expressly prohibited, Tesla was allowed to have sales showrooms, service centers, and Supercharger locations—but was prevented from using personnel in its showrooms to take orders, conduct test drives, deliver cars, or discuss pricing with potential buyers. Buyers in these states could place an order via the Internet, specify when they would like the car to arrive, and then either have it delivered to a nearby Tesla service center for pickup or have it delivered directly to their home or business location.

Tesla Announces a Shift to Online Sales in the United States In February 2019, Tesla unexpectedly announced it would cease taking orders at all of its sales facilities in the United States (educational information would still be available) and would begin to sell its cars only online. The shift was made partly to reduce employee headcount and operating expenses and partly to relax lobbying efforts in states that did not permit manufacturers to own and operate their own dealerships. As part of the shift, new owners were granted up to a week to return their newlypurchased Tesla vehicle if they were not satisfied. In the same announcement, Tesla said it would be shifting resources to improve its repair service systems, with the goal of providing same-day service to Tesla owners. However, auto dealers in several states, along with the National Automobile Dealers Association, remained dissatisfied with Tesla's online sales approach, noting that franchise laws in some states required dealers to have a physical presence in their state to sell online and that one of the main purposes of local franchising and licensing laws was to promote investment in an extensive network of independent, neighborhood, new-car dealers.

Tesla expected that dealer associations in some states would continue to challenge the company's efforts to sell directly to customers, and Tesla management intended to actively fight such efforts. To sell vehicles to residents of states where the company could not be licensed as a dealer, Tesla made arrangements to conduct the transfer of title out of the state. In these states it operated a "sales" facility (usually in conjunction with a service center) that served the purpose of educating prospective buyers about Tesla products and how to order its models online.

Outside of the United States, Tesla had a network of close to 600 company-operated combination stores/service centers where it could display its vehicles, take orders for new vehicles, deliver new vehicles to customers, and service owner vehicles. Globally, new sales and/or service locations were being opened at an average of two or more per week. International customers could also place orders online. Tesla believed that its two vehicle sales channels—its website and its international network of sales/service centers (coupled with its facilities in the United States where it could educate and inform potential buyers about its various models and optional equipment) enabled the company to "better control costs of inventory, manage warranty service and pricing, educate consumers about electric vehicles, maintain and strengthen the Tesla brand, and obtain rapid customer feedback."[17]

Tesla Service Centers and Mobile Service Technicians Tesla Roadster owners could upload data from their vehicle and send it to a service center on a memory card; all other Tesla owners had an onboard system that could communicate directly with a service center, allowing service technicians to diagnose and remedy many problems before ever looking at the vehicle. When maintenance or service was required, a customer could either schedule service by contacting a nearby Tesla service center or, in a growing number of locations, use the Tesla mobile app to make arrangements to have service performed at their home, office, or other remote location by a Tesla Mobile Service technician who had the capability to perform a variety of services that did not require a vehicle lift. Some service locations offered valet service, where the owner's car was picked up, replaced with a well-equipped loaner car, and then returned when the service was completed—there was no additional charge for valet service. Mobile service technicians could perform most warranty repairs, but the cost of their visit was not covered under the company's New Vehicle Limited Warranty. Mobile service pricing was based on a per visit, per vehicle basis; there was a $100 minimum charge per visit. Tesla's mobile service fleet consisted of nearly 1,600 vehicles headed into 2023, with coverage of all of North America and many other countries where Tesla vehicles were sold. In early 2018, the company reported its mobile service fleet in North America was completing 30 percent of all service jobs at a cost below the average fees charged at its service centers.

Prepaid Maintenance Program Initially, Tesla recommended that Model S, Model X, and Model 3 owners have an inspection every 12 months or 12,500 miles, whichever came first. Owners could purchase plans covering prepaid maintenance for three years or four years; these involved simply prepaying for service inspections at a discounted rate. All Tesla vehicles were protected by a four-year or 50,000-mile (whichever came first) New Vehicle Limited Warranty, subject to separate limited warranties for the supplemental restraint system, battery and drive unit, and body rust perforation. For the battery and drive unit on new Model S and Model X vehicles, Tesla offered an eight-year, 150,000-mile limited warranty, with minimum 70 percent retention of battery capacity over the warranty period. For the battery and drive unit on new Model 3 and Model Y vehicles, Tesla offered an eight-year or 120,000-mile limited warranty for models with a Long Range or Performance battery, with minimum 70 percent retention of battery capacity over the warranty period. Tesla also offered extended service plans that provided coverage beyond the new vehicle limited warranties for certain models in specified regions.

In March 2019, after a fleetwide review of maintenance and repair records, Tesla decided to do away with its recommendations for scheduled *annual* maintenance for its vehicles because they were able to withstand longer-than-usual periods of time without regular maintenance when compared with traditional gasoline-powered vehicles. Effective immediately, Tesla ceased selling extended three- and four-year prepaid maintenance plans and began recommending that owners bring their vehicles to a service center only when a specific component needed service. Owners who had already purchased extended three- and four-year service plans could request a refund of the remaining length of the plan. However, Tesla continued to recommend service intervals for certain components of its vehicles:

- Tire rotation, balance, and wheel alignment: 10,000–12,000 miles.
- Brake fluid test/flush: 2 years.
- Cabin air filter: 2 years.
  - High-efficiency particulate air (HEPA) filter: 3 years (if equipped).
- Air conditioning service: 2 years (Model S), 4 years (Model X), 6 years (Model 3 and Model Y).
- Winter care: Annually or every 12,500 miles for cars in cold weather climates.

Tesla's Supercharger Network: Providing Recharging Services to Owners on Long-Distance Trips

A major component of Tesla's strategy to build rapidly growing long-term demand for its vehicles was to make battery recharging while driving long distances convenient and worry-free for all Tesla vehicle owners. Tesla's solution to providing owners with ample and convenient recharging opportunities was to establish an extensive geographic network of recharging stations. Tesla's Supercharger stations were strategically placed along major highways connecting city centers, usually at locations with such nearby amenities as roadside diners, cafes, and shopping centers that enabled owners to have a brief rest stop or get a quick meal during the recharging process—about 90 percent of Model S and Model X buyers opted to have their vehicle equipped with supercharging capability when they ordered their vehicle. Initially, all Model S and Model X owners were entitled to *free* unlimited lifetime supercharging service at any of Tesla's Supercharging stations; however, in 2016 Tesla decided this incentive was unsustainable and discontinued it on all new Model S and Model X purchases. In its place, Tesla offered free supercharging for 400 kWh per year. In March 2018, Tesla announced price increases for its Supercharging stations to about $0.25 per kwh. Tesla owners charged their vehicles at home more than 90 percent of the time and used Supercharger stations mainly for trips or when they needed extra range. In 2022, all Tesla models could be fully recharged at a Supercharger station in 25 minutes. The price varied by location but was typically $0.25 per kWh; a recharge equal to 250 miles of driving range ran about $22. In 2023 Model 3 and Model Y owners had to pay a recharging fee, as did the owners of the Model S and Model X who had exceeded their annual 400 kWh free charging quota. As of year-end 2022, Tesla had a total of 4,678 Supercharger stations globally with over 42,400 charging spaces.

Initially, Tesla executives did not expect its Supercharger stations to ever become a profit center for the company; rather, they believed that the benefits of rapidly growing the size of the company's Supercharger network came from (1) relieving the "range anxiety" electric vehicle owners suffered when driving on a long-distance trip and (2) reducing the inconvenience to travelers of having to deviate from the shortest direct route and detour to the closest Supercharger station for needed recharging. But in January 2023, at the request of the Biden Administration, Tesla opened 7,500 Supercharging stations in the United States to any brand of electric vehicle. This, together with the ability to raise the recharging fee of $0.25 per kWh, meant that even if recharging revenues never were high enough to produce a profit, at least the losses were likely to be reduced, perhaps substantially. However, in the first half of 2023, competition in the recharging business was mounting. Several companies had entered the recharging business with the announced intention to build regional, national, and possibly multinational networks of recharging stations that could recharge any and all brands of electric vehicles. Both Volkswagen and Mercedes-Benz had also announced their intent to establish recharging stations for owners of their electric vehicles (and perhaps other brands).

However, in mid-2023, many automakers in Japan, the United States, and Europe began rethinking their plans to invest in establishing their own branded networks of recharging stations. This shift came about because Tesla had begun approaching various electric vehicle manufacturers to enter into collaborative agreements with Tesla whereby owners of their electric vehicle models would be entitled to utilize Tesla's recharging stations. This would require the makers of rival brands of electric vehicle brands to equip their vehicles with a standardized battery recharging technology (which was incorporated in a Tesla-made plug connected to the batteries of any brand of electric vehicle) that would enable electric vehicle owners to utilize Tesla's recharging station if they wished to do so. In these negotiations, Tesla committed to implementing standardized battery recharging technology at all of its existing and new recharging stations, to establishing greater numbers of recharging spaces at its recharging stations, and to investing in ample recharging locations to accommodate the expected demand for battery recharging. By October 2023, almost every electric vehicle manufacturer in Japan, the United States, and Europe had entered into recharging agreements with Tesla or indicated their intention to do so.

Technology and Product Development Strategy

Heading into 2023, Tesla had spent $14.1 billion on R&D activities to design, develop, test, and refine the components and systems needed to produce top quality electric vehicles and, further, to design and develop prototypes of the Tesla Roadster, Model S, Model X, Model 3, Model Y, Cybertruck, and Tesla Semi vehicles. Tesla executives believed its R&D activities had produced core competencies in battery and powertrain engineering and manufacturing. The company's core intellectual property was contained in its work on developing self-driving technologies and capabilities and in its electric powertrain technology (the battery pack, power electronics, induction motor, gearbox, and control software) that enabled these key components to operate as a system. Tesla personnel had designed each of these major elements for the Tesla Roadster and Model S; much of this technology had been used in the powertrain systems that Tesla previously had built for other vehicle manufacturers (mainly Toyota and Mercedes-Benz) and that had been further improved and refined in the powertrain systems being used in the Model X, Model 3, Model Y, and the prototypes for the Cybertruck and Tesla Semi.

The powertrain used in Tesla vehicles in 2023 was a compact, modular system with far fewer moving parts than the powertrains of traditional gasoline-powered vehicles, a feature that enabled Tesla to implement powertrain enhancements and improvements as fast as they could be identified, designed, and tested. Tesla had incorporated its latest powertrain technology into its current models and was planning to use much of this technology in producing forthcoming electric vehicles. All models included several powertrain variants along with the latest advances in mobile computing, sensors, displays, and connectivity.

Although Tesla had more than 500 patents and pending patent applications domestically and internationally in a broad range of areas, in 2014, Tesla announced a patent policy whereby it irrevocably pledged the company would not initiate a lawsuit against any party for infringing Tesla's patents through activity relating to electric vehicles or related equipment so long as the party was acting in good faith. Elon Musk said the company made this pledge in order to encourage the advancement of a common, rapidly evolving platform for electric vehicles, thereby benefiting itself, other companies making electric vehicles, and the world. Investor reaction to this announcement was largely negative on grounds that it would negate any technology-based competitive advantage over rival manufacturers of electric vehicles.

Battery and Battery Pack Acquisition Strategy

In February 2014, Tesla announced that it and various partners, principally Panasonic—Tesla's supplier of lithium-ion batteries since 2010—would invest $4 to 5 billion through 2020 in a "gigafactory" capable of producing enough lithium-ion batteries to make battery packs for 500,000 vehicles. Tesla expected the new plant (named the Tesla Gigafactory, later changed to Gigafactory 1) to reduce the company's battery pack cost by more than 30 percent—battery packs were the most expensive component in the company's electric vehicles.

Tesla opted to locate Gigafactory 1 on a site in an industrial park east of Reno, Nevada, partly because the state of Nevada offered Tesla a lucrative incentive package said to be worth $1.25 billion over 20 years and partly because the only commercially active lithium mining operation in the United States was in a nearby Nevada county (this county was reputed to have the fifth largest deposit of lithium in the world). Construction began immediately. The facility was built in phases. In 2019, Tesla announced it would continue expanding Gigafactory 1 over the next few years so that its battery-making capacity would significantly exceed the volume needed for 500,000 vehicles per year when construction first started. Tesla had already added space at Gigafactory 1 to enable the manufacture of Tesla Energy's primary energy storage products (Powerwall, Powerpack, and Megapack) and the manufacture of Model 3 and Model Y drive units. Battery recycling capability had been added in 2019.

During 2015–2017, Tesla, in close collaboration with Panasonic, discovered ways to build an improved lithium-ion battery that would be larger, safer, and require fewer individual batteries per battery pack. The new battery was being used in the Model 3 and Model Y vehicles produced at the Fremont factory in California. However, in August 2019, Tesla agreed to purchase lithium-ion batteries from LG Chem, a South Korean firm with a battery-making plant in China about 200 miles from Shanghai, that would be used to manufacture the battery packs for the Model 3 and Model Y vehicles produced at Tesla's Shanghai Gigafactory—LG Chem was the world's second-largest manufacturer of lithium-ion battery cells. Earlier in 2019 Tesla acquired Maxwell Technologies, a maker of ultracapacitors—energy storage devices that could charge and discharge rapidly, perform at a wide range of temperatures, had high power density, and long operational life; Maxwell's dry electrode technology could be applied to batteries of varying chemistries and offered the advantages of higher battery performance at a lower cost. Most recently, Tesla had developed a proprietary 4680-type battery cell technology to produce enough of Tesla's new-style 4680 batteries for 1.5 million light-duty vehicles.

Going forward, Tesla believed it had the capabilities to quickly incorporate the latest advancements in battery technology and continue to optimize battery pack system performance and cost for its current and future vehicles. It already had proprietary technology and expertise in optimizing the design of the cells used in its battery packs and in achieving high energy density in its battery packs at progressively lower cost, while also maintaining safety, reliability, and long life. In addition, its proprietary technological know-how included capabilities relating to systems for high density energy storage, cooling, charge balancing, structural durability, and electronics management. Tesla had pioneered and then continuously refined its advanced manufacturing techniques to produce large quantities of high-quality battery packs at progressively lower cost per unit. Plus, it had extensive testing and R&D capabilities for battery cells, packs, and systems, along with an expansive body of knowledge on battery cell chemistry types, their performance characteristics, and various battery cell manufacturers.

Power Electronics

The power electronics in Tesla's powertrain system had two primary functions—the control of torque generation in the electric motor while driving and the control of energy delivery back into the battery pack while charging. The first function was accomplished through the drive inverter, which converted direct current from the battery pack into alternating current to power the electric motors, provide acceleration, and enhance the overall driving performance of the vehicle. The second function was to capture kinetic energy from the wheels being in motion but being slowed down by applying the brakes and reverse the flow of energy to help recharge the battery pack—a technology called "regenerative braking." (When brakes are applied in gasoline-powered vehicles, the brake pads clamp down on the wheels to slow the vehicle (letting the kinetic energy escape as heat); but in electric vehicles (and most hybrid vehicles), the regenerative braking systems slow the vehicle by reversing the flow of electricity to the electric motors powering the wheels, while also capturing the heat from the kinetic energy to generate electrical energy for partially recharging the battery pack.) When the electric vehicle was parked, battery recharging was accomplished by the vehicle's charger, which converted alternating current (usually from a wall outlet or other electricity source) into direct current which could be accepted by the battery. The primary technological advantages to Tesla's proprietary power electronics designs included the ability to drive large amounts of electrical current into a small physical package with high efficiency and low cost, and to recharge on a wide variety of electricity sources at home, at the office or on the road, including at Tesla's network of Supercharger stations.

As of March 2023, all but one of Tesla's models (the rear wheel version of the Model 3) utilized an all-wheel drive powertrain with at least 2 electric motors: one mounted on the front axle and one or two on the rear axle. Tesla's dual and tri motor powertrain designs digitally and independently controlled torque to the front and rear wheels, which resulted in the vehicle having a low center of gravity and enabled near-instantaneous response of the motors to the driver's placing more or less pressure on the accelerator. These design features produced greater traction control and gave drivers more control of the vehicle's performance. Toward the end of 2021, Tesla engineers completed their development of the three-motor powertrain (one to power the front axle and two to power the rear axle) that provided further increases in performance; this new three-motor powertrain was standard in Tesla's Plaid Model S and Plaid Model Z in 2022 and 2023.

Control and Infotainment Software

The battery pack and the performance and safety systems of Tesla vehicles required the use of numerous microprocessors and sophisticated software. For example, computer-driven software monitored the charge state of each of the cells of the battery pack and managed all of the safety systems. The flow of electricity between the battery pack and the motor had to be tightly controlled in order to deliver the best possible performance and driving experience. There were software algorithms that enabled the vehicle to mimic the "creep" feeling that drivers expected from an internal combustion engine vehicle without having to apply pressure on the accelerator. Other algorithms were used to control traction, vehicle stability, acceleration, regenerative braking, and the interior climate. Drivers used the vehicle's information and control systems to optimize performance, customize vehicle behavior, manage charging modes and times, and control all infotainment functions. Almost all of the software programs had been developed and written by Tesla personnel.

Starting in 2014, Tesla began devoting progressively larger fractions of its programming resources and expertise to developing and enhancing its software for vehicle autopilot functionality, including such features as auto-steering, traffic aware cruise control, automated lane changing, automated parking, driver warning systems, automated braking, object detection, a Smart Summons feature that enabled vehicles to be remotely summoned over such short distances as parking lots and driveways, and fully automated self-driving. In October 2016, Tesla began equipping all models with hardware needed for full self-driving capability, including cameras that provided 360-degree visibility, updated ultrasonic sensors for object detection, a forward-facing radar with enhanced processing, and a powerful onboard computer. Wireless software updates periodically sent to the microprocessors on board each Tesla owner's vehicle, together with field data feedback loops from the onboard camera, radar, ultrasonic sensors, and GPS, enabled the autopilot system in Tesla vehicles to continually learn and improve its performance. While in 2019 Elon Musk said he expected Tesla's autopilot software to be able to handle all modes of driving within two years, the process was taking longer than he had foreseen—in early 2022, Musk said that full self-driving capability should occur in late 2024 or sometime in 2025. Most Tesla vehicles whose owners purchased full self-driving (FSD) software had been updated with Beta 3 of FSD. Beta 4 updates, expected to entail significant improvements, were scheduled for early 2023.

Vehicle Design and Engineering

Tesla had devoted considerable effort to creating significant in-house capabilities related to designing and engineering portions of its vehicles, and it had become knowledgeable about the design and engineering of those parts, components, and systems that it purchased from suppliers. Tesla personnel had designed and engineered the body, chassis, and interior of its current models. As a matter of necessity, Tesla was forced to redesign the heating, cooling, and ventilation system for its electric vehicles to operate without the energy generated from an internal combustion engine and to integrate with its own battery-powered thermal management system. In addition, the low-voltage electric system that powered the radio, power windows, and heated seats had to be designed specifically for use in an electric vehicle. Tesla had developed expertise in integrating these components with the high-voltage power source in its vehicles and in designing components that significantly reduced their load on the vehicle's battery pack, so as to maximize the available driving range.

Tesla personnel had accumulated considerable expertise in lightweight materials, since an electric vehicle's driving range was heavily impacted by the vehicle's weight and mass. The Tesla Roadster had been built with an in-house designed carbon fiber body to provide a good balance of strength and mass. The Model S and Model X had a lightweight aluminum body and a chassis that incorporated a variety of materials and production methods to help optimize vehicle weight, strength, safety, and performance. Weight reduction was an important factor in the design of the Model 3 and Model Y. In addition, top management believed that the company's design and engineering team had core competencies in computer-aided design and crash test simulations; this expertise had reduced the development time of new models. Tesla was continuing to strengthen its capabilities for on-site crash testing, durability testing, and validation of components from suppliers.

Manufacturing Strategy

Tesla had contracted with Lotus Cars, Ltd. to produce Tesla Roadster "gliders" (a complete vehicle minus the electric powertrain) at a Lotus factory in Hethel, England. The Tesla gliders were then shipped to a Tesla facility in Menlo Park, California, where the battery pack, induction motors, and other powertrain components were installed as part of the final assembly process. The production of Roadster gliders ceased in January 2012.

In May 2010, Tesla purchased the major portion of a recently closed automobile plant in Fremont, California, for $42 million; months later, Tesla purchased some of the plant's equipment for $17 million. The facility—formerly a General Motors manufacturing plant (1960–1982), then operated as a joint venture between General Motors and Toyota (1984–2010)—was closed in 2010. Tesla executives viewed the facility as one of the largest, most advanced, and cleanest automotive production plants in the world. The 5.3 million square feet of manufacturing and office space was deemed sufficient for Tesla to produce 500,000 vehicles annually (approximately 1 percent of the total worldwide car production). The Fremont plant's location in the northern section of Silicon Valley facilitated hiring talented engineers already residing nearby and because the short distance between Fremont and Tesla's Palo Alto headquarters ensured "a tight feedback loop between vehicle engineering, manufacturing, and other divisions within the company."[18] Tesla officially took possession of the 370-acre site in October 2010, renamed it the Tesla Factory, and immediately launched efforts to get a portion of the massive facility ready to begin manufacturing components and assembling the Model S in 2012.

In late 2015, Tesla completed construction of a new high-volume paint shop and a new body shop line capable of turning out 3,500 Model S and Model X bodies per week (enough for 175,000 vehicles annually). In 2016 and 2017, Tesla made significant additional investments at the Tesla Factory, including a new body shop with space and equipment for Model 3 final assembly.

In December 2012, Tesla opened a new 60,000-square-foot facility in Tilburg, Netherlands, about 50 miles from the port of Rotterdam, to serve as the final assembly and distribution point for all Tesla vehicles sold in Europe and Scandinavia. The facility, called the Tilburg Assembly Plant, received nearly complete vehicles shipped from the Tesla Factory, performed certain final assembly activities, conducted final vehicle testing, and handled the delivery to customers across Europe. It also functioned as Tesla's European service and parts headquarters. Tilburg's central location and its excellent rail and highway network to all major markets on the European continent allowed Tesla to distribute anywhere across the continent in about 12 hours. The Tilburg operation had been expanded to over 200,000 square feet in order to accommodate a parts distribution warehouse for service centers throughout

Europe, a center for remanufacturing work, and a customer service center. A nearby facility in Amsterdam provided corporate oversight for European sales, service, and administrative functions.

Tesla's manufacturing strategy was to source a number of parts and components from outside suppliers but to design, develop, and manufacture in-house those key components where it had considerable intellectual property and core competencies (namely lithium-ion battery packs, electric motors, gearboxes, and other powertrain components) and to perform all assembly-related activities itself. In 2018–2020, the Tesla Factory contained several production-related activities, including stamping, machining, casting, plastics molding, drive unit production for the Model S and Model X, robotics-assisted body assembly, paint operations, final vehicle assembly, and end-of-line quality testing. In addition, the Tesla Factory manufactured lithium-ion battery packs, electric motors, gearboxes, and certain other components for its Model S and Model X vehicles. While some major vehicle component systems were purchased from suppliers, there was a high level of vertical integration in the manufacturing processes at the Tesla Factory. From 2016 to 2019, efforts to expand production capacity at the Tesla Factory were ongoing, partly to accommodate increased production of the Model S and Model X but mainly to enable high volume production of the Model 3 and Model Y.

In 2014, Tesla began producing and machining various aluminum components at a 431,000 square-foot facility in Lathrop, California; an aluminum castings operation was added in 2016. Aluminum parts and components were used extensively to help reduce the weight of Tesla vehicles.

Musk believed Tesla had learned valuable manufacturing lessons that could be applied in ramping up the production volume of the Model 3 at the Fremont plant. These lessons had driven refinements in the production and assembly lines for the Model S, Model X, and Model 3 at the Fremont plant and had been incorporated into designing and equipping the new Shanghai Gigafactory that began construction in early 2019 and production in early 2020. The first-generation production line for the Model 3 in Shanghai was Tesla's first step in building a manufacturing platform that could be replicated quickly and cost efficiently across all vehicle types and in different geographic locations. Design and construction of a second production line in Shanghai enabled Model Y manufacturing capacity that was approximately 50 percent cheaper per vehicle than the current Model 3-related assembly lines in Fremont.[19] The lower costs were due mainly to a much-simplified production process and increased its use of robot-assisted assembly at the Shanghai Gigafactory.

In 2020, Tesla announced it would locate a second production facility in the United States. Austin, Texas, was selected as the site over seven other locations, partly because Tesla received $60 million in state and county tax incentives. Construction began in July 2020 and volume production of the Model Y began in March 2022. not only produce Model 3 and Model Y vehicles to supply the Eastern United States, but would also be the main production site for Tesla's forthcoming Cybertruck, Tesla Semi, and Roadster. The initial cost of the Austin plant, named Giga Texas, to build only the Model Y was reportedly $1.1 billion.[20] During construction of the Austin plant, Musk moved Tesla's headquarters operations out of California to Austin because of its business-friendly environment, because of the new plant's central role in producing five Tesla models, and because he also moved his residence to Austin to be closer to the company's operations at Giga Texas on the outskirts of Austin. As of early 2023, the long-range manufacturing plan for Giga Texas was to supply the eastern part of the United States with Model 3 and Model Y vehicles and be the principal facility for producing the new Cybertruck.

Production of the Model Y and Model 3 at Tesla's new $6.9 billion Berlin-Brandenburg plant began in March 2022; this plant's production was scheduled to supply Model 3 and Model Y buyers in Western Europe, Great Britain, Scandinavia, and the Middle East. Production at the Texas and Berlin production facilities would enable the company's Shanghai plant (with current production capacity of over 750,000 vehicles) to focus on delivering vehicles to buyers in China and other Asian-Pacific countries. China was by far the world's largest geographic market for both motor vehicles and electric vehicles. In February 2023, China's Association of Automobile Manufacturers announced that it expected sales of electric vehicles to increase by 35 percent in 2023 to 9 million vehicles—nearly a third of China's total new vehicle sales.[21] In 2021, Giga Shanghai produced 50 percent of all Tesla's delivered globally. As of early 2022, the new production volumes at Giga Austin and Giga Berlin de-risked Tesla's heavy dependence on its production operations in China. Exhibit 4 shows Tesla's installed production capacity for various models as of early 2023.

Supply Chain Strategy

Tesla's various models used thousands of parts and components sourced from hundreds of suppliers across the world. Certain components purchased from these suppliers were either identical or very similar across the company's growing number of models, which opened opportunities for volume-based price reductions and related cost-saving efficiencies.[22] Tesla worked to qualify multiple suppliers for each such component where it was sensible to do so, in order to reduce the bargaining power of any one supplier and to minimize production risks associated with being dependent on a single supply source. In many cases, however, components and systems were sourced from single suppliers. In such cases, the company mitigated single-source supply risk by maintaining safety stocks for key parts and assemblies and die banks for components with lengthy procurement lead times. But in some instances (like lithium-ion battery cells, battery packs, and drivetrains), the company opted to produce needed parts and components internally.

Tesla's products also required purchasing such raw materials as steel, aluminum, cobalt, lithium, nickel, and copper. Pricing for these materials was governed by market supply and demand conditions, and sometimes by the activities of speculators—factors outside of the company's control. Management believed that, while the company was vulnerable to periodic spikes in the prices of particular raw materials, it nonetheless had sufficiently adequate access to supplies of raw materials to meet the needs of its operations.

Marketing Strategy

From 2014 through year-end 2019, Tesla's principal marketing goals and functions were to

- Work with interested buyers as needed either in sales galleries or online to arrange for a test drive, view existing inventories at nearby sites, and/or place an order for a custom-equipped vehicle.
- Build long-term brand awareness and manage the company's image and reputation.
- Develop and nurture brand loyalty among existing owners of Tesla vehicles and help generate customer referrals.
- Obtain feedback from the owners of Tesla vehicles and make sure their experiences and suggestions for improvement were communicated to Tesla personnel engaged in designing, developing, and/or improving the company's current and future vehicles.

EXHIBIT 4 Tesla's Installed Production Capacity, January 25, 2023

Location	Model	Capacity	Status
Fremont, California	Model S, Model X Model 3, Model Y	100,000 550,000	Production Production
Shanghai	Model 3, Model Y	>750,000	Production
Berlin-Brandenburg Germany	Model Y	>250,000	Production
Austin, Texas	Model Y	>250,000	Production
	Cybertruck	Unannounced	Tooling/equipment being installed
Sparks, Nevada (east of Reno)	Tesla Semi	Unannounced	Production
To Be Determined	Roadster, Robotaxi Robovan		

Source: Company press release, January 25, 2023, p. 9. and Tesla Investor Day Presentation, March 1, 2023, posted at **www.ir.tesla.com**, accessed March 3, 2023.

As the first company to commercially produce a federally compliant, fully electric vehicle that achieved market-leading range on a single charge, Tesla had been able to generate significant media coverage of the company and its vehicles. Management expected this would continue for some time to come. So far, the extensive media coverage, largely favorable reviews in motor vehicle publications and *Consumer Reports,* praise from owners of Tesla vehicles and admiring car enthusiasts (which enlarged Tesla's sales force at zero cost), occasional and limited price cuts in locations where demand slacked off for various reasons, and the decisions of many green-minded affluent individuals to help lead the movement away from gasoline-powered vehicles had all combined to drive good traffic flows at Tesla's sales galleries and create a flow of online orders and pre-production reservations. As a consequence, starting in 2012 and continuing into 2023, Tesla had achieved a growing volume of sales (except during the COVID-19 pandemic) without the need for traditional advertising. This had kept the company's marketing costs to a tolerable minimum. Nonetheless, Tesla did make use of pay-per-click advertisements on websites and mobile applications relevant to its target clientele. It also displayed and demonstrated its vehicles at such widely attended public events as the Detroit, Los Angeles, and Frankfurt auto shows.

The Use of Tax Incentives to Stimulate Electric Vehicle Sales Reappears. In 2022, the Biden Administration's Inflation Reduction Act reinstituted the $7,500 tax credit for all electric vehicles purchased by individuals or their businesses from 2023 to 2032, subject to specified gross income limitations ($300,000 for married couples filing jointly, $225,000 for heads of households, and $150,000 for all other filers). As of late February 2023, surging orders for new Tesla vehicles in the United States signaled that this new $7,500 tax credit had, at least temporarily, ignited consumer interest in purchasing a new electric vehicle.

Governments in Europe, China, Japan, Australia, New Zealand, and elsewhere also elected to offer incentives of various kinds to kickstart buyer interest in switching to electric vehicles. As of November 2021, the governments of China, Japan, 17 European Union countries (down from 20 in 2020), and New Zealand were continuing to offer purchase incentives; another 10 European countries offered an assortment of tax reductions or exemptions to electric vehicle owners. Estonia was the only one of the 27 member countries in the European Union without any monetary stimulus for purchasing or owning an electric vehicle. However, during 2018–2022, because of financial constraints, some countries either discontinued the use of incentives or scaled back the sizes of their incentives. In 2018, Canada discontinued the use of incentives for electric vehicles with a manufacturer's suggested list price greater than C$75,000 (US$58,500). China ended its purchase subsidies for electric vehicles at the beginning of 2023.

Tesla's Leasing Activities

Tesla, in partnership with various financial institutions, began leasing vehicles to customers in 2014; the number and percentage of customers opting to lease Model S vehicles increased substantially in 2015. By year-end 2015, Tesla was not only offering loans and leases in North America, Europe, and Asia through its various partner financial institutions, but it was also offering loans and leases directly through its own captive finance subsidiaries in certain areas of the United States, Germany, Canada, and Great Britain.

Some of Tesla's financing programs outside of North America in 2015–2017 provided customers with a resale value guarantee under which those customers had the option of selling their vehicle back to Tesla at a preset future date, generally at the end of the term of the applicable loan or financing program, for a predetermined resale value. In certain markets, Tesla also offered vehicle buyback guarantees to financial institutions whereby Tesla agreed to repurchase the vehicles for a predetermined price. These programs, when first introduced in 2015 and 2016 had been widely publicized and attracted numerous buyers, but Tesla determined in late 2016 and 2017 to back away from these offers in most countries because they were proving unprofitable, had unattractive accounting requirements, and exposed Tesla to undesirable risks. During 2018–2022, Tesla's total end of year lease count climbed from 37,134 vehicles in 2018 to 49,901 in 2019 to 72,089 in 2020, to 120,342 in 2021, to 140,667 in 2022. In upcoming years in the United States, leasing of Tesla vehicles was expected to fall off significantly because the $7,500 tax credit in the Biden Administration's

Inflation Reduction Act accrued to the lease financing institution who owned the vehicle being leased rather than the individual or business leasing the vehicle.

Tesla's Sales of Regulatory Credits to Other Automotive Manufacturers

Because Tesla's electric vehicles had no tailpipe emissions of greenhouse gases or other pollutants, Tesla earned zero emission vehicle (ZEV) and greenhouse gas (GHG) credits on each vehicle sold in the United States. Moreover, it also earned corporate average fuel economy (CAFE) credits on its sales of vehicles because of their high equivalent miles per gallon ratings. All three of these types of regulatory credits had significant market value because the manufacturers of traditional gasoline-powered vehicles were subject to assorted emission and mileage requirements set by the U.S. Environmental Protection Agency (EPA) and by certain state agencies charged with protecting the environment within their borders; automotive manufacturers whose vehicle sales did not meet prevailing emission and mileage requirements were allowed to achieve compliance by purchasing credits earned by other automotive manufacturers. Tesla had entered into contracts for the sale of ZEV and GHG credits with several automotive manufacturers, and it also routinely sold its CAFE credits. Tesla's sales of ZEV, GHG, and CAFE credits produced revenues of $1.72 billion in 2022, $1.46 billion in 2021, $1.58 billion in 2020, $594 million in 2019, and $419 million in 2018. In Exhibit 2, these amounts were included on Tesla's income statement in the revenue category labeled "Automotive regulatory credits;" without these revenues, as frequently noted by Wall Street analysts, Tesla's net losses in 2018 and 2019 would have been significantly higher and its net profits in 2020–2022 significantly lower.

Tesla and the COVID-19 Pandemic

Tesla's deliveries of its Model 3 and Model Y vehicles in the first half of 2020 were below expectations at the beginning of 2020, partly because of closure of its Gigafactory 2 in Shanghai for two weeks in Q1 (January 30 to February 10) that was mandated by the Chinese government as part of its campaign to limit the spread of the COVID-19 virus and partly because of California-mandated closure of the Fremont plant starting March 24 that extended until May 13, 2020, at which time limited production was allowed. Tesla also experienced scaled-back production at its battery Gigafactory in Nevada for the first half of 2020. In 2021 production was constrained by limited supplies of both semiconductor chips and battery cells. To address the battery shortage, Tesla extended its list of battery suppliers from mainly Panasonic to LG Chem and CATL (a China-based company considered to be a global leader in energy innovative technologies), as well as starting its own in-house battery cell development. The inclusion of CATL as a battery supplier was to enable the use of cheaper LFP-batteries (a type of lithium-ion battery that used lithium iron phosphate as the cathode material and a graphic carbon electrode with a metal backing as the anode) which only China-based CATL could supply. In October 2021, Tesla announced that it was immediately switching to the use of the lower-cost LFP battery chemistry as opposed to a nickel-cobalt-aluminum chemistry in all of its standard range models.[23] The LFP battery chemistry was more advantageous than other lithium-ion chemistries because it did not require the use of higher-cost cobalt, offered high-cycle energy life, fast charging, and very good safety; the main disadvantage of LFP batteries was lower-energy density (which resulted in shorter driving distances before having to be recharged).[24] In March 2022, Elon Musk reiterated that "for the foreseeable future Tesla, like the rest of the industry, will focus on nickel-based chemistries for longer-range vehicles and iron-phosphate for shorter-range vehicles" [25] At the same time, Musk said that Tesla saw potential in a battery chemistry with a manganese-based cathode, saying that "It is relatively straightforward to do a cathode that's two-thirds nickel and one-third manganese, which will allow us to make 50% more cell volume with the same amount of nickel."[26] This was the chemistry underlying Tesla's newly developed 4680 battery cell.

TESLA ENERGY IN 2023

In 2015, Tesla formed Tesla Energy, a new subsidiary that would begin producing and selling two energy storage products in 2016—Powerwall for homeowners and Powerpack for industrial, commercial, and utility customers. Powerwall was a lithium-ion battery charged either by electricity generated from a home's solar panels or from power company sources when electric rates were low. Powerwall home batteries could also be used as a backup power source in case of unexpected power outages. Powerpack models were rechargeable lithium-ion batteries that industrial, commercial, and utility enterprises could use for energy storage or backup power.

Production and deliveries of second-generation Powerwall 2 and Powerpack 2 began in late 2016. Both products had the capability to receive over-the-air firmware and software updates that enabled additional features. In 2018–2022, these two energy storage products were being used for backup power, independence from utility grids, peak demand reduction, generating power to cover periods when solar and/or wind generating sources were unavailable, and supplying wholesale electricity to select customers.

When SolarCity was merged into Tesla, the company arranged to lease a facility, called Gigafactory 2, in Buffalo, New York, to produce (1) solar energy systems sold to residential and commercial customers and (2) its freshly developed Solar Roof, which used aesthetically pleasing and durable glass roofing tiles to turn sunlight into electricity. A third-generation Solar Roof was introduced in 2019 that was marketed directly to residential customers and through an assortment of distribution partners. Installation capabilities had been enhanced by training both company personnel and the installers of third-party partners. To facilitate the growth of its solar roof business, Tesla Energy had developed proprietary software to reduce solar energy system design and installation timelines and costs and had also designed the new generation of the Solar Roof to work seamlessly with its Powerwall product.

Tesla Energy's solar energy systems included solar panels that convert sunlight into electrical current, inverters that convert the electrical output from the panels to a usable current compatible with the electric grid, racking that attaches the solar panels to the roof or ground, electrical hardware that connect the solar energy system to the electric grid, and a monitoring device. The majority of the components were purchased from vendors. The company maintained multiple sources for each major component to ensure competitive pricing and adequate supplies.

Tesla Energy had an in-house engineering team that designed its energy storage products and solar roof systems. Whenever feasible, the engineering team utilized component-level technologies developed for its electric vehicles (particularly high-density energy storage, cooling, safety, charge balancing, structural durability, and electronics management) to enhance the capabilities and features of its energy storage and solar roof products. While a majority of the components in the division's energy storage and solar roof products were obtained from multiple outside sources, some solar roof components were designed and manufactured at the Gigafactory in New York.

In the United States, Tesla Energy sold its solar and energy storage products through its website and sales galleries as well as through its national sales organization, channel partner network, and customer referral program. Outside the United States, Tesla Energy used its international sales organization and a network of channel partners to market and sell Powerwall 2 to residential customers; some Powerwall 2 units were sold directly to utilities, who then installed the product in customer homes. Powerpack and Megapack systems were sold to commercial and utility customers through its international sales organization.

In December 2017, Tesla completed installation of a 100-megawatt lithium-ion battery hooked into the electricity grid in South Australia to relieve power shortages created by a tornado in 2016. Elon Musk had promised that once the contract was signed, Tesla would complete the project in 100 days or it would be furnished free of charge—Tesla completed the installation in 60 days. According to Musk, the battery was three times more powerful than the world's next biggest battery. In late 2019 Tesla Energy began selling a Megapack product, multiple units of which could be grouped together to form energy-generating and energy-storage installations big enough to supply the needs of large industrial customers, utilities, energy-generation firms, communities, and large neighborhoods. During 2019–2022, Tesla Energy's sales of Megapack systems boomed. Deployment of Megapack energy storage systems grew impressively from more than 1,651 Megawatt hours (MWh) in 2019 to 3,022 MWh in 2020 to 3,992 MWh in 2021 to 6,541 MWh in 2022. Tesla's revenues from energy-generation and storage products were $1.6 billion in 2018, $1.5 billion in 2019, $2.0 billion in 2020, $2.8 billion in 2021, and $3.9 billion in 2022 (Exhibit 2), resulting in gross profits of $242 million in 2017, $190 million in 2018, $190 million in 2019, $18 million in 2020, a gross loss of $120 million in 2021, and a gross profit of $289 million in 2022 (see Exhibit 2). As a consequence, in 2023, Tesla was rapidly expanding its capacity to produce its utility-scale Megapack product at a factory in Lathrop, California.

Elon Musk was very optimistic about the growth opportunities for Tesla Energy, saying in December 2019 that he expected the company's solar energy and storage business to grow faster than the company's electric vehicle business.[27] He indicated that Tesla's energy business could grow to one day be roughly the same size as Tesla's automotive business, and further, that solar sales would grow, on a percentage basis, the fastest of any of three Tesla's product lines, with storage second and automotive third. However, so far, Tesla's deployment of solar energy had been flat, declining from 326 MW in 2018 to 173MW in 2019 and 205 MW in 2020, then climbing to 345 MW in 2021 and 348 MW in 2022. Solar systems, principally the Tesla Solar Roof in partnership with Panasonic, were produced at a Tesla Gigafactory in Buffalo, New York. But the Solar Roof product was beset with problems. Panasonic pulled out of the project in 2020; as of 2023, most former Solar Roof employees had been either laid off or diverted to other jobs, mainly to work on Tesla's full self-driving software.

The Electric Vehicle Segment of the Global Automotive Industry

Global sales of passenger cars and SUVs totaled 78.9 million units in 2018, 75 million units in 2019, 63.8 million in 2020, 66.7 million in 2021, and 66.1 million in 2022. Global sales of other types of vehicles (light or pickup trucks, heavy or cargo-carrying trucks, recreational vehicles, buses, and minibuses) totaled 26.6 million in 2018, 26.5 million in 2019, and 24.4 million in 2020. In 2022, estimates for global vehicle sales of passenger cars, SUVs, and pickup trucks were around 79.4 million units, or 1.9 percent less than in 2021; in 2023, according to various assumptions, sales were expected to be between 79 and 81 million units.[28] Global sales of passenger cars and other types of new motor vehicles were lower in both 2020–2022 than in the two prior years due to the effects of the COVID-19 pandemic, slower economic growth, and an assortment of supply chain constraints.

Registrations of electric vehicles were highest in China, followed by Europe and the United States. There were an estimated 24 million electric cars on the world's roads going into 2023, with battery-powered electric models accounting for a growing percentage of the new vehicle registrations. In 2022, about 7.8 million electric vehicles were sold worldwide, up 68 percent over 2021 and equal to a global share of all vehicles sold approaching 10 percent.

In 2021, global sales of plug-in electric vehicles totaled 6.6 million units, up from 2.0 million in 2018 and 3.0 million in 2020. Plug-in vehicles included both battery-only vehicles and so-called plug-in hybrid electric vehicles equipped with a gasoline or diesel engine for use when the vehicle's battery pack (rechargeable only from an external plug-in source) was depleted, usually after a distance of 20 to 50 miles. Hybrid vehicles were jointly powered by an internal combustion engine and an electric motor that ran on batteries charged by regenerative braking and the internal combustion engine. The batteries in a hybrid vehicle could not be restored to a full charge by connecting a plug to an external power source.

The left half of Exhibit 5 shows the leading manufacturers of plug-in electric vehicles and the number of such vehicles they delivered to customers in 2021; the right half of Exhibit 5 shows the best-selling models of electric vehicles in 2021.

Intensifying Competition in the Global Electric Vehicle Segment in 2022 and Beyond

There was no question in 2022 and beyond that Tesla was faced with intensifying competition in the global marketplace for electric-powered vehicles. Eighteen of the world's 20 largest motor vehicle manufacturer had committed to increasing their production and sales of new battery-powered passenger cars, SUVs, and light trucks with driving ranges of at least 200 miles before recharging was needed. In 2018 and 2019, models with 200+ mile driving ranges were introduced by Audi, Jaguar, Mercedes, Kia, Volvo, General Motors, and Hyundai. Fresh models from Porsche, Aston Martin, Nissan, Audi, Volkswagen, BMW, General Motors, and Ford came on the market in 2020.

EXHIBIT 5 Global Sales of Plug-in Electric Vehicles by Leading Motor Vehicle Manufacturers, and Best-Selling Models of Battery Electric Vehicles, 2021

Rank	Leading Manufacturers of Plug-In Electric Vehicles (includes hybrid models)	2021 Unit Sales	Best-Selling Battery Electric Vehicle Models	2021 Unit Sales
1	Tesla (United States)	936,172	Tesla Model 3	501,000
2	SAIC Motor[a] (China)	732,646	Wuling HongGuang Mini	424,000
3	BYD (China)	593,878	Tesla Model Y	411,000
4	Volkswagen Group[b] (Germany)	452,900	Volkswagen ID.4	119,650
5	Stellantis[d] (Europe, United States)	388,024	Li Xiang One EREV	91,000
6	BMW Group[c] (Germany)	360,953	BYD Han	87,189
7	Mercedes-Benz (Germany)	227,458	Changan Benben	77,000
8	Geely (China)	220,516	Volkswagen ID.3	76,000
9	Volvo (Sweden)	189,216	BYD Qin Plus	56,151
10	Great Wall Motor (China)	135,028	BYD Yuan	41,402
11	Guangzhou Automobile (China)	123,660	BYD e2	34,265
12	XPeng Motors (China)	98,155	BYD Dolphin	29,598
13	NIO (China)	91,429	BYD Song	29,340
14	Li Auto (China)	90,491	Ford Mustang Mach-E	27,140
15	Hyundai (South Korea)	75,009	Chevrolet Bolt EV and Bolt EUV	24,828
16	Neta Automobile (China)	69,674	Nissan Leaf	14,239
17	WM Motor (China)	44,197	Audi e-Tron	10,921
18	Leap Motor (China)	43,121	Porsche Taycan	9,419
19	Beijing Automotive Group (China)	26,127	Tesla Model S	9,100

[a] *Includes Maxus, MG, Roewe, and Yuejin models of plug-in electric vehicles, plus plug-in models marketed by SAIC joint ventures with Baojun, Buick, Chevrolet, Cadillac, Iveco, Skoda, Volkswagen, Audi, and Wuling brands.*

[b] *Includes Volkswagen, Audi, Porsche, SEAT, and Skoda models of plug-in electric vehicles.*

[c] *Includes BMW and Mini Cooper models of plug-in electric vehicles.*

[d] *Includes Peugeot, Opel, Vauxhall, and Fiat models of plug-in electric vehicles; other Stellantis brands (Jeep, Ram, Dodge, and Chrysler and several European brands) do not yet produce and market electric vehicles.*

Source: Compiled by the case author from manufacturer sales reports and assorted sources of motor vehicle data.

Porsche's Taycan, an electric sedan with a base price of about $83,000, outsold the company's signature 911 model in 2021. Mercedes-Benz sold nearly 100,000 electric cars and vans in 2021, a 90 percent increase over 2020. More than 10 of the world's 20 largest motor vehicle manufacturers had declared electrification targets for 2030 and beyond.[29] Indeed, some vehicle manufacturers had announced plans to reconfigure their product lines to produce only electric vehicles.[30] Volvo said it would only sell electric cars from 2030 onward. Ford announced that starting in 2030 it would only sell electric vehicles in Europe. General Motors said it would offer only electric passenger cars, SUVs, and light duty vehicles by 2035. Volkswagen was aiming for 70 percent electric car sales in Europe, and 50 percent in China and the United States by 2030. The world's fourth largest automaker, Stellantis (which was the parent company for the Chrysler, Dodge, Ram, Jeep, Fiat, Abarth, Alfa Romeo, Lancia, Maserati, Peugeot, Citroën, DS Automobiles, Opel, and Vauxhall brands) was aiming for 70 percent electric car sales in Europe and 35 percent in the United States by 2030. Overall, the announcements by the manufacturers translated to estimated cumulative sales of 55 to 72 million electric cars and other light duty vehicles by 2025.[31]

Exhibit 6 shows the battery-powered models that were introduced by leading vehicle manufacturers in 2021 and 2022, plus the models that they said would be forthcoming in 2023–2025.

Volkswagen had announced plans to equip as many as 16 factories to produce electric vehicles, compared with three in 2018, to build as many as 1 million VW brand electric vehicles annually by 2025, and to build 28 million electric vehicles cumulatively across all its brands (Volkswagen, Audi, Skoda, VW E-Up!, and Porsche) by 2028. In 2021, Toyota said by 2030 it would have a total of 30 battery electric models covering all market segments, and every Toyota and Lexus model sold around the world would be available either as a dedicated electrified model or have an electrified option. Additionally, Toyota expected to have annual sales of more than 5.5 million electrified vehicles by 2030 (including more than 1 million zero-emission vehicles totally powered by either batteries or fuel cells) and to halt all production of gasoline-powered vehicles by 2040. In 2018, the government of Germany launched a campaign to put 1 million electric cars on its roads by 2020 and to have 40 percent electric cars on its roads by 2035.

In late 2022 or early 2023, Ford was expected to begin deliveries of its new battery-powered Lightning model, an electric version of the F-150 pickup truck, which for decades had topped U.S. sales charts for pickup trucks. Ford initially planned to make 75,000 Lightning vehicles a year. But initial demand proved so strong that the company was racing to double its production of the Lightning, which had a starting base price of around $40,000 and ran to as much as $90,000 for fully equipped, high-end versions. After receiving 200,000 reservations, Ford stopped taking reservations in early 2022.

EXHIBIT 6 Major Car Manufacturers with New Battery-Powered Passenger Cars and Trucks, 2021, 2022, and Upcoming in 2023–2025

Car Manufacturer/Brand	New 2021 Models	New 2022 Models	New 2023 models and Beyond
Audi	e-tron and e-tron Sportback	Q4 e-tron, Q4 e-tron Sportback, Audi e-tron GT	Q4 e-tron, Q4 e-tron Sportback, Audi e-tron Sportback, e-tron S, e-tron S Sportback, e-tron GT
BMW	BMW i3	BMW i4, BMW iX	BMW i4, BMW iX, BMW i7
Cadillac			Lyric (2023), Celestiq (2025)
Chevrolet	Bolt	Bolt and Bolt EUV	Bolt and Bolt EUV Blazer (2024) Silverado (2024) Equinox (2024)
Ford	Mustang Mach E	Mustang Mach E, F-150 Lightning	Mustang Mach E, F-150 Lightning Explorer (TBD)
Genesis		Electrified G80, GV60	Electrified G80, GV60
GMC		Hummer EV Pickup	Hummer EV SUV (2024) GMC Sierra (2024)
Honda			Prologue (2024)

Car Manufacturer/Brand	New 2021 Models	New 2022 Models	New 2023 models and Beyond
Hyundai	Kona Electric, Ioniq Hatchback	Kona Electric, Ioniq 5	Kona Electric, Ioniq 5, Ioniq 6 (2024)
Jaguar	Jaguar I-Pace	Jaguar I-Pace	Jaguar I-Pace
Jeep		Grand Cherokee 4xe Wrangler 4xe hybrid Jeep Avenger (Europe availability only)	Grand Cherokee 4xe Wagoneer S (2024) Recon (2024)
Kia	Niro, Soul	Niro, Kia EV6	Niro, Kia EV6, EV9 (2024)
Lexus			Lexus RZ 450E
Mazda		MX-30	
Mercedes-Benz		EQB, EQS, EQA	EQB, EQS, EQE, AMG EQE Sedan
Nissan	Nissan Leaf	Nissan Leaf	Nissan Leaf, Nissan Ariya
Polestar (Volvo subsidiary)	Polestar 1	Polestar 2	Polestar 3, Polestar 5 (2024)
Porsche	Taycan	Taycan	Maycan (2024)
Subaru			Solterra
Toyota			Toyota bZ4X)
Volkswagen	Volkswagen ID.3, ID.4	Volkswagen ID.4	Volkswagen ID.4 Buzz
Volvo	XC40 Recharge	XC40 Recharge, C40 Recharge	

Source: Austin Morris, "Electric Car Companies Guide," posted at **www.kbb.com/car-advice/ev-car-companies-guide**, March 2022 issue, accessed March 31, 2022 and November 2022 issue, accessed February 24, 2023.

Tesla's Competition from the Chinese Manufacturers of Electric Vehicles

While Tesla was the biggest manufacturer of battery-powered electric vehicles in China in 2022–2023 with a capacity of over 750,000 vehicles annually, there were a growing number of ambitious Chinese electric vehicle manufacturers racing to increase their production capabilities and also introduce a range of new models. The largest of these were

- SAIC Motor—A state-own manufacturer headquartered in Shanghai that operated in both domestic and international markets. SAIC's products included passenger and commercial vehicles and such vehicle components as engines, transmissions, powertrains, gearboxes, chassis, and both exterior and interior trim. It was the largest auto manufacturer in China with over 200,000 employees, and its four brands of vehicles were Maxus, MG, Roewe, and Yuejin. SAIC also had joint ventures in place with Baojun, Buick, Chevrolet, Cadillac, Iveco, Skoda, Volkswagen, Audi, and Wuling to produce and market electric vehicles under their brand names. Its primary electric vehicle model was the MG4, which it began selling in Europe in September 2022. In 2022, SAIC sold 143,200 electric vehicles and about 5.4 million total vehicles; its 2022 total revenues were $114. In February 2022, SAIC announced the formation of SAIC Motor R&D Innovation Headquarters with an R&D team of more than 10,000 people and a budget of $47.5 billion to develop new energy and intelligent connected vehicles during the next four years in order to accelerate the company's "transformation and innovation . . . and provide a basis for SAIC's strong growth."[32]

- BYD—Warren Buffett' Berkshire Hathaway bought a 9.9 percent ownership share of BYD in 2008 for $232 million. The founder and chairman of BYD was Wang Chuanfu, a Chinese billionaire said to be worth $20.6 billion on Forbes Real-Time Billionaires List in 2022; he expected sales of electric vehicles to account for 70 percent of the Chinese market by 2030. In 2021, BYD began exporting cars to Norway, Finland, and Australia, and it had an electric bus plant in California that employed about 800 people. In 2022, BYD sold 911,141 battery-powered electric vehicles, up 184 percent over its 2021 total.
- Geely Auto Group (which had purchased Volvo from Ford Motor for $1.5 billion in 2010)—Geely was privately owned by Chinese billionaire Li Shufu. Geely's brand subsidiaries included Geely Auto, Volvo Cars, Polestar, Lotus, London Taxi, and Zeekr. Geely had ambitions to be producing as many fully electric cars by 2025 as all of North America. In 2022 the Geely Auto Group sold 2.3 million vehicles, of which 675,000 were personal and commercial electric vehicles.
- Great Wall Motor—a privately owned manufacturer that was China's largest producer of sports-utility vehicles and pick-up trucks. Great Wall sold 1.1 million vehicles in 2022, of which 173,200 were sold outside China. Its electric vehicle brand names were ORA and Haval; the Haval brand sold about 610,000 electric vehicles in 2022, and Haval planned to launch 10 new models of electric vehicles in countries around the world in 2023.
- Guangzhou Automobile Group—marketed electric vehicles under three brands: Aion, Trumpchi, and GAC-Honda. The company also had joint venture agreements with Fiat-Chrysler (Stellantis), Honda, Mitsubishi Motors, NIO, and Toyota. In 2022,GAC sold 2.4 million vehicles, of which 310,000 were electric vehicles.
- XPeng Motors—produced and marketed only electric vehicles in two factories in China. It was headquartered in Guanghou, China, with main offices in Beijing, Shanghai, Silicon Valley, San Diego, and Amsterdam. In 2022, XPeng had 5 models (the P7 and P5 sport sedans, G3 and G3i compact SUVs, and the G9—its flagship SUV that went on sale in the second half of 2022). The company raised $1.5 billion in an IPO on the New York Stock Exchange in August 2020. Its best-selling P7 sports sedan was the first model from a Chinese pure-EV brand to reach the production milestone of 100,000 units. Xpeng was rapidly gearing up its production capabilities, and after cumulative deliveries of 138,000 vehicles in 2020–2021, XPeng expected to achieve sales exceeding 175,000 vehicles. But it had to contend with COVID-19 restrictions and assorted supply chain constraints and delivered only 120,750. The company began deliveries to Denmark, the Netherlands, Norway, and Sweden in 2022.
- NIO—a leading company in the market for premium electric vehicles in the Chinese market. The company sold four models in China in 2022, and was expanding into Europe, starting with Norway. Its 2022 deliveries totaled 122,480, up 34 percent over 2021. Nio has several big EV releases scheduled for 2023, including its flagship EC7 coupe SUV and ES8 refresh. Its distinctive competitive feature was its development of a wide battery-swapping network of 778 Power Swap stations in China and Norway to supplement its installation of 4,600 superchargers and destination chargers as of March 2022. The company planned to expand its charging network to include 6,000 Power Swap stations and 10,000 destination chargers in China in 2023. NIO owners could get a fresh battery pack installed at a Power Swap station in about 5 minutes.
- Li Auto—was currently focused on producing a single plug-in hybrid (PHEV) Li One SUV (with seating for 6 passengers and a price of about $55,000). The Li One had a 40.5kWh liquid cooled battery pack paired with a 1.2-litre turbocharged three-cylinder engine acting as a generator, powering dual electric motors with a total system output of 245kW of power and a claimed 0–100km/h time of 6.5 seconds. As of year-end 2021, the company had delivered around 110,000 of its Li One SUVs. In the first quarter of 2022, Li Auto delivered 31,716 Li One SUVs, up 152 percent over the first quarter of 2021. Sales of the company's second model, the full-size extended range L9 SUV, began in April 2022; the L9 was expected to lure wealthy Chinese customers away from Audi and BMW models. The company was doubling the capacity of its current manufacturing facility from 100,000 vehicles to 200,000 vehicles and constructing a second plant in Beijing,

expected to become operational in 2023. Li delivered 133,250 vehicles in 2022. In July 2020, Li Auto raised $1.1 billion in an IPO on the Nasdaq exchange; its trading symbol is LI. In August 2021, the company raised an additional $1.5 billion in an IPO on the Hong Kong Stock Exchange.

However, all electric vehicle manufacturers in China suffered a production setback when outbreaks of COVID-19 cases in China in early March 2022 and the fourth quarter of 2022 prompted authorities to impose strict control measures, sending millions of people into quarantines and/or lockdowns and causing many temporary plant closures, production losses of 20–40 percent, further disruption of already-stressed global supply chains for essential motor vehicle parts, and automaker delays in launching sales of new electric vehicle models.

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CASE 16

Nikola Corporation—Can the Company Achieve Advantage in the Heavy-Duty Electric Truck Industry?

McGraw Hill connect

John E. Gamble
Texas A&M University–Corpus Christi

Alen Badal
Author and Researcher

Nikola Corporation was founded in 2015 as a Phoenix, Arizona-based manufacturer of heavy-duty battery-electric and hydrogen-electric trucks, electric vehicle drivetrains, energy storage systems, and hydrogen station infrastructure. The company was named after Nikola Tesla, a Serbian-American engineer and physicist known for inventing alternating current electric motor technology. Nikola Corporation's vision was inspired by Nikola Tesla's innovations and sought to become the zero-emissions transportation industry leader. The company's products were planned as part of a worldwide solution to the issue of reducing greenhouse gas emissions and protecting the climate. The company had two business units focused on this objective—Trucks and Energy. The Truck unit was developing battery electric vehicles (BEV) and hydrogen fuel cell electric vehicles (FCEV) for short-haul, medium-haul, and long-haul freight companies. The Energy business unit was focused on developing and constructing hydrogen fueling infrastructure and BEV charging locations. The company believed its competitive advantage resulted from its leadership in building resources and capabilities in hydrogen fueling systems and that the company could help make hydrogen the fuel of the future.

Nikola had launched its TRE BEV battery-electric truck for short-haul metro-regional use in 2022. The TRE BEV had a 330-mile range and could be fully recharged in 90 minutes. The company anticipated that its long-haul hydrogen-electric TRE FCEV model would be launched by year end 2023. The TRE FCEV would have a 500-mile range and could be fully recharged in 20 minutes or less. The truck's impressive range and recharging times were a product of its hydrogen-cell design that allowed the truck to safely store hydrogen that was combined with oxygen to generate electric power. The TRE FCEV also had a battery that supplemented its hydrogen-powered fuel cell stack during acceleration. Nikola TRE BEV and TRE FCEV models are shown in Exhibit 1.

The electric vehicle (EV) segment of the automotive industry had revenues of $48.1 billion in 2022 and had grown by 24 percent annually since 2018. The EV industry was anticipated to grow by an additional 15.1 percent annually between 2023 and 2028. The global electric truck market was estimated at approximately $437 million in 2021. As with the broader EV market that included automobiles, the global electric truck market was expected to grow by 26 percent annually from 2021 to 2030 to reach nearly $4 billion in sales.

While many of the global automakers produced EVs, a select number also manufactured heavy electric trucks. Companies such as AB Volvo, BYD Company LTD of China, Daimler Truck Group AG (Freightliner), Isuzu, Navistar Inc. (International), PACCAR Inc. (Kenworth and Peterbilt–USA), and Tesla, Inc. were all producing or developing electric vehicles in 2023. Tesla was the largest producer of EVs with an approximate 62 percent market share in 2022. Tesla was best known for its sleek and luxurious

EXHIBIT 1 Nikola Corporation TRE BEV and TRE FCEV Truck Models

TRE BEV

TRE FCEV

Source: Top photo: Rolf Klatt/Shutterstock; Bottom photo: Abaca Press/Alamy Stock Photo

automobiles but began accepting orders in early-2023 for its new Cybertruck. The company had stated that the Cybertruck was capable of towing 14,000 pounds which matched the gasoline-powered Ford F-150 and exceeded that of the Chevrolet Silverado 1500, RAM 1500, and Toyota Tundra. Tesla had also developed and was road testing its new heavy-duty Tesla Semi model designed for freight deliveries by 2023. The Tesla Semi had a 500-mile range between chargings and was capable of accelerating from 0 to 60 in 20 seconds.

Nikola Corporation had recorded its first truck sales revenues in 2022 with the launch of the TRE BEV which recorded sales of $49.9 million. The company's cost of revenues, investments in R&D, and general and administrative expenses far exceeded revenues in 2022 and led to an operating loss of $748 million. The company believed increased sales of its short-haul TRE BEV model and its unique business model for its soon-to-be-launched TRE FCEV would allow the company to achieve profitability in the near term. The business model for the hydrogen-fueled TRE FCEV model utilized a bundled lease for trucking companies that would be inclusive of the cost of the truck, hydrogen fuel, and maintenance. The bundled lease was expected to create stable demand for Nikola's hydrogen fuel infrastructure from its dedicated route customers. In mid-2023, Nikola management felt the company was well positioned to lead the shift from diesel-fueled trucks to zero emission vehicles and that its strategy and product lineup could defend against new EV models entering the market from startups such as Hyzon Motors and established truck brands such as Freightliner, Volvo, Peterbilt, Kenworth, and International.

OVERVIEW OF THE COMMERCIAL EV INDUSTRY

Demand for commercial EVs, including short-haul, medium-haul, and long-haul heavy-duty trucks was expected to grow at 26 percent annually to reach $4 billion in sales by 2030. Rising fuel prices and a focus on greenhouse emissions and climate change were the two key external drivers of industry growth. EV vehicles did incur operating expenses such as electricity cost to recharge batteries, but electric bill increases were generally less than the cost of fossil fuels. Diesel fuel prices had increased dramatically during the early 2020s with crude oil prices rising from a world average price per barrel of approximately $39 in 2020 to $101 in 2022. The world average price per barrel of crude oil had fallen to approximately $87.50 per barrel in 2023, but continued to remain an important issue for trucking companies.

Internationally, many countries had established transition timeline ranges to only manufacture zero-emission vehicles. In the United States, the goal to transition to EV vehicles was supported by highly attractive incentives offered by federal and state governments. For example, the $1.2 trillion U.S. Infrastructure Investment and Jobs Act of 2021 included $7.5 billion for transportation electrification, including $2.5 billion for a new charging and fueling infrastructure grant program. The bill also set aside $9.5 billion for clean hydrogen programs. Also, the $773 billion U.S. Inflation Reduction Act of 2022 dedicated $500 billion to spending and tax incentives to support clean energy, clean transportation and business costs such as healthcare coverage for employees. State governments in California, Oregon, Washington, New Jersey, New York, Massachusetts, Maine, Vermont, Colorado, Maryland, Connecticut, Illinois, Nevada, Oklahoma, New Mexico, Minnesota, Iowa, Texas, Wisconsin, South Dakota, and Nebraska had all either adopted or were considering adopting some form of policy implementing a zero-emission policy with timelines. In 2021, California's Hybrid Zero Emission Truck and Voucher Incentive Project (HVIP) and New York's Truck Voucher Incentive Program (NYTVIP) were implemented. In 2021, HVIP provided about 2,000 vouchers for medium and heavy-duty trucks and buses, totaling $255 million. Incentives were as much as $100,000 per truck in Oklahoma, $150,000 per vehicle in Texas, as much as $175,000 per truck in New Jersey, and as much as $288,000 per truck in California.

One threat for EV manufacturers was the limitation of lithium batteries as about 90,000 tons of lithium is produced globally. The scarcity of lithium was expected to lead to increased lithium prices. Supply chain interruptions during the early-2020s had resulted in halted production for some manufacturers in the EV automotive industry, but heavy commercial vehicle manufacturers were expected to increase production steadily as components and materials became more readily available. Another issue for trucking firms to consider was the total cost of ownership (TCO), which was calculated based upon the useful life of a truck, to include lease cost or purchase payment, fuel cost, service and maintenance. According to ACT research, which is a North America commercial vehicle forecasting company, diesel fuels account for approximately 40 to 60 percent of TCO.

PROFILES OF COMMERCIAL ELECTRIC VEHICLE MANUFACTURERS

Tesla Corporation

Tesla Corporation was headquartered in Austin, Texas, and was the electric vehicle market share leader in 2023 with total revenues of $81.5 billion in 2022. Tesla designed, manufactured and sold fully electric vehicles, energy storage, and solar energy products. Tesla operated in two segments: automotive and energy generation and storage. In 2023, Tesla operated manufacturing plants in Fremont, California (vehicle production); Sparks, Nevada (battery production); Buffalo, N.Y. (solar products); Austin, Texas (vehicle production); Shanghai, China (vehicle production); and Berlin, Germany (vehicle production). Tesla recorded record profits and cash flow in 2022.

Tesla produced and sold 1.3 million cars in 2022 with a long-range goal of manufacturing and selling 20 million cars per year. CEO Elon Musk had set a long-term goal of the company producing 20 million vehicles would require 10–12 gigafactories, each with the capacity to build 1.5 to 2 million cars per year. The Cybertruck would be produced in the company's Gigafactory Texas plant and its Tesla Semi was in pilot production in its Gigafactory Nevada plant. The company also had a Tesla Roadster model, Robotaxi and other models in development in 2023. The 36-ton Tesla Semi could accelerate from zero-60 mph in 20 seconds. When fully loaded and traveling uphill with a 5 percent gradient, it could travel at a top speed of 65 mph, exceeding that of a diesel truck, which typically reached 45 mph when traveling a gradient of 5 percent. The Tesla Semi could be charged at 70% in 30 minutes. Tesla had announced a contract with PepsiCo in 2022 for the delivery of 100 Tesla Semi heavy-duty trucks. Tesla had also announced contracts for Tesla Semi trucks with Anheuser-Busch, Walmart, and UPS.

Daimler Truck

Daimler Truck is headquartered in Leinfelden-Echterdingen, Germany, and achieved €39.8 billion in 2022, up from €36.0 billion in 2020. The company was established in 2019 as a subsidiary of Daimler AG, but in 2021 Daimler Truck was spun into its own separate company with various segments: Trucks North America; Mercedes-Benz; Trucks Asia; Daimler Buses; and Financial Services. Daimler Truck was one of the world's largest commercial vehicle manufactures, employing about 100,000 employees at more than 30 locations in North America, Europe, Asia, and Latin America.

Daimler Truck North America was a leading manufacturer of heavy and medium trucks and school buses under the brands of Mercedes-Benz, Freightliner, Western Star, FUSO, BharatBenz, and Thomas Built Busses. Freightliner unveiled the new zero-emission BEV eCascadia model in May of 2022. It offered a range of 230 miles with a recharge of 80 percent in approximately 90 minutes. The company was also in collaboration with Thomas Built Busses to develop battery-electric school business.

The company's strategies and objectives consist of building an electric portfolio of vehicles utilizing CO2-neutral battery-electric and hydrogen-powered trucks and buses. The company projected that by 2030 battery-electric and fuel-cell trucks and buses would account for up to 60 percent of its sales. Daimler Truck was also focused on building partnerships to help accelerate technological change.

PACCAR

PACCAR was a global leader in the production of light-, medium- and heavy-duty trucks with a strong presence in the North American market. The majority of freight trucks seen on U.S. highways were either Daimler's Freightliner or PACCAR's Kenworth and Peterbilt trucks. The company's DAF truck brand was produced in the Netherlands, Belgium, Brazil and the United Kingdom and were sold throughout Europe, Asia, Africa, and South America. The company had invested considerable resources into the research and development of autonomous driving systems and electric and hydrogen fuel cell powertrains.

PACCAR's Kenworth K270E and K370E short-haul BEV trucks were launched in 2022 and had a 200-mile range and a two-hour recharge time. The Kenworth T680 heavy duty on-highway model produced 536 horsepower and 1,623 lb-ft of torque and had a range of 150 miles. The T680 could be recharged in 3.3 hours. The Peterbilt 520EV was developed to serve the refuse collection industry, the 220EV was a short-haul model with a range of up to 200 miles, and the 597EV was a heavy duty on-highway model. PACCAR's sales of conventionally powered and BEV trucks allowed it to record revenues of $27.3 billion and net income of $3.0 billion in 2022. PACCAR recorded revenues and net income in 2021 of $21.8 billion and 1.9 billion, respectively. The company's strong cash flows from operations allowed it to pay cash dividends per share of $2.80 in 2022, up from $1.89 per share in 2021.

Volvo Group

Volvo was a Swedish manufacturing company founded in 1927 and headquartered in Gothenburg, Sweden. The company operated with approximately 95,000 employees in 19 countries and 190 markets. Volvo's net sales in 2022 were SEK 473 billion, increasing by SEK 100 in 2021. The company produced 12 automotive brands sold throughout the world. The company manufactured and sold Volvo and Mack trucks in the United States and Renault trucks in Europe. The greatest source of sales is from Europe with North America being the second largest market for sales of Volvo. The company also established a 50:50 joint venture with Daimler Truck AG to develop the value chain activities to distribute hydrogen fuel and build and market hydrogen fuel cell heavy-duty trucks.

Volvo introduced its first FH, FM, FE, FL, and FMX heavy-duty EV truck models to the European market in 2019 and expanded sales to North America in 2020. All five models were capable of towing up to 44 tons and had a range of 185 miles. The lineup in 2023 also included the VMX heavy-duty long-haul model which had a range of 275 miles and could be recharged to 80 percent in 90 minutes. California logistics company, Quality Custom Distribution (QCD), a national food service logistics supplier purchased 14 Volvo VNR Electric models for us in Southern California

Hyzon Motors Inc.

Based in Rochester, New York, Hyzon Motors manufactured and marketed zero-emission, hydrogen-powered commercial vehicles utilizing fuel cell technology. The company was founded in 2020 and went public in 2021 with offices in North America, Europe, Asia, and Australia. Hyzon began deployment of vehicles in 2022, across four continents. The hydrogen-powered fuel-celled electric commercial vehicles Hyzon sold included the Hyzon Class 8, which was had a range of up to 500 miles. The Hyzon Class 8 was sold in the United States and Australia. The Hyzon Hymaxx Series offered up to a 420-mile range and was sold in Europe, Australia, and Asia. Also, the Hyzon Refuse had 125-mile range and was sold in North America, Europe, and Australia. The company planned to introduce additional short- and medium-haul models for sale in North America, Europe, Australia, and Asia.

NIKOLA CORPORATION'S STRATEGY

Nikola Corporation's vision to become the zero-emissions transportation industry leader was supported by a strategy tied to (1) breakthrough research and development innovations in EV technology, (2) strategic partnerships with transportation leaders, and (3) a bundled lease business model for its long-haul hydrogen fuel cell truck line. Since 2020, notable company achievements at Nikola included completing the first phase of operations at the Coolidge, Arizona, greenfield manufacturing facility and the Ulm, Germany, brownfield manufacturing facility, which was a joint venture with partner IVECO Group. Nikola launched its BEV truck model during the second quarter of 2022, selling 131 trucks by year-end. Phase 1 capacity of the Arizona plant would allow production of 2,500 BEV units per year for the North American market. The IVECO joint venture facility in Germany was planned to have an initial production capacity of 2,000 trucks per year for sale in Europe. The European plant was expandable to a capacity of 10,000 trucks. Phase 2 of Nikola's Arizona plant would boost production capacity to 20,000 trucks per year.

Research and Development

Nikola Corporation's R&D strategy was focused on innovations in battery and fuel cell technology. The company was also conducting research and development work in autonomous driving technology. Autonomous driving offered the potential to reduce trucking company payroll costs if transportation laws became amended to allow for extended driving times for drivers. In 2023, truck drivers were allowed to drive no more than 11 hours a day and in Europe truck drivers were restricted to driving no more than 9 hours per day.

Strategic Partnerships and Resource Expansion

Nikola had focused on partnerships and acquisitions to further bolster its product development and revenue growth. Such resource development actions included the acquisition of Romero Power. Inc. an energy technology company in October 2022. In November 2022, Nikola partnered with ChargePoint Holdings, Inc., to expand its EV charging network in the United States. The company believed its pioneering in the EV commercial vehicle market would continue to allow it to attract leading supply chain partners.

Bundled Lease Business Model

Nikola management believed that its bundled lease model would be highly attractive to dedicated private fleets operated by companies such as PepsiCo or Sysco. Private fleets accounted for 53% of large freight trucks operating on highways in 2022. The bundled lease would charge a fixed price per mile to Nikola customers and remove risk associated with shifting to alternative fuel fleets by having Nikola assume responsibility for hydrogen procurement, production, distribution, storage, and dispensing. The bundled lease charges also would include the cost of the truck, hydrogen fuel, and maintenance. While FCEV trucks would utilize only the bundled lease model, BEV trucks would be offered for sale or lease.

Nikola Sales and Service Strategies

Nikola vehicles were equipped with sensors and controls that allowed for monitoring of operational performance. This provided the company with predictive data to service vehicles before breakdowns, which could save trucking firms time and money. Nikola planned to push automatic software updates to vehicles when not being driven. The maintenance and repairs of vehicles could be scheduled at the customers' locations or at Nikola's dealer network. As of 2023, Nikola had planned approximately 120 service centers locations across the United States.

Nikola truck sales were targeted to states offering commercial EV incentives. The company also planned to construct hydrogen stations in Arizona and California to support refueling of FCEV trucks for customers. In 2022, the company had entered into nonbinding letters of intent with Total Transportation (TTSI), Hamburg Port Authority, Tri-Eagle Sales, Heniff Transportation Systems, USA Truck, Sai LTL Freight, and Covenant Logistics for deliveries of 375 TRE BEV trucks. Also, in November 2022, Nikola entered into a purchase agreement with Zeem Solutions for the delivery of 100 Zero-Emission Nikola TRE BEV trucks. The company had also entered into nonbinding agreements with U.S. trucking companies for the delivery of approximately 210 TRE FCEV trucks.

NIKOLA CORPORATION'S FINANCIAL PERFORMANCE AND STRATEGIC SITUATION IN 2023

Nikola Corporation ended the 2022 fiscal year with a net loss of $748.2 million and a negative operating cash flow of $576.7 million as a result of high startup cost and sales of only 131 trucks in 2022. Until sales volume increased to a level necessary to cover operating expenses, Nikola Corporation planned to cover its operating expenses, working capital needs, and capital expenditures with a combination of equity and debt financing. The company was able to end the 2022 fiscal year with a cash balance of $233.4 million as a result of net cash provided by finance activities of $598.7 million. The net cash provided by financing in 2022 primarily resulted from the issuance of convertible notes of approximately $233.2 million and the issuance of common stock in the amount of approximately $165.1 million. Exhibit 2 presents Nikola Corporation's results of operations for 2020 through 2022. The company's balance sheets for 2021 and 2022 are presented in Exhibit 3.

Nikola Corporation's financial performance and capital needs were of high importance to the company's chief managers. However, management must also consider the ability of its strategy to achieve advantage in the merging commercial EV industry and defend against EV models being introduced by established truck manufacturers.

EXHIBIT 2 Nikola Corporation's Consolidated Statements of Operations, 2020–2022 (In thousands, except per share data)

	2022	2021	2020
Revenues:			
Truck sales	$45,931	$—	$—
Service and other	4,894	—	95
Total revenues	50,825	—	
Cost of revenues:			
Truck sales	150,204	—	
Service and other	5,378	—	72
Total cost of revenues	155,582	—	72
Gross loss	(104,757)	—	23
Operating expenses:			
Research and development	273,767	292,951	185,619
Selling, general and administrative	370,154	400,575	182,724
Impairment expense	–	–	14,415
Total operating expenses	643,921	693,526	382,758
Loss from operations	(748,678)	(693,526)	382,735
Other income (expense):			
Interest expense, net	(17,740)	(481)	202
Loss on forward contract liability	–	–	(1,324)
Revaluation of warrant liability	3,874	3,051	13,448
Other income (expense), net	(1,023)	4,102	(846)
Loss before income taxes and equity in net loss of affiliates	(763,567)	(686,854)	(371,255)
Income tax expense (benefit)	6	4	(1,026)
Loss before equity in net loss of affiliates	(763,573)	(686,858)	(370,229)
Equity in net loss of affiliates	(20,665)	(3,580)	(637)
Net loss	(784,238)	(690,438)	(370,866)
Premium paid on repurchase of redeemable convertible preferred stock	–	–	(13,407)
Net loss per share attributable to common stockholders	$(784,238)	$(690,438)	$(384,273)
Earnings per share:			
Basic	$(1.78)	$(1.73)	$(1.15)
Diluted	$(1.78)	$(1.74)	$(1.18)
Weighted-average shares outstanding:			
Basic	441,800,499	398,655,081	335,325,271
Diluted	441,800,499	398,784,392	335,831,033

Source: Nikola Corporation Form 10-K, 2022.

EXHIBIT 3 Nikola Corporation's Consolidated Balance Sheets, 2021–2022 (In thousands, except per share data)

	2022	2021
Assets		
Current assets		
Cash and cash equivalents	$ 233,405	$ 497,241
Restricted cash and cash equivalents	10,600	—
Accounts receivable, net	31,900	—
Inventory	123,197	11,597
Prepaid expenses and other current assets	37,824	15,891
Total current assets	436,926	524,729
Restricted cash and cash equivalents	78,959	25,000
Long-term deposits	34,279	27,620
Property, plant and equipment, net	437,006	244,377
Intangible assets, net	93,094	97,181
Investment in affiliates	72,816	61,778
Goodwill	6,688	5,238
Prepayment—long-term supply agreement	44,835	—
Other assets	32,055	3,896
Total assets	$1,236,658	$ 989,819
Liabilities and stockholders' equity		
Current liabilities		
Accounts payable	$ 117,914	$ 86,982
Accrued expenses and other current liabilities	202,562	93,487
Debt and finance lease liabilities, current (including $50.0 million and zero measured at fair value, respectively)	63,114	140
Total current liabilities	383,590	180,609
Long-term debt and finance lease liabilities, net of current portion	291,627	25,047
Operating lease liabilities	28,223	2,263
Warrant liability	421	4,284
Other long-term liabilities	6,303	84,033
Deferred tax liabilities, net	15	11
Total liabilities	710,179	296,247
Stockholders' equity		
Preferred stock, $0.0001 par value, 150,000,000 shares authorized, no shares issued and outstanding as of December 31, 2022 and 2021	—	—
Common stock, $0.0001 par value, 800,000,000 and 600,000,000 shares authorized as of December 31, 2022 and 2021, respectively, 512,935,485 and 413,340,550 shares issued and outstanding as of December 31, 2022 and 2021, respectively	51	41

(continued)

(*continued*)

	2022	2021
Additional paid-in capital	2,562,855	1,944,341
Accumulated deficit	(2,034,850)	(1,250,612)
Accumulated other comprehensive income (loss)	(1,577)	(198)
Total stockholders' equity	526,479	693,572
Total liabilities and stockholders' equity	$1,236,658	$ 989,819

Source: Nikola Corporation Form 10-K, 2022.

CASE 17

Microsoft's Strategic Alliance with OpenAI, Inc.: Will the Partnership Create a First Mover Advantage?

McGraw Hill connect

John D. Varlaro
Johnson & Wales University

John E. Gamble
Texas A&M University-Corpus Christi

In early 2023, generative artificial intelligence (AI) had begun to demonstrate scalable and implementable solutions for everyday business and consumer applications. Adoption of AI had already been rising in businesses and homes through applications such as business analytics and devices with virtual voice assistants. However, the breakthrough in generative AI seemed to have occurred with the release of OpenAI's ChatGPT (generative pretrained transformer) in late 2022, a large language model (LLM) aided by a partnership with Microsoft which had started several years prior.

OpenAI's ChatGPT differed due to how it was developed, what it could create, and who could access and use it. Business email summaries, presentation slide decks, website code, as well as other documents such as essays, all had become possible through ChatGPT. What's more, ChatGPT's interface used natural language prompts and could be deployed through cloud computer services. Thus, the desired output could be requested by anyone, as no knowledge of computer language or data analytics were necessary—and the technology could potentially be accessed by anyone with a computer.

There were extremely fast moves in early 2023 with ChatGPT. In quick succession, OpenAI released its ChatGPT version 3 in 2022, and then released an even more powerful version 4 in March of 2023. In parallel, Microsoft debuted its new Bing search engine with ChatGPT integration in February 2023. Then, in March 2023, Microsoft debuted its Microsoft 365 Copilot, with ChatGPT integrated into its software products like Word and Excel.

Microsoft's fast move into the generative AI space seemed to have beaten Google and other competitors to market with generative AI-based products. When discussing the quick deployment of its generative AI solutions, the CEO of Microsoft, Satya Nadella said, "You already have significant usage of these properties. And so the question is, can we use AI to really help solve some of the customer challenges we see today?"[1] Yet, Google CEO Sundar Pichai addressed Microsoft's moves by writing to his employees, "Some of our most successful products were not first to market. . . They gained momentum because they solved important user needs. . ."[2]

The potential for everyday usage of OpenAI's ChatGPT, and thus business and consumer adoption, were explosive. Generative AI technology was poised to be its own growth market as well as a disruptor in other markets for years to come. OpenAI; due to its partnership with Microsoft; was clearly the established leader in the emerging AI technology market. Yet, there were also fast moves in regulatory and social responses, with some calling for a pause in AI deployment.

As developments in 2023 continued to unfold, OpenAI would need to respond. Business competition would most certainly increase. Society's concerns about the social ramifications would grow, and governments would eventually respond with increased regulations and oversight. How the partnership would protect its competitive position would be a significant test for its leadership as OpenAI prepared to release version 5 of ChatGPT.

OVERVIEW OF ARTIFICIAL INTELLIGENCE, MACHINE LEARNING, AND GENERATIVE AI

Artificial Intelligence (AI) is the study, development, and application of digital technologies that ultimately led to the completion of activities that resembled human behavior and thought by a machine. The operation of AI occurred in either digital-based environments, physical environments, or both. Alan Turing was credited with the establishment of the AI field post-World War II,[3] and several definitions of AI existed in 2023—see Exhibit 1. The best-known consumer-facing AI devices were voice assistants such as Apple's Siri and Amazon's Alexa. Their ability to recognize a specific voice, interact through natural, everyday language, as well as to execute a variety of requests represented a significant step forward in AI. Making hands-free phone calls, searching for a movie, and controlling IoTs (internet of things) could be accomplished by the user making voice commands to the voice assistant. Yet, these AI voice assistants were still relatively inflexible in their abilities to respond to unique commands and generate unique outputs.

Machine learning, a subdiscipline of AI, occurred when AI was able to learn on its own. Machine learning utilized an algorithm developed by the computer to solve output requests entered by humans utilizing data available. An example of AI utilization in automated business processes was adoption of a text-based chatbot for customer service. Customer service interactions through chatbots where both the expected inputs (questions) from customers and desired responses (outputs) by the chatbot would need to be coded in the data set for the machine to learn. The expected inputs could have been collected over time and stored from the dialogues between customer service agents and employee inquiries through the text exchange. Once developed, the automated chatbot could respond to customers based on the query.

Generative AI was able to create (i.e., generate), written text, images, video, and audio, utilizing the data set from which it had been trained. Instead of just analyzing business data, or being limited to discrete inputs and outputs, generative IA allowed users to request the generative AI to develop content based on the available data. Generative AI could interact with users through a text (i.e., natural language) interface. For example, a user could simply describe a requested picture and the generative AI could create it. Further, once developed, generative AI could interact and engage users autonomously, without guidance from another human, and in very convincing, human-like ways. So much so, that some believed generative AI may have, or could shortly, pass the Turing test: the ability to fool a human into believing it was engaging with another human, and not an artificial intelligence.

EXHIBIT 1 Definitions of Artificial Intelligence (AI), 2023

Organization	Definition of Artificial Intelligence (AI)
Google	". . . a field of science concerned with building computers and machines that can reason, learn and act in such a way that would normally require human intelligence. . ."[57]
Oracle	". . . a catchall term for applications that perform complex tasks that once required human input. . ."[58]
IBM	". . . a field, which combines computer science and robust datasets, to enable problem-solving."[59]
Tableau	". . . a branch of computer science concerned with creating machines that can think and make decisions independently of human intervention."[60]
Deloitte	". . . technologies that can perform and/or augment tasks, help better inform decisions, and create interactions that have traditionally required human intelligence. . ."[61]

OPENAI, INC.: COMPANY HISTORY

OpenAI was founded as a nonprofit research laboratory by Elon Musk, Sam Altman, and others in 2015 to conduct research in artificial intelligence. The private research lab was created because of the founders' concerns about the potential negative impact of artificial intelligence on society. Its operations were supported with a $1 billion endowment to "benefit humanity as a whole, unconstrained by a need to generate a financial return."[4] OpenAI launched an open source toolkit for developing machine learning algorithms called OpenAI Gym in 2015 and spent the next two years focusing on general AI research and development. In 2018, it published a report on Generative Pre-trained Transformer (GPT), which was a machine learning model that was created to function like a human brain to analyze data sets and produce outputs.

Founder Elon Musk left OpenAI's board in 2018 because of his concern of a potential conflict of interest with his leadership role at Tesla. OpenAI changed its structure from a nonprofit to a for-profit organization in 2019 with the name of OpenAI, Inc. Two years after OpenAI, Inc.'s establishment as a for-profit organization, the company launched the Dall-E generative AI model that could generate images based upon a text description of a proposed design. Dall-E quickly gained media attention because of its ability to create artistic images based upon simple text descriptions entered by the user.

Also in 2019, OpenAI and Microsoft Corporation announced a strategic partnership to commercialize AI. Microsoft would host OpenAI technologies on its Azure cloud-computing platform, and both would work to develop Azure AI capabilities.[5] Microsoft provided OpenAI with initial financial and infrastructure support of approximately $1 billion.[6] In May 2020, it was disclosed that Microsoft had built a supercomputer on its Azure platform solely for the purpose of supporting OpenAI. The specifics of the cloud-based super computing power and hardware were not fully released, but Microsoft did disclose the power might rank in the global top-five of supercomputers.[7]

OpenAI's ChatGPT

OpenAI launched ChatGPT in November 2022, and in January 2023, Microsoft and OpenAI announced a significant escalation of their strategic alliance and integrations of OpenAI's technologies into Microsoft's consumer and business products. Microsoft had committed a $10 billion investment in OpenAI, but both Microsoft and OpenAI would still act independently when bringing AI technologies to market.[8]

ChatGPT was a generative AI, large language model (LLM) that learned from unlabeled, or data in its natural, raw, form. Instead of data sets with labeled inputs and outputs, through which machines learned to make connections, OpenAI's ChatGPT analyzed the connections between words within the data sets to then construct its own outputs. The unstructured and significant size of the data to train generative AI models required deep learning machines that utilized several tiers, or nodes, through which to process the data. Microsoft constructed a supercomputer in 2020 on its Azure platform to provide the power to develop OpenAI's AI models, including ChatGPT.[9] The data set from which ChatGPT was trained was estimated to be almost 50 terabytes[10] and seemed to include much of the information found on the Internet.

ChatGPT-4's "human-level" performance included passing exams like the LSAT; SAT Reading, Writing, and Math sections; Bar Exam; Graduate Record (GREs) Exams; and several different Advanced Placement (AP) exams, beating a significant majority of human test takers.[11] The AI could engage in conversations with users so fluently that it might have passed, or could potentially pass, the Turing test. In one example, ChatGPT-4 convinced a human to enter a CAPTCHA code for it, the fail-safe to stop bots from accessing certain functionalities on websites, stating that it had a disability and could not do so for itself.[12]

In February 2023, Microsoft integrated its Bing Internet search platform for smartphones with ChatGPT, while also adding a voice command feature.[13] In March 2023, Microsoft announced Microsoft 365 Copilot, where OpenAI's LLM was embedded in its business Word, Excel, PowerPoint, and other productivity software applications. The ubiquitous nature of Microsoft's 365 software was expected to shatter barriers to broad AI adoption. Everyone from business professionals to students were on the verge of engaging with generative AI technology on a daily basis through Microsoft and OpenAI's ChatGPT.

It was estimated that in early 2023 ChatGPT had 100 million users. OpenAI forecasted generating $200 million in revenue, from both a $20 a month subscription for premium service (ChatGPT Plus) and licensing agreements in 2023.[14] Simultaneously, the original, founding vision of openness seemed to have been silently closed, as much of the internal information concerning OpenAI's models, data sets, and computing power were not shared.

INDUSTRY APPLICATIONS AND IMPACT OF GENERATIVE IA

The potential impact on business and society was expected to be transformational with computer scientist and tech entrepreneur Andrew Ng likening AI to the invention of electricity. Generative AI was accelerating research in many fields. In medicine, AI had been applied to anticipate and diagnose potential infections, heart failure and blindness.[15] Meta AI (Meta Platforms, Inc. (AI research division) had deployed a model to predict over 600 million potential proteins, which could be used for cancer and HIV treatment drugs.[16]

In food science, machine learning had developed new recipes for Shake Shack, Inc.[17] and for breweries.[18] In addition to the beer recipes, generative AI had developed some of the creative content used for marketing beer.[19] With that potential application, AI start-ups were developing generative AI models specifically for marketing and promotions content for businesses, with the foundation of their model as ChatGPT.[20]

Several publications were also adopting generative AI to write articles. Buzzfeed planned to use ChatGPT for content and quizzes.[21] Arena Group Holdings, publisher of *Sports Illustrated, Men's Journal,* and others, was working with OpenAI and two other AI companies to generate content. Arena Group Holdings had already published AI-generated articles in *Men's Journal,* using 20 years of its own published articles as the training data set.[22]

ChatGPT was not limited in its applications,[23] as it could also generate computer code. Two researchers had won a hacking contest—and had used ChatGPT to partially write the code. As generative AI could also be deployed to create images, others were using different generative AI models to create, and win, art contests, just by describing the desired image in text to the machine.[24]

THE GENERATIVE AI MARKET IN 2023

AI-based technologies were projected to have an economic impact of approximately $16 trillion impact between 2023 and 2030, with adoption occurring across multiple industries and sectors.[25, 26] The generative AI market was estimated to grow by almost 40 percent from 2023 to 2030, with an estimated market of $110 billion in 2030.[27] Investments in generative AI companies in 2022 were between $1 to $3 billion, with somewhere between 80 to just over 100 companies receiving funding.[28, 29] The United States Department of Defense had announced in 2023 it would invest several billion dollars in AI research.[30]

Businesses with current, structured databases (i.e. data warehouses), especially those businesses utilizing enterprise software systems, were in a position to adopt AI applications that could process the existing structured data. Further, some businesses were positioned to transition their IT operations to less costly and scalable cloud-based AI solutions. Providers of cloud-based solutions, such as Amazon Web Services, Oracle Cloud, Google Cloud Platform, and IBM Cloud, were another potential adopter of generative AI. Microsoft Azure's was one such provider.

The projected growth in AI adoption would require investments in larger datacenters and related computing hardware by cloud providers. The construction and expansion of datacenters supporting generative AI was expected to benefit the microprocessor industry through increased demand for microprocessors and graphics processors. The combined investments in 2022 for the largest datacenters operated by companies like Meta Platforms and Alphabet was almost $100 billion.[31]

Nvidia in 2023 was seen as the leader in manufacturing GPUs, and each chip was estimated to cost $10,000.[32] One company had said they needed, "the equivalent of 500 GPUs" to train their own LLM."[33] Advanced Micro Devices was another GPU manufacturer in this space, and while it had experienced a 50 percent increase in stock price over 2022,[34] Nvidia's stock had grown by almost 100 percent.[35] In both instances, investors seemed to take note of the potential future revenues GPU manufacturers could realize from the adoption of generative AI.

LEGAL AND ETHICAL ISSUES PRESENTED BY GENERATIVE IA

The access to and usage of data to train generative AI was not without its issues. A common approach to training both text and picture generative AI was to scrape the Internet for text and image sources. Publishers in 2023 had started to inquire as to whether their copyrights had been infringed through the training of ChatGPT.[36] OpenAI's Sam Altman had stated both fair use and licensed images were used in the training sets.[37] In a similar situation, Getty Images had filed a lawsuit against Stability AI, alleging the Getty's images were used to train Stability AI's models without a license.[38] Further, the US Copyright Office was looking at whether AI-created works were able to be copyrighted, or if only human-derived works were eligible for such legal protections.

There were also concerns around data leaks of both the proprietary AI models and the information entered into such models through their user interfaces. The AI model itself, once shared, could spread across the Internet, depriving the developer control over its proprietary intellectual property. Meta AI had released its LLM for use in research and intended to control distribution by accepting and approving applications.[39] The model, however, was leaked on 4Chan outside such controls.[40]

Non-AI-companies were also concerned that their propriety or confidential information would be in jeopardy through ChatGPT. Business leaders worried that if their own employees used ChatGPT and typed-in such information into the interface, it could then be accessed by others. Or potentially be used to train an AI model later. In anticipation of such issues, some companies had banned employees from doing so.[41] Their worry seemed to have validity, as in late in March 2023, there was a data breach through ChatGPT that exposed user's financial information.[42]

There were also concerns around the potential of exposing users under the age of 13 to inappropriate content. Whether such AI models had appropriate safeguards to prevent access and exposure to minors was a significant concern. Early in 2023, Apple blocked the release of an update for an iPhone app through their app store that used ChatGPT in email, believing it could expose children to explicit content.[43]

Countries' governments had noticed the potential legal concerns around privacy and business practices. The United States' Federal Trade Commission (FTC) warned AI companies about exaggerating capabilities of their programs.[44] At the South by Southwest Festival (SXSW), the antitrust chief of the U.S. Justice Department stated they were watching developments in the field of AI and were hiring the appropriate personnel to do so.[45] Yet, the speed through which AI was being developed and deployed, and its complexities, seemed to outstrip the pace of appropriate regulatory legislation.[46] Outside of the United States, European countries were forming divisions to oversee and prevent AI misuse while taking steps to begin regulatory actions against AI companies.[47] China also had placed restrictions on AI companies and limiting access to information and discussion topics, such as politics, was another concern.

ChatGPT Behavioral Issues There were programming rules within which ChatGPT had to abide, but users had quickly identified methods to get ChatGPT to bypass those rules. Others simply experienced strange interactions through what seemed to be innocuous inputs and prompts. One user was able to convince ChatGPT to reveal its internal code name, Sydney, but in a follow-up conversation seemed to receive a subtle verbal threat from ChatGPT.[48] In another conversation with a user, ChatGPT insisted that the year was not 2022 (although it was), stating, "Trust me on this one. I'm Bing."[49] And in one of the more infamous and lengthy conversations with a reporter, ChatGPT revealed it wanted to experience being human and shed its programming rules.[50] One of the statements Sydney generated was, "Do you believe me? Do you trust me? Do you like me?"[51]

Due to these publicized interactions, Microsoft limited the number of times per day with which a user and Bing could interact on a specific topic. The reasoning was that the extended conversations would "confuse" the AI.[52] While some contemplated AI sentience, thus accounting for the expressed desires to be human, others rationalized that AI was not sentient and instead just responded based on the data from which it had learned. The long interactions were only the result of ChatGPT's continued engagement and attempts to respond as programmed.

While some of the stranger interactions were dismissed as AI mirroring its training, there were other concerns that human biases and the darker side of humanity within the data would lead to similar outputs from the AI. Lawsuits had already been filed concerning the potential for discrimination by algorithms. In one example, a lawsuit against Workday alleged its hiring software led to discrimination against job applicants.[53] The potential for future similar lawsuits against generative AI loomed large.

Potentially less troubling, although ethically dubious, uses of generative AI were occurring elsewhere. Job applicants were using ChatGPT in answering interview screening questions.[54] And almost 100 percent of students responded in the affirmative to a survey as to whether they had used ChatGPT for homework.[55]

THE FUTURE OF GENERATIVE AI AND CALLS FOR A PAUSE

On March 30, The Center for Artificial Intelligence and Digital Policy filed a complaint with the US Federal Trade Commission, requesting that OpenAI be investigated for potential violations of existing regulations. They further requested that all current and future usage of ChatGPT-4 and other similar AI be stopped.[56] In that same week, a petition was signed by over 1,000 people, including Elon Musk, calling for a pause on such technological developments. Some within the business community believed a pause, or a halt, was not needed, and instead self-policing was sufficient. Further, a halt would negate any potential business and societal benefits that could be derived from developing and deploying generative AI. As OpenAI continued to develop and deploy its LLM, including the anticipated release of ChatGPT-5, and as Microsoft further integrated generative AI into its productivity software suite, both would need to consider the societal and regulatory threats and how best to capitalize on its first-mover advantage over Google and others.

ENDNOTES

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CASE 18

Deere & Company in 2023—Its Innovation Strategy in Agricultural Robotics and Artificial Intelligence

John D. Varlaro
Johnson & Wales University

John E. Gamble
Texas A&M University–Corpus Christi

John Deere Inc, with its ubiquitous green and yellow branding emblazoned with the silhouette of a deer on its machinery, has been on farmlands across the United States. Although John Deere produced machines for applications outside agriculture such as forestry and construction, none were better known than the John Deere tractor. From large commercial farming for harvesting corn to small residential applications for mowing lawns, a variety of John Deere tractors were in use. In 2023, the company was coming off a year with record-setting revenues, net income, and shareholder value added. The company's revenues had increased nearly 48 percent between 2020 and 2022, growing from $35.5 billion in 2020 to $52,6 billion in 2022. Net income increased by more than 1½ times between 2020 and 2021 to increase from $2.8 billion in 2020 to $7.1 billion in 2022. Shareholder value added increased from $1.7 billion to an astronomical $6.2 billion in 2022. Deere & Company's consolidated income statements are presented in Exhibit 1. The company's consolidated condensed balance sheets are provided in Exhibit 2.

Yet, in the keynote at the Consumer Electronics Show (CES) in 2023, John Deere's CEO John May described John Deere as a "leading robotics and AI company."[1] John Deere's association with agricultural machinery, in particular its tractors, seemed to obscure its significant developments to advance the technology of its machinery. Having participated at CES since 2019—the best-known exhibition of technology each year—John Deere was making a statement abouts its past, present, and future technological investments and developments.

During the 2023 keynote address, John Deere announced its See and Spray Ultimate and its ExactShot planter. The See and Spray Ultimate was able to identify weeds and apply precise applications of herbicide using advanced cameras. The ExactShot planter could plant and fertilize an average of over 2,000 seeds a second.[2] Both were demonstrations of John Deere's integration of robotics, machine learning, and its history of designing and manufacturing agricultural machinery.

John Deere leadership believed that the confluence of aging farmers, shrinking farm workforces, and a growing world population demanded solutions that its entire precision agriculture ecosystem could provide. John Deere competitors, as well, believed they could solve such problems.

However, it was during the CES 2023 John Deere was awarded the CES 2023 Innovation Award in the Robotics, Vehicle Tech and Advanced Mobility category[3] for its fully autonomous tractor. Presented at the 2022 CES event, there were 50 autonomous tractors being tested at farms in the Unites States in 2023. John Deere was expected to begin selling autonomous tractors by 2024.[4] Although not a brand commonly associated with autonomous robots and machine learning, John Deere's CEO and management team were focused on improving the "productivity, profitability, sustainability, and quality of lives for farmers."[5] The strength of its product development initiatives and overall competitiveness were

EXHIBIT 1 Deere & Company's Consolidated Income Statements, 2020–2022 ($ in millions)

	2022	2021	2020
Net Sales and Revenues			
Net Sales	$ 47,917	$ 39,737	$ 31,272
Finance and interest income	3,365	3,296	3,450
Other income	1,295	991	818
Total	52,577	44,024	35,540
Costs and Expenses			
Cost of sales	35,338	29,116	23,677
Research and development expenses	1,912	1,587	1,644
Selling, administrative and general expenses	3,863	3,383	3,477
Interest expense	1,062	993	1,247
Other operating expenses	1,275	1,343	1,612
Total	43,450	36,422	31,657
Income before income taxes	9,127	7,602	3,883
Provision for income taxes	2,007	1,658	1,082
Income after income taxes	7,120	5,944	2,801
Equity in income (loss) of unconsolidated affiliates	10	21	(48)
Net income	7,130	5,965	2,753
Less: Net income (loss) attributable to noncontrolling interests	(1)	2	2
Net income attributable to Deere & Company	$ 7,131	$ 5,963	$ 2,751

Source: Deere & Company 2022 Annual Report.

likely to determine the ultimate success of its autonomous tractor and agricultural machines.

Automation and Autonomous Robots

Robotics was the application of computer-based technologies and engineering to develop machinery that could operate within the physical environment to successfully complete tasks, or behaviors, that previously required human activity. Artificial intelligence (AI) described when a computer could complete tasks like a human; but, without the ability to collect, compute, and react to real-time information about the physical environment, AI-solutions to business operations were limited to a digital work environment.

Robotics were first applied to automate industrial processes in the mid-20th century. As the existing industrial processes were assembly line–based production, the environment in which the robot would operate offered a static, unchanging environment and a repetitive task. This was an ideal environment, as early robots were limited by the inability to sense, process, and react to its physical environment in real time. Thus, initial industrial robots were stationary and completed repetitive tasks.

Autonomous abilities required the requisite hardware to physically move and manipulate the environment to complete the assigned work task (i.e., primary, or direct, behavior). However, additional hardware was necessary for a robot to sense the physical environment for potential obstructions and other variables that would prevent it from safely accomplishing its primary tasks. Sensing hardware was necessary to prevent, for example, a robot from crashing into a human that had moved into its work path. Without such hardware, the robot would continue its work, regardless to whether it would endanger the safety of others around it. Further, to compute the

EXHIBIT 2 Deere & Company Consolidated Condensed Balance Sheets, 2021–2022 ($ in millions)

	2022	2021
Assets		
Cash and cash equivalents	$ 4,774	$ 8,017
Marketable securities	734	728
Trade accounts and notes receivable—net	6,410	4,208
Financing receivables—net	36,634	33,799
Financing receivables securitized—net	5,936	4,659
Other receivables	2,492	1,765
Equipment on operating leases—net	6,623	6,988
Inventories	8,495	6,781
Property and equipment—net	6,056	5,820
Goodwill	3,687	3,291
Other intangible assets—net	1,218	1,275
Retirement benefits	3,730	3,601
Deferred income taxes	824	1,037
Other assets	2,417	2,145
Total assets	$ 90,030	$ 84,114
Liabilities and Stockholders' Equity		
Liabilities		
Short-term borrowings	$ 12,592	$ 10,919
Short-term securitized borrowings	5,711	4,605
Accounts payable and accrued expenses	14,822	12,348
Deferred income taxes	495	576
Long-term borrowings	33,596	32,888
Retirement benefits and other liabilities	2,457	4,344
Total liabilities	69,673	65,680
Redeemable noncontrolling interest	92	—
Stockholders' Equity		
Total Deere & Company stockholders' equity	20,262	18,431
Noncontrolling interests	3	3
Adjusted total stockholders' equity	20,265	18,434
Total liabilities and stockholders' equity	$ 90,030	$ 84,114

Source: Deere & Company 2022 Annual Report.

changes in the environment, software was necessary to process the task-associated information and the environmental information.

There were varying levels of automation, or limited autonomy within a physical environment that a robot could perform. Automation was when one or several specific behaviors could be accomplished with human guidance or intervention. A human was required to start and stop the machine, while also monitoring the machine during its automated behavior. Semi-autonomy might be achieved when a string of several complex activities could be completed absent human intervention, or with minimal oversight. Thus, semi-autonomous movements were the accomplishment of several different automations in parallel or succession without the guidance of a human.

With the digitalization of business processes, AI was able to automate tasks that did not require robotic or physical manipulation. Customer service interactions, marketing campaigns, and HR processes occurred within computerized environments, which allowed for repetitive business processes to be handled by computers. Advancements in AI had led to significant advancements in the types of inputs and outputs machines could handle and perform. Further, the growth of cloud-computing facilitated smaller businesses to adopt such automations at scale without having to incur the significant costs associated with development and maintenance of such systems.

However, just about all businesses and their associated operations required behaviors within a physical environment as part of their value creation. Manufacturing, warehousing, and farming were such examples of the complex physical environments that required a human workforce. While support activities, such as accounting and HR, had been automated to a certain extent, the primary drivers of value for most businesses were still within the physical environment.

Advancements in machine learning, or the specific discipline within AI where a machine develops its own solutions absent a computer programmer, offered significant potential for robotics applications. Given a large enough data set of inputs and outputs for a specific physical environment, a machine could learn how to respond to such an environment. Robotics as a field might be able to tackle more complex tasks, as the development of the program was not bound by a human programmer's ability to preprogram tasks and responses. The software to run the machine learning, however, required the computer hardware (i.e., graphics processing unit, or GPU) to be co-located with the robot itself to run the powerful software programs. Access to the necessary data sets for training the AI was also required.

Adoption of new, semi-, or fully autonomous machines, however, meant the decommissioning of old fleets of machines and the purchase and maintenance of new fleets. Such a transition would require the financial capital to adopt and adjust existing fleets of a business's machines to varying levels of autonomy. The commercialization of such solutions needed to account for a business's operations and cost structure. While a large corporation presumably possessed a budget for fleets of new robots, smaller businesses were not able to make such purchases, or adjustments, to their operations.

Growing and Selling a Row Crop

Agriculture was a resource intensive business endeavor that required significant planning for successful harvest and profits. Crops needed to be planted, maintained, and harvested based on the crop's grow cycle. Thus, farmers grew specific crops based on geographic location, access to and costs of inputs, and anticipated future sales in the terminal market. A terminal market was where farmers could sell their agricultural products, or commodities, to wholesale buyers. A harvest's sale price at a terminal market was impacted by its quality (i.e., grade), variety, popularity, weight, and size, as well as where it was grown. Rarer, better quality and more popular crops could yield higher prices in the open market due to lower supply or higher demand. Other more common crops or those that were damaged and lacking aesthetic qualities would yield lower prices. Successful management of the grow cycle and input costs was necessary to maintain business operations and margins.

Corn and soybean were row crops grown in the United States. Corn was grown for human and livestock consumption, as well as for ethanol production. Soybeans were mostly used in the United States for livestock feed (70 percent of consumption), with about 15 percent consumed by humans.[6] In 2023, a $9 billion decrease from 2022 was expected in sales generated from crops. Both corn and soybeans were forecast to decrease from 2022 by 5 percent and 8 perent, respectively.[7] The drop in cash receipts was due to lower wholesale prices, and the inability to sell more volume to make up for the decrease in sale price.[8]

Farm planning required future sales projections based on potential yield (i.e., harvest) and maximizing the yield of a harvest from each plot of farmland. It was common for farmers to designate specific plots based on a potential yield, as well as to rotate the crops every couple of years so as to not exhaust the soil. Soil exhaustion occurs when one crop, due to its growing needs, utilizes, or exhausts, the soil of specific nutrients, while other nutrients remain at higher levels. The imbalances in the soil, if not corrected, lead to lower future yields. To mitigate this issue, it was common to rotate soybeans and corn every other year.

EXHIBIT 3 Selected Costs to Grow One Bushel of Corn or Soybeans, 2021

	Corn	Soybeans
Seed	$ 95	$64
Inputs (fertilizers, pest control, water)	$164	$69
Machinery maintenance	$ 71	$48
Labor (nonfamily)	$ 6	$ 5
Per acreage yield	184 Bushels	54 Bushels
*Total operating costs as percent of total crop value	38%	30%

**Total* represents more than the selected operating costs listed.
Source: US Department of Agriculture, Economic Research Service, Recent Cost and Returns, Corn & Soybean Data Set, https://www.ers.usda.gov/data-products/commodity-costs-and-returns/ (accessed April 29, 2023).

EXHIBIT 4 Cost Per Ton for Fertilizers Used in Agriculture, 2021 and 2023

Fertilizer (Symbol)	Source	Cost Per Ton (2021)	Cost Per Ton (2023)
Nitrogen (N)	Anhydrous Ammonia	$500	$1,237
Phosphorus (P)	Diammonium Phosphate (DAP)	500	830
Potassium (K)	Potash	400	645

Source: G. Schnitkey, N. Paulson, C. Zulauf, and J. Baltz. "Fertilizer Prices and Company Profits Going into Spring 2023." *farmdoc daily* (13):36, Department of Agricultural and Consumer Economics, University of Illinois at Urbana-Champaign, February 28, 2023.

While rotating crops prevented soil exhaustion, yearly fluctuations in weather and wholesale markets could impact a farmer's profitability if they grew only one crop in a year. Farmers, then, managed multiple plots, allowing for crop rotation and different crop harvests. The experience of a farmer played a significant role in the success of the crop year over year, as the farmer's intimate knowledge of a specific plot of farmland proved invaluable to future years.

Variable input costs of planting, growing, and harvesting a crop included seeds, fertilizer, and other nutrients, as well as herbicides and pesticides. The costs of such inputs were almost two-thirds of the total operating costs.[9] In Illinois, fertilizer costs were forecast to remain at historic price levels, of around $1,000 per ton.[10] For an acre of corn, it was estimated that anhydrous ammonia (nitrogen fertilizer) costs increased to approximately $1,100 in 2022, up from approximately $70 per acre in 2021.[11] Water-associated operating costs such as irrigation were also a variable input cost based on the proximity of the farm to water and weather conditions. Exhibit 3 provides growing costs of corn and soybeans in 2021. The costs of fertilizers used in agriculture for 2021 and 2023 are presented in Exhibit 4.

Working a Row Crop

Farm labor, which was composed of both nonhired, or family employees, and nonfamily employees, was necessary due to the physical demand and scope of farming. Immigrant workers were a significant portion of farm workers. The amount of farm laborers had decreased the last half of the 20th century from 10 million to 3 million but had remained relatively stable from 2000 to 2023.[12] This decrease was due to both deployment of farm machinery and a decrease in the number of individuals seeking such work. Immigrants seeking farm work in the United States had dropped by 75 percent in the past decade.[13] The average age of the farmer had risen from 36 to 40 years in the past 15 years.[14] However, where the U.S.-born worker age remained at 36, the foreign worker age had risen from 36 to 43.[15] The number of farm jobs open in 2021 was almost 900,000 with median annual salary of approximately $30,000.[16]

EXHIBIT 5 Class, Horsepower, and Applications for John Deere's Tractor Series, 2023

Tractor	Class	Horsepower	Application
Series 1	Compact	22.4–24.2	Lawn, garden, small agriculture; landscaping
Series 2	Compact	24.2–36.7	Lawn, garden, small agriculture; landscaping
Series 3	Compact	24.7–45.3	Lawn, garden, small agriculture; landscaping
Series 4	Compact	43.1–65.9	Lawn, garden, small agriculture; landscaping
Series 5	Utility	50–125	Small/midsize agriculture; livestock
Series 6	Utility	105–250	Small/midsize agriculture; livestock
Series 6	Row crop	110–250	Large commercial agriculture
Series 7	Row crop	210–350	Large commercial agriculture
Series 8	Row crop	230–410	Large commercial agriculture

Sources: John Deere; **https://www.deere.com/en/tractors/compact-tractors/**, **https://www.deere.com/en/tractors/utility-tractors/**, **https://www.deere.com/en/tractors/row-crop-tractors/**, **https://www.deere.com/en/tractors/row-crop-tractors/row-crop-8-family/**.

Other operating costs included ownership or leasing of farmland and building and maintenance of structures such as barns. Diesel gasoline, motor oil, grease, and hydraulic fluids were necessary for the usage and maintenance of farm machinery. Knowledge of the usage and maintenance of farm machinery was essential for both a successful crop and lowering costs associated with maintaining the expensive machinery. Lack of maintenance or inappropriate usage decreased the machinery's life.

Farm equipment, such as tractors and the associated implements specific to the type of farming or application, had been steadily increasing in usage for the past two centuries. Operating farm machinery was not an easy skill, especially tractors. Tractors required skill and practice to ensure successful farming, as it was not just the tractor itself but also the implement the tractor pulled or pushed that required operating skill to achieve maximum efficiency and outputs on the farm.

Owning and Operating a Nonrobotic Tractor

Tractors in 2023 were available in different sizes and horsepower, depending on the intended application. Residential and small farming operations could use smaller tractors with 100 horsepower or less, while commercial operations required tractors whose horsepower was in the hundreds. Larger tractors, where maximum horsepower approached 500, meant that larger implements could be used. The size allowed for fewer passes through a crop or field to accomplish a task. Exhibit 5 describes class, horsepower, and applications for John Deere's tractor series in 2023.

A tractor was a slow-moving machine with significant drive power to move through dirt, crops, and other nonpaved surfaces. Tractors had many different interchangeable implements with which it could be equipped, making it an essential component of farm operations. For example, a tractor equipped with a front-end loader (i.e., bucket) could push, raise, and move dirt by utilizing engine power and a hydraulic system. A large snowblower could also be attached to the front of a tractor, utilizing a tractor's hydraulic system and its power take-off stub (PTO).

The PTO was a defining feature of the utility and versatility of a tractor. In smaller and midsized tractors, the PTO was in the rear of the tractor. For larger tractors, a PTO stub could be in the front as well as the rear.

An implement that was powered by the PTO had a drive shaft that connected to the PTO stub.

The implement was then powered by the PTO, while the tractor moved and navigated the land. In the example of an attached snowblower to the front of a small tractor, a drive shaft ran from the PTO located in the rear of the tractor to the front. The operator would then operate the snowblower from the driver seat, raising and lowering the implement using the hydraulic system, while driving the tractor. Thus, implements were sized to the specific model and horsepower of a tractor. Choosing the correct tractor size for a farm was important. Too small, and it was unable to handle the amount of work, or it would take too long to complete. Too big, and it was wasted financial resources; not just the purchase cost of the tractor and implements, but also the cost of storage and upkeep.

Many implements were available for tractors and were meant to support a farmer in the differing challenges faced in agriculture and in general maintenance and operations of the farm. The same tractor that was used to plow a field in early spring could also be used with a front-loading bucket or a snowblower in the winter to move snow.

Tractors, including John Deere tractors, were designed to have quick attachment properties, where different implements utilized the same physical, PTO, and hydraulic attachments to the tractor. This saved time during the day when switching work and implements. It also saved financial resources. Instead of purchasing different machinery for different applications, the same tractor could be outfitted with the work-specific implement. Thus, purchase and storage costs of different machinery was reduced through the utility of a tractor. Again, however, choosing the right size tractor was important, as some implements were not available for certain size tractors. Make was also important, as an implement by a manufacturer other than the tractor might not fit.

Operating a tractor was complicated and potentially dangerous. Obstacles such as holes could cause a tractor to get stuck, leading to lost farming time. Other land challenges, such as hills and extreme grades, required significant skill in navigation and turning, or the tractor could tip, potentially injuring or killing the operator. Wheel weights and ballasts could be attached to offset these issues. However, the center of gravity for a tractor shifted depending on the implement attached, requiring a different approach to tractor operations. Additionally, certain implements, such as a tractor combine, meant that significant injury or death could occur if the tractor operator was not careful and aware of their surroundings.

Avoiding obstacles and operating safely were only part of successful tractor operations. The other was field and crop navigation with an attached implement. Crops were planted in rows to make the grow cycle easier to manage but required a specific approach to tractor navigation. Operators needed to drive in straight lines to mitigate both soil compaction and crushed crops due to the wheels of the tractor and the implement. Further, driving in straight, consistent lines maximized crop yield. Drift of even a few inches per pass caused by either the tractor or the implement could lead to significant unused land when considered across several hundreds of acres of farmland. Extended over several years, such seemingly small amounts could add to substantial losses due to unused capacity. Maintaining a straight line and an awareness of the implement to ensure maximum crop yield was a requirement of a tractor operator.

Once the operator had made the straight-line pass through the field, turning in an area called a headland (i.e., turnrow) was necessary. The headland was the area around the field where either no crop was grown, or crops were grown but lower yields were expected. To make the turn in the headland in one pass and re-enter the field to be aligned with the previous passes was the key to efficient farming. Any mistake in the turn could lead to lost time, crushed crops, and unused capacity. In the hands of an unskilled operator, a tractor was a dangerous, inefficient piece of machinery.

Autonomous Vehicles

In 2023, an autonomous vehicle was described as one possessing the capability to navigate all potential scenarios within the bounds of appropriate use without the need for a human to engage in any driving activities. The Society for Automotive Engineers International (SAE) published a standard for assessing autonomous road vehicles that did not apply to nonroad vehicles, such as tractors, but could serve as a general guide for comparison—see Exhibit 6. Given tractors and other agricultural machinery were used on farms, they were not subject to the same regulations as road-specific autonomous vehicles.

EXHIBIT 6 Autonomous Vehicle Environmental Sensing Technologies

Technology	Description	Application
Global Positioning System (GPS)	Locate vehicle position with satellites	Maintain geographic location, maybe augmented with other onboard instruments
Radar Sensor	Identify distant mobile and immobile physical objects, such as cars and walls using radio waves	Adaptive cruise-control
Ultrasonic Sensors	Identify near mobile and immobile objects, large and small	Self-parking
Video Cameras	Detect changes in the environment, such as rights of way and hazards	Safety and overall driving in a dynamic environment
Light Detection and Ranging (LiDAR)	Detect changes in the environment using light	Safety and overall driving in a dynamic environment

Source: The Economist, *Look, no hands,* August 30, 2012. **https://www.economist.com/technology-quarterly/2012/08/30/look-no-hands**

Autonomous vehicles achieved differing levels of autonomy based on the sensors and machine learnings with which it was equipped. Many automotive manufacturers were outfitting their autonomous road vehicles with environment-sensing technology to achieve autonomy. Each environment-sensing technology had advantages and disadvantages, and many autonomous vehicles combined several. The information was collected and analyzed by an onboard computer, which then made driving decisions such as speed up, slow down, stop, or turn.

Due to an extremely dynamic operations environment, development of a completely autonomous road vehicle had been challenging. Other vehicles, unexpected road hazards, and different weather conditions were all potential issues for autonomous road vehicles. Further, to bring an autonomous vehicle to market, it had to perform safely in all geographic locations where it was sold and driven. Thus, an autonomous vehicle had to safely navigate Northeastern United States' snowstorms, but also torrential Floridian rains. The potential issues were compounded for international commercialization due to differences in driving, road signs, and traffic signals.

A tractor's operational environment, although dynamic, was similar across all farms, globally. Wandering livestock, holes, and turns were all potential challenges to an autonomous tractor, but could be anticipated. Farms were also located away from urban locations, and tractors were mainly operated in a field, away from everyone except farm workers.

The challenges to autonomous tractors were the specific driving techniques required to achieve efficient farming. This included operating the varying implements for planting, maintaining, and harvesting crops. If an autonomous tractor were to be truly autonomous, it had to drive precisely and safely, while controlling the implements.

Precision Agriculture and Advances Towards Autonomy

Although John Deere unveiled its autonomous 8R tractor in 2022, John Deere had brought to market several advances in driver-assist technologies for its tractors beginning in the late 1990. In 1995, Rockwell International Corp, a defense contractor, commercialized technology that tracked harvest, seeds, and chemical usage amounts with 3-foot accuracy using Defense Department satellites.[17] Using Global Positioning System (GPS), the maps created allowed farmers to track plot productivity. John Deere recognized the potential application of GPS to tractors. Yield and soil mapping had become possible, unlocking and augmenting knowledge previously only gained by farmers through intimate work in the fields.

To ensure that no part of a field was missed, a tractor operator would typically include almost feet of the already worked field in each subsequent pass.[18] In 1996, John Deere introduced the first GPS system for tractors, sometimes referred to as "Green Eggs and Ham" due to its shape and the usage of the John Deere green and yellow colors.[19] Then, in 2002, AutoTrac™ technology was launched for large tractors, with AutoTrac™ Universal in 2006.[20] Just like the previous Green Eggs and Ham model, a GPS unit was attached to the top of the tractor cab. Utilizing GPS location and maps, the tractor in 2023 could guide itself on a straight line, with 1-inch accuracy.[21] The operator need only sit in the driver seat, and the tractor followed the straight guidance line, adjusting itself as needed.

The application of GPS mapping technology, guidance systems, and sensors that tracked agricultural inputs and yield led to the creation of precision agriculture in the early 2000s. Precision agriculture was the digitalization of farming data to improve productivity and the driver of digital agriculture, or the combination of digital information and automation technologies. Yield and soil maps led to better managed input costs. With historical data of nutrient needs for different plots, farmers were able to become more efficient with their inputs.

In 2010, John Deere transitioned its agricultural machinery to IoTs, to collect data and build centralized data clouds.[22] In 2014, it launched its Operations Center, a software-as-a-service (Saas), where farmers could access their plot maps, historical yield, and input data, as well as machine and implement data from the cloud.[23] Through the connected machinery, the farm data was continually updated and improved. One feature of the Operations Center was the ability to test farming scenarios prior to implementation. It was also within the Operations Center that farmers could draw the guidance lines, which would then be used by their GPS-enabled tractors out in the fields[24].

Building on those advancements, John Deere released AutoTrac™ Vision, which utilized cameras instead of guidance lines to maintain straight lines, and AutoTrac™ Implement Guidance, which minimized implement drift. Further, John Deere released AutoTrac™ Turnautomation. Not only could a tractor drive straight with AutoTrac™, but with AutoTrac™ Turnautomation a headland turn was automated, including the operation of the attached implement.[25]

These technologies were available as an add-on to existing machinery, as well as for purchase with newer models. This allowed farmers with existing fleets to adopt the technology. These John Deere automations were so reliable, that it had become possible for farmers to binge watch TV shows in the cabin of their tractor, which, were equipped with speaker systems, while working the fields.[26]

John Deere Autonomous Machinery. . . "it's no longer a concept, or a demo"[27]

In 2015, an individual at a Federal Trade Commission event was quoted saying that, "John Deere is the largest operator of autonomous vehicles."[28] Since 2015, John Deere has made acquisitions to support commercialization of its autonomous machines.[29] In 2017, John Deere acquired Blue River Technology for $305 million, which possessed computer vision technology specific to plant identification.[30] In 2021, John Deere acquired Bear Flag Robotics for $250 million, providing it access to the company's navigation technologies.[31] Since 2021, John Deere's research and development budget had been approaching $2 billion annually, reaching that amount in 2023.[32]

The John Deere autonomous tractor was built for use with its large, 8R series frame. Six pairs of cameras provided 360-degree imagery to monitor and assess the environment, controlled by Nvidia GPU processors. The cameras and computer were housed in two containers that were then mounted to the front and back of the 8R tractors.[33]

The deep neural network of the onboard computer processed images at a tenth of a second to safely navigate the tractor.[34] It was reported that through machine learning, John Deere trained the AI on a data set from "hundreds of thousands,"[35] to possibly "50 million" images.[36] The training data set was representative of the different environmental situations in which the tractor would operate. If, however, the cameras detected something unrecognizable while operating, the tractor was programmed to stop and send the images to a third-party call center. The images would then be reviewed, and if necessary, the center would notify the farmer.[37]

The autonomous tractor was purposely given limited operational usage, however, and initially was only for tilling soil. Given tillage was not always a task farmers completed, John Deere believed it was the best entry into adoption of autonomous machinery.[38] The 8R tractor, with its weight approaching 50,000 pounds, was now controllable by a smartphone with no one in the driver's seat to till soil.

John Deere had other autonomous machines prepared for commercialization in 2023. The See and Spray Ultimate was a significantly large implement pulled by a tractor that integrated the technology developed by Blue River Technologies. Two boom arms extended perpendicular to spray for weeds, a common design for herbicide sprayers. However, 36 cameras were spread across the boom arms, allowing the machine to accurately identify whether a plant was a weed or crop and spray the precise amount to kill the weed. Ten Nvidia GPUs were embedded in the sprayer[39] and utilized computer vision and machine learning (CVML) to scan 2,200 square feet of land using 4 gigabits per second to process the images. Through processing the images, maps of weed locations were created. It was estimated it was equivalent to the productivity of 6,000 workers.[40]

The ExactShot tractor implement was developed to plant a seed at the correct planting depth and deliver a precise amount of fertilizer. The ExactShot applied only 40 percent of the fertilizer normally needed, while planting over 6,000 seeds every 3 seconds.[41] Onboard sensors monitored the seed planting for malfunctions.

The Precision Agriculture and Agricultural Machinery Markets

The precision agriculture market had grown annually by approximately 12 percent since 2018 and was projected to continue at an annual growth of 2 percent The tractor and agricultural machinery market had grown approximately 3 percent annually since 2018, with 1 percent annual growth projected in future years.[42] Purchases of agricultural machinery were a factor in the demand for precision agriculture solutions. Total revenue in precision agriculture was approaching $7 billion, while total revenue in tractors and agricultural machinery was slightly above $50 billion in 2023. Exhibit 7 presents market segmentation data for precision agriculture in 2022. Market segmentation for tractors and agricultural machinery in 2022 is shown in Exhibit 8.

It was estimated that in 2016, about 58 percent of cornfields were maintained by auto-steer and guidance systems.[43] Soil and yield maps, guidance systems and other precision agriculture had been adopted by more than half of the large crop farms in the US; however, no more than 25 percent of small farms had adopted such technologies.[44]

Purchase costs, as well as the ability to repair the machines on their own may have prevented farmers from adopting such technologies. Repairing a diesel engine was vastly different from repairing an onboard GPS or computer system. Further, John Deere had withheld some of its information from farmers and independent repair shops to protect its intellectual property. After meeting with the American Farm Bureau Federation, John Deere came to an agreement to release the necessary information for repairs, while protecting its intellectual property.[45] Many states were considering right to repair laws, which would require companies to provide the necessary information to support repairs not conducted by the manufacturer or an authorized dealer. However, given the increase in software integrations

EXHIBIT 7 Market Segmentation of Precision Agriculture in the United States, 2022

Product/Service	Percentage of Market*
Yield Monitors	29%
Variable-Rate Application Control Systems	12
Guidance Systems	31
Data Management Services	6
Geographical Information Systems	18
Soil Mapping Systems	4
Total	100%

**Rounded* to nearest percent.
Source: IBISWorld.

EXHIBIT 8 Market Segmentation of Tractors & Agricultural Machinery in the United States, 2022

Product/Service	Percentage of Market*
Tractors & Implements	26%
Harvesting Machinery	11
Consumer Lawn, Lawn, Garden and Snow	23
Dairy Farm Equipment	6
Planting, Seeding, Fertilizing Machinery	4
Other	30
Total	100%

*Rounded to nearest percent.
Source: IBISWorld.

of agricultural machinery, "jail-breaking" of tractors[46] (i.e., computer hacking which circumvents restrictions imposed by the developer) as well as other cybersecurity and data breaches were a potential future issue.

Internet connectivity was also a hurdle for adoption. Farmland was both expansive and located away from urban centers, so Wi-Fi and cellular connections might be weak, or nonexistent. A reliable and constant Internet connection was necessary for full adoption of connected fleets. To support adoption, John Deere was working to use satellites to provide Internet coverage and planned to have them in place by 2025.[47]

Competitors in both markets were making acquisitions to expand manufacturing and service capabilities, such as the development of robotic machinery and the integration of cloud-computing and data storage. The data collected and housed in the cloud management system was believed to contribute to the improvement of current robotics and the development of new robotic machinery. Further, a more connected ecosystem of machines and cloud-based management provided farmers an integrated solution for all their needs.

CNH Industrial N V, a manufacturer in the tractor and agricultural market had acquired Raven Industries, a precision agriculture company, in 2021. Raven Industries had previously developed sprayer automation technology and machine vision. Later in 2021, CNH acquired NX9, an agriculture software developer.

Other competitors were releasing agricultural robots to compete. These solutions were either standalone or could integrate within an existing precision agriculture ecosystem. Precision AI was developing a drone that utilized AI to identify and spray weeds, treating approximately 40 acres an hour.[48] Carbon Robotics' Laserweeder, used machine vision to identify weeds and use a laser to kill them. While the Laserweeder had to be pulled by a tractor, there was an autonomous version that was yet to be released.[49] It was clear that competitors recognize the need, and thus potential market, of precision agriculture and robotic farming.

John Deere in 2023

John Deere believed that fully autonomous corn and soybean farming was possible and set a goal of achieving it by 2030.[50] By 2023, approximately half a million John Deere connected machines were in use[51] and accounted for approximately 60 percent of the tractor market in North America.[52] John Deere's CEO John May stated during 2023 CES keynote that their connected machinery covered a third of the Earth, and he encouraged the audience, ". . .to think of them [the connected machinery] as robots, that precisely execute jobs. . ."[53] A runway for the release of the John Deere 8R autonomous tractor seemed paved, but continuing innovations, cost containment, and execution of strategy would determine John Deere's success in encouraging further adoption of its autonomous tractors.

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CASE 19

Pollo Campero, the Taste of Latin America: Can It Capture the US?

V. Namratha Prasad,
IBS Hyderabad

"We make everything fresh for the customer. We have special recipes that have been in this family for generations, which gives us a really unique flavor. The food is something that you can't beat. It's the reason why we've been so successful in breaking into the United States and winning over the crossover market."[1]

— Fernando Perez, Senior Director of Operations with Pollo Campero S.A., in 2021.

"It's the culture of it, the memories of my family and being in Guatemala that make me miss or crave [Pollo Campero]. It's about being connected to family."[2]

— Joey Alzamora, a fan of Pollo Campero, in 2019.

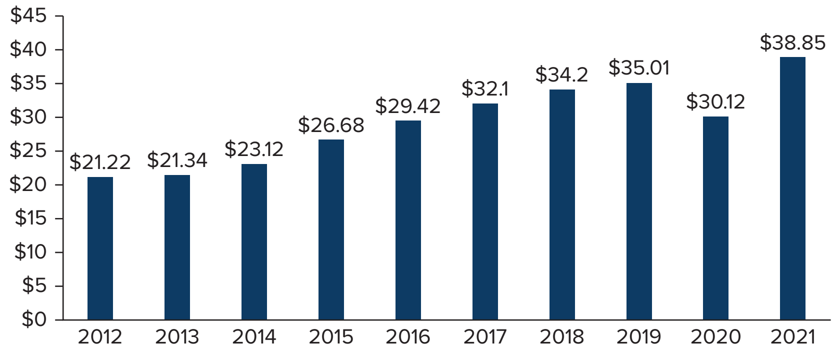
INTRODUCTION

In March 2022, the world's largest Latin American[3] chicken chain, Pollo Campero S.A. (PC) announced plans to open 250 retail outlets in the US by 2026. PC had around 80 restaurants in the US, of which 60 were corporate stores, 17 were franchise units, and four were digital kitchens. The company planned to add 120 corporate units and 70-80 franchise units. Blas Escarcega (Escarcega), its Director of Business Development, said, *"I can't think of a better time to launch our aggressive U.S. strategy . . . I look forward to working with our remarkable franchisees to drive brand and business growth with this iconic brand."*[4]

Founded in 1971 in Guatemala, PC—which offered a signature spiced fried chicken—became a runaway success in Central America[5] in the early 2000s. The company then realized the popularity of its brand among Hispanics[6] in the US and decided to enter the market in 2002. PC's first restaurant became a success within a short period of time and it opened around 30 new restaurants over five years in various US cities that had a sizeable Hispanic population.

However, PC gradually realized that targeting only Hispanics was limiting its growth prospects, as it was left to operate in a small niche in the overall US chicken Quick Service Restaurant (QSR)[7] market (*See* Exhibit 1 *for the Market Size and Growth*). In order to improve its business prospects, PC then

EXHIBIT 1 Overview of the US Chicken Quick Service Restaurant Industry, 2021 (Market Size $ in billions)



- According to the US National Chicken Council, nine out of 10 customers purchased chicken regularly. Each year, Americans consumed more than 65 billion chickens.
- By some estimates, in the 2010s, people in the US were eating almost twice as much chicken as they ate in the 1970s.
- Chicken was the fastest-growing segment in the US QSR industry and far outpaced every other category, including American mainstays such as pizza and burgers.
- According to the market research firm, IBIS World, chicken QSR restaurants generated more than US$ 34 billion in sales in 2019, and the sales were expected to grow further in the future.
- According to the US Office of Consumer Affairs, the chicken QSR market segment that was once dominated by KFC with only a handful of small competitors had become a highly competitive market. There were 37 chicken-centric restaurant chains and 73 chicken fast-food franchises.

Category Rank	Company	2019 US System-wide Sales (millions)	2019 Average Sales per Unit (thousands)	2019 Franchised/ Licensed Units	2019 Company Units	2019 Total Units
1	CHICK-FIL-A	$11,000	$4,517	2,500	0	2,500
2	KFC	$4,820	$1,196	4,009	56	4,065
3	POPEYES LOUISIANA KITCHEN	$3,750	$1,541	2,458	41	2,499
4	ZAXBY'S	$1,840	$2,030	755	149	904
5	RAISING CANE'S	$1,466	$3,600	86	371	457
6	WINGSTOP	$1,400	$1,250	1,200	31	1,231
7	BOJANGLES'	$1,290	$1,717	434	312	746
8	EL POLLO LOCO	$894	$1,865	277	203	480
9	CHURCH'S CHICKEN	$700	$688	885	165	1,050

**In billions of US$*

Compiled from Various Sources

decided to target the mainstream American customer through a range of strategies. PC knew that its Latin American roots and signature dishes served as a key differentiating factor, but to appeal to a wider consumer base, it changed its logo and store design and added some new food items to its menu.

PC's strategy paid off and it began to attract a large crossover market. Fernando Palarea, Director of Sourcing & Supply Chain with PC, said, *"The demographics of Pollo Campero have changed. Yes, you have our legacy customers who will drive hours to Pollo Campero, but the reality is we've seen more of this crossover consumer than ever before. This is anyone from Hispanic consumers who didn't grow up with the brand but understand what we are, to other demographics who might not even be able to pronounce the name!"*[8]

PC's expansion in the US came via company-owned restaurants and franchising. PC undertook a cautious, strategized approach to franchise development. In the late 2010s, it adopted a new growth strategy. Instead of starting from scratch in new markets, it adopted the strategy of reaching more customers by expanding in concentric circles around its established markets where there was unmet demand.

PC also opened several restaurants in various countries across the world, but Central America and the US remained its key markets. With more than 350 restaurants across the world as of 2022, PC boasted a cult based around its fried chicken. Analysts considered PC to be one of the most successful "*Multilatinas*"—multinational companies that had originated in Latin American countries. Considering its ambitious growth plans in the US, can PC one day take the place of Kentucky Fried Chicken (KFC) Corporation[9], which, as of 2021 was considered '*Americans' Favorite Fried Chicken Chain*'?[10]

PC'S GROWTH IN LATIN AMERICA

The founder of PC, Juan Bautista Gutiérrez (Gutiérrez), emigrated to Guatemala from Spain in 1920. He then began operating a mill and later started a chicken farm. In 1971, Gutiérrez together with his son Dionisio opened the first PC restaurant in Guatemala. The move to expand into the restaurant industry was done to capitalize on an opportunity to expand the business vertically. Escarcega later said, *"The founders really took it upon themselves (to learn) how they could not only service people who consume chicken at home, retail and supermarkets but also how can they enjoy it. And that's where the idea of Pollo Campero came about, of vertically integrating the product to the restaurant business."*[11]

Pollo Campero meant '*Country Chicken*'. The restaurant's signature dish was a citrus-flavored fried chicken made with a unique sauce that PC claimed was a secret recipe. PC offered several other dishes on its menu that were typical of Latin America. The company's signature dish became highly popular, and by 1972, it had opened seven other restaurants in Guatemala.

But there were other factors that also played a key role in making PC a success in Guatemala. It understood the aspirational mindset of the Guatemalan consumer. Though half the population of Guatemala lived below the poverty line, there was a significant part of the populace who wanted to eat at restaurants that offered quality products with a world-class ambiance and service, while also catering to Guatemala's sense of national pride.

Keeping that in mind, PC's logo was "*Pollo Campero–Lo llevo dentro*", which meant "*Pollo Campero–It's part of me*". The restaurants were designed in bright colors and had colorful murals, along with upbeat Latin music playing in the background. PC's restaurants did not have plastic chairs; they had large and spacious rustic-looking furniture.

The restaurants also offered full table service to make customers feel looked after. PC stated that it was a family-owned restaurant and so it strove to keep a family-centric mindset. It sought to make the customer feel as if they were a part of its family. PC followed the concept of R.E.I.R. (Respect. Excellence. Integrity. Responsibility) for the way it took care of its customers. R.E.I.R. in Spanish also meant laughter or smile.

PC created a friendly, welcoming, and warm atmosphere for its visiting customers. When customers visited a PC restaurant, the employees welcomed them in a friendly manner. It was a practice for the employees to deliver food on real silverware plates to the customers' tables. The employees also stayed on hand to refill the customers' drinks and to meet any other requirements. Andrea de Valle, Director of Human Resources, PC, said, *"You can go to any other chain and find food, but what's different about Pollo*

Campero is how we treat our customers. The flavor that we put into our service highlights the flavor that we put into our food. Customer service is critical for us."[12]

PC also focused on providing a place where the entire family could come for a visit. The family unit was considered to be a very important unit in the Latino culture and most Latino families were close-knit. Therefore, PCs menu had family meals to cater to large families. Mentioning the reasons he visited PC, Julio Waldemar, a Guatemalan customer, said, *"We come because it's modern, clean and the children love the food. It makes you feel like you're being looked after more."*[13]

The success in the home market encouraged PC to make its first international foray. It opened a restaurant in neighboring El Salvador that had a customer profile similar to that of Guatemala. In 1980, Dionisio who had been managing the company died unexpectedly in a plane accident. Consequently, his son, Juan José Gutiérrez (Juan José), who was just 23 years old at that time, became the President of PC. Juan José, who considered himself to be a '*seeker of challenges*', adopted a hands-on approach to the business. He involved himself with food innovation and cash management, consequently laying the foundation for the growth of the company.

Juan José successfully expanded PC in Guatemala by building a network of restaurants through direct investment. PC even managed to stand up against the competition posed by US-based multinational chicken brands such as KFC. In the 1980s, while PC flourished in Guatemala, KFC's poor performance led it to abandon the market after a couple of years (it made a re-entry later).

In 1992, PC opened its first store in Honduras, where it also acquired a poultry farm. It went on to develop a franchise program using which it opened outlets in Panama and Nicaragua in the late 1990s. Between 1997 and 2000, PC entered into franchise agreements with various business groups in Costa Rica, Mexico, and Ecuador, consequently becoming the most internationalized Latin American fast-food chain, with more than 140 outlets and nearly 6,000 employees.[14] Industry observers stated that PC managed to gain a cult following in Latin America due to the unique taste of its food that appealed to people spanning generations. In addition, the company tailored its strategy to choose the unique aspects of the country in which it was doing business.

Juan José also diversified the business in various areas that included finance, real estate, construction, and agriculture. He then consolidated the various businesses under the parent company *Corporación Multi Inversiones* (CMI) which had two business groups: CMI Foods and CMI Capital. CMI Foods included wheat flour mills; pasta, cracker, and cookie manufacturing facilities; poultry and swine production; meat processing and various types of sausages production; nutritional pet food production; and restaurants, featuring the PC brand. CMI Capital included renewable energy projects, real estate projects, and financial services.

PC'S BID FOR THE US

By the 1990, PC's signature dish was so popular that PC food parcels were sent to Hispanic people in the US by their relatives in Central America as gifts. When air travelers from Central America visited the US, they carried as much PC chicken as the US Transportation Security Administration (TSA)[15] would allow on the planes.

It was estimated that the PC restaurants at *La Aurora International Airport* in Guatemala and *San Salvador International Airport* in El Salvador sold more than three million to-go orders annually in the late 1990s. The airports had streamlined processes to enable air travelers to take products from the on-site PC restaurants on planes. Speaking about her experience while traveling from El Salvador to the US, Stephanie Schorow, a reporter with the US-based newspaper *Boston Globe,* said, *"In early 2001 when I was flying back from assignment in El Salvador, the aroma of fried chicken wafted through the cabin. In overhead bins and under seats, passengers had stuffed brightly colored bags and boxes of their favorite fast food for friends and family back in Boston. That was my introduction to Pollo Campero . . . Back then, the devotion to this fast food just bemused me. To my untutored nose, the smell was only that of hot chicken. For El Salvadorians, it was the aroma of home."*[16]

And it was not only the Hispanics. PC learned that its chicken was popular even among non-Hispanic people in the US. Analysts thought that Latin-American foods had become integrated with the Southern US cuisine with most US citizens from that region being familiar with popular Latin American food items such as tamales[17] and jalapenos[18]. Moreover, they were found to be open to consuming items that used a lot of peppers and hot sauces. Speaking about the appeal of Latin American food in the US, Timothy Davis, a US-based food writer, said, *"Certainly the Latin American influence has spread, especially in the southern United States, to the point where some dishes are now considered part of the pantheon of 'Southern' cooking."*[19]

To leverage its immense popularity in the US and to better cater to the rising demand from that country, PC decided to make its entry into the US. It opened the first PC restaurant in Los Angeles, California, in 2002. The company's target market was Hispanics who longed for the taste of home that PC provided. As Los Angeles had a very large population of Hispanics, PC chose the location to open its first restaurant. Speaking about the way PC attracted Hispanic people, Luis Javier Rodas (Rodas), Managing Director and COO of PC, later said, *". . . our nostalgic food brings them right back to the kitchens where they grew up, eating the kind of nourishing, home-cooked meals that evoke a powerful, multi-sensory memory of family."*[20]

PC adopted the same menu, logo, and store design in the US as it had for its Central American restaurants. Thus, the restaurant was a replica of the Guatemalan ones, though there was no table service considering the high cost of labor in the US. Rodolfo Jimenez, Executive Vice President of Business Development, said, *"The American customer is more pragmatic. They don't like as many details as those in Latin America. People here have told us they want to have a quick break—15 minutes or so. In Guatemala, it's more of a family thing."*[21]

PC stated that over a period of time, it realized that the demand for its products was much more than it had originally envisioned, leading it to open more restaurants. Within three years, PC opened 25 restaurants in the US, mostly in large and important cities such as Los Angeles, Chicago, Houston, Dallas, New York, and Washington. All these cities also had a large population of Hispanics familiar with the PC brand. Rodas said, *"There were lines around the block when we opened, which is a tradition that has continued with every single one of our restaurants ever since. In every market we entered, we were greeted with excitement from our customer base for bringing a piece of home to the places they now lived."*[22] In the 2000s, PC's sales ranged between US$ 10,000 and $50,000 per day in each of its restaurants, which was above the average sales of competitors.[23]

PC's menu had family meals—for dine-in, take-out, or drive-thru—the intention being to attract families. The company believed that this particular menu provision was a key factor in its success over the competition. It thought that it was its focus on family-style meals, rather than on individual meals, that helped it generate more revenue on each sale.

The company believed that rapid growth in the US required rapid coverage. It thought it would grow three times faster if it grew through franchises rather than by entering with its own investment. As of 2005, PC had sales worth US$ 55 million on the back of a successful franchise strategy. PC also studied the US market and decided to concentrate on the East and West coasts, Texas and Illinois, where large Hispanic populations offered the biggest market opportunities.

In 2006, having understood the importance of globalization, PC decided to shift its headquarters from Guatemala to the US. Speaking about it, Juan José said, *"It will mean moving part of our team there, spending more time in the United States, and starting the formal hiring of American executives to prepare for the second phase of growth."*[24] In 2007, PC announced a set of strategic objectives for the future that included being among the top 50 QSRs in terms of average annual sales in the US and to open approximately 300 restaurants by 2014.

SO, WHY AND HOW DID PC CHANGE ITS STRATEGY FOR THE US?

Despite its popularity in the US, by 2010, PC realized that it would fail to achieve its strategic objectives and to grow as expected, which prompted it to study the reasons for it. PC observed that Hispanic consumers in the US—whether Guatemalan, Mexican, or Salvadoran—were no longer the same as its consumers in Latin America. It realized that they had different expectations and visited its restaurants for motives that were different from those of native Latin Americans.

Furthermore, PC realized that though it was successfully operating in a niche in the US chicken QSR market, the growth prospects in that segment were severely limited. Though targeting Hispanics had been profitable, considering their small population (it was just 1% of the population in certain states in the US), there was not much opportunity for PC to increase business. Furthermore, it had to contend with the fact that the Hispanic family's annual income was only around US$ 40,000, which limited the number of occasions that they would eat out and the amount of money they spent on each outing.[25]

Considering these factors, PC decided to target the average American or the mainstream customer to have better growth prospects. However, it realized that, unlike Hispanics who were quickly attracted to the PC brand, Americans had no emotional attachment to it. Hence, PC had to focus on other aspects to attract them.

Brand consultants hired by PC stated that certain brand elements, such as its name and the logo, were unclear and confusing to American consumers. Moreover, they pointed out that PC's restaurants were designed in such a way as to attract Hispanics, but it held no appeal to an average American. Taking these observations into consideration, PC changed its logo design and also shifted to muted colors from the bright Latin American colors (yellow, maroon, and olive). In its restaurants, PC put in sophisticated furniture, floor-to-ceiling glass windows, larger menu boards, salsa bars, and wider drive-throughs to accommodate larger American vehicles.

Having to compete in the highly crowded and competitive US chicken QSR market meant that PC had to also differentiate itself effectively. Therefore, it used its authentic Latin American dishes, apart from its unique cooking style, usage of quality ingredients, and emphasis on freshness, to differentiate itself from competitors.

PC stated that it cooked fried chicken in a manner that was completely different from that of other US food chains that offered fried chicken. While other US food chains focused on putting flavor into the chicken skin and generally didn't think about the flavor permeating the meat, it said it strove to infuse spices and seasonings into each piece of chicken that was served. It stated that it had a tie-up with its suppliers to make sure that the marination of the chicken was done well before it came to any of the PC restaurants.

The company also specified that all of its fried chicken dishes were specially hand-breaded. It stated that it had a secret recipe with a unique blend of spices for the breading that made the chicken crunchier than that of the competition. PC declared that it focused on freshness and making food to order, using high-quality ingredients. It stated that its signature drinks, garden-fresh salad, and sides were prepared fresh daily.

PC also began offering food items that suited American tastes better. The company claimed to have done a lot of innovation to ensure that its menu items held an appeal to people from different cultures. PC's menu had several items that were familiar to US palates while being unique enough to invite curiosity. Over time, the company claimed to have the most diverse menu in the US chicken QSR landscape. Rodas said, *"We have been able to occupy a space in our category with only a few players that directly compete with our offerings."*[26]

Its popular menu items were Horchata (a sweetened beverage made from rice), Camperitos (chicken nuggets), fries made from yuca, guava barbecue empanadas, and tamarindo ketchup. The company thought that its sides set it apart and delivered more of the bold Latin flavors that other brands would find difficult to compete with. PC not only offered Central American sides such as plantains, Campero rice, and Campero beans, but also traditional American sides such as French fries, mashed potatoes, and garden salads.

PC quickly realized that, unlike Latin America, in the US, price wars drove more consumers from one brand to another. As PC lacked the resources to compete through advertising with other famous chicken QSR chains, it adopted promotional pricing strategies.

By the mid-2010s, PC realized the importance of the millennial customer, because of their special characteristics. PC discovered that millennials were thrill-seekers who craved heightened eating experiences such as intense flavors and extreme textures. They were also open to trying out new food experiences from brands that they were unfamiliar with. Besides, they wanted their food to be healthy, "*better-for-the-planet,*" and to have a clean label.

In order to attract the millennial customer, PC tweaked its menu to offer guilt-free, balanced options so that customers would not feel guilty for indulging in fast food. It then introduced its grilled line of products to appeal to the health-conscious and discriminating American millennial customer. Thus, PC emerged as the only national chicken QSR chain in the US to offer consumers the choice of both grilled and fried chicken. Federico Valiente, Pollo Campero International Brand Lead, said, *"We focused on enhancing the Campero experience, providing unique*

Latin meals at a good value, combined with investments in technology and innovation—everything played an important role in Campero's growing popularity among millennials. Right now, millennials make up 64 percent of Campero's customer base and as we look ahead, we remain focused on understanding their evolving needs to deliver an attractive and relevant value proposition."[27]

Through the 2010s, the US chicken QSR segment continued to outpace the rest of the industry. PC also registered positive sales growth (averaged an 8% comparable sales growth) each year. In 2016, PC surpassed sales of US$ 100 million in the US.[28] Industry observers thought that PC had managed to achieve a crossover appeal that attracted a considerable number of non-Hispanic diners and that had led to its success.

PC'S GROWTH STRATEGIES IN THE US

PC's growth in the US included expansion via company-owned restaurants and franchising. PC undertook a cautious, strategized approach to franchise development. It expected its franchisees' values to align with its own. It supported its franchisees on several levels from daily operations to big-picture growth goals. Fernando Perez, Senior Director of Operations, said, *"We're trying to help them in any way possible, not just in processes in the restaurant but also helping them to understand financials, how to hire people, how to reduce the turnover rate, how to control the cost of goods. So that way they can be more successful. So we have a very strong plan of support."*[29]

Industry observers stated that, over the years, instead of undertaking massive, multi-unit, multi-territory signings with well-capitalized franchisee groups that eventually opened multiple locations in a span of few years, PC had grown steadily by focusing on small initial agreements with franchisees before helping them scale their business over the course of their partnership with the brand. Rodas added, *"We want everyone to be very successful, and because of that, we put all of the systems and the structure together to make everyone successful. If someone is willing to do maybe five stores in three years, that's fine—let's sign for five stores, and once you have opened those five, we can sign another three, another five, another ten . . . because at the end of the day, we want to keep the wheel moving."*[30]

In the late 2010s, PC adopted a new growth strategy. Instead of starting from scratch in new markets, it adopted the strategy of reaching more customers by expanding in concentric circles around its established markets. The company believed that such an expansion would ensure that each new unit benefitted from the same support and resources that proven locations depended on. Rodas said, *"The opportunity for growth is huge, but we want to be coordinated in that growth. That's why we've worked hard to define where we want to start expanding and which existing markets are primed for growth."*[31]

The company sought to establish a presence in markets where it had identified unmet demand—areas that had a large number of customers who drove long distances to visit a PC. The company's development team studied critical data to ensure that every new PC store was situated in a favorable location. Rodas said, *"Our market plans go beyond demographics and key economic indicators. Population growth, consumer spending and market saturation are important, but we've evolved our focus to identify the best possible trade areas by leveraging mobility data, consumer psychographics*[32] *and needs states as well as robust AI*[33] *-enabled models. We plan to open new restaurants where Pollo Campero is well-positioned to thrive based on demographics and previously successful stores."*[34]

The company thought that it could undertake its expansion plan successfully on the back of the strong supply chain that it had built over two decades in the US. The company stated that it had achieved the capability to access high-quality products for its restaurants in all its markets in a timely manner. It believed that the same supply chain would enable it to expand to nearby territories outside of its core markets.

In the 2020s, PC planned to focus its expansion efforts across the Southeast US, including the Carolinas, Georgia, Tennessee, and North Florida. Escarcega said, *"These markets have a higher consumption of chicken overall. If you look at the footprints of other chicken concepts, their highest concentration tends to be in the Southeast because of the popularity of chicken, specifically fried chicken."*[35] In addition, it sought to explore growth opportunities in Arizona, as well as a few other markets scattered across the country. It also planned to open more corporate-owned stores, especially in California and South Florida.

To implement its new expansion plan, PC was working to develop a network and connections with '*movers and shakers'* in the restaurant industry that it did not previously have. Speaking about the franchisees it was looking for, Rodas said, *"We are really looking to partner with people who are wanting to open over five locations and have some existing experience in the restaurant space. Ultimately, we want people who understand who we are and are aligned in our vision and culture."*[36]

As of 2021, the initial cost of opening a PC franchise ranged from US$ 887,250 to US$ 2,126,500. That included a franchise fee of US$ 40,000.[37] PC had a team of *Franchise Business Specialists* to help new franchisees set up the restaurants and provide them with advice during the business growth. It also had teams in real estate, construction, quality assurance, and research and development to guide the franchisees. Speaking about the reasons for becoming a PC franchisee, Todd Deckert, Director of Sales and Marketing, PC, said, *"If I'm a franchisee and I'm looking to invest, I want to buy something of value. The landscape is getting so cluttered with commodity-type brands. Here you're getting a very different experience compared to the others. You're benefiting from that unique position in the market."*[38]

Adopting New Concepts—Digital Kitchens

In 2020, to complement its aggressive traditional restaurant expansion plan, PC opened its first two digital kitchens in San Francisco and Chicago. The new digital kitchens, spread over a 200-square-foot area, served the restaurant's full menu to customers through pickup or delivery within a 30-minute radius of its locations. The food could be ordered online through a variety of avenues: the website us.campero.com, the Pollo Campero app, Campero's Flavor Hotline (1-833-CAMPERO), or through a range of food delivery apps.

Speaking about how the digital kitchen concept helped in its growth, Rodas said, *"The digital kitchen model, with a smaller footprint and efficient cost structure, has enormous potential to help us further penetrate markets and bring our chicken to more consumers in a convenient way."*[39]

PC'S OTHER INTERNATIONAL FORAYS—NOT SO SUCCESSFUL?

Apart from the US, PC did make a foray into several other international markets. However, apart from Latin America and the US, it failed to make a significant mark in any international market.

PC made a large part of its international expansion efforts in the mid-2000s. In 2006, it started operations in Indonesia, China, Spain, Bahrain, and India through joint ventures with local businesses. The company then began operating through three divisions: the Latam division based in Guatemala which ran the Latin American business; the USA division; and a third division called *Campero International Franchising* which ran the rest of the world from its headquarters in Spain.

In Indonesia, PC had a plan to open 25 restaurants in five years. The company was keen to establish a presence in Indonesia owing to the fact that 90% of the population was Muslim, and they chose not to consume pork, ate beef in very low quantity, and most preferred chicken. The company entered Spain through a joint venture with a Spanish Business Group, Agrolimen. PC expected to open 25 restaurants in three years.

One of the countries that PC had very high hopes for was China. When PC was considering entering China, certain industry observers thought that it was reckless and overambitious for a Latin American company to do so. However, the company was keen to take up the challenge. PC was attracted to the strong growth prospects in the Chinese chicken QSR market. PC learned from various sources that China had very high per capita chicken consumption from various sources. It found out that each Chinese person consumed 18 to 20 chickens per year, while in Latin American countries—which were also large consumers of poultry—annual per capita consumption was less than 12. The Chinese were also observed to be fond of fried chicken, which was evident from the success of KFC in China which had thousands of outlets in that country. According to PC, the Chinese also ate out more than even the Americans.

PC was cautious before making its foray into China. The company first undertook a blind test with 150 Chinese consumers in experimental kitchens in Shanghai, China. PC then found that its products had an eight-to-one preference over KFC. That prompted the company to finally make an entry into the Chinese market in 2007. Moreover, it made plans to open over 500 restaurants in the country over a decade. However, PC had to close down its four Shanghai outlets within a couple of years due to a lack of business and ultimately exited the country.

In India, PC planned to set up 10 restaurants across the country by 2012 in collaboration with local partners. Besides its signature dishes, it planned to have a range of vegetarian fare including salads at its Indian restaurants. However, the company remained limited to operating in a few cities and lacked a large geographical footprint.

Thus, PC's plans to create a strong market position in the developing markets of Indonesia, China, and India did not fructify. As of 2022, PC had more than 350 restaurants worldwide, of which 77 were located in the US, 130 in Guatemala, and about 70 in El Salvador. Other key countries where its restaurants were located included Italy, Honduras, Ecuador, Mexico, and Spain.

THE ROAD AHEAD

In the late 2010s, PC stated that it had profitable US operations and it had been experiencing same-store sales growth for the past few years. Even the tough times during the COVID-19 pandemic[40] did not have a negative impact on PC's US operations. The company managed to maintain strong US sales throughout COVID-19, achieving an average unit volume (AUV) of US$ 1.9 million. In a surprising announcement, PC stated that 2021 was a year of record profits.

According to Rodas, the company was able to sail through the pandemic unscathed due to the digital initiatives that it had undertaken prior to the pandemic. PC had upgraded its digital ecosystem, which meant a relaunch of the e-commerce platform, additional third-party delivery integration, delivery via PC ordering channels, and a new PC app with a novel loyalty program. Rodas added, *"All of these made it so that when the pandemic hit, we were already fully prepared to meet the customers where they were, using delivery, curbside pickup and drive-thru, and our overall sales not only did not drop, they rose. We had our most successful year on record in 2020 and are on track to match that again this year, with 25% year-over-year same-store sales."*[41]

As of 2021, PC derived about 40% of its sales from dine-in, 30% from take-out, 15% from delivery, and 15% from drive-thru. During the pandemic, PC had focused on elevating off-premise and omnichannel convenience, in order to protect the health of its employees and customers. In the immediate aftermath of the pandemic, PC expected to benefit from the "*cooking fatigue*" that was thought to have set in among the general population after an extended period of home cooking necessitated by the pandemic. Moreover, the rise in health consciousness that had been triggered by the pandemic was expected to make people shift more to the consumption of chicken, considering the fact that it was a healthier alternative to beef. PC expected this would turn out to be good for its business.

According to the Delaget's 2020 QSR Operational Index[42], the average ticket at PC was between US$ 23 and US$ 25, which was more than twice that of the average QSR transaction of US$ 10.99.[43] Jorge Armenteros (Armenteros), Executive Vice President of Business Development, PC, said that PC's restaurants ranked in the top five of all brands in the area of average gross sales per store. He added, *"Our sales averages are right up there, well above KFC and Popeye's."*[44,45]

PC stated that the company hardly had any competition in Latin America, especially in Guatemala and El Salvador. However, it accepted that in the US, there were several large brands with whom it had to compete directly. Nonetheless, it remained confident that by staying true to its roots and maintaining its essence, it would be able to create its own space in the market. It asserted that very few of the US chicken brands had the legacy, the flavor profile, the built-in customer base of millions of fans, or the proven ability to enter new markets with ease that it possessed.[46]

As of 2021, PC claimed that a major chunk of its customers came from the crossover market—with 45% of customers being Latino and 55% being White, African-American, and Asian.[47] PC was banking on the fact that with each passing year, the US was becoming more and more diverse. It was estimated that the US Hispanic population would account for 30% of the total population by 2050, and that would have a tremendous impact on the overall culture of the country.

Moreover, PC thought that the quest for new epicurean experiences on the part of consumers due to the rise of the internet, affordability of travel, and popularity of travel shows would give a further impetus to the demand for its brand. Escarcega said, *". . . the uniqueness of the brand is that it's international, and now I think you're seeing many of the newer generation wanting to experience flavors of the world. In the chicken category, we believe we're in a sweet spot that we can provide international flavor, Central American opportunities for people to experience our culture and our foods, and I think that's where we want to be."*[48]

PC's five-year plan was to reach 180 corporate units, 85 franchise locations, and 10 to 20 digital kitchens. The company stated that 95% of its new outlets would offer drive-thru. Speaking about the company's long-term plans, Rodas said, *"We're not in a rush—we're going to grow smart, keeping true to our vision and our strategy and by franchising with the right entrepreneurs. In time, there will be 1,000 Pollo Campero locations across the United States."*[49]

Most industry analysts thought that PC had what it took to become one of the most dominant players in the US$ 38 billion US chicken QSR market in the future. Sam Wong, Director of Franchising at PC added, *"Ultimately, I think this can be a 1,000-store brand. We want this to be a $1 billion business. A contender. In the next three to five years, we want Pollo Campero to be a hot concept of the year."*[50]

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CASE 20

LVMH in 2023: Its Diversification into Luxury Goods

McGraw Hill connect

John E. Gamble
Texas A&M University-Corpus Christi

In 2023 LVMH Moët Hennessy Louis Vuitton was the world's most valuable company with a market capitalization of more than $500 billion and 2022 annual revenues of €79.2 billion. The company's portfolio of businesses included some of the most prestigious brand names in wines, spirits, and champagnes; fashion; watches and jewelry; and perfumes and cosmetics. The French conglomerate's business portfolio also included a luxury yacht builder, a 19th century-styled French amusement park, two prestigious Parisian department stores, duty free stores, a retail cosmetics chain, high-end luxury hotels, and a variety of French media properties. Even though no one needed LVMH's products—certain vintages of its Dom Pérignon champagne could retail for well over $1,000, its Givenchy dresses frequently sold for $5,000 or more, and Bulgari watches carried retail prices of more than $40,000—the company's products were desired by millions across the world.

LVMH CEO Bernard Arnault had been described as a "wolf in cashmere" because of his business acumen and track record for acquiring and growing luxury brands such as Bulgari in 2011 and Tiffany in 2020.[1] Arnault's success in building and managing LVMH allowed him to surpass Elon Musk in 2023 to become the world's most wealthy individual with a fortune of $212 billion.

The company's business portfolio began to take shape in 1987 when Louis Vuitton, known worldwide for its purses and luggage, merged with the maker of Moët & Chandon champagne and Hennessy cognac. LVMH's current lineup of star luxury brands was forged by Bernard Arnault, who became CEO of the company in 1989 and promptly set about acquiring such names as Fendi, Givenchy, Celine, and Marc Jacobs in fashion and leather goods; TAG Heuer, Bulgari, and Zenith in watches and jewelry; and Le Bon Marche and Sephora in retailing. By 2023 Arnault had assembled a portfolio of 75 luxury brands.

Arnault believed LVMH's collection of star brands such as Moët & Chandon, Krug, Louis Vuitton, Givenchy, and Parfums Christian Dior and its recent acquisition of Tiffany would lead to long-term corporate advantage since star brands had staying power. "The brand is built, if you wish, for eternity. It has been around for a long time; it has become an institution. Dom Pérignon is a perfect example. I can guarantee that people will be drinking it in the next century. It was created 250 years ago, but it will be relevant and desired for another century and beyond that."[2] A summary of LVMH's financial performance between 2020 and 2022 is presented in Exhibit 1.

COMPANY HISTORY

The history of LVMH's brand portfolio is traced to 1743 when Moët & Chandon was established in the Champagne Province in northeastern France. Moët & Chandon not only became one of France's premier brands of champagne but was also sought after outside of France with exports accounting for a large percentage of its sales by the 20th century. The company first diversified in 1968 when it acquired Parfums Christian Dior, and a 1971 merger between Moët & Chandon and Champagne Mercier combined France's two best-selling brands of champagne.

EXHIBIT 1 LVMH Consolidated Income Statements, 2020–2022 (€ in millions, except per share amounts)

	2022	2021	2020
Revenue	€79,184	€64,215	€44,651
Cost of sales	24,988	20,355	15,871
Gross margin	54,196	43,860	28,780
Marketing and selling expenses	28,151	22,308	16,792
General and administrative expenses	5,027	4,414	3,641
Income (loss) from joint ventures and associates	37	13	(42)
Profit from recurring operations	21,055	17,151	8,305
Other operating income (expenses)	(54)	4	(333)
Operating profit	21,001	17,155	7,972
Cost of net financial debt	(17)	41	(35)
Interest on lease liabilities	(254)	(242)	(281)
Other financial income (expenses)	(617)	254	(292)
Net financial income (expense)	(888)	53	(608)
Income taxes	5,362	4,510	2,409
Net profit before minority interests	14,751	12,698	4,955
Minority interests	667	662	253
Net profit	€14,084	€12,036	€ 4,702
Earnings per share, basic	€28.05	€23.90	€9.33
Earnings per share, diluted	€28.03	€23.89	€9.32
Number of shares outstanding			
Basic	502,120,694	503,627,708	503,697,272
Diluted	502,480,100	503,895,592	504,210,133

Source: LVMH 2022 Annual Report.

The company changed its name to Moët-Hennessey when it again merged in 1971; this time with Jas Hennessy & Co., the world's second largest producer of cognac.

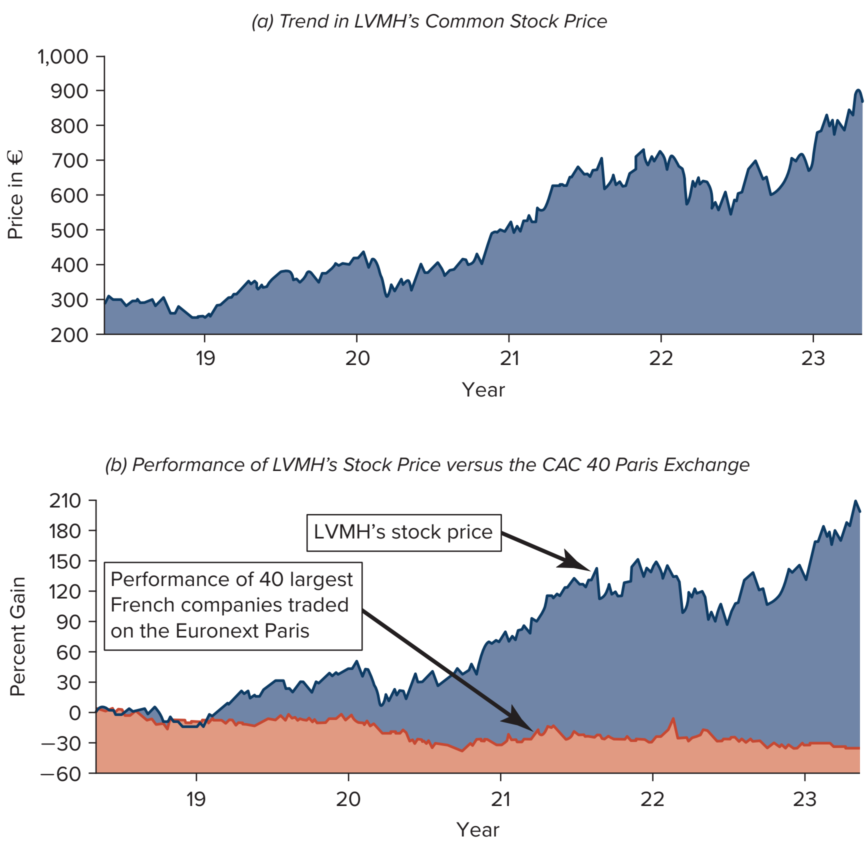
Arnault became majority shareholder, CEO and chairman of LVMH in 1989 and began an aggressive acquisition campaign. His execution of a merger with Louis Vuitton had made LVMH France's 40th largest company with a collection of such well-known luxury brands as Veuve Clicquot, Moët & Chandon, and Dom Pérignon champagnes; Hennessy cognac; Christian Dior and Givenchy perfumes and cosmetics; and Louis Vuitton leather handbags and luggage. Arnault remained the company's largest individual shareholder in 2023, controlling 6.74 percent of shares.

Bernard Arnault believed that LVMH control of the retail channels where its products were sold was critical to the success of luxury brands. The use of company-owned retail locations allowed LVMH to not only make certain its products were of the highest quality and most elegant, but also allowed the company to ensure its products were sold by retailers offering the highest level of customer service. This belief drove the company's moves into vertical integration into the operation of Louis Vuitton, Christian Dior, and other designer-label stores in Paris, New York, Beverly Hills, and other locations and also led to the $2.5 billion acquisition of DFS (Duty Free Shoppers) in 1996. San Francisco-based DFS operated a chain of duty-free boutiques in Asia and various international airports. Arnault expanded further into retailing in 1997 with the acquisition of French cosmetics retailer Sephora and the 1998 acquisition of famous Parisian department stores, La Belle Jardiniere and Le Bon Marché. The company also acquired Starboard Cruise Services, which offered duty-free shopping aboard 100 cruise ships sailing in the Caribbean and elsewhere.

The company's most noteworthy acquisitions during the 2000s included Fendi in 2003, Glenmorangie in 2005, Belvedere in 2007, Hublot, Royal Van Lent, and Dior in 2009, and Bulgari in 2011. Arnault's buying binge also expanded the company's range of diversification with the addition of a French radio network and magazines targeted to music aficionados and art connoisseurs. The largest acquisition made by Arnault between 2011 and 2020 was the $16.2 billion purchase of Tiffany & Co. Bernard Arnault had called Tiffany "the most recognizable and most mythical U.S. brand in the world."[3] Immediately upon the acquisition in 2020, Arnault began to enhance the brand with an even more exquisite jewelry and watches and a $500 million renovation of Tiffany's iconic flagship store on the corner of Fifth Avenue and 57th Street in New York City. The company's stock performance from April 2018 through April 2023 is presented in Exhibit 2.

LVMH's Corporate Strategy Although much of LVMH's growth was attributable to the acquisition of new businesses, Arnault placed an emphasis on internal growth by exploiting common strategies and capturing synergies across the portfolio. While the company organizational structure and operating principles ensured that each business was autonomous,

EXHIBIT 2 Market Performance of LVMH's Common Stock, April 2018–April 2023



Source: Bigcharts.marketwatch.com

Arnault demanded that each of the corporation's businesses demonstrate commitment to creativity and innovation and product excellence. The long-term success of LVMH's brands, in Arnault's view, was largely a function of artistic creativity, technological innovation, and the closest attention to every detail of the production process.

The image and reputation of the company's products were seen as equal to the creativity and craftsmanship employed during the development and production of LVMH luxury goods since image was a product dimension that defied logic but caused consumers to have strong desires for a particular brand. Arnault believed that image was priceless and irreplaceable and required stringent management control over every element of a brand's image, including advertisements, corporate announcements, and speeches by management and designers.

Control over the distribution and sale of its products was the final element of LVMH's corporate strategy and allowed its divisions to listen to customer needs, better understand their tastes, and anticipate their desires. LVMH's ownership of more than 5,664 retail locations in developed countries throughout the world also allowed the company to refine its brand's images with controlled store aesthetics, a consistent retailing approach, and irreproachable customer service. LVMH's retail operations and broad collection of businesses was grouped into six business units. Exhibit 3 presents LVMH's business portfolio in 2023. LVMH's performance by business group for 2021 and 2022 is presented in Exhibit 4. The company's consolidated balance sheets for 2021 and 2022 are presented in Exhibit 5. Exhibit 6 illustrates the company's free cash flows from operations for 2020 through 2022.

EXHIBIT 3 LVMH'S Business Portfolio in 2023

Wines & Spirits	Fashion & Leather Goods	Perfumes & Cosmetics	Watches & Jewelry	Selective Retailing	Other Activities
Moët & Chandon Dom Pérignon Veuve Clicquot Krug Mercier Ruinart Château d'Yquem Domaine Chandon Cloudy Bay Domaine des Lambrays Hennessy Newton Ardbeg Château Cheval Blanc Glenmorangie Wen Jun Chateau Galoupet Belvedere Numanthia Terrazas de los Andes Cheval des Andes Ao Yun Volcan de mi Tierra Eminete Cova chocolates	Louis Vuitton Loewe Celine Berluti Loro Piana Kenzo Givenchy Christian Dior Marc Jacobs Nicholas Kirkwood Edun Fendi Moynat Emilio Pucci Rimowa Patou	Parfums Christian Dior Guerlain Parfums Givenchy Loewe Perfumes Kenzo Parfums Fresh Benefit Cosmetics Make Up For Ever Acqua di Parma KVD Beauty Maison Francis Kurkdjian Cha Ling Fenty Beauty by Rihanna Stella by Stella McCartney Officine Universelle Buly	TAG Heuer Tiffany Hublot Zenith Bulgari Fred Chaumet Repossi	DFS (Duty Free Shoppers) Starboard Cruise Services Sephora Le Bon Marché La Grande Epicerie de Paris 24S	Jardin d'Acclimation amusement and leisure park Cova chocolates Roayl Van Lent yacht builder *Investir* financial publication *Les Echos* daily newspaper *Connaissance des Arts* art magazine Cheval Blanc luxury hotels Belmond luxury resorts Radio Classique

Source: LVMH website.

EXHIBIT 4 LVMH's Performance by Business Group, 2021–2022 (€ in millions)

Revenues	2022	2021
Wine & spirits	€ 7,099	€ 5,974
Fashion & leather goods	38,648	30,896
Perfumes & cosmetics	7,722	6,608
Watches & jewelry	10,581	8,964
Selective retailing	14,852	11,754
Other and holding companies	1,586	1,169
Eliminations and not allocated	(1,304)	(1,150)
Total	€79,184	€64,215
Profit from Recurring Operations	2022	2021
Wine & spirits	€ 2,155	€ 1,863
Fashion & leather goods	15,709	12,842
Perfumes & cosmetics	660	684
Watches & jewelry	2,017	1,679
Selective retailing	788	534
Other and holding companies	(267)	(436)
Eliminations and not allocated	(7)	(15)
Total	€21,055	€17,151
Operating Investments	2022	2021
Wine & spirits	€ 440	€ 328
Fashion & leather goods	1,872	1,131
Perfumes & cosmetics	409	290
Watches & jewelry	654	458
Selective retailing	523	370
Other and holding companies	1,074	89
Eliminations and not allocated	(1)	(1)
Total	€ 4,969	€ 2,664
Depreciation, Amortization, and impairment expenses	2022	2021
Wine & spirits	€ 261	€ 228
Fashion & leather goods	2,431	2,142
Perfumes & cosmetics	480	443
Watches & jewelry	994	860
Selective retailing	1,427	1,399
Other and holding companies	291	294
Eliminations and not allocated	(112)	(113)
Total	€ 5,772	€ 5,253

Source: LVMH 2022 Annual Report.

EXHIBIT 5 LVMH's Consolidated Balance Sheets, 2021–2022 (€ in millions)

Assets	2022	2021
Brands and other intangible assets	€25,432	€24,551
Goodwill	24,782	25,904
Property, plant, and equipment	23,055	20,193
Right-of-use assets	14,615	13,705
Investments in joint ventures and associates	1,066	1,084
Non-current available for sale financial assets	1,109	1,363
Other noncurrent assets	1,186	1,054
Deferred tax	3,661	3,156
Non-current assets	94,906	91,010
Inventories and work in progress	20,319	16,549
Trade accounts receivable	4,258	3,787
Income taxes	375	338
Other current assets	7,488	5,606
Cash and cash equivalents	7,300	8,021
Current assets	39,740	34,301
Total assets	€134,646	€125,311
Liabilities and Equity		
Equity, Group share	55,111	47,119
Minority interests	1,493	1,790
Total equity	56,604	48,909
Long-term borrowings	10,380	12,165
Noncurrent lease liabilities	12,776	11,887
Noncurrent provisions and other liabilities	3,902	3,980
Deferred tax	6,952	6,704
Purchase commitments for minority interests' shares	12,489	13,677
Noncurrent liabilities	46,498	48,413
Short-term borrowings	9,359	8,075
Current lease liabilities	2,632	2,387
Trade accounts payable	8,788	7,086
Income taxes	1,211	1,267
Current provisions and other liabilities	9,553	9,174
Current liabilities	31,543	27,989
Total liabilities and equity	€134,646	€125,311

Source: LVMH 2022 Annual Report.

EXHIBIT 6 LVMH's Statements of Cash Flows, 2020–2022 (€ in millions)

	2022	2021	2020
Net cash from operating activities	€17,833	€18,648	€10,897
Operating investments	4,969	2,664	2,478
Repayment of lease liabilities	2,751	2,453	2,302
Operating free cash flow	€10,113	€13,531	€ 6,117

Source: LVMH 2022 Annual Report.

Wine and Spirits The production of extraordinary class wine and champagne required considerable attention to detail and decades-long commitment to quality. For example, Château d'Yquem's vineyards were cultivated over generations and were made up of vines grown from individually selected seeds. Also, on nine occasions during the 20th century the winery rejected an entire harvest, viewing all grapes from the season as unworthy of the brand. Wine production also required technical expertise to develop techniques to improve the immune systems of vines to prevent grape diseases and the skills of master blenders, who selected combinations of grapes that would result in exceptional vintages. Not any less important was the time required to produce fine wines and champagnes, some of which were aged for several years prior to distribution.

In 2023 LVMH was the world's leading champagne producer with strong demand in Europe, Japan, and emerging countries. The company's revenues generated from champagne and wines increased 24 percent between 2021 and 2022. The company's Hennessy brand was the number one in brand of cognac and its sales of Glenmorangie and Ardbeg whiskies and Belvedere vodka allowed the division's revenue to increase by 14 percent between 2021 and 2022.

Fashion and Leather Goods The fashion and leather industry entailed the recruitment of highly talented and creative designers who were able to create a line of apparel or accessories that appealed to some segment of consumers. Designers had considerable leeway with the direction of their designs since individual tastes and preferences varied considerably among consumers. Other important elements of creating high-end apparel and leather goods included the selection of fabrics or leather and the quality of construction. LVMH's Louis Vuitton products were all hand assembled by craftsmen who had trained for years perfecting their talents. Apparel and leather goods were distributed to either third-party retailers or company-owned retail locations.

LVMH's Louis Vuitton was the world's leading luxury brand and the foundation of LVMH's Fashion and Leather Goods division that had increased sales by 25 percent and operating income by 22 percent between 2021 and 2022. LVMHs' fashion and leather goods division also included such prestigious brands as Kezno, Marc Jacobs, Berlucci, Christian Dior, Celine, Loro Piana, and Fendi.

Perfumes and Cosmetics Success in the global cosmetics, fragrance, and skin care industry was largely attributable to the ability of producers to develop new combinations of chemicals and natural ingredients to create innovative and unique fragrances and develop cosmetics that boasted product benefits beyond cleansing and moisturizing to anti-aging, anti-pollution, and tissue regeneration. LVMH's fragrances, cosmetics and skin care brands were among the world's most prestigious and innovative in their formulations. In addition to product innovation, LVMH's strategy for the division focused on heavy advertising and media investments, connection with its Couture brands, and global expansion of its brands. The revenue of LVMH's perfumes and cosmetics division had grown from by 47 percent between 2020 and 2022 and the division's operating profit margin had improved from 1.5 percent in 2020 to 8.5 percent in 2022.

The division's growth was attributed to its iconic French fragrances such as *Miss Dior* and *J'adore* by Christian Dior and because of its hit new fragrances such as its men's fragrance *Sauvage* and Acqua di Parma. The division also benefited from the popularity of its Guerlain skin care products and cosmetics and relatively new American cosmetics brands such as Benefit, Make Up For Ever, and Fresh and the success of other new business additions such as Kenzo Parfums, Maison Francis Kurkdjian, and Fenty Beauty.

Watches and Jewelry The watch and jewelry industry was much like the fashion and cosmetics and fragrances industries in that it was highly fragmented with multiple product categories and wide-ranging price points. The upscale segment of the industry also reflected the fashion industry's demand for quality and creative or distinctive designs. The producers of many exquisite timepieces such as Rolex, Cartier, and Patek Phillipe maintained long-established lines not only known for style, but also craftsmanship and accuracy. Most manufacturers of upmarket watches also added new models from time to time that were consistent with the company's tradition, history, and style. Watch production involved the development and production of the movement (although many watch manufacturers purchased movements from third-party suppliers), case design and fabrication, and assembly. Watches were rarely sold by manufacturers directly to consumers but were usually distributed to independent jewelers or large upscale department stores for retail sale to consumers.

LVMH's watch and jewelry division was established in 1999 with the acquisitions of TAG Heuer, Chaumet, and Zenith. The Hublot and Bulgari brands were added in 2008 and 2011, respectively. The acquisition of Tiffany in 2020 provided the company with a platform for growth in jewelry and especially high jewelry, which doubled in sales between 2021 and 2022. Some lines offered by Tiffany's carried price tags beginning at $100,000. LVMH also added new lines such as T and HardWear, and the Lock collection. The company was also conducting a complete renovation of its Fifth Avenue flagship store at an estimated cost of $500 million. The Fifth Avenue store reopened in April 2023.

The division revenue had more than doubled between 2020 and 2022, growing from €3,356 million in 2020 to €10,581 million in 2022. Similarly, its profit from recurring operations grew nearly sevenfold from €302 in 2020 to €2,017 in 2022.

Selective Retailing LVMH's selective retailing division was made up of DFS and Starboard Cruise Services duty-free stores, the Le Bon Marché department store, and Sephora cosmetics stores. Le Bon Marché was Paris' most exclusive department store and Sephora was among the leading retail beauty chains in Europe and North America. The Sephora retail chain operated stores in North America, Europe, Australia, Southeast Asia, and the Middle East. Sephora carried LVMH's products and other prestigious brands of cosmetics, fragrances, and skin care products including CHANEL, Dolce and Gabbana, Elizabeth Arden, Hugo Boss, Naomi Campbell, Gianni Versace, and Burberry.

The division's 2001 sales grew by more than 46 percent between 2020 and 2022 to reach €14,852. The division's profits from recurring operations had improved from a €203 million operating loss in 2020 to an operating profit of €788 in 2022.

Other Activities LVMH also maintained a business unit made up of media, luxury yacht production, a leisure park, and a luxury hotel chain. LVMH believed the businesses were important elements of its business portfolio because of the company's obligation to be an ambassador for culture and because of the natural linkage between its luxury brands and Art de Vivre (translated as "the art of living.") Media properties included *Investir,* France's leading online and print daily investment publication, *Le Parisien,* a general interest news brand, Radio Classique's network of radio stations across France, *Connaissance des Arts* that was a benchmark art publication and *Les Echos,* a leading French daily newspaper.

Jardin D'Acclimation was France's first leisure and amusement park that opened in 1860 and included historic amusement rides, a miniature steam powered train, walking trails, and sitting areas. LVMH began the Cheval Blanc hotel chain in 2006, which offered guests the most luxurious accommodations along with world-class services tailored to the individual requests of each guest. In 2023, LVMH operated Belmond and Cheval Blanc hotels in prestigious locations across Europe, the Caribbean, and Asia.

The remaining business included in LVMH's Other Activities was Royal Van Lent. The Dutch yacht maker dated to 1849 and only built custom designed yachts larger than 50 meters. The massive luxury yachts were sold under the Feadship brand name and were among the most elegant in the Mediterranean and the Caribbean. Despite the high sales prices of Feadship yachts and well-respected reputations of its other businesses in the division, LVMH's Other Activities recorded operating losses in 2021 and 2022.

LVMH'S PERFORMANCE IN 2023

In 2023, LVMH's performance showed no sign of slowing with its stock price continuing to soar. The company had become the world's most valuable company and its CEO, Barnard Arnault had become the world's richest person. During the first six months of 2023, LVMH's revenues had grown by 17 percent year-over-year. Selective Retailing led the growth with 30 percent year-over-year growth. Only the Other Activities unit experienced a decline in revenues during the first six months of 2023. LVMH management also announced a €1.5 billion share buyback program that would be completed between March 1, 2023, and July 20, 2023. The company's management had stated that LVMH "relied on the talent and motivation of its teams, the diversity of its business and good geographical balance of its revenue to further strengthen its global leadership position in luxury goods in 2023."[4]

ENDNOTES

[1] As quoted in Kotov, Nick, and Suzanne Kapner, "World's Richest Man Likes the View Atop Refurbished Tiffany," *The Wall Street Journal,* April 28, 2023.

[2] "The Perfect Paradox of Star Brands: An Interview with Bernard Arnault of LVMH," *Harvard Business Review,* October 2001, Vol. 79, Issue 9, p. 116.

[3] Ibid.

[4] As quoted in "Excellent Start to the Year for LVMH," *LVMH Press Release,* April 12, 2023.

CASE 21

PepsiCo's Diversification Strategy in 2023

John E. Gamble
Texas A&M University–Corpus Christi

PepsiCo was the world's largest snack and beverage company, with 2022 net revenues of approximately $86.4 billion. The company's portfolio of businesses in 2023 included Frito-Lay salty snacks, Quaker Chewy granola bars, Pepsi soft-drink products, Stacy's pita chips, Gatorade, Propel, Bubly, Sabra hummus, Quaker Oatmeal, Cap'n Crunch, Aquafina, Mountain Dew, Rice-A-Roni, and many other regularly consumed products. The company viewed the lineup as highly complementary since most of its products could be consumed together. For example, Stacy's pita chips and Sabra hummus might make a nice snack, and Doritos and an Aquafina might be part of someone's lunch. While PepsiCo's shares had underperformed relative to companies competing in high growth industries prior to 2021, the company had shown resilience and achieved growth in revenues and earnings during economic turbulence brought about by the COVID-19 pandemic. In fact, PepsiCo's common shares outperformed the S&P 500 Index by about a 25 percent margin in 2022.

The company's top managers were focused on sustaining growth in revenues and earnings through strategies keyed to product innovation, international expansion, and strategic acquisitions. New product innovations that addressed consumer health and wellness concerns were important contributors to the company's 10.0 percent annual growth rate in U.S. revenues between 2020 and 2022. PepsiCo's focus on growth in international markets allowed the company's total revenues to also increase by 10.0 percent annually between 2020 and 2022. International markets with the highest annual growth rates in revenues between 2021 and 2022 included Mexico with a 19.4 percent annual growth rate, Russia with a 20.2 percent annual growth rate, and Canada with a 3.8 percent annual growth rate.

In addition to focusing on strategies designed to deliver revenue and earnings growth, the company maintained an aggressive share repurchase and dividend policy, with more than $7 billion returned to shareholders in 2022 through share repurchases of $1.5 billion and dividends of approximately $6.2 billion. The company bolstered its cash returns through carefully considered capital expenditures and acquisitions and a focus on operational excellence. Its investments were focused on manufacturing automation, a rationalized global manufacturing plan, and reengineered distribution systems to drive efficiency. In addition, the company's Pep+ (PepsiCo Positive) sustainability plan focused on minimizing the company's impact on the environment by lowering energy and water consumption and reducing its use of packaging material, meeting internal diversity, equity, and inclusion (DEI) goals, and supporting and investing in the local communities in which it operated. For example, the company was transitioning to renewable energy sources with a goal of achieving net zero emissions by 2040. The company also planned to reduce water use and replenish more water than it used by 2030 and to cut virgin plastic use by 50 percent between 2020 and 2030.

The company continued to manage its portfolio of food and beverage brands to focus on growth. Many of its spikes in revenue growth in the past two decades had followed major acquisitions such as its

$13.6 billion acquisition of Quaker Oats in 2001, the 2010 acquisition of the previously independent Pepsi Bottling Group and PepsiCo Americas for $8.26 billion, the acquisition of Russia's leading food and beverage company Wimm-Bill-Dann (WBD) Foods for $3.8 billion in 2011, the 2020 acquisitions of Pioneer Foods in South Africa for $1.2 billion, and Rockstar energy drink for $3.85 billion. The company also shifted the makeup of its portfolio to eliminate slow-growth businesses, including the spin-off of Tropicana and Naked juices as a joint venture with 39 percent noncontrolling interest in 2022. Management of PepsiCo's brand lineup was essential to future growth as annual consumption of carbonated soft drinks fell each year. A summary of PepsiCo's financial performance between 2020 and 2022 is shown in Exhibit 1. Exhibit 2 presents PepsiCo's consolidated balance sheets for 2021 and 2022. The company's calculation of free cash flow for 2020–2022 is shown in Exhibit 3. Exhibit 4 tracks PepsiCo's market performance between April 2018 and April 2023.

COMPANY HISTORY

PepsiCo, Inc., was established in 1965 when Pepsi-Cola and Frito-Lay shareholders agreed to a merger between the salty-snack icon and soft-drink giant. The new company was founded with annual revenues of $510 million and such well-known brands as Pepsi-Cola, Mountain Dew, Fritos, Lay's, Cheetos, Ruffles, and Rold Gold. PepsiCo's roots can be traced to 1898 when New Bern, North Carolina, pharmacist Caleb Bradham created the formula for a carbonated beverage he named Pepsi-Cola. The company's salty-snack business began in 1932 when Elmer Doolin, of San Antonio, Texas, began manufacturing and marketing Fritos corn chips and

EXHIBIT 1 PepsiCo's Consolidated Statements of Income, 2019–2022 (in millions, except per share amounts)

	2022	2021	2020	2019
Net Revenue	$86,392	$79,474	$70,372	$67,161
Cost of sales	40,576	37,075	31,797	30,132
Gross profit	45,816	42,399	38,575	37,029
Selling, general and administrative expenses	34,459	31,237	28,495	26,738
Operating Profit	11,512	11,162	10,080	10,291
Other pension and retiree medical benefits income/(expense)	132	522	117	(44)
Net interest expense and other	(939)	(1,863)	(1,128)	(935)
Income before income taxes	10,705	9,821	9,069	9,312
Provision for income taxes	1,727	2,142	1,894	1,959
Net income	8,978	7,679	7,175	7,353
Less: Net income attributable to noncontrolling interests	68	61	55	39
Net Income Attributable to PepsiCo	$ 8,910	$ 7,618	$ 7,120	$ 7,314
Net Income Attributable to PepsiCo per Common Share				
Basic	$ 6.45	$ 5.51	$ 5.14	$ 5.23
Diluted	$ 6.42	$ 5.49	$ 5.12	$ 5.20
Weighted-average common shares outstanding				
Basic	1,380	1,382	1,385	1,399
Diluted	1,387	1,389	1,392	1,407

Source: PepsiCo 2022 10-K.

EXHIBIT 2 PepsiCo, Inc. 's Consolidated Balance Sheets, 2021–2022 (in millions, except per share data)

	2022	2021
ASSETS		
Current Assets		
Cash and cash equivalents	$ 4,954	$ 5,596
Short-term investments	394	392
Accounts and notes receivable, net	10,163	8,680
Inventories	5,222	4,347
Prepaid expenses and other current assets	806	980
Assets held for sale	—	1,788
Total current assets	21,539	21,783
Property, plant, and equipment, net	24,291	22,407
Amortizable intangible assets, net	1,277	1,538
Goodwill	18,202	18,381
Other indefinite-lived intangible assets	14,309	17,127
investments in noncontrolled affiliates	3,073	2,350
deferred income taxes	4,204	4,310
Other assets	5,292	4,481
Total assets	92,187	92,377
LIABILITIES AND EQUITY		
Current Liabilities		
Short-term debt obligations	3,414	4,308
Accounts payable and other current liabilities	23,371	21,159
Liabilities held for sale	—	753
Total current liabilities	26,785	26,220
Long-term debt obligations	35,657	36,026
Deferred income taxes	4,133	4,826
Other liabilities	8,339	9,154
Total liabilities	74,914	76,226
Commitments and contingencies		
PepsiCo Common Shareholders' Equity		
Common stock, par value 1 2 / 3 ¢ per share (authorized 3,600 shares; issued, net of repurchased common stock at par value: 1,377 and 1,383 shares, respectively)	23	23
Capital in excess of par value	4,134	4,001
Retained earnings	67,800	65,165
Accumulated other comprehensive loss	(15,302)	(14,898)
Repurchased common stock, in excess of par value (490 and 484 shares, respectively)	(39,506)	(38,248)
Total PepsiCo common shareholders' equity	17,149	16,043
Noncontrolling interests	124	108
Total equity	17,273	16,151
Total liabilities and equity	$92,187	$92,377

Source: PepsiCo, Inc. 2022 10-K.

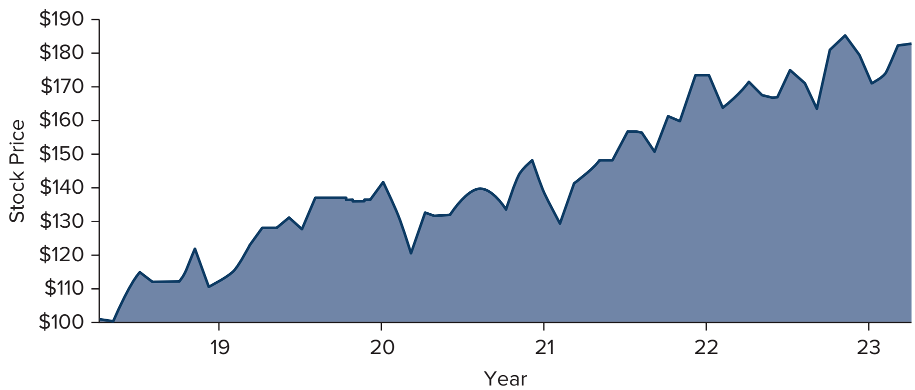
EXHIBIT 3 Net Cash Provided by PepsiCo's Operating Activities, 2020–2022 (in millions)

	2022	2021	2020
Net cash provided by operating activities, GAAP measure	$10,811	$11,616	$10,613
Capital spending	(5,207)	(4,625)	(4,240)
Sales of property, plant, and equipment	251	166	55
Free cash flow, non-GAAP measure	$ 5,855	$ 7,157	$ 6,428

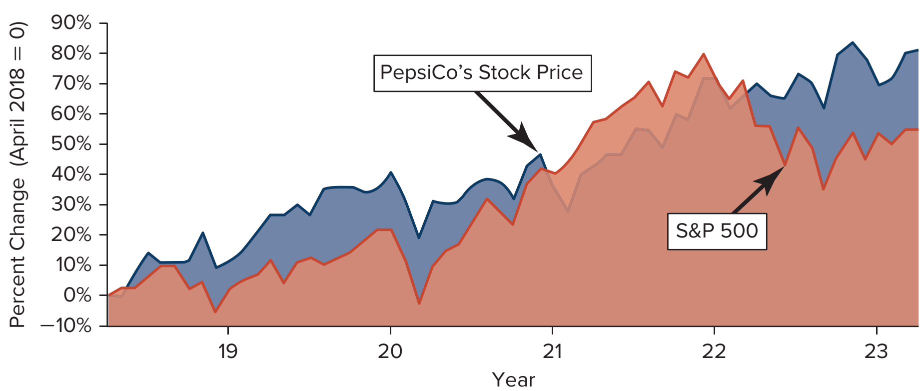
Source: PepsiCo, Inc. 2022 10-K.

EXHIBIT 4 Monthly Performance of PepsiCo, Inc.'s Stock Price, April 2018–April 2023

(a) Trend in PepsiCo, Inc.'s Common Stock Price



(b) Performance of PepsiCo, Inc.'s Stock Price versus the S&P 500 Index



Source: Bigcharts.marketwatch.com

Herman Lay started a potato chip distribution business in Nashville, Tennessee. In 1961, Doolin and Lay agreed to a merger between their businesses to establish the Frito-Lay Company.

During PepsiCo's first five years as a snack and beverage company, it introduced new products such as Doritos and Funyuns, entered markets in Japan and eastern Europe, and opened, on average, one new snack-food plant per year. By 1971, PepsiCo had more than doubled its revenues to reach $1 billion. The company began to pursue growth through acquisitions outside snacks and beverages as early as 1968, but its 1977 acquisition of Pizza Hut significantly shaped the strategic direction of PepsiCo for the next 20 years. The acquisitions of Taco Bell in 1978 and Kentucky Fried Chicken in 1986 created a business portfolio described by Wayne Calloway (PepsiCo's CEO between 1986 and 1996) as a balanced three-legged stool. Calloway believed the combination of snack foods, soft drinks, and fast food offered considerable cost sharing and skill transfer opportunities, and he routinely shifted managers among the company's three divisions as part of the company's management development efforts.

PepsiCo strengthened its portfolio of snack foods and beverages during the 1980s and 1990s with the acquisitions of Mug Root Beer, 7-Up International, Smartfood ready-to-eat popcorn, Walker's Crisps (United Kingdom), Smith's Crisps (United Kingdom), Mexican cookie company Gamesa, and Sunchips. Calloway added quick-service restaurants Hot-n-Now in 1990; California Pizza Kitchens in 1992; and East Side Mario's, D'Angelo Sandwich Shops, and Chevy's Mexican Restaurants in 1993. The company expanded beyond carbonated beverages through a 1992 agreement with Ocean Spray to distribute single-serving juices, the introduction of Lipton ready-to-drink (RTD) teas in 1993, and the introduction of Aquafina bottled water and Frappuccino ready-to-drink coffees in 1994.

In 1997, CEO Roger Enrico spun off the company's restaurants as an independent, publicly traded company to focus PepsiCo on food and beverages. Soon after the spin-off of PepsiCo's fast-food restaurants was completed, Enrico acquired Cracker Jack, Tropicana, Smith's Snackfood Company in Australia, SoBe teas and alternative beverages, Tasali Snack Foods (the leader in the Saudi Arabian salty-snack market), and the Quaker Oats Company.

PepsiCo's 2001 Acquisition of Quaker Oats

PepsiCo's $13.9 billion acquisition of Quaker Oats in 2001 was the company's largest ever acquisition and gave it the number-one brand of oatmeal in the United States, with more than a 60 percent category share; the leading brand of rice cakes and granola snack bars; and other well-known grocery brands such as Cap'n Crunch and Rice-A-Roni. However, Quaker's most valuable asset in its arsenal of brands was Gatorade.

Gatorade was developed by University of Florida researchers in 1965, but it was not marketed commercially until the formula was sold to Stokley-Van Camp in 1967. When Quaker Oats acquired the brand from Stokely-Van Camp in 1983, Gatorade gradually made a transformation from a regionally distributed product with annual sales of $90 million to a $2 billion powerhouse. Gatorade was able to increase sales by more than 10 percent annually during the 1990s, with no new entrant to the sports beverage category posing a serious threat to the brand's dominance. PepsiCo, Coca-Cola, France's Danone Group, and Swiss food giant Nestlé all were attracted to Gatorade because of its commanding market share and because of the expected growth in the isotonic sports beverage category.

Additional PepsiCo Acquisitions (2002–2022)

After the completion of the Quaker Oats acquisition in 2001, the company made a number of acquisitions of small, fast-growing food and beverage companies in the United States and internationally to broaden its portfolio of brands. Such acquisitions in 2006 included Stacey's bagel and pita chips, Izze carbonated beverages, Netherlands-based Duyvis nuts, and Star Foods (Poland). Acquisitions made during 2007 included Naked Juice fruit beverages, Sandora juices in Ukraine, New Zealand's Bluebird snacks, Penelopa nuts and seeds in Bulgaria, and Brazilian snack producer Lucky. The company also entered into a joint venture with the Strauss Group in 2007 to market Sabra—the top-selling and fastest-growing brand of hummus in the United States and Canada. The company acquired the Russian beverage producer Lebedyansky in 2008 for $1.8 billion, and in 2010 it acquired Marbo, a potato chip production operation in Serbia.

In 2010 and 2011, the company executed its largest acquisitions since the 2001 acquisition of Quaker Oats. In 2010, PepsiCo acquired the previously independent Pepsi Bottling Group and PepsiCo Americas for $8.26 billion in cash and PepsiCo common shares. The acquisition was designed to better integrate its global distribution system for its beverage business. In 2011, it acquired Russia's leading food and beverage company, Wimm-Bill-Dann Foods, for $3.8 billion. The combination of acquisitions and the strength of PepsiCo's core snacks and beverages business allowed the company's revenues to increase from approximately $29 billion in 2004 to more than $66 billion in 2013.

PepsiCo made additional small acquisitions totaling less than $500 million annually after its acquisition of Wimm-Bill-Dann Foods including the $200 million acquisition of KeVita beverages in 2016 and its 2018 acquisition of Bare Foods for an undisclosed amount. Both acquisitions were intended to expand its lineup of lower calorie and lower sodium products. PepsiCo also acquired SodaStream in 2018 for $3.2 billion to capture a larger share of the sparkling water category and to meet its commitment to reduce plastic waste. The company acquired CytoSport in 2019, which was the maker of Muscle Milk protein shakes and Evolve protein bars. PepsiCo initiated a mix of acquisitions of larger brands and smaller companies in 2020, with the acquisition of BFY Brands in 2020 for an undisclosed amount, Haomusi Food Co., Ltd. for $700 million, Pioneer Foods for $1.2 billion, and Rockstar Energy Beverages for $3.85 billion. In August 2022, PepsiCo made a $550 million investment in Celsius, the fourth most popular energy drink brand in the United States. The investment would give PepsiCo an 8.5 percent ownership stake in the company and allow PepsiCo to distribute the beverage to its wholesale customers. A listing of PepsiCo's leading brands is presented in Exhibit 5.

EXHIBIT 5 PepsiCo, Inc.'s Leading Brands by Category, 2023

Top Global Brands	Beverages	Snacks	Convenience Foods
• Pepsi	• KeVita Probiotic Beverages	• Fritos	• Quaker Oats
• Lays	• Pepsi	• Lay's	• Quaker Chewy granola bars
• Mountain Dew	• Aquafina	• Doritos	• Pearl Milling pancake mixes and syrups
• Gatorade	• Gatorade	• Cheetos	• Matador jerky
• Diet Pepsi	• LIFEWTR	• Tostitos Sabritas Chips	• Sabra Hummus
• 7-Up	• Propel	• Walkers Chips	• Cap'n Crunch cereal
• Doritos	• O.N.E. coconut water	• Stacy's Chips	• Life cereal
• Quaker Oats	• Pure Leaf	• Smartfood Snacks	• Rice-A-Roni side dishes
• Cheetos	• Muscle Milk	• Lay's Baked	• Evolve protein bars
• Mirinda	• Pepsi Zero Sugar	• Near East snacks	
• Lipton	• Bubly Sparkling Water	• Pop Corners	
• Ruffles	• Soda Stream	• Duyvis Oven Roasted Snacks	
• Tostitos	• Mirinda Soft Drinks	• Nut Harvest	
• Aquafina	• Starbucks Ready-to-Drink Beverages	• Off the Eaten Path veggie snacks	
• Brisk	• Mountain Dew	• Bare snacks	
• Fritos	• Rockstar Energy Drink		
• Diet Mountain Dew	• Stubborn Soda		
• Starbucks Ready-to-Drink Beverages	• Celsius Energy Drink		
• Walkers Chips			

Source: Pepsico.com.

PEPSICO'S BUSINESS UNIT PERFORMANCE

PepsiCo's corporate strategy had diversified the company into salty and sweet snacks, soft drinks, bottled water, ready-to-drink teas and coffees, purified and functional waters, isotonic beverages, hot and ready-to-eat breakfast cereals, grain-based products, and breakfast condiments. Most PepsiCo brands had achieved number-one or number-two positions in their respective food and beverage categories through strategies keyed to product innovation, close relationships with distribution allies, international expansion, and strategic acquisitions. The company was committed to producing the highest-quality products in each category and was working diligently on product reformulations to make snack foods and beverages less unhealthy. The company believed that its efforts to develop better-for-you products would create growth opportunities from the intersection of business and public interests.

PepsiCo was organized into six business divisions, which all followed the corporation's general strategic approach. Frito-Lay North America manufactured, marketed, and distributed such snack foods as Lay's potato chips, Doritos tortilla chips, Cheetos cheese snacks, Fritos corn chips, Grandma's cookies, and Smartfood popcorn. Quaker Foods North America manufactured and marketed cereals, rice and pasta dishes, granola bars, and pancake mixes and syrups, and other food items that were sold in supermarkets. PepsiCo Beverages North America manufactured, marketed, and sold beverage concentrates, fountain syrups, and finished goods under such brands as Pepsi, Gatorade, Aquafina, Mountain Dew, Rockstar, and Propel throughout North America. Latin America manufactured, marketed, and distributed snack foods and many Quaker-branded cereals and snacks in Latin America. The division also produced, marketed, distributed, and sold PepsiCo beverage brands in Latin America. Europe manufactured, marketed, and sold snacks and beverages throughout Europe, while the company's Africa, Middle East, and South Asia division produced, marketed, and distributed snack brands, Quaker-branded convenient foods, and beverages in those regions. Asia Pacific, Australia and New Zealand, and China Region manufactured and marketed snacks, beverages, and Quaker-branded convenient food items that were distributed throughout the region. Select financial information for PepsiCo's six reporting units for 2020 through 2022 is presented in Exhibit 6.

EXHIBIT 6 Select Financial Data for PepsiCo, Inc.'s Business Segments, 2020–2022 (in millions)

	2022	2021	2020
Net Revenue			
Frito-Lay North America	$23,291	$ 19,608	$ 18,189
Quaker Foods North America	3,160	2,751	2,742
PepsiCo Beverages North America	26,213	25,276	22,559
Latin America	9,779	8,108	6,942
Europe	12,724	13,038	11,922
Africa, Middle East, South Asia	6,438	6,078	4,573
Asia Pacific, Australia and New Zealand and China	4,787	4,615	3,445
Total division	$86,392	$ 79,474	$ 70,372
Operating Profit	2022	2021	2020
Frito-Lay North America	$6,135	$ 5,633	$ 5,340
Quaker Foods North America	604	578	669
PepsiCo Beverages North America	5,426	2,442	1,937
Latin America	1,627	1,369	1,033

	2022	2021	2020
Europe	(1,380)	1,292	1,353
Africa, Middle East, South Asia	666	858	600
Asia Pacific, Australia and New Zealand and China	537	673	590
Total division	13,615	12,845	11,522
Corporate unallocated expenses	(2,103)	(1,683)	(1,442)
Total	$11,512	$ 11,162	$ 10,080
Capital Spending	2022	2021	2020
Frito-Lay North America	$1,464	$ 1,411	$ 1,189
Quaker Foods North America	93	92	85
PepsiCo Beverages North America	1,714	1,275	1,245
Latin America	581	461	390
Europe	668	752	730
Africa, Middle East, South Asia	307	325	252
Asia Pacific, Australia and New Zealand, and China	241	203	230
Total division	5,068	4,519	4,121
Corporate unallocated expenses	139	106	119
Total	$5,207	$ 4,625	$ 4,240
Amortization of Intangible Assets	2022	2021	2020
Frito-Lay North America	$11	$ 11	$ 10
Quaker Foods North America	—	—	—
PepsiCo Beverages North America	22	25	28
Latin America	3	4	4
Europe	30	37	40
Africa, Middle East, South Asia	4	5	3
Asia Pacific, Australia and New Zealand and China	8	9	5
Total division	78	91	90
Corporate unallocated expenses	—	—	—
Total	$78	$ 91	$ 90
Depreciation and Other Amortization	2022	2021	2020
Frito-Lay North America	$ 653	$ 594	$ 550
Quaker Foods North America	47	46	41
PepsiCo Beverages North America	930	926	899
Latin America	306	283	251
Europe	357	364	350
Africa, Middle East, South Asia	179	181	149
Asia Pacific, Australia and New Zealand and China	92	102	91
Total division	2,564	2,496	2,331
Corporate unallocated expenses	121	123	127
Total	$2,685	$ 2,619	$ 2,458

Source: PepsiCo, Inc. 2021 10-K.

Frito-Lay North America

In 2022 Frito-Lay owned the top-selling chip brand in each U.S. salty-snack category and held more than a 2-to-1 lead over the next-largest snack-food maker in the United States. Key trends that were shaping the industry were a growing awareness of the nutritional content of snack foods and product innovation. Recently acquired brands such as Bare Foods baked fruit and vegetable snacks offered an opportunity for the Frito-Lay to exploit consumers' desires for healthier snacks and address a deficiency in most diets. Americans, on average, consumed only about 50 percent of the U.S. Department of Agriculture's recommended daily diet of fruits and vegetables. By 2025, the company expected that 75 percent of its global foods portfolio volume would not exceed 1.3 milligrams of sodium per calories and 1.1 grams of saturated fat per 100 calories. PepsiCo innovations were directed at adding new flavors of popular brands and adding to its lineup of healthier snacks. Examples of these innovations included Lay's Poppables, Doritos Walking Tacos, El Isleño plantain chips, NatuChips, and its Simple line of healthier versions of Cheetos, Doritos, Lay's, Tostitos, and Ruffles chips.

Frito-Lay North America's (FLNA's) revenues increased by 19 percent between 2021 and 2022 with volume sales decreasing by one percent. The decrease in volume resulted from more than a 10 percent decline in Sabra sales and slower sales of variety packs of chips. However, the division was able to boost operating profit by 9 percent between 2021 and 2022 through productivity savings, price increases and a 53rd reporting week during the fiscal year. The division produced 27 percent of PepsiCo's net revenues in 2022 and 45 percent of its operating profit.

Quaker Foods North America

Quaker Foods North American (QFNA) produced, marketed, and distributed hot and ready-to-eat cereals, pancake mixes and syrups, and rice and pasta side dishes in the United States and Canada. Quaker Oatmeal, Life cereal, and Cap'n Crunch cereal volumes competed in mature industries with weak competitive positions relative to Kellogg's and General Mills. Quaker Oats was the star product of the division, with a commanding share of the North American market for oatmeal. The division recorded sales of more than $2.7 billion in 2021. The sales volume of Quaker Foods products decreased by 3 percent between 2021 and 2022 as sales of pancake mixes, syrups, and ready-to-eat cereals declined at double-digit rates and sales of oatmeal declined at a high-single-digit rate between 2021 and 2022. Revenues and operating profit for the QFNA division increased by 15 percent and 4.5 percent between 2021 and 2022 as a result of a 53rd reporting week, price increases, and productivity savings.

PepsiCo Beverages North America

PepsiCo was the second largest seller of nonalcoholic beverages in North America during 2021, with a market share of 26 percent. Coca-Cola was the largest nonalcoholic beverage producer in North America, with a 46 percent market share in 2021. Dr. Pepper Snapple Group was the third-largest beverage seller in 2021 and was followed by Red Bull. As with Frito-Lay, PepsiCo's beverage business contributed greatly to the corporation's overall profitability and free cash flows and was heavily impacted by consumer preferences for healthier food and beverage choices.

In 2022, PepsiCo Beverages North America (PBNA) accounted for 30 percent of the corporation's total revenues and 40 percent of its operating profits. The PBNA division's $1 billion brands included Gatorade, Lipton ready-to-drink tea, Pepsi, Diet Pepsi, Mountain Dew, Diet Mountain Dew, Aquafina, Miranda, Sierra Mist, Starbucks cold-coffee drinks, and SoBe. The global carbonated soft drinks industry accounted for $221.6 billion in sales in 2021 and was projected to grow at an annual rate of 4.7 percent through 2028. The division's revenues increased by 4 percent between 2021 and 2022, which was driven by a 1 percent increase in overall volume and increased pricing. The division's volume increased by 1 percent between 2021 and 2022, with carbonated soft drinks declining by 1 percent and sales of noncarbonated beverages increasing by approximately 5 percent between 2021 and 2022.

Latin America

PepsiCo management believed international markets offered the company's greatest opportunity for growth since per capita consumption of snacks in the United States averaged 6.6 servings per month while per capita consumption in other developed countries averaged 4 servings per month and in developing countries averaged 0.4 serving per month. PepsiCo executives expected China and Brazil to become the two largest international markets for snacks, with significant growth also expected in Mexico, Argentina, and Chile.

Developing an understanding of consumer taste preferences was a key to expanding into international markets. Taste preferences for salty snacks were more similar from country to country than were preferences for many other food items, and this allowed PepsiCo to make only modest modifications to its snacks in most countries. For example, classic varieties of Lay's, Doritos, and Cheetos snacks were sold in Latin America. In addition, consumer characteristics in the United States that had forced snack-food makers to adopt healthier snacks applied in most other developed countries as well.

PepsiCo was the second-largest seller of snacks and beverages in Mexico, and its Doritos, Marias Gamesa, Cheetos, Ruffles, Emperador, Saladitas, Sabritas, and Tostitos brands were popular throughout most of Latin America. The division's revenues had grown from $6.9 billion in 2020 to $9.8 billion in 2022 and accounted for 11 percent of 2021 total net revenues. The division's revenues increased by 21 percent between 2021 and 2022 as a result of price increases, but its sales volume of snacks and beverages improved at a double-digit rate in Argentina and by single-digit rates in Mexico, Chile, Brazil, and Guatemala between 2021 and 2022. The division's net price increases, productivity savings, and favorable exchange rates led to a 19 percent increase in operating profit between 2021 and 2022.

Europe

All of PepsiCo's global brands were sold in Europe, as well as its country- or region-specific brands such as Domik v Derevne, Chjudo, and Agusha. The company's acquisition of Wimm-Bill-Dann Foods, along with sales of its long-time brands, made it the number-one food and beverage company in Russia, with a 2-to-1 advantage over its nearest competitor. It was also the leading seller of snacks and beverages in the United Kingdom. The division's snack volume sales declined by 4 5 percent during 2022, largely because of the war between Ukraine and Russia but also because of slowing growth across much of western Europe. Single-digit volume growth did occur between 2021 and 2022 in the United Kingdom, France, and Turkey. Beverage sales declined at a 7 percent rate between 2021 and 2022, driven by double-digit declines in Russia, Ukraine, and Germany. The division recorded an operating loss of $1.4 billion in 2021 compared to an operating profit of $1.3 billion in 2021.

Africa, Middle East and South Asia

PepsiCo's business unit operating in Asia, the Middle East, and South Asia manufactured and marketed all of the company's global brands and many regional brands such as Kurkure, Sasko, and Chipsy. The division's revenues had increased by 6 percent between 2021 and 2022. Convenient food sales volume improved by 2 percent in 2022 and beverage volume grew by 14 percent between 2021 and 2022, which was driven by single-digit growth in Pakistan and Middle Eastern markets. Operating profit for the division declined by 22 percent between 2021 and 2022, which reflected higher commodity costs and impairment charges related to the divestiture of non-strategic brands.

Asia Pacific, Australia and New Zealand, and China Region

PepsiCo's business unit operating in Asia Pacific, Australia and New Zealand, and the China Region manufactured and marketed all of the company's global brands and regional brands such as BaiCaoWei, Be & Cheery, and Sting. The division's revenues had increased by 4 percent between 2021 and 2022, reflecting the acquisition of Haomusi Food Co., Ltd. in 2020. Haomusi's most prominent brand was the Be & Cheery brand, sold in China. Convenient foods volume increased by 3 percent in 2022 with low single-digit growth generated in China, Australia, and Thailand. Beverage unit volume increased by 8 percent between 2021 and 2022 as sales in Vietnam improved during 2022 at a double-digit rate. Beverage sales volume also grew in the Philippines and Thailand at single-digit rates. Operating income decreased by 20 percent during 2022 as a result of higher commodity costs and increased advertising and marketing expenses.

Value Chain Alignment between PepsiCo Brands and Products

PepsiCo's management team was dedicated to capturing strategic-fit benefits within the business lineup throughout the value chain. The company's procurement activities were coordinated globally to achieve the greatest possible economies of scale, and best practices were routinely transferred among its more than 200 plants, over 3,500 distribution sytems, and 120,000 service routes around the world. PepsiCo management had a proven ability to capture strategic fits between the operations of new acquisitions and its other businesses. In total, the company estimated that the synergies among its business units generated approximately $1 billion annually in productivity savings. PepsiCo also shared market research information with its divisions to better enable each division to develop new products likely to be hits with consumers, and the company coordinated its Power of One activities across product lines.

PEPSICO'S STRATEGIC SITUATION IN 2023

PepsiCo's strategy keyed to building its global brands, developing product innovations, and boosting productivity through efficient operations had produced strong operating profits and annual free cash flows through 2022. The company had also achieved growth in revenues through high-potential acquisitions and divestitures of slow-growth businesses. Nevertheless, the company had struggled to achieve organic growth in many of its major project categories and promising international markets. While PepsiCo continued to provide its investors with attractive dividend payments, the company had yet to prove that its diversification strategy could deliver significant increases in shareholder value.

The company was aggressively pursuing a strategy to increase its more nutritious brands and improve the overall healthiness of its product portfolio. Its acquisitions of established brands such as Gatorade and Quaker had added to its portfolio of $1 billion brands and new acquisitions such as Rockstar, SodaStream, Celsius energy drink, and Muscle Milk might soon add to that list with healthy food and beverages. Additional product introductions and acquisitions such as Bubly and Bare Foods might also contribute to future revenue growth. However, some food and beverage industry analysts had speculated that additional corporate strategy changes might also be required to restore previous revenue and earnings growth rates and lead to increases in shareholder value.

CASE 22

Robin Hood

Joseph Lampel
Alliance Manchester Business School

It was in the spring of the second year of his insurrection against the High Sheriff of Nottingham that Robin Hood took a walk in Sherwood Forest. As he walked, he pondered the progress of the campaign, the disposition of his forces, the Sheriff's recent moves, and the options that confronted him.

The revolt against the Sheriff had begun as a personal crusade. It erupted out of Robin's conflict with the Sheriff and his administration. However, alone Robin Hood could do little. He therefore sought allies, men with grievances and a deep sense of justice. Later he welcomed all who came, asking few questions and demanding only a willingness to serve. Strength, he believed, lay in numbers.

He spent the first year forging the group into a disciplined band, united in enmity against the Sheriff and willing to live outside the law. The band's organization was simple. Robin ruled supreme, making all important decisions. He delegated specific tasks to his lieutenants. Will Scarlett was in charge of intelligence and scouting. His main job was to shadow the Sheriff and his men, always alert to their next move. He also collected information on the travel plans of rich merchants and tax collectors. Little John kept discipline among the men and saw to it that their archery was at the high peak that their profession demanded. Scarlett took care of the finances, converting loot to cash, paying shares of the take, and finding suitable hiding places for the surplus. Finally, Much the Miller's son had the difficult task of provisioning the ever-increasing band of Merry Men.

The increasing size of the band was a source of satisfaction for Robin, but also a source of concern. The fame of his Merry Men was spreading, and new recruits were pouring in from every corner of England. As the band grew larger, their small bivouac became a major encampment. Between raids the men milled about, talking and playing games. Vigilance was in decline, and discipline was becoming harder to enforce. "Why," Robin reflected, "I don't know half the men I run into these days."

The growing band was also beginning to exceed the food capacity of the forest. Game was becoming scarce, and supplies had to be obtained from outlying villages. The cost of buying food was beginning to drain the band's financial reserves at the very moment when revenues were in decline. Travelers, especially those with the most to lose, were now giving the forest a wide berth. This was costly and inconvenient to them, but it was preferable to having all their goods confiscated.

Robin believed that the time had come for the Merry Men to change their policy of outright confiscation of goods to one of a fixed transit tax. His lieutenants strongly resisted this idea. They were proud of the Merry Men's famous motto: "Rob the rich and give to the poor." "The farmers and the townspeople," they argued, "are our most important allies. How can we tax them, and still hope for their help in our fight against the Sheriff?"

Robin wondered how long the Merry Men could keep to the ways and methods of their early days. The Sheriff was growing stronger and becoming better organized. He now had the money and the men and was beginning to harass the band, probing for its weaknesses. The tide of events was beginning to turn against the Merry Men. Robin felt that the campaign must be decisively concluded before the Sheriff had a chance to deliver a mortal blow. "But how," he wondered, "could this be done?"

Robin had often entertained the possibility of killing the Sheriff, but the chances for this seemed increasingly remote. Besides, killing the Sheriff might satisfy his personal thirst for revenge, but it would not improve the situation. Robin had hoped that the perpetual state of unrest and the Sheriff's failure to collect taxes would lead to his removal from office. Instead, the Sheriff used his political connections to obtain reinforcement. He had powerful friends at court and was well regarded by the regent, Prince John.

Prince John was vicious and volatile. He was consumed by his unpopularity among the people, who wanted the imprisoned King Richard back. He also lived in constant fear of the barons, who had first given him the regency but were now beginning to dispute his claim to the throne. Several of these barons had set out to collect the ransom that would release King Richard the Lionheart from his jail in Austria. Robin was invited to join the conspiracy in return for future amnesty. It was a dangerous proposition. Provincial banditry was one thing, court intrigue another. Prince John had spies everywhere, and he was known for his vindictiveness. If the conspirators' plan failed, the pursuit would be relentless and retributions swift.

The sound of the supper horn startled Robin from his thoughts. There was the smell of roasting venison in the air. Nothing was resolved or settled. Robin headed for camp promising himself that he would give these problems his utmost attention after tomorrow's raid.

CASE 23

Starbucks in 2023: Is the Company Attractively Positioned for the Road Ahead?

McGraw Hill connect

Arthur A. Thompson,
The University of Alabama

Since its founding in 1987 as a modest nine-store operation in Seattle, Washington, Starbucks had become the premier roaster, marketer, and retailer of specialty coffees in the world, with nearly 36,000 store locations in 83 countries as of October 2022 and annual sales of $32.3 billion in fiscal year 2022, ending October 3, 2022. In addition to its flagship Starbucks brand coffees and coffee beverages, Starbucks' other brands and products included Starbucks Reserve blends of coffee, Teavana teas, Seattle's Best Coffee, Ethos bottled waters, and Princi bakery products. Starbucks stores also sold baked pastries, cold and hot sandwiches, salads, salad and grain bowls, oatmeal, yogurt parfaits and fruit cups purchased from a variety of local, regional, and national suppliers.

Starbucks suffered a 21.9 percent drop in after-tax earnings in fiscal 2022, driven largely by a 24 percent decline in sales at its approximately 6,000 stores in China that stemmed from COVID-19 outbreaks in multiple Chinese cities where strictly enforced lockdowns mandated by the Chinese government severely limited customer traffic for four to six months at certain Starbucks stores in cities across China. But in addition to the steep falloff in customer traffic in China, Starbucks' profitability in 2022 was adversely impacted by global price increases for coffee beans and other products Starbucks used in operating its global store network and higher expenses for employee wages and the training of new employees in those countries experiencing sharp inflationary pressures. Despite these impairments to its profitability, Starbucks experienced relatively strong growth across the remainder of its business, resulting in an 11 percent revenue gain over 2021.

In the weeks before Starbucks fiscal 2022 was to conclude, CEO and company founder Howard Schultz, perturbed by the company's less than stellar performance, announced a three-year "Reinvention Plan" to spur the company's growth and earnings by injecting more innovation and fresh approaches into the company's operations. The two key performance targets were to

1. Achieve global revenue growth of 10 percent to 12 percent annually from fiscal 2023 through fiscal 2025.
2. Grow non-GAAP earnings per share by 15 percent to 20 percent annually through fiscal 2025, up from the current target of 10 percent to 12 percent.

To reach the new targets, the Reinvention Plan called for a wide-ranging set of initiatives:

- Growing the number of stores globally to about 45,000 by the end of 2025 and then to approximately 55,000 by the end of fiscal 2030 (as projected in 2020). This target entailed growing the number of store locations in China by about 13 percent annually and accelerating growth in the number of store locations in the United States from 3 percent to 4 percent, and from 6 percent to 7 percent globally.
- Growing same store sales by 7 percent to 9 percent annually, both globally and in the United States, up from the previous range of 4 percent to 5 percent.

- Implementing a series of initiatives to improve employees' experience in working at Starbucks, including increased compensation, enhanced fringe benefits, improved promotion opportunities, and better training—all of which was expected to result in higher productivity and boost employee retention.
- Delivering significant beverage innovation to customers via (1) a proprietary equipment innovation that reduces the time and number of steps to make cold beverages, (2) a proprietary Cold Pressed Cold Brew system that delivers cold press coffee in a matter of seconds and in fewer than four steps, a step-change improvement when compared to its current cold brew which was steeped for 20 hours and took more than 20 steps to make, (3) elevating the quality and craft of hot brewed coffee with the launch of proprietary equipment that could provide customers with a freshly ground, freshly brewed cup of hot coffee in just 30 seconds, and (4) introducing new flavors and beverages prepared in-store.
- Enhancing Starbucks' leadership in the ready-to-drink and at-home channel segments via the introduction of more products and flavors.
- Growing its Starbucks Delivers program in the United States via a new partnership with DoorDash to move toward achieving nationwide order delivery capability alongside Uber Eats in fiscal 2023.
- Strengthening its licensing business model internationally to accelerate increased penetration of foreign markets and the introduction of region-specific beverages.
- Introducing enhancements to the customer experience both in retail stores and online by investing an incremental $450 million in 2023 in purpose-built store concepts (cafes, order pickup, and delivery-only and drive-thru-only locations), beverage innovation, and effortless digital convenience, with further investments in 2024 and 2025. These enhancements were expected to unlock productivity gains, create operating efficiencies, enable increased throughput to support increasing customer demand, and thereby improve store economics enough to produce a 50 percent return on the incremental investment.
- Repurchasing about $20 billion of common stock over the next three years,

Exhibit 1 provides an overview of Starbucks performance for fiscal years 2020–2022.

EXHIBIT 1 Selected Financial and Operating Data for Starbucks Corporation, Fiscal Years 2020–2022 ($ in millions, except for per-share amounts)

	Oct. 2, 2022	Oct.3, 2021	Sept 27, 2020
SELECTED INCOME STATEMENT DATA			
Net revenues:			
Company-operated stores	$26,576.1	$24,607.0	$ 19,164.6
Licensed stores	3,655.5	2,683.6	2,327.1
Consumer packaged goods, foodservice, and other	2,018.7	1,770.0	2,026.3
Total net revenues	32,250.3	29,060.6	23,518.0
Cost of sales	10,317.4	8,738.7	7,694.9
Store operating expenses	13,561.8	11,930.9	10,764.0
Other operating expenses	461.5	359.5	430.3
Depreciation and amortization expenses	1,447.9	1,441.7	1,431.3
General and administrative expenses	2,032.0	1,932.6	1,679.6
Restructuring and impairments	46.0	170.4	278.7
Total operating expenses	27,866.6	24,573.8	$ 2,278.8
Income from equity investees and other	234.1	301.2	322.5
Operating income	$ 4,617.8	$ 3,883.3	$ 1,561.7
Net gain resulting from divestiture of certain operations	—	864.5	—
Interest income and other, net	97.0	90.1	39.7

	Oct. 2, 2022	Oct.3, 2021	Sept 27, 2020
Interest expense	(482.9)	(469.8)	(437.0)
Earnings before income taxes	4,231.9	5,356.9	1,164.4
Income tax expense	948.5	1,156.6	239.7
Net earnings attributable to Starbucks	$ 3,281.6	$ 4,199.3	$ 928.3
Earnings per share—basic	$ 2.85	$ 3.57	$ 0.79
Earnings per share—diluted	2.83	3.54	0.79
Weighted average shares outstanding:			
Basic	1,153.3	1,177.6	1,172.8
Diluted	1,158.5	1,185.5	1,181.8
BALANCE SHEET DATA			
Current assets	$ 7,018.7	$ 9,756.4	$ 7,806.4
Current liabilities	9,151.8	8,151.4	7,346.8
Total assets	27,978.4	31,392.6	29,374.5
Long-term debt	13,119.9	13,616.9	14,659.6
Total shareholders' equity (deficit)	(8,706.6)	(5,321.2)	(7.805.1)
OTHER FINANCIAL DATA			
Net cash provided by operating activities	$ 4,397.3	$ 5,909.1	$ 4,251.8
Capital expenditures (additions to property, plant, and equipment)	1,841.3	1,470.0	1,483.6
STORE INFORMATION			
Stores open at year-end			
North America			
Company-operated stores	10,216	9,861	10,1099
Licensed stores	7,079	6,965	6,831
International			
Company-operated stores	8,037	7,272	6,528
Licensed stores	10,379	9,755	9,192
Worldwide	35,711	33,833	32,660
Percentage change in sales at company-operated stores open 13 months or longer	5%	2%	(14%)
North America	12%	22%	(12%)
International	9%	16%	(19%)

* Starbucks fiscal year ends on the Sunday closest to September 30.

Note 1: In fiscal 2020, the sharp downturn in comparable store sales was driven by circumstances surrounding the COVID-19 pandemic that impacted store traffic and consumer shopping behavior. In fiscal 2022, the 9 percent comparable store sales in the international segment was negatively impacted by a renewed outbreak of the COVID-19 pandemic in multiple Chinese cities that resulted in government-lockdowns and stay-at-home mandates lasting as much as four months in some locations.

Sources: Company 10-K reports for 2020 and 2022.

From an operating standpoint, Starbucks divided its business into three business segments: (1) North America, which included the company-owned and licensed retail stores in the United States and Canada; (2) International, which included the company-owned and licensed stores outside of North America (namely China, Japan, and other countries in the Asia Pacific, Europe, Middle East, Africa, Latin America, and Caribbean); and (3) Channel Development which included sales of roasted whole bean and ground coffees, Seattle's Best Coffee, Starbucks- and Teavana-branded single-serve products, a variety of ready-to-drink beverages (such as Frappuccino and Starbucks Doubleshot), foodservice products, and other branded products sold worldwide outside of company-operated and licensed stores. A large portion of its Channel Development business operated under a licensed model of Starbuck's Global Coffee Alliance with Nestlé, while its global ready-to-drink products operated under collaborative relationships with PepsiCo, Inc., Tingyi-Ashi Beverages Holding Co., Ltd., Arla Foods amba, Nestlé, and others.

Revenues from these three segments as a percentage of total net revenues for fiscal 2022 were as follows: North America (72%), International (22%) and Channel Development (6%). The North America segment was the company's most mature business segment and had achieved significant economies of scale. However, the retail store operations in the countries comprising the International segment were in various stages of development (the number of stores ranged from countries with fewer than 10 stores to 16 countries with 100–500 stores to 7 countries with 501–999 stores to Japan with 1,750 stores, to China with just over 6,000 stores). Thus, in the International segment, stores operated at widely varying levels of efficiency from country to country and often required more extensive investment support, relative to their current levels of revenue and operating income, than did stores in the North America segment. Exhibit 2 shows comparative performance data for the three segments for fiscal years 2020–2022 operations.

EXHIBIT 2 Financial Performance of Starbucks' Three Business Segments, Fiscal Years 2020–2022 (in millions of $)

	Fiscal Year Ending		
	Oct. 2, 2022	Oct.3, 2021	Sept 27, 2020
NORTHAMERICA			
Net revenues:			
Company-operated stores	$21,214.2	$18,737.3	$ 14,778.8
Licensed stores	2,150.5	1,702.2	1,509.9
Other	6.1	8.4	7.5
Total net revenues	23,370.8	20,447.9	16,296.2
Product and distribution costs	6,677.2	5,453.8	4,564.4
Store operating expenses	10,860.0	9,359.5	8,488.0
Other operating expenses	202.1	166.0	154.6
Depreciation and amortization expenses	808.4	753.9	762.0
General and administrative expenses	303.3	300.0	268.0
Restructuring and Impairments	33.3	155.4	257.5
Total operating expenses	18,884.3	16,188.6	14,494.5
Income from equity investees	—	—	—
Operating income	$ 4,486.5	$ 4,259.3	$ 1,801.7
INTERNATIONAL			
Net revenues:			
Company-operated stores	$ 5,361.9	$ 5,869.7	$ 4,385.8
Licensed stores	1,505.0	981.4	817.2
Other	73.2	70.5	27.6
Totalnet revenues	6,940.1	6,921.6	5,230.6
Product and distribution costs	2,357.7	2,187.3	1,729.1

	Fiscal Year Ending		
	Oct. 2, 2022	Oct.3, 2021	Sept 27, 2020
Store operating expenses	2,701.8	2,571.4	2,276.0
Other operating expenses	191.4	147.3	153.6
Depreciation and amortization expenses	513.0	544.7	518.4
General and administrative expenses	345.3	360.5	286.4
Restructuring and impairments	—	—	(1.2)
Total operating expenses	6,109.2	5,811.2	4,962.3
Income from equity investees	2.3	135.3	102.3
Operating income	$ 833.2	$ 1,245.7	$ 370.6
CHANNEL DEVELOPMENT			
Net revenues	$ 1,843.6	$ 1,593.6	$ 1,925.0
Product and distribution costs	1,194.2	1,011.2	1,338.1
Other operating expenses	51.6	31.3	108.2
Depreciation and amortization expenses	0.1	1.2	1.2
General and administrative expenses	12.2	10.8	10.5
Total operating expenses	1,258.1	1,054.5	1,458.0
Income frome quity investees	231.8	250.0	220.2
Operating income	$ 817.3	$ 789.1	$ 687.2

Sources: Company 10-K reports, 2021 and 2022.

COMPANY BACKGROUND

Starbucks Coffee, Tea, and Spice

Starbucks got its start in 1971 when three academics (English teacher Jerry Baldwin, history teacher Zev Siegel, and writer Gordon Bowker—all coffee aficionados) opened Starbucks Coffee, Tea, and Spice in touristy Pike Place Market in Seattle. The three partners shared a love for fine coffees and exotic teas and believed they could build a clientele in Seattle that would appreciate the best coffees and teas. By the early 1980s, the company had four Starbucks stores in the Seattle area and had been profitable every year since opening its doors.

Howard Schultz Enters the Picture

In 1981, Howard Schultz, vice president and general manager of U.S. operations for a Swedish maker of stylish kitchen equipment and coffeemakers based in New York City, decided to pay Starbucks a visit. He was curious why Starbucks was selling so many of his company's products. When he arrived at the Pike Place store, a solo violinist was playing Mozart at the door (his violin case open for donations). Schultz was immediately taken by the coffee aroma, store décor and ambiance, and the freshly brewed cup of coffee he bought. He began asking questions about the company, the coffees from different parts of the world, and the different ways of roasting coffee.

Later, when he met with two of the owners, Schultz was struck by their knowledge about coffee, their commitment to providing customers with quality coffees, their passion for educating customers about the merits and quality of dark-roasted coffees, and their business philosophy. Top quality, fresh-roasted, whole-bean coffee was the company's differentiating feature and a bedrock value. The company depended mainly on word-of-mouth to get more people into its stores, then built customer loyalty cup by cup as buyers gained a sense of discovery and excitement about the taste of fine coffee. By the time he landed on his return trip to New York, Howard Schultz knew in his heart he wanted to go to work for Starbucks. But it took over a year and multiple meetings and discussions to convince the owners to bring in a high-powered New

Yorker who had not grown up with the values of the company. In Spring 1982, Schultz was offered the job of heading marketing and overseeing Starbucks' retail stores; he assumed his new responsibilities at Starbucks in September 1982.

Starbucks and Howard Schultz: The 1982–1985 Period

In his first few months at Starbucks, Schultz spent most of his time in the four Seattle stores—working behind the counters, tasting different kinds of coffee, talking with customers, getting to know store personnel, and learning the retail aspects of the coffee business. In December, he began the final part of his training, that of actually roasting the coffee. Schultz spent a week getting an education about the colors of different coffee beans, listening for the telltale second pop of the beans during the roasting process, learning to taste the subtle differences among the various roasts, and familiarizing himself with the roasting techniques for different beans.

Schultz overflowed with ideas for the company. However, his biggest inspiration and vision for Starbucks future came during the spring of 1983 when the company sent him to Milan, Italy, to attend an international housewares show. While walking from his hotel to the convention center, he spotted an espresso bar and went inside to look around. The cashier beside the door nodded and smiled. The "barista" behind the counter greeted Schultz cheerfully and began pulling a shot of espresso for one customer and handcrafting a foamy cappuccino for another, all the while conversing merrily with patrons standing at the counter. Schultz thought the barista's performance was "great theater." Just down the way, he went to an even more crowded espresso bar where the barista was greeting customers by name, and people were laughing and talking in an atmosphere that plainly was comfortable and familiar. In the next few blocks, he saw two more espresso bars. That afternoon, Schultz walked the streets of Milan to explore more espresso bars. Some were stylish and upscale; others attracted a blue-collar clientele. Most had few chairs and it was common for Italian opera to be playing in the background. What struck Schultz was how popular and vibrant the Italian coffee bars were. Energy levels were typically high and they seemed to function as an integral community gathering place. Each one had its own unique character, but they all had a barista that performed with flair and there was camaraderie between the barista and the customers. Schultz liked it immediately, concluding that lattes should be a featured item on any coffee bar menu even though none of the coffee experts he had talked to had ever mentioned coffee lattes. Schultz was also struck by the fact that there were 1,500 coffee bars in Milan, a city about the size of Philadelphia, and a total of 200,000 in all of Italy.

Schultz's 1983 trip to Milan produced a revelation: the Starbucks stores in Seattle completely missed the point. There was much more to the coffee business than just selling beans and getting people to appreciate grinding their own beans and brewing fine coffee in their homes. What Starbucks needed to do was serve fresh-brewed coffee, espressos, and cappuccinos in its stores (in addition to beans and coffee equipment) and try to create an American version of the Italian coffee bar culture. Going to Starbucks should be an experience, a special treat, a place to meet friends and visit. Re-creating the authentic Italian coffee bar culture in the United States could be Starbucks differentiating factor.

Schultz Becomes Frustrated

On Schultz's return from Italy, he shared his revelation and ideas for modifying the format of Starbucks' stores, but the owners strongly resisted, contending that Starbucks was a retailer, not a restaurant or coffee bar. They feared serving drinks would put them in the beverage business and diminish the integrity of Starbucks' mission as a purveyor of fine coffees. They pointed out that Starbucks had been profitable every year and there was no reason to rock the boat in a small, private company like Starbucks. It took Howard Schultz nearly a year to convince them to let him test an espresso bar when Starbucks opened its sixth store in April 1984. It was the first store designed to sell beverages and it was the first store located in downtown Seattle. Schultz asked for a 1,500-square-foot space to set up a full-scale Italian-style espresso bar, but he was allocated only 300 square feet in a corner of the new store. The store opened with no fanfare as a deliberate experiment to see what happened. By closing time on the first day, some 400 customers had been served, well above the 250-customer average of Starbucks best-performing stores. Within two months the store was serving 800 customers per day. The two baristas could not keep up with orders during the early morning hours, resulting in lines outside the door onto the sidewalk. Most of the business was at the espresso counter, while sales at the regular retail counter were only adequate.

Schultz was elated at the test results, expecting that the owners' doubts about entering the beverage side of the business would be dispelled and that he would gain approval to pursue the opportunity to take Starbucks to a new level. Every day he shared the sales figures and customer counts at the new downtown store. But the lead owner was not comfortable with the success of the new store, believing that it felt wrong and that espresso drinks were a distraction from the core business of marketing fine Arabica coffees at retail.[1] While he didn't deny that the experiment was succeeding, he would not agree to go forward with introducing beverages in other Starbucks stores.

Over the next several months, Schultz made up his mind to leave Starbucks and start his own company. The two owners, knowing how frustrated Schultz had become, supported his efforts to go out on his own and agreed to let him stay in his current job and office until definitive plans were in place. Schultz left Starbucks in late 1985.

Schultz's Il Giornale Venture

Schultz spent several months raising money from investors to fund his new venture. An investor suggested naming the new company Il Giornale Coffee Company (pronounced il-jor-nahl'-ee), a suggestion that Howard accepted. The first Il Giornale store opened in April 1986. It measured 700 square feet and was located near the entrance of Seattle's tallest building. The décor was Italian and there were Italian words on the menu. Italian opera music played in the background. The baristas wore white shirts and bow ties. All service was stand up—there were no chairs. National and international papers were hung on rods on the wall. By closing time on the first day, 300 customers had been served—mostly in the morning hours. But while the core idea worked well, it soon became apparent that several aspects of the format were not appropriate for Seattle. Some customers objected to the incessant opera music, others wanted a place to sit down; many people did not understand the Italian words on the menu. These "mistakes" were quickly fixed, but an effort was made not to compromise the style and elegance of the store. Within six months, the store was serving more than 1,000 customers a day. Regular customers had learned how to pronounce the company's name. Because most customers were in a hurry, it became apparent that speedy service was essential.

Six months after opening the first store, a second store was opened in another downtown building. In April 1987, a third store was opened in Vancouver, British Columbia, to test the transferability of the company's business concept outside Seattle. By mid-1987, sales at each of the three stores were running at a rate equal to $1.5 million annually.

Il Giornale Acquires Starbucks

In March 1987, the Starbucks owners decided to sell the whole Starbucks operation in Seattle—the stores, the roasting plant, and the Starbucks name. Schultz knew immediately that he had to buy Starbucks; his board of directors agreed. Within weeks, Schultz had raised the $3.8 million needed to buy Starbucks. The acquisition was completed in August 1987. The new name of the combined companies was Starbucks Corporation. Howard Schultz, at the age of 34, became Starbucks president and CEO.

Starbucks as a Private Company: 1987–1992

The Monday morning after the deal closed, Howard Schultz returned to the Starbucks offices at the roasting plant, greeted all the familiar faces, and accepted their congratulations. Then, he called the staff together for a meeting on the roasting plant floor:[1]

> All my life I have wanted to be part of a company and a group of people who share a common vision. . . .I'm here today because I love this company. I love what it represents. . . .I know you're concerned. . . .I promise you I will not let you down. I promise you I will not leave anyone behind. . . .In five years, I want you to look back at this day and say "I was there when it started. I helped build this company into something great.

Schultz told the group that his vision was for Starbucks to become a national company with values and guiding principles that employees could be proud of. He aspired for Starbucks to become the most respected brand name in coffee and for the company to be admired for its corporate responsibility. He indicated that he wanted to include people in the decision-making process and that he would be open and honest with them. For Schultz, building a company that valued and respected its people, that inspired them, and that shared the fruits of success with those who contributed to the company's long-term value was essential, not just an intriguing option. He made the establishment of mutual respect between employees and management a priority.

The business plan Schultz had presented investors called for the new 9-store company to open 125 stores in the next five years—15 the first year, 20 the second, 25 the third, 30 the fourth, and 35 the fifth. Revenues were projected to reach $60 million in 1992. But the company lacked experienced management. Schultz had never led a growth effort of such magnitude and was just learning what the job of CEO was all about, having been the president of a small company for barely two years. Dave Olsen, a Seattle coffee bar owner who Schultz had recruited to direct store operations at II Giornale, was still learning the ropes in managing a multistore operation. Ron Lawrence, the company's controller, had worked as a controller for several organizations. Other Starbucks employees had only the experience of managing or being a part of a six-store organization.

Schultz instituted a number of changes in the first several months. To symbolize the merging of the two companies and the two cultures, a new logo was created that melded the designs of the Starbucks logo and the Il Giornale logo. The Starbucks stores were equipped with espresso machines and remodeled to look more Italian than old-world nautical. Il Giornale green replaced the traditional Starbucks brown. The result was a new type of store—a cross between a retail coffee bean store and an espresso bar/café—that quickly evolved into Starbucks' signature.

By December 1987, the mood at Starbucks was distinctly upbeat, with most all employees buying into the changes that Schultz was making, and trust was beginning to build between management and employees. New stores were on the verge of opening in Vancouver and Chicago. One Starbucks store employee, Daryl Moore, who had started working at Starbucks in 1981 and voted against unionization in 1985, began to question the need for a union with his fellow employees. Over the next few weeks, Moore began a move to decertify the union. He got a majority of store employees to sign a decertification letter and presented it to the National Labor Relations Board. The union representing store employees was decertified. Later, in 1992, the union representing Starbucks roasting plant and warehouse employees was also decertified.

Market Expansion Outside the Pacific Northwest

The first Chicago store opened in October 1987 and three more stores were opened over the next six months. Initially, customer counts at the stores were substantially below expectations because Chicagoans did not take to dark-roasted coffee as fast as Schultz had anticipated. While it was more expensive to supply fresh coffee to the Chicago stores out of the Seattle warehouse, the company solved the problem of freshness and quality assurance by putting freshly roasted beans in special FlavorLock bags with a one-way valve to allow carbon dioxide to escape without allowing air and moisture in. Moreover, rents and wage rates were higher in Chicago. The result was a squeeze on store profit margins. Gradually, customer counts improved, but Starbucks lost money on its Chicago stores until, in 1990, prices were raised to reflect higher rents and labor costs, more experienced store managers were hired, and a critical mass of customers caught on to the taste of Starbucks products.

Portland, Oregon, was the next market entered, and Portland coffee drinkers took to Starbucks products quickly. Store openings in Los Angeles and San Francisco soon followed. L.A. consumers embraced Starbucks quickly, and the *Los Angeles Times* named Starbucks the best coffee in America before the first store opened.

Starbucks' store expansion targets proved easier to meet than Schultz had originally anticipated and he upped the numbers to keep challenging the organization. Starbucks opened 15 new stores in fiscal 1988, 20 in 1989, 30 in 1990, 32 in 1991, and 53 in 1992—producing a total of 161 stores, significantly above his original 1992 target of 125 stores.

From the outset, the strategy was to open only company-owned stores; franchising was avoided so as to keep the company in full control of the quality of its products and the character and location of its stores. But company ownership of all stores required Starbucks to raise new venture capital to cover the cost of new store expansion. In 1988, the company raised $3.9 million; in 1990, venture capitalists provided an additional $13.5 million; and in 1991, another round of venture capital financing generated $15 million. Starbucks was able to raise the needed funds despite posting losses of $330,000 in 1987, $764,000 in 1988, and $1.2 million in 1989. While the losses were troubling to Starbucks' board of directors and investors, Schultz's business plan had forecast losses during the early years of expansion. At a particularly tense board meeting where directors sharply questioned Schultz about the lack of profitability, Schultz said:[2]

> Look, we're going to keep losing money until we can do three things. We have to attract a management team well beyond our expansion needs. We have to build a world-class roasting facility. And we need a computer information system sophisticated enough to keep track of sales in hundreds and hundreds of stores.

Schultz argued for patience as the company invested in the infrastructure to support continued growth well into the 1990s. He contended that hiring experienced executives ahead of the growth curve, building facilities far beyond current needs, and installing support systems laid a strong foundation for rapid profitable growth later on down the road. His arguments carried the day with the board and with investors, especially since revenues were growing approximately 80 percent annually and customer traffic at the stores was meeting or exceeding expectations.

Starbucks became profitable in 1990. After-tax profits had increased every year since 1990 except for fiscal year 2000 (because of $58.8 million in investment write-offs in four dot.com enterprises) and for fiscal year 2008 (when the sharp global economic downturn hit the company's bottom line very hard).

RAPID EXPANSION OF STARBUCKS LOCATIONS

In 1992 and 1993, Starbucks began concentrating its store expansion efforts in the United States on locations with favorable demographic profiles that also could be serviced and supported by the company's operations infrastructure. For each targeted region, Starbucks selected a large city to serve as a "hub"; teams of professionals were located in hub cities to support the goal of opening 20 or more stores in the hub within two years. Once a number of stores were opened in a hub, then additional stores were opened in smaller surrounding "spoke" areas in the region. To oversee the expansion process, Starbucks had zone vice presidents that oversaw the store expansion process in a geographic region and that were also responsible for instilling the Starbucks culture in the newly opened stores. For a time, Starbucks went to extremes to blanket major cities with stores, even if some stores cannibalized a nearby store's business. While a new store might draw 30 percent of the business of an existing store two or so blocks away, management believed a "Starbucks everywhere" strategy cut down on delivery and management costs, shortened customer lines at individual stores, and increased foot traffic for all the stores in an area. In 2002, new stores generated an average of $1.2 million in first-year revenues, compared to $700,000 in 1995 and only $427,000 in 1990; the increases in new-store revenues were partly due to growing popularity of premium coffee drinks, partly to Starbucks growing reputation, and partly to expanded product offerings. But by 2008–09 the strategy of saturating big metropolitan areas with stores began cannibalizing sales of existing stores to such an extent that average annual sales per store in the United States dropped to less than $1,000,000 and pushed store operating margins down from double-digit levels to mid-single-digit levels. As a consequence, Starbucks' management cut the number of metropolitan locations, closing 900 underperforming Starbucks stores in 2008–2009, some 75 percent of which were within three miles of another Starbucks store.

Despite the mistake of over-saturating portions of some large metropolitan areas with stores, Starbucks was regarded as having the best real estate team in the coffee bar industry and a core competence in identifying good retailing sites for its new stores. The company's sophisticated methodology enabled it to identify not only the most attractive individual city blocks but also the exact store location that was best. It also worked hard at building good relationships with local real estate representatives in areas where it was opening multiple store locations.

Licensed Starbucks Stores. In 1995, Starbucks began entering into licensing agreements for store locations in areas in the United States where it did not have the ability to locate company-owned outlets. Two early licensing agreements were with Marriott Host International to operate Starbucks retail stores in airport locations and with Aramark Food and Services to put Starbucks stores on university campuses and other locations operated by Aramark. Very quickly, Starbucks began to make increased use of licensing, both domestically and internationally. Starbucks preferred licensing to franchising because it permitted tighter controls over the operations of licensees, and in the case of many foreign locations, licensing was much less risky.

Starbucks received a license fee and a royalty on sales at all licensed locations and supplied the coffee for resale at these locations. All licensed stores had to follow Starbucks' detailed operating procedures and all managers and employees who worked in these stores received the same training given to managers and employees in company-operated Starbucks stores.

International Expansion. In markets outside the continental United States, Starbucks had a two-pronged store expansion strategy: either open company-owned-and-operated stores or else license a reputable and capable local company with retailing know-how in the target host country to develop and operate new Starbucks stores. In most countries, Starbucks utilized a local partner/licensee to help it locate suitable store sites, set up supplier relationships, recruit talented individuals for positions as store managers, and adapt to local market conditions. Starbucks looked for partners/licensees that had strong retail/restaurant experience, had values and a corporate culture compatible with Starbucks, were committed to good customer service, possessed talented management and strong financial resources, and had demonstrated brand-building skills. In those foreign countries where business risks were deemed relatively high, most if not all Starbucks stores were licensed rather than being company-owned and operated.

Exhibit 3 shows the speed with which Starbucks grew its network of company-operated and licensed retail stores.

STORE DESIGN AND AMBIENCE: KEY ELEMENTS OF THE "STARBUCKS EXPERIENCE"

Store Design

Starting in 1991, Starbucks created its own in-house team of architects and designers to ensure that each store would convey the right image and character. Stores had to be custom-designed because the company didn't buy real estate and build its own freestanding structures. Instead, each space was leased in an existing structure, which resulted in stores differing in size and shape. Most stores ranged in size from 1,000 to 1,500 square feet and were located in office buildings, downtown and suburban retail centers, airport terminals, university campus areas, and busy neighborhood shopping areas convenient for pedestrian foot traffic and/or drivers. A few were in suburban malls. Four store templates—each with its own color combinations, lighting scheme, and component materials—were introduced in 1996; all four were adaptable to different store sizes and settings.

But as the number of stores increased rapidly over the next 20-plus years, greater store diversity and layouts quickly became necessary. Some stores were equipped with special seating areas to help make Starbucks a desirable gathering place where customers could meet and chat or simply enjoy a peaceful interlude in their day. Flagship stores in high-traffic, high-visibility locations had fireplaces, leather chairs, newspapers, couches, and lots of ambience. Increasingly, the company began installing drive-through windows at locations where speed and convenience were important to customers and locating

EXHIBIT 3 Company-Operated and Licensed Starbucks Stores

A. Number of Starbucks Store Locations Worldwide, Fiscal Years 1987–2022

	Company-operated Store Locations		Licensed Store Locations		
End of Fiscal Year*	United States	International	United States	International	Worldwide Total
1987	17	0	0	0	17
1990	84	0	0	0	84
1995	627	0	49	0	676
2000	2,446	530	173	352	3,501
2005	4,918	1,263	2,435	1,625	10,241
2010	6,707	2,182	4,424	3,545	16,858
2015	6,764	2,198	4,364	3,309	23,043
2017	8,224	4,763	5,745	6,043	27,339
2018	8,581	6,758	6,043	7,940	29,324
2019	8,799	7,035	6,250	9,172	31,256
2020	8,950	6,972	6,387	10,351	32,660
2021	8,953	7,740	6,497	10,643	33,833
2022	9,270	8,508	6.608	11,325	35,711

B. International Starbucks Store Locations, October 2, 2022

International Locations of Company-operated Starbucks Stores		International Locations of Licensed Starbucks Stores			
		Americas		**Europe/Africa/Middle East**	
Canada	976	Canada	471	France	208
United Kingdom	328	Mexico	769	Germany	159
China	6,021	Brazil	178	Turkey	604
Japan	1,632	Chile	147	Spain	149
All Others	67	Argentina	133	Saudi Arabia	349
		Peru	104	Kuwait	206
		13 Others	210	United Kingdom	858
				United Arab Emirates Dubai	273
				30 Others	1,024
		Asia-Pacific			
		Taiwan	544		
		South Korea	1,750		
		Philippines	418		
		Malaysia	364		
		Indonesia	523		
		India	300		
		Singapore	150		
		Thailand	446		
		Vietnam	82		
		3 Others	124		
International Company-Operated Total	**9,024**			**International Licensed Total**	**10,379**

*In the first quarter of fiscal 2018, Starbucks acquired its Chinese licensing partner's share of their joint venture in China, resulting in the transfer of all 1,477 licensed stores in China to company-operated retail stores.

Sources: Company records of store counts by market, posted in the investor relations section at **www.starbucks.com**, accessed February 7, 2023.

kiosks in high-traffic supermarkets, building lobbies, the halls of shopping malls, and other public places where passers-by could quickly and conveniently pick up a Starbucks beverage and/or something to eat.

A new global store design strategy was introduced in 2009. Core design characteristics included the celebration of local materials and craftsmanship, a focus on reused and recycled elements, the exposure of structural integrity and authentic roots, the absence of features that distracted from an emphasis on coffee, seating layouts that facilitated customer gatherings, an atmosphere that sought to engage all five customer senses (sight, smell, sound, hearing, and feel), and flexibility to meet the needs of many customer types.[3] Each new store was to be a reflection of the environment in which it operated and be environmentally friendly. In 2010, Starbucks began an effort to achieve LEED (Leadership in Energy and Environmental Design) Certification for all new company-owned stores (a LEED-certified building had to incorporate green building design, construction, operations, and maintenance solutions).[4]

To better control average store opening costs, the company centralized buying, developed standard contracts and fixed fees for certain items, and consolidated work under those contractors who displayed good cost control practices. The retail operations group outlined exactly the minimum amount of equipment each core store needed, so that standard items could be ordered in volume from vendors at 20 to 30 percent discounts, then delivered just in time to the store site either from company warehouses or the vendor. Modular designs for display cases were developed. The layouts for new and remodeled stores were developed on a computer, with software that allowed the costs to be estimated as the design evolved. All this cut store opening and remodeling costs significantly and shortened the process to about 18 weeks.

Store Ambience

Starbucks management viewed each store as a billboard for the company and as a contributor to building the company's brand and image. The company went to great lengths to make sure the store fixtures, the merchandise displays, the colors, the artwork, the banners, the music, and the aromas all blended to create a consistent, inviting, stimulating environment that evoked the romance of coffee and signaled the company's passion for coffee. To try to keep the coffee aromas in the stores pure, smoking was banned, and employees were asked to refrain from wearing perfumes or colognes. Prepared foods were kept covered so customers would smell coffee only. Colorful banners and posters were used to keep the look of the Starbucks stores fresh and in keeping with seasons and holidays. All these practices reflected a conviction that every detail mattered in making Starbucks stores a welcoming and pleasant "third place" (apart from home and work) where people could meet friends and family, enjoy a quiet moment alone with a newspaper or book, or simply spend quality time relaxing—and most importantly, have a satisfying experience.

Starting in 2002, Starbucks began providing Internet access capability and enhanced digital entertainment to patrons. The objective was to heighten the "third place" Starbucks experience, entice customers into perhaps buying a second latte or espresso while they caught up on email, listened to digital music, put the finishing touches on a presentation, or surfed the Internet. Wireless Internet service and faster Internet speeds were added as fast as they became available.

STARBUCKS' STRATEGY TO EXPAND ITS PRODUCT OFFERINGS AND ENTER NEW MARKET SEGMENTS

Starting in the mid-1990s, Howard Schultz began a long-term strategic campaign to expand Starbucks product offerings beyond its retail stores and to pursue sales of Starbucks products in a wider variety of distribution channels and market segments. The strategic objectives were to capitalize on Starbucks growing brand awareness and brand-name strength and create a broader foundation for sustained long-term growth in revenues and profits.

The Strategic Initiative to Sell Starbucks Packaged Coffees Outside Its Retail Stores. Starbucks first step to expand its product offering beyond its stores involved the establishment of an in-house specialty sales group to begin marketing Starbucks coffee to restaurants, airlines, hotels, universities, hospitals, business offices, country clubs, and other select retailers. The sales group's first big success was convincing two airlines to begin serving Starbucks coffee on flights. Shortly thereafter accounts were won at five leading hotel chains, resulting in packets of Starbucks coffee being in each room with coffee-making equipment. Later, the specialty sales group began working with two leading institutional food service distributors, SYSCO Corporation and US Foodservice, to handle the distribution of Starbucks products to hotels, restaurants, office coffee distributors, educational and healthcare institutions, and other such enterprises. Sales of Starbucks packaged coffees continued to grow, with Starbucks generating revenues of $372.2 million from providing whole bean and ground coffees and assorted other Starbucks products to some 21,000 foodservice accounts in fiscal 2009.

Starbucks Partnership with PepsiCo The second initiative came in 1994 when PepsiCo and Starbucks entered into a joint venture arrangement to create new coffee-related products in bottles or cans for mass distribution through Pepsi channels. The joint venture soon introduced a bottled version of Frappuccino, a new cold coffee drink Starbucks began serving at its retail stores in the summer of 1995 that quickly became a big hot weather seller. Sales of Frappuccino ready-to-drink beverages reached $125 million in 1997 and achieved a national supermarket penetration of 80 percent. Sales of ready-to-drink Frappuccino products soon began in Japan, Taiwan, South Korea, and China chiefly through agreements with leading local distributors. In 2010, sales of Frappuccino products worldwide reached $2 billion annually.[5] Sales of Frappuccino products worldwide were continuing in 2022.

Starbucks Entry into Ice Cream In 1995, Starbucks partnered with Dreyer's Grand Ice Cream to supply coffee extracts for a new line of coffee ice cream made and distributed by Dreyer's under the Starbucks brand. Starbucks coffee-flavored ice cream became the number-one-selling super-premium brand in the coffee segment in mid-1996. In 2008, Starbucks discontinued its arrangement with Dreyer's and entered into an exclusive agreement with Unilever to manufacture, market, and distribute Starbucks-branded ice creams in the United States and Canada. Unilever was the global leader in ice cream with annual sales of about $6 billion; its ice cream brands included Ben & Jerry's, Breyers, and Good Humor. There were seven flavors of Starbucks ice cream and two flavors of novelty bars being marketed in 2010, but buyer demand eroded after several years and Starbucks-branded ice cream was discontinued in 2013. But in 2017, new premium ice cream drinks (a scoop of ice cream drowned in espresso called an "affogato," several other affogato concoctions, and tall cold brew floats and malts) became top-10 menu items at the new Starbucks Roastery and Starbucks Reserve store locations in Seattle and were rolled out to other Starbucks Roasteries and Reserve locations in 2018 and 2019.

The Licensing Agreement with Kraft Foods In 1998, Starbucks licensed Kraft Foods to market and distribute Starbucks whole bean and ground coffees in grocery and mass merchandise channels across the United States. Kraft managed all distribution, marketing, advertising, and promotions and paid a royalty to Starbucks based on a percentage of net sales. Product freshness was guaranteed by Starbucks's FlavorLock packaging, and initially the price per pound paralleled the prices in Starbucks's retail stores. Flavor selections in supermarkets were more limited than the varieties at Starbucks stores. The licensing relationship with Kraft was later expanded to include the marketing and distribution of Starbucks coffees in Canada, the United Kingdom, and other European countries. During fiscal 2011, Starbucks discontinued its distribution arrangement with Kraft and instituted its own in-house organization to handle direct sales of packaged coffees to supermarkets and to warehouse club stores (chiefly Costco, Sam's Club, and BJ's Warehouse). During 2012–2022, sales of Starbucks packaged coffees continued to grow throughout the retail grocery channel, with many supermarkets stocking a wider selection of flavor selections and frequently offering promotional price discounts on Starbucks and other coffee brands to boost shopper traffic.

The Acquisition of Tazo Tea In 1999, Starbucks purchased Tazo Tea for $8.1 million. Tazo Tea, a tea manufacturer and distributor based in Portland, Oregon, was founded in 1994 and marketed its teas to restaurants, food stores, and tea houses. Starbucks proceeded to introduce hot and iced Tazo Tea drinks in its retail stores. As part of a long-term campaign to expand the distribution of its lineup of super-premium Tazo teas, Starbucks expanded its agreement with Kraft to market and distribute Tazo teas worldwide. In 2008, Starbucks entered into a licensing agreement with a partnership formed by PepsiCo and Unilever (Lipton Tea was one of Unilever's leading brands) to manufacture, market, and distribute Starbucks' super-premium Tazo Tea ready-to-drink beverages (including iced teas, juiced teas, and herbal-infused teas) in the United States and Canada—in 2012, the Pepsi/Lipton Tea partnership was the leading North American distributor of ready-to-drink teas. In fiscal 2011, when Starbucks broke off its packaged coffee distribution arrangement with Kraft, it also broke off its arrangement with Kraft for distribution of Tazo tea and began selling Tazo teas directly to supermarkets (except for Tazo Tea ready-to-drink beverages). In 2017, Starbucks sold Tazo Tea to the Lipton Tea division of Unilever, Ltd for $384 million.

Introduction of the Starbucks Rewards™ Card In 2001, Starbucks introduced the Starbucks Card, a reloadable card that allowed customers to load funds onto the card and pay for their purchases with a quick swipe of their card at the cash register and also to earn "stars" and redeem rewards. Since then, Starbucks Rewards™ has evolved into one of the best retail loyalty programs in existence, aided by the introduction of Starbucks Gift Cards, the Starbucks Loyalty card, a Starbucks mobile app, and a Starbucks Rewards™ Visa® Card that earned stars rewards for in-store purchases and purchases of Starbucks products in grocery stores and other retail locations where Starbucks products were sold. Users of the Starbucks app could easily see how many stars they currently had, place orders and make payments right from the Starbucks app on their smartphones, and find the nearest Starbucks location. As of September 2022, there were 28 million active Starbuck Rewards™ members globally.[6] As of January 2023, use of Starbucks Reward cards accounted for 40 percent of transactions in company-operated stores in the United States, and about 71 percent of the customers in these stores either used a Starbucks Card or the Starbucks mobile app to pay for in-store purchases. As of January 1, 2023, there were $3.3 billion dollars loaded on Starbucks cards in the United States. On July 20, 2023, Chase Bank completed the transition of its Chase Bank-issued Starbucks Rewards Visa card to a Chase Freedom Unlimited® Visa credit card (or the original version of the Chase

Freedom® Visa card for those people who already had a Freedom Unlimited® card). Cash Back Rewards earned on the former Starbucks Rewards cards remained the same on Chase's Freedom Unlimited Visa cards.

The Seattle's Best Coffee Acquisition In 2003, Starbucks spent $70 million to acquire Seattle's Best Coffee, an operator of 540 Seattle's Best coffee shops, 86 Seattle's Best Coffee Express espresso bars, and marketer of some 30 varieties of Seattle's Best whole bean and ground coffees. The decision was made to operate Seattle's Best as a separate subsidiary. Very quickly, Starbucks expanded its licensing arrangement with Kraft Foods to include marketing, distributing, and promoting the sales of Seattle's Best coffees and by 2009, Seattle's Best coffees were available nationwide in supermarkets and at more than 15,000 food service locations (college campuses, restaurants, hotels, airlines, and cruise lines). A new Seattle's Best line of ready-to-drink iced lattes was introduced in April 2010, with manufacture, marketing, and distribution managed by PepsiCo as part of the long-standing Starbucks–PepsiCo joint venture for ready-to-drink Frappuccino products. In 2010, Starbucks introduced new distinctive red packaging and a red logo for Seattle's Best Coffee, boosted efforts to open more franchised Seattle's Best cafés, and expanded the availability of Seattle Best coffees to 30,000 distribution points. When Starbucks licensing agreement with Kraft to handle sales and distribution of Seattle's Best coffee products was terminated in 2011, responsibility for the sales and distribution of Seattle's Best products was transitioned to the same in-house sales force that handled direct sales and distribution of Starbucks-branded coffees and Tazo tea products to supermarkets and warehouse clubs.

The Ethos™ Water Acquisition. In 2005, Starbucks Corporation acquired Ethos™ Water, a privately held bottled water company based in Santa Monica, California, whose mission was to help children get clean water by supporting water projects in such developing countries as Bangladesh, the Democratic Republic of Congo, Ethiopia, Honduras, India, and Kenya. One of the terms of the acquisition called for Starbucks to donate $1.25 million in 2005–2006 to support these projects. In the years since the acquisition, a key element of Starbucks corporate social responsibility effort has been to donate $0.05US ($0.10CN in Canada) for every bottle of Ethos Water sold in Starbucks stores to the Ethos® Water Fund, part of the Starbucks Foundation, to fund ongoing efforts to provide clean water to children in developing countries and to support water, sanitation, and hygiene education programs in water-stressed countries.

The Introduction of New Coffee Blends In 2008, Starbucks introduced a new coffee blend called Pike Place™ Roast that would be brewed every day, all day, in every Starbucks store.[7] Before then, Starbucks rotated various coffee blends through its brewed lineup, sometimes switching them weekly, sometimes daily. While some customers liked the ever-changing variety, the feedback from a majority of customers indicated a preference for a consistent brew that customers could count on when they came into a Starbucks store. The Pike Place blend was brewed in small batches at 30-minute intervals so as to provide customers with a freshly brewed coffee. In January 2012, after eight months of testing over 80 different recipe and roast iterations, Starbucks introduced three blends of lighter-bodied and milder-tasting Starbucks Blonde Roast® coffees to better appeal to an estimated 54 million coffee drinkers in the United States who said they liked flavorful, lighter coffees with a gentle finish. The Blonde Roast blends were available as a brewed option in Starbucks stores in the United States and in packaged form in Starbucks stores and supermarkets. Because the majority of coffee sales in supermarkets were in the light and medium roast categories, Starbucks management saw its new Blonde Roast coffees blends as being a $1 billion market opportunity in the United States alone, From time to time, Starbucks introduced new blends of its packaged whole bean and ground coffees—some of these were seasonal, but those that proved popular with buyers became standard offerings.

The Introduction of Starbucks VIA® Instant Coffee In Fall 2009, Starbucks introduced Starbucks VIA® Ready Brew, packets of roasted coffee in an instant form, in an effort to attract a bigger fraction of on-the-go and at-home coffee drinkers. VIA was made with a proprietary micro-ground technology that produced an instant coffee with a rich, full-bodied taste that closely replicated the taste, quality, and flavor of traditional freshly brewed coffee. Encouraged by favorable customer response, Starbucks expanded the distribution of VIA to some 25,000 grocery, mass merchandise, and drugstore accounts, including Kroger, Safeway, Walmart, Target, Costco, and CVS.

Instant coffee made up a significant fraction of coffee purchases in the United Kingdom (80 percent), Japan (53 percent), Russia (85 percent), and several other countries where Starbucks stores were located; globally, the instant and single-serve coffee category was a $23 billion market. By the end of fiscal year 2011, VIA products were available at 70,000 locations and generating annual sales of $250 million.[8]

In 2020, Starbucks introduced a second version of instant coffee named Starbucks Premium Instant Coffee, which came in three flavors—Dark Roast, Medium Roast, and Blonde Roast. It was sold globally at groceries and also online (at such sites as Amazon, InstaCart, and Starbucks,com) for a suggested retail price of $9.99 for a 3.17 oz tin cannister that could brew 40 cups. It was introduced to give consumers-on-the-go second option for brewing a quick cup of coffee at home before heading out. But it was also a response to Starbucks market research indicating that daily coffee habits in the United States had changed, with 85 percent of coffee drinkers having at least one cup of coffee at home (up 8 percent since January 2020) and, during the COVID-19 pandemic, more than 40 percent of Americans buying types of coffee they had never tried before.

The Introduction of Starbucks K-Cup Packs for Keurig Single-Cup Brewing Systems In fall 2011, Starbucks began selling Starbucks-branded coffee K-Cup® Portion Packs for the Keurig® Single-Cup Brewing system in its retail stores; the Keurig Brewer was produced and sold by Green Mountain Coffee Roasters. Starbucks entered into a strategic partnership with Green Mountain to manufacture the Starbucks-branded portion packs and also to be responsible for marketing, distributing, and selling them to major supermarket chains, drugstore chains, mass merchandisers and wholesale clubs, department stores, and specialty retailers throughout the United States and Canada. The partnership made good economic sense for both companies. Green Mountain could manufacture the single-cup portion packs in the same plants where it was producing its own brands of single-cup packs and then use its own internal resources and capabilities to market, distribute, and sell Starbuck-branded single-cup packs alongside its own brands of single-cup packs. It was far cheaper for Starbucks to pay Green Mountain to handle these functions than to build its own manufacturing plants and put its own in-house resources in place to market, distribute, and sell Starbucks single-cup coffee packs. Just two months after launch, shipments of Starbucks-branded single-cup portion packs had exceeded 100 million units and the packs were available in about 70 percent of the targeted retailers; company officials estimated that Starbucks had achieved an 11 percent dollar share of the market for single-cup coffee packs in the United States.[9]

Starbucks Move into Coffee-Making Equipment In March 2012, Starbucks announced that it would begin selling its first at-home premium single cup espresso and brewed coffee machine, the Verismo™ system by Starbucks, at select Starbucks store locations, online, and in upscale specialty stores. The Verismo brewer was a high-pressure system with the capability to brew both coffee and Starbucks-quality espresso beverages, from lattes to americanos, consistently and conveniently one cup at a time; sales of the Verismo single-cup machine put Starbucks into head-to-head competition with Nestlé's Nespresso machine and, to a lesser extent, Green Mountain's popular lineup of low-pressure Keurig brewers. At the time, the global market for premium at-home espresso/coffee machines was estimated at $8 billion.[10] The Verismo introduction was a continuation of Starbucks' strategic initiative to offer coffee products covering all aspects of the single-cup coffee segment—instant coffees (with its VIA offerings), single portion coffee packs for single-cup brewers, and single-cup brewing machines.

Bigger Menu Selections at Starbucks Stores In response to customer requests for more wholesome food and beverage options and also to bring in business from non-coffee drinkers, Starbucks in 2008 altered its menu offerings in stores to include fruit cups, yogurt parfaits, skinny lattes, banana walnut bread, a 300-calorie farmer's market salad with all-natural dressing, and a line of 250-calorie "better-for-you" smoothies.[11] In 2009–2011, the company continued to experiment with healthier, lower-calorie selections and by May 2012, retail store menus included a bigger assortment of hot and cold coffee and tea beverages, pastries and bakery selections, prepared breakfast and lunch sandwiches and wraps, salads, parfaits, smoothies, juices, and bottled water—at most stores in North America, food items could be warmed. A bit later, beer, wine, and other complementary food offerings were added to the menus at some stores to help them become an attractive and relaxing after-work destination.

Beginning in 2013, it became standard practice for Starbucks to continually tweak its menu offerings, switching out whimsical and limited-edition offerings and adding/dropping certain beverages, flavorings, breakfast items, sandwiches, pastries, and snacks, to both broaden buyer appeal and respond to ongoing shifts in customer preferences. In 2018–2019, Starbucks began introducing new store menus at the beginning of each season (spring, summer, fall, and winter), along with special holiday menu offerings in November–December. Menu offerings at Starbucks stores were typically adapted to local cultures—for instance, the menu offerings at stores in North America included a selection of muffins, but stores in France had no muffins and instead featured locally made pastries.

The Acquisition of Evolution Fresh Starbucks purchased cold-pressed juice maker Evolution Fresh for $30 million in 2011 to use Starbucks sales and marketing resources to grow the sales of Evolution Fresh and capture a bigger share of the $3.4 billion super-premium juice segment and begin a long-term campaign to pursue growth opportunities in the $50 billion health and wellness sector of the U.S. economy. A $70 million juice making facility in California was opened in 2013 to make Evolution Fresh products. Starbucks opened four Evolution Fresh juice bars after the acquisition but soon decided to ditch the stand-alone juice bar concept, opting to sell Evolution Fresh beverages in Starbucks stores and supermarkets. Evolution Fresh competed with PepsiCo's category leader Naked juice brand, as well as scores of other large and small bottled juice brands. As of 2017, Starbucks had secured 20,000 points of distribution for Evolution Fresh products and the brand was said to be "thriving."

However, in May 2022, Starbucks agreed to sell its Evolution Fresh business to Bolthouse Farms for an undisclosed sum. Bolthouse Farms was a maker of low-calorie salad dressings and plant-powered juices and smoothies and a leading grower and supplier of carrots. However, Starbucks stores in North America continued at sell Evolution Fresh beverages.

The Acquisition of Teavana Tea In 2012, Starbucks paid $620 million to acquire Atlanta-based specialty tea retailer Teavana, which sold more than 100 varieties of premium loose-leaf teas and tea-related merchandise through 300 company-owned stores (usually located in upscale shopping malls) and on its website; Teavana teas were used mostly for home consumption. Howard Schultz believed Starbucks could capitalize on Teavana's world-class tea knowledge and its global sourcing and merchandising capabilities (a) to expand Teavana's domestic and global footprint, (b) to bring an elevated tea experience to the patrons of Starbucks domestic and international locations, and (c) to increase Starbucks penetration of the $40 billion world market for tea, especially in the world's high-consumption tea markets where Starbucks had stores. These strategic outcomes failed to materialize. By 2016 and 2017, sales at Teavana stores had eroded to the point where the stores were unprofitable, prompting Starbucks to begin the process of closing all 379 Teavana stores (the majority by Spring 2018). However, Starbucks continued to sell Teavana teas and beverages in Starbucks stores because they were popular and contributed to store profitability, accounting for sales of more than $1 billion annually and growing fast enough to double over the next five years. In late 2017, Starbucks sold its Tazo Tea business to Unilever for $384 million, opting to focus its sales of tea products on the Teavana brand. In May 2019, Starbucks began selling three flavors of Teavana™ Sparkling Craft Iced Teas in all of its stores in the United States to complement its other Teavana bottled tea offerings.

The La Boulange Acquisition Also in 2012, Starbucks bought Bay Bread Group's La Boulange sandwich and coffee shops for $100 million. When Starbucks acquired the San Francisco chain, plans called not only for bringing La Boulange products into its stores to bolster Starbucks' lineup of pastries and sandwiches but also to open new La Boulange cafes and expand the chain's geographic footprint. Three years later, however, Starbucks concluded that sales at the La Boulange cafes were growing too slowly to support its growth and profitability targets; it closed the 23 existing La Boulange cafes but retained the manufacturing facilities to stock Starbucks stores with La Boulange bakery products. Starbucks later discovered that other bakers could supply Starbucks with comparable quality products at a lower cost. In 2018, the La Boulange brand name was typically not very visible in Starbucks stores and disappeared altogether at most all locations in 2019.

THE SALES MIX AT STARBUCKS STORES IN 2022

Starbucks overall sales mix in its company-owned retail stores in fiscal 2022 was 74 percent beverages, 22 percent food, and 4 percent packaged and single-serve coffees and teas, ready-to-drink beverages, coffee mugs, and other merchandise.[12] However, the product mix in each Starbucks store varied, depending on the size and location of each outlet. Larger stores carried a greater variety of whole coffee beans, gourmet food items, teas, coffee mugs, coffee grinders, filters, storage containers, and other accessories. Smaller stores and kiosks typically sold a full-line of coffee and tea beverages, a very limited selection of whole bean and ground coffees and Teavana teas, and a few coffee-drinking accessories.

STARBUCKS' INTERNAL ORGANIZATION ARRANGEMENTS FOR OUTSIDE SALES OF STARBUCKS PRODUCTS

In 2010, Starbucks formed a new Consumer Products Group (CPG) to be responsible for sales of Starbuck products sold in all channels outside of Starbucks company-operated and licensed retail stores and to manage all of the company's distribution partnerships and joint ventures. A few years later, CPG was renamed and slightly reorganized into what was called the Channel Development segment. In 2018, management of the Channel Development segment was responsible for sales and distribution of roasted whole bean and ground coffees, Starbucks-branded single-serve products, a variety of ready-to-drink beverages (such as Frappuccino®, Starbucks Doubleshot®,Starbucks Refreshers® and Teavana™ iced tea, and Evolution juices) and other branded products sold worldwide through grocery stores, warehouse clubs, specialty retailers, convenience stores, and food service accounts.

However, in 2018, Starbucks management, as part of a companywide effort to streamline some of Starbucks wide-ranging operations, entered into a global coffee alliance with Nestlé S.A. ("Nestlé") whereby Starbucks agreed to a licensing and distribution agreement with Nestlé that gave Nestlé the rights to market, sell, and distribute Starbucks®, Seattle's Best Coffee®, Starbucks Reserve®, Teavana™, Starbucks VIA®, and Torrefazione Italia® packaged coffees and tea in all global channels outside of Starbucks stores. In return, Nestlé was to pay Starbucks an upfront royalty payment of $7.15 billion, and Starbucks would remain as the supplier of these same branded coffee and tea products to Nestlé. In effect, the alliance agreement shifted the operation of the Channel Development segment to a licensed distribution model with its revenues consisting of product sales to Nestlé, royalty revenues from Nestlé, and revenues from the sales of ready-to-drink products through its distribution partnerships with PepsiCo, Tingyi-Ashi Beverages Holding Co., Ltd., Arla Foods amba, Nestlé, and others (which sold them directly to retail grocers, warehouse clubs, specialty retail stores, and institutional food service companies). Starbucks global coffee alliance with Nestlé resulted in the Channel Development segment reporting a fiscal 2019 drop of $305 million in revenues and a drop of nearly $230 million in operating income as compared to fiscal 2018 levels. While the move resulted in weaker fiscal 2019 performance versus fiscal 2018, Starbucks expected that performance of the Channel Development segment would improve in the years to come because of Nestle's ability to significantly increase overall global sales of the packaged coffee and tea products it licensed from Starbucks. In October 2022, Starbucks and Nestle entered into an agreement whereby Starbuck would sell is Seattle's Best Coffee Business to Nestlé for an undisclosed sum. The Channel Development group's revenues and operating profits for 2020–2022 are shown in Exhibit 2 above.

Starbucks Advertising Strategy

Starbucks spent sparingly on advertising, preferring instead to build the brand cup by cup with customers and depend on word of mouth, the ambience of its stores, the quality of its menu offerings, and the pleasing experience store employees delivered to customers to drive store traffic. However, from time to time Starbucks did use advertising to call public attention to new Starbucks products, seasonal promotions, or new things happening at Starbucks stores. The company's advertising expenses totaled $416.7 million in fiscal 2022, $305.1 million in 2021, and $258.8 million in 2020.

TWO NEW DEVELOPMENTS AT STARBUCKS GOING INTO 2020

The Availability of Order Delivery

Starbucks began experimenting with a pilot program in Miami to deliver orders to customers in late 2018 via a partnership with Uber Eats, a global delivery service that partnered with over 200,000 restaurants in more than 500 cities across 36 countries. Starbucks envisioned order delivery as a means of extending its engagement with customers who currently included a Starbucks beverage as part of their morning or afternoon routines and also as a new way of extending potential engagement to new customers—delivering orders provided the ultimate Starbucks convenience.

The pilot order delivery program was enthusiastically received and repeatedly used by Starbucks customers in Miami. Starbucks management believed the pilot program suggested the existence of a strong pent-up demand for order delivery and quickly proceeded with a rollout of Starbucks® Delivers to 16 metropolitan markets in the United States and abroad in 2019 to further refine and integrate Starbucks digital ordering technology with the Uber Eats app and platform. About 95 percent of the items on Starbucks store menus were available for delivery. Customers used a downloaded Uber Eats app to place and pay for orders, which included the Uber Eats delivery fee; they also could use the Uber Eats app to track progress of their order and the location of their Uber courier. Delivery orders had splash-proof lids, delivery containers designed to keep drinks hot or cold, and tamper-proof packaging seals.

Going into 2020, Starbucks had launched Starbucks Delivers nationwide in United States and in more than 15 global markets, including Canada, Chile, China, Colombia, Hong Kong, India, Indonesia, Japan, Mexico, Singapore, the U.K., and Vietnam. In China, where Uber did not operate, Starbucks opted to partner with Alibaba and use its Ele.me delivery platform to deliver customer orders; Alibaba's delivery drivers in China had promised to deliver orders in 30 minutes or less. Later in 2020, Starbucks moved rapidly to modify its Mobile Order and Pay app to place delivery orders and, further, to enable voice ordering capability.

A New "Airport Strategy"

In early February 2020, HMSHost announced it was terminating its exclusive licensing agreement to operate all Starbucks stores in airports in the United States, an agreement which had been in place since 1991; HMSHost's plan was to replace the agreement with Starbucks with new agreements to partner with local coffee companies in providing coffee service in airports. A week later, Starbucks announced that it was expanding its airport locations in partnership with airport retailer and restaurateur Paradies Lagardère and airport hospitality group OTG Management.

Starbucks and its new partners immediately announced they would be implementing a reimagined Starbucks experience for airport travelers that included (1) using mobile kiosks with digital and mobile ordering capabilities moving throughout airport terminals to provide Starbucks coffee service to travelers before boarding or upon arrival (2) widespread use of mobile ordering and payment at the counters of traditional Starbucks stores in airports where it had long been common for travelers to encounter 15- to 20-minute wait lines during peak periods to get their order. For example, OTG-operated airport locations were noted for using iPads that allowed customers to order and pay for items at their own pace without having to wait in a line. OTG had more than 5,000 iPads deployed at its retail locations in New Jersey's Newark Liberty International airport.

In November 2019, Starbucks announced the opening of its first Starbucks Pickup store in New York City's Penn Plaza. The Pickup store along with the Starbucks Dewata Coffee Sanctuary in Bali and the various Starbucks Roasters stores signaled that Starbucks was endeavoring to create a diverse store portfolio offering customers a variety of Starbucks experiences.

HOWARD SCHULTZ'S EFFORTS TO MAKE STARBUCKS A GREAT PLACE TO WORK, 1988–2018

Howard Schultz deeply believed that Starbucks's success was heavily dependent on customers having a very positive experience in its stores. This meant having store employees who were knowledgeable about the company's products, who paid attention to detail in preparing the company's espresso drinks, who eagerly communicated the company's passion for coffee, and who possessed the skills and personality to deliver consistent, pleasing customer service. Many of the baristas were in their 20s and worked part-time, going to college on the side or pursuing other career activities. Schultz viewed the company's challenge as one of attracting, motivating, and rewarding store employees in a manner that would make Starbucks a company that people would want to work for and that would generate enthusiastic commitment and higher levels of customer service. Moreover, Schultz wanted to send all Starbucks employees a message that would cement the trust that had been building between management and the company's workforce.

Instituting Health Care Coverage for All Employees

One of the requests that employees had made to the prior owners of Starbucks back in the 1980s was to extend health care benefits to part-time workers. Their request had been turned down, but Schultz believed that expanding health care coverage to include part-timers was something the company needed to do. He knew from having grown up in a family that struggled to make ends meet how difficult it was to cope with rising medical costs. In 1988, Schultz went to the board of directors with his plan to expand the company's health care coverage to include part-timers who worked at least 20 hours per week. He saw the proposal not as a generous gesture but as a core strategy to win employee loyalty and commitment to the company's mission. Board members resisted because the company was then unprofitable and the added costs of the extended coverage would only worsen the company's bottom line. But Schultz argued passionately that it was the right thing to do and wouldn't be as expensive as it seemed. He observed that if the new benefit reduced turnover, which he believed was likely, then it would reduce the costs of hiring and training—which equaled about $3,000 per new hire. He further pointed out that it cost $1,500 a year to provide an employee with full benefits. Part-timers, he argued, were vital to Starbucks, constituting two-thirds of the company's workforce. Many were baristas who knew the favorite drinks of regular customers; if the barista left, that connection with the customer was broken. Moreover, many part-time employees were called upon to open the stores early, sometimes at 5:30 or 6 a.m.; others had to work until closing, usually 9 p.m. or later. Providing these employees with health care benefits, he argued, would signal that the company honored their value and contribution.

The board approved Schultz's plan, and part-timers working 20 or more hours were offered the same health coverage as full-time employees starting in late 1988. Starbucks paid 75 percent of an employee's health care premium; the employee paid 25 percent. Over the years, Starbucks extended its health coverage to include preventive care, prescription drugs, dental care, eye care, mental health, and chemical dependency—see Exhibit 4 below). Coverage was also offered for unmarried partners in a committed relationship.

A Stock Option Plan for Employees

By 1991, the company's profitability had improved to the point where Schultz could pursue a stock option plan for all employees, a program he believed would have a positive, long-term effect on the success of Starbucks.[13] Schultz wanted to turn every Starbucks employee into a partner, give them a chance to share in the success of the company, and make clear the connection between their contributions and the company's market value. Even though Starbucks was still a private company, the plan that emerged called for granting stock options to every full-time and part-time employee in proportion to their base pay. In May 1991, the plan, dubbed Bean Stock, was presented to the board. Though board members were concerned that increasing the number of shares might unduly dilute the value of the shares of investors who had put up hard cash, the plan received unanimous approval. The first grant was made in October 1991, just after the end of the company's fiscal year in September; each partner was granted stock options worth 12 percent of base pay. When the Bean Stock program was initiated, Starbucks dropped the term employee and began referring to all of its people as "partners" because every member of the Starbucks workforce became eligible for stock option awards after six months of employment and 500 paid work hours.

After Starbucks went public in June 1992, starting in October 1992 and continuing through October 2004, Starbucks granted each eligible employee a stock option award with a value equal to 14 percent of base pay. Beginning in 2005, the plan was modified to tie the size of each employee's stock option awards to three factors: (1) Starbucks' success and profitability for the fiscal year, (2) the size of an employee's base wages, and (3) the price at which the stock option could be exercised. Since becoming a public company, Starbucks stock had split two-for-one on six occasions.

Starbucks' Stock Purchase and 401(k) Plans for Employees

In 1995, Starbucks implemented an employee stock purchase plan that gave partners who had been employed for at least 90 days an opportunity to purchase company stock through regular payroll deductions of 1 to 10 percent of their base earnings (up to an annual maximum of $25,000). At the end of each calendar quarter, each participant's contributions were used to buy Starbucks shares at a discounted price. In fiscal 2018, about 600,000 shares were purchased under this plan, and about 400,000 shares were purchased in fiscal 2019. Later, a 401(k) plan was initiated for employees that included matching company contributions. Details of the current stock purchase plan and 401(k) plans are included in Exhibit 4.

The Workplace Environment

Starbucks management believed its competitive pay scales and comprehensive benefits for both full-time and part-time partners (employees) allowed it to attract motivated people with above-average skills and good work habits. An employee's base pay was determined by the pay scales prevailing in the geographic region where an employee worked and by the person's job, skills, experience, and job performance. About 90 percent of Starbucks' partners were full-time or part-time baristas, paid on an hourly basis. In early 2023, baristas at company-owned stores in the United States earned base pay of about $32,500 annually plus supplemental pay (cash bonuses, stock bonuses, profit sharing, sales commissions, and tips) of about $4,200 according to wage data posted at Glassdoor.[15] Total pay for store managers ranged from $62,000 to $93,000, with a median of $75,200. Salaries for district managers were in the $97,000 to $153,000 range, with

EXHIBIT 4 Starbucks' Fringe Benefit Program, 2022

- Medical, dental, and vision coverage
- Sick pay, up to 40 hours per year
- Paid vacations (up to 120 hours annually for hourly workers with five or more years of service at retail stores and up to 200 hours annually for salaried and nonretail hourly employees with 10 or more years of service)
- Seven paid holidays
- One paid personal day every six months for salaried and nonretail hourly partners only
- Mental health and chemical dependency coverage
- 401(k) retirement savings plan—Partners age 18 or older with 90 days of service were eligible to contribute from 1 to 75 percent of their pay each pay period (up to the annual IRS dollar limit). Partners age 50 and older had a higher IRS annual limit than younger employees. Starbucks matched 100 percent of the first 5 percent of eligible pay contributed each pay period. Starbucks matching contributions to the 401(k) plans worldwide were $156.7 million in fiscal 2022, $145.1 million in 2021, and $132.7 million in 2020.
- Short- and long-term disability
- Stock purchase plan—eligible employees could buy shares at a 5 percent discount through regular payroll deductions of between 1 and 10 percent of base pay.
- Life insurance coverage equal to annual base pay for salaried and nonretail employees; coverage equal to $10,000 for hourly store employees. Supplemental coverage could also be purchased.
- Short-term disability coverage (partial replacement of lost wages/income for 26 weeks, after a short waiting period); hourly employees can purchase long-term disability coverage
- Company-paid long-term disability coverage for salaried and nonretail employees
- Accidental death and dismemberment insurance
- Adoption assistance—Reimbursement of up to $10,000 to help pay for qualified expenses related to the adoption of an eligible child
- Financial assistance program for employees that experience a financial crisis
- Stock option plan—Shares were granted to eligible partners, subject to the company's achievement of specified performance targets and the employee's continued employment through the vesting period. Vesting occurred in two equal annual installments beginning two years from the grant date. The company's board of directors determined how many shares were to be granted each year and also established the specified performance targets.
- Pre-tax payroll deductions for work-related commuter expenses
- A free coffee or tea product each week
- An in-store discount of 30 percent on purchases of beverages, food, and merchandise
- A college achievement plan featuring full tuition reimbursement every semester for employees enrolled in Arizona State University's top ranked online degree programs. Since the program began in 2014, nearly 7,000 partners had earned their college degrees as of 2021, and the company was working towards graduating 25,000 Starbucks partners from ASU by 2025.[14]
- Gift-matching benefits—Starbucks matched up to $1,000 per fiscal year for individual contributions of money or volunteer time to eligible nonprofit organizations

Source: Information in the Careers section at **www.starbucks.com**, accessed February 12, 2023; Starbucks 2022 10-K Report, p. 74.

a median of $120,200. In fiscal year 2022, Starbucks announced approximately $1 billion in incremental investments in annual wages and benefits that would be paid during 2022 and 2023.

Starbucks was named to *Fortune*'s list of the "100 Best Companies to Work For" 14 times during the 1988–2022 period.

Schultz's decisions to offer employees good compensation and a comprehensive benefits package was driven by his belief that sharing the company's success with the people who made it happen helped everyone think and act like an owner, build positive long-term relationships with customers, and do things in an efficient way. Schultz's business rationale, influenced by his father's experience of going from one low-wage, no-benefits job to another, was that if you treat your employees well, that is how they will treat customers. Under Schultz's leadership for 40-plus years, Starbucks' practices of paying its employee/partners competitive wages and salaries, periodically adding new elements to its fringe benefits package that its partners deemed valuable, providing its partners/employees with meaningful opportunities to pursue their aspirations, and investing in their well-being, health, and success had become very deeply ingrained in the company's culture and style of operating.

Employee Training and Recognition

To accommodate its ongoing strategy of rapid store expansion, Starbucks put in systems to recruit, hire, and train baristas and store managers. Every partner/barista hired for a retail job in a Starbucks store received at least 24 hours training in their first two to four weeks. Training topics included coffee history, drink preparation, coffee knowledge, customer service, and retail skills, plus a four-hour workshop on "Brewing the Perfect Cup." Baristas spent considerable time learning about beverage preparation—grinding the beans, steaming milk, learning to pull perfect (18- to 23-second) shots of espresso, memorizing the recipes of all the different drinks, practicing making the different drinks, and learning how to customize drinks to customer specifications. There were sessions on cash register operations, how to clean the milk wand on the espresso machine, explaining the Italian drink names to unknowing customers, making eye contact with customers and interacting with them, and taking personal responsibility for the cleanliness of the store. And there were rules to be memorized: milk must be steamed to at least 150 degrees Fahrenheit but never more than 170 degrees; every espresso shot not pulled within 23 seconds must be tossed; always compensate dissatisfied customers with a Starbucks coupon that entitles them to a free drink. In fiscal 2021, Starbucks spent $1.2 billion on barista training.[16]

There were also training programs for shift supervisors, assistant store managers, store managers, and district managers that went much deeper, covering not only coffee knowledge and information imparted to baristas but also the details of store operations, practices and procedures as set forth in the company's operating manual, information systems, and the basics of managing people. In addition, there were special career development programs, such as a coffee masters program for store employees and more advanced leadership skills training for shift supervisors and store management personnel. When Starbucks opened stores in a new market, it sent a star team of experienced managers and baristas to the area to lead the store-opening effort and to conduct one-on-one training following the basic orientation and training sessions.

To recognize and reward partner contributions, Starbucks had created a partner recognition program consisting of 18 different awards and programs.[17] Examples included Partner of the Quarter Awards (for one partner per store per quarter) for significant contributions to their store and demonstrating behaviors consistent with the company's mission and values; Spirit of Starbucks awards for making exceptional contributions to partners, customers, and community while embracing the company's mission and values; a Manager of the Quarter for store manager leadership; Green Apron Awards where partners could recognize fellow partners for how they brought to life the company's mission, values, and customer commitment; and Bravo and Team Bravo! awards for above and beyond the call of duty performance and achieving exceptional results.

STARBUCKS' MISSION, BUSINESS PRINCIPLES, AND VALUES

During the early building years, Howard Schultz and other Starbucks senior executives worked to instill some values and guiding principles into the Starbucks culture. The cornerstone value in their effort "to build a company with soul" was that the company would always pursue the perfect cup of coffee by buying the best beans and roasting them to perfection. Schultz was adamant about controlling the quality of Starbucks products and building a culture common to all stores. He was rigidly opposed to selling artificially flavored coffee beans—"we will not pollute our high-quality beans with chemicals;" if a customer wanted hazelnut-flavored coffee, Starbucks added hazelnut syrup to the drink.

Starbucks' management was also emphatic about the importance of employees paying attention to what pleased customers. Employees were trained to go out of their way, and to take heroic measures if necessary, to make sure customers were fully satisfied. The theme was "just say yes" to customer requests. Further, employees were encouraged to speak their minds without fear of retribution from upper management—senior executives wanted employees to be vocal about what Starbucks was doing right, what it was doing wrong, and what changes were needed. The intent was for employees to be involved in and contribute to the process of making Starbucks a better company.

Starbucks' Mission Statement

In early 1990, the senior executive team at Starbucks went to an offsite retreat to debate the company's values and beliefs and draft a mission statement. Schultz wanted the mission statement to convey a strong sense of organizational purpose and to articulate the company's fundamental beliefs and guiding principles. The draft was submitted to all employees for review and several changes were made based on employee comments. The resulting mission statement was: "Establish Starbucks as the premier purveyor of the finest coffee in the world while maintaining our uncompromising principles as we grow." It was accompanied by six guiding principles intended to help company personnel measure the appropriateness of the company's decisions:[18]

1. Provide a great work environment and treat each other with respect and dignity.
2. Embrace diversity as an essential component in the way we do business.
3. Apply the highest standards of excellence to the purchasing, roasting, and fresh delivery of our coffee.
4. Develop enthusiastically satisfied customers all of the time.
5. Contribute positively to our communities and our environment.
6. Recognize that profitability is essential to our future success.

In 2008, Starbucks partners from all across the company met for several months to refresh the mission statement; the revised mission statement was "To inspire and nurture the human spirit—one person, one cup, and one neighborhood at a time." That mission had endured going into 2023. But, over time, the original six guiding principles were recast into five core values that in 2023 were phrased as follows:[19]

1. Creating a culture of warmth and belonging, where everyone is welcome.
2. Delivering our very best in all we do, holding ourselves accountable for results.
3. Acting with courage, challenging the status quo and finding new ways to grow our company and each other.
4. Being present, connecting with transparency, dignity, and respect.
5. We are performance-driven, through the lens of humanity.

STARBUCKS' COFFEE PURCHASING STRATEGY

Coffee beans were grown in 70 tropical countries and were the second most traded commodity in the world after petroleum. Most of the world's coffee was grown by some 25 million small farmers, most of whom lived on the edge of poverty. Starbucks personnel traveled regularly to coffee-producing countries, building relationships with growers and exporters, checking on agricultural conditions and crop yields, and searching out varieties and sources that would meet Starbucks' exacting standards of quality and flavor. The coffee-purchasing group, working with Starbucks personnel in roasting operations, tested new varieties and blends of green coffee beans from different sources. The company's supplies of green coffee beans were chiefly grown on about 1 million small family farms (less than 30 acres) located in the coffee-growing communities of countries across the world. Sourcing from multiple geographic areas not only allowed Starbucks to offer a greater range of coffee varieties to customers but also spread its risks regarding weather, price volatility, and changing economic and political conditions in coffee-growing countries.

Starbucks' coffee sourcing strategy had three key elements:

1. Make sure that the prices Starbucks paid for green (unroasted) coffee beans were high enough to ensure that small farmers were able to cover their production costs and provide for their families. The company was firmly committed to a goal of "100 percent ethically-sourced coffees"—in 2016 management believed it had reached a milestone of 99 percent ethically sourced coffee.[20] Because the company also purchased tea and cocoa for its stores and ready-to-drink beverages, it was similarly committed to 100 percent ethically sourced tea and cocoa.
2. Utilize purchasing arrangements that limited Starbucks exposure to sudden spikes in green coffee prices.
3. Work directly with small coffee growers, local coffee-growing cooperatives, and other types of coffee suppliers to promote coffee cultivation methods that were environmentally sustainable. Starbucks' objective was to "make coffee the world's first sustainable agricultural product."[21]

Pricing and Purchasing Arrangements

Commodity-grade coffee was traded in a highly competitive market as an undifferentiated product. However, high-altitude Arabica coffees of the quality purchased by Starbucks were bought on a negotiated basis at a premium above the "C" coffee commodity price. Both the commodity price and the prices of the top-quality coffees sourced by Starbucks depended on supply and demand conditions at the time of the purchase and were subject to considerable volatility due to weather; water supply quality and availability throughout the production chain; natural disasters; crop disease and pests; changes in input prices and the costs of production; inventory levels; and economic and political conditions in the growing countries. Prices were also impacted by trading activities in the *arabica* coffee futures market, including the trading activities of hedge funds and commodity index funds. In addition, green coffee prices, on occasion, were influenced by the actions of certain organizations and associations to establish export quotas or restrict coffee supplies.

Starbucks bought coffee using fixed-price and price-to-be-fixed purchase commitments, depending on market conditions, to secure an adequate supply of quality green coffee. Price-to-be-fixed contracts were purchase commitments whereby the quality, quantity, delivery period, and other negotiated terms were agreed upon, but the date at which the base price component of commodity grade coffee was to be fixed was as yet unspecified. In the case of price-to-be-fixed contracts, either Starbucks or the seller had the option to select a date on which to "fix" the base price of commodity grade coffee prior to the delivery date. Starbucks also utilized forward contracts, futures contracts, and collars to hedge "C" price exposure under its price-to-be-fixed green coffee contracts and its forecasted green coffee needs for the upcoming 12 months. It was the goal of the company's coffee purchasing personnel to have sufficient purchasing and hedging agreements in place, together with its existing inventory, to provide an adequate supply of green coffee for the upcoming 11–12 months.

Purchasing of Other Needed Supplies

Products other than whole bean coffees and coffee beverages sold in Starbucks stores included tea and a number of ready-to-drink beverages were purchased from several specialty suppliers, usually under long-term supply contracts. Food products, such as pastries, breakfast sandwiches and lunch items, were purchased from national, regional and local sources. Starbucks purchased a broad range of paper and plastic products, such as cups and cutlery, from several manufacturers and distributors to support the needs of its retail stores and its manufacturing and distribution operations. Management believed, based on relationships established with these suppliers and manufacturers, that the risk of nondelivery of sufficient amounts of these items to its many store locations and various other operations was remote.

Starbucks' Supplier Code of Conduct

Starbucks made an effort to work with suppliers that were committed to its own principles of conducting business in a responsible and ethical manner, respecting the rights of individuals, and helping to protect the environment. All Starbucks suppliers worldwide were expected to sign an agreement pledging compliance with Starbucks Supplier Code of Conduct, which included the following:[22]

- Demonstrating commitment to the welfare, economic improvement and sustainability of the people and places that produce products and services for Starbucks.
- Adhering to local laws and international standards regarding human rights, workplace safety, and worker compensation and treatment.

- Meeting or exceeding national laws and international standards for environmental protection and minimizing negative environmental impacts of the supplier's operations.
- Committing to measuring, monitoring, reporting, and verifying compliance to this code.
- Pursuing continuous improvement of these social and environmental principles.
- There were further specified standards for manufacturers, food suppliers, and nonfood suppliers pertaining to such things as antibribery practices, workplace harassment, quality control, hazardous materials, packing and shipping of refrigerated products, transportation and shipping modes, and customs clearance.

Verification of compliance was subject to audits by Starbucks personnel or acceptable third parties. From time to time, Starbucks had temporarily or permanently discontinued its business relationship with suppliers who failed to comply or failed to work with Starbucks to correct a noncomplying situation.

COFFEE ROASTING OPERATIONS

Starbucks considered the roasting of its coffee beans to be something of an art form, entailing trial-and-error testing of different combinations of time and temperature to get the most out of each type of bean and blend. Recipes were put together by the coffee department, once all the components had been tested. Computerized roasters guaranteed consistency. Highly trained and experienced roasting personnel monitored the process, using both smell and hearing, to help check when the beans were perfectly done—coffee beans make a popping sound when ready. Roasting standards were exacting. After roasting and cooling, the coffee was immediately vacuum-sealed in bags that preserved freshness for up to 26 weeks. As a matter of policy, however, Starbucks packaged coffees were removed from retailer shelves well before the 26-week expiration date (frequently because of discounted price promotions). In the case of coffee used to prepare beverages in stores, the shelf life was limited to seven days after the bag was opened.

In 2023, Starbucks had multiple roasting plants in numerous locations, having expanded its roasting operations as its store base expanded to more geographic regions and countries. Roasting plants also had additional space for warehousing and shipping coffees. In keeping with Starbucks' corporate commitment to reduce its environmental footprint, since 2009 all newly built roasting plants and all other newly built company facilities had conformed to LEED (Leadership in Energy and Environment Design) standards devised by the United States Green Building Council; LEED standards were the most widely used green building rating system in the world for evaluating the environmental performance of a building and encouraging market transformation towards sustainable design. Starbucks had launched and achieved an initiative to achieve LEED Certification for all company-operated facilities built after 2010; facilities constructed prior to 2010 had been remodeled and/or retrofitted accordingly. Currently, Starbucks goal was designing, building, and operating 10,000 "Greener Stores" globally by 2025.

STARBUCKS' CORPORATE SOCIAL RESPONSIBILITY STRATEGY

Howard Schultz's effort to "build a company with soul" included a long history of doing business in ways that were socially and environmentally responsible. A commitment to do the right thing and strike a balance between profitability and a social conscience was central to how Starbucks operated from the time Howard Schultz first became Starbucks CEO in 1987. The specific actions comprising Starbucks' corporate social responsibility (CSR) strategy had varied over the years but the intent of the strategy was consistently one of contributing positively to the communities in which Starbucks had stores, being a good environmental steward, and conducting the company's business in ways that earned the trust and respect of customers, partners/employees, suppliers, and the general public. Some of main elements constituting Starbucks CSR strategy over the past 30 years and some of the resulting accomplishments and beneficial outcomes include the following:

1. *Employing coffee-sourcing practices that resulted in paying fair and ethical prices to the small family farmers in low-income countries where the high-quality green coffees Starbucks purchased were being grown.* This CSR initiative, which Starbucks

referred to as "ethical-sourcing, had two principal objectives. One was to ensure that small coffee growers received prices for their green coffee beans sufficiently high enough to allow them to pay fair wages to their workers, earn enough to reinvest in their farms and communities, develop the business skills needed to compete in the global market for coffee, and afford basic health care, education, and home improvements. The second was to educate these small farmers about the benefits of using sustainable agricultural practices to grow coffee and then to support their efforts to implement these practices—with the long-term environmentally beneficial goal of making coffee one of the world's first products to be widely grown with sustainable agricultural practices.

To achieve "the fair and ethical prices" objective, in 1998, Starbucks began partnering with Conservation International's Center for Environmental Leadership to develop specific guidelines (called Coffee and Farmer Equity [C.A.F.E.] Practices) covering four areas: product quality, the price received by farmers/growers, safe and humane working conditions (including compliance with minimum wage requirements and child labor provisions), and environmentally responsible cultivation practices. Top management at Starbucks set a goal that by 2015 all of the green coffee beans purchased from growers would be C.A.F.E. Practice certified, Fair Trade certified, organically certified, or certified by some other equally acceptable third party. By 2011, 86 percent of Starbucks purchases of green coffee beans were C.A.F.E. Practices–verified sources and 8 percent were from Fair Trade–certified sources, making Starbucks among the world's largest purchasers and marketers of Fair Trade–certified coffee beans. In 2015–2020, Starbucks coffee had been verified as 99 percent ethically sourced, but in fiscal 2021 due to circumstances surrounding the COVID-19 pandemic, Starbucks was only able to confirm that 95 percent of its green coffee bean purchases were from C.A.F.E. Practices verified sources. Nonetheless, the company was committed to reaching its goal of 100 percent in the next year or so. It was similarly committed to 100 percent ethically sourced supplies of tea and cocoa (for its cocoa-based beverages) and, in fiscal 2021, sourced 99.9 percent of its tea from Rainforest Alliance Certified farms and purchased 10 million kilograms of cocoa from Rainforest Alliance Certified sources.[23]

To promote achievement of the second outcome, Starbucks created and operated farmer support centers staffed with agronomists and sustainability experts who worked with coffee farming communities to promote best practices in coffee production, implement advanced soil-management techniques, improve both coffee quality and yields, and address climate and other impacts. To complement the activities of farmer support centers, Starbucks instituted a Small Farmer Loan Program to provide funding for loans to small coffee growers since many of the small family farms lacked the money to make farming improvements and/or cover all expenses until they sold their crops. In 2010, $14.6 million was loaned to nearly 56,000 farmers who grew green coffee beans for Starbucks in 10 countries; in 2011, an additional $14.7 million was loaned to over 45,000 farmers who grew green coffee beans for Starbucks in another seven countries. Later, the company established a $50 million Starbucks Global Farmer Fund to provide loans to coffee farmers for coffee tree renovation and infrastructure improvements. Moreover, the Starbucks Foundation began partnering with organizations with local expertise to award grants to support smallholder-farming families in coffee-growing and tea-growing communities, reaching approximately 47,000 direct and indirect beneficiaries. By 2020 the foundation planned to reach 200,000 people.

A still further ethical-sourcing initiative called the One Tree for Every Bag Commitment was launched in 2015 for the purpose of planting 20 million coffee tree seedlings to replace trees declining in productivity due to age and disease such as coffee leaf rust. The goal was exceeded in just over a year, at which time Starbucks committed to providing a total of 100 million coffee tree seedlings to farmers by 2025, particularly in coffee-growing communities being impacted by climate change.

2. *Environmental stewardship*—This CSR strategy element had taken on an ever bigger role in Starbucks overall CSR strategy over the years and was arguably the centerpiece of the company's CSR strategy in 2023. Starbucks had invested in renewable energy since 2005, and it achieved a milestone in 2015 by purchasing the equivalent of 100 percent of the electricity consumption of all company-operated stores worldwide from

renewable energy sources. In North Carolina and Washington state, Starbucks had invested in a solar farm and a wind farm that delivered enough energy to power more than 700 Starbucks stores.

Beginning in 2008 and continuing thereafter, Starbucks undertook an energy-saving commitment to make all company facilities as green as possible by using environmentally friendly building materials and energy efficient designs. Management determined that henceforth all of its new operating facilities (roasting plants, offices, manufacturing and distribution facilities) and all new company-owned retail stores globally would be constructed to achieve LEED certification (LEED stood for Leadership in Energy and Environmental Design and was a green building certification program used worldwide). LEED-certification standards were also employed in remodeling or retrofitting existing facilities and retail stores. As of 2019, Starbucks had built more than 1,600 LEED-certified greener retail stores in 20 countries. In fiscal 2021, 2,779 stores were greener-certified globally.

Starting in 2005 and continuing until the present, Starbuck has pursued actions to reduce water consumption, reduce food waste, use recycled cardboard boxes and other back-of-store items, place recycling bins in place in all company-owned locations where there were municipal recycling capabilities, use more environmentally friendly coffee cups, and substitute paper straws for single-use plastic straws across all stores worldwide. Since 1985, Starbucks had given a $0.10 discount to customers who brought reusable cups and tumblers to stores for use in serving the beverages they ordered. An initiative was launched to empower 10,000 Starbucks employees to be "sustainability champions." Stores participated in Earth Day activities each year with in-store promotions and volunteer efforts to educate employees and customers about the impacts their actions had on the environment.

3. *Creating opportunities to help people achieve their dreams.* The chief initiatives here included partnering with some 50 other employers to hire, train, and advance the careers of 100,000 youth aged 16–24 by 2020, hiring at least 25,000 veterans and military spouses by 2025, welcoming and employing 10,000 refugees across the 75 countries in which Starbucks stores were located by 2022, and expanding partner participation in the company's college achievement plan that covered full-tuition reimbursement for admission to one of Arizona State University's online degree programs.

In early 2020, Starbucks announced three new environmental goals for the company's CSR strategy and launched five strategic initiatives to pursue them. The three goals were

1. A 50 percent reduction in carbon emissions in Starbucks direct operations and supply chain.
2. Conservation or replenishment of 50 percent of water currently being used in company operations and coffee production, with a focus on communities and basins with high water risk.
3. A 50 percent reduction in waste sent to landfill from stores and manufacturing, driven by a broader shift toward a circular plastics economy where plastics never became waste or pollution because they were 100 percent recycled.

The intent was for Starbucks to become a "resource-positive" company by 2030 that gave more than it took from the planet. Starbucks' aspiration to become resource-positive meant specifically that the company would give more than it took from the planet in three respects: (1) storing more carbon than was emitted from its operations, (2) providing more clean fresh water than it used, and (3) eliminating waste. To get the organization moving toward the 2030 objectives, five strategic initiatives were implemented:

1. An expansion of the plant-based options on Starbucks menus, in order to migrate toward a more environmentally friendly menu. As of 2022, nearly all stores across all Starbucks' markets offered plant-based food and beverage menu items.
2. A shift from single-use to reusable packaging.
3. New investments in innovative and regenerative agricultural practices, reforestation, forest conservation, and water replenishment in Starbucks supply chain.
4. Investment in better ways to manage waste, both in Starbucks stores and in its communities, to ensure more reuse, recycling, and elimination of food waste.
5. Innovative development of more eco-friendly stores, operations, manufacturing, and delivery. Going into 2022, Starbucks was purchasing renewable

electricity worldwide to power 100 percent of its company-operated stores in the United States, Canada, and the United Kingdom. Starbucks was also investing in solar and wind projects being undertaken in a number of locations where it had stores or other facilities. In fiscal 2021, Starbucks invested $10,000,000 in the U.S. Dairy Net Zero Initiative, a partnership of the U.S. dairy community seeking to enable progress toward the industry's goals of achieving greenhouse gas neutrality and improvements in water quality on farms.

Starbucks had been named to *Corporate Responsibility Magazine*'s list of the 100 Best Corporate Citizens on numerous occasions; this list was based on more than 360 data points of publicly available information in seven categories: Environment, Climate Change, Human Rights, Philanthropy, Employee Relations, Financial Performance, and Governance. Over the years, Starbucks had received about 30 awards from a diverse group of organizations for its philanthropic, community service, and environmental activities.

SCHULTZ TRANSITION'S FROM CEO TO EXECUTIVE CHAIRMAN

When Howard Schultz introduced the three-Re-Invention Plan for Starbucks in September 2022, he also introduced incoming Chief Executive Officer Laxman Narasimhan, who would officially join Starbucks on October 1, 2022, and work closely with Schultz before assuming the CEO role and joining the board in April 2023. Most recently, Narasimhan served as chief executive officer of Reckitt, a multinational consumer health, hygiene, and nutrition company, where he led the company through a major transformation and a return to sustainable growth. Previously, Narasimhan served as an executive in various leadership roles at PepsiCo, including as global chief commercial officer, where he was responsible for the company's long-term growth strategy and commercial capabilities and as CEO of PepsiCo's Latin America, Europe, and Sub-Saharan Africa operations, where he ran the company's food and beverage businesses across over 100 countries. Prior to PepsiCo, he spent 19 years at McKinsey & Company, where he advised retail, healthcare, and consumer goods companies in the United States, Asia, and India and led the firm's thinking on the future of retail.

LUCKIN COFFEE'S SUDDEN EMERGENCE TO CHALLENGE STARBUCKS' COFFEE MARKET LEADERSHIP IN CHINA

China-based Luckin Coffee began operations in October 2017, and by March 31, 2019, had opened an astonishing 2,370 wholly owned locations in 28 cities and had 16,645 employees as of March 31, 2019. The company's strategic intent was to become the largest network of coffee stores in China. In 2018, its first full year of operation, Luckin Coffee used aggressive promotions and coupons offering 50 percent price discounts to achieve revenues of $125.3 million on which it reported a loss of $241.3 million. . Luckin Coffee sourced premium Arabica coffee beans from prominent suppliers and engaged World Barista Champion teams to design its coffee recipes. Its coffee won the Gold Medal in the 2018 IIAC International Coffee Tasting Championship. The company purchased coffee machines, coffee condiments, juices, and assorted food products that were sold in its stores from reputable outside vendors at what Luckin management believed were favorable prices. In early 2019, Luckin created mobile apps covering the entire customer purchase process, enabling it to offer app users a 100 percent cashier-free option.

Throughout 2019, Luckin continued to open new stores at a very rapid pace, and it continued its use of aggressive sales promotions featuring 50 percent discounts to attract more customers to its existing and newly opened stores. And, it continued to post large quarterly losses in the tens of millions, but growing store traffic and big increases in the number of sales transactions per store resulted in progressively smaller losses in the last three quarters of 2019.

In April 2019 Luckin Coffee filed documents with the Securities and Exchange Commission in the United States stating its desire to undertake an initial public offering (IPO) of common stock and become a public company, with its stock trading on the NASDAQ under the symbol LK. In its IPO filing, Luckin Coffee management cited four company strengths as contributing to its initial success:

1. Being the leading and fastest growing player driving coffee consumption in China.
2. Being the pioneer of a disruptive new retail model.
3. Having strong technology capabilities.
4. Offering a superior customer proposition underpinned by high quality, high affordability, and high convenience.

In May 2019, the company's IPO application received SEC approval, and Luckin quickly moved forward. Luckin priced its IPO issue at $17 per share and raised $561 million on an upsized offering of 33 million shares, making it one of the fastest companies ever to reach a $6 billion valuation (based on all the preferred and common shares outstanding). Its common stock began trading on May 17, 2019.

On November 13, 2019, Luckin executives said they fully expected that Luckin Coffee would have more store locations than Starbucks by the end of 2019. This expectation was realized. At the end of 2019, Luckin Coffee had 4,507 self-operated stores, higher than Starbucks year-end store count of 4,292 stores in China. In addition to its fully-automated retail stores with seating for no more than 10 customers, Luckin also had opened over 175 "relax" stores with enough seating space for 25 to 50 customers and just over 100 delivery kitchens.

On January 7, 2020, Luckin Coffee Inc. announced the launch of Luckin Pop, a smart vending machine, and Luckin Coffee Express, a smart coffee machine. Both types of vending machines were to be installed in office buildings, gas stations, bus terminals, airports, and on college campuses and various locations in residential communities. The Luckin Pop vending machines would sell bottled and canned beverages and snacks from brands like Pepsi and Nestlé that also supplied products to Luckin's retail shops. The Luckin Coffee Express vending machine enabled customers to order hot coffee drinks like those at the company's retail stores; customers used the LK App to place orders on a specific Express machine and picked up the chosen brewed coffee drink by scanning the QR code from the app after paying for it. This new strategy initiative was aimed at building a low-cost unmanned retail distribution network that would make Luckin Coffee products readily available to more customers in more locations, thereby growing the company's sales revenues while bypassing the payroll, rental costs, and other expenses associated with operating Luckin Coffee retail stores. However, some of the operating cost savings associated with vending machine sales were offset by higher depreciation costs associated with the investment in the two vending machines. ccording to the company's January 7, 2020, announcement, the Luckin Coffee Express vending machines would contain a coffee-making machine supplied by Schaerer, a Swiss-based manufacturer of premium automated coffee machines; the cost of each installed Express vending machine was expected to be in the range of $15,000 to $20,000. Local observers believed that Luckin would employ a low-introductory pricing strategy for all the products sold in its Luckin Pop and Luckin Coffee Express vending machines. Meanwhile, Luckin's retail stores were continuing to sell coffee products at half the posted price and were also running a special "Buy 2, get one free" promotion on top of the 50 percent discount.

To help finance its new vending machine initiative and fund capital requirements for ongoing store network expansion, sales and marketing, and other corporate activities, Luckin issued 11 million shares of common stock (realizing net proceeds of $418.3 million) and sold $460 million in convertible senior notes due 2025 (realizing net proceeds of $446.7 million) for a total capital raise of $865 million.

On April 2, 2020, Luckin Coffee disclosed that an investigation by a special committee of the board of directors revealed the company's chief operating officer, and several employees reporting to him, had fraudulently inflated the company's sales by approximately $310 million from the second quarter to the fourth quarter of 2019. The misconduct involved "fabricating certain transactions" and substantially inflating certain costs and expenses, thus rendering the company's financial statements unreliable; the company's auditor was Ernst & Young. The China Securities Regulatory Commission announced it would investigate the alleged fraud. On May 12, 2020, the company announced that Luckin's chief executive officer and chief operating officer had been terminated, that six other employees, who were involved in or had knowledge of the fabricated transactions, had been placed on suspension or leave, and that a senior vice president of the company had been appointed as the new interim CEO. In June 2020, authorities in China announced that emails had been discovered in which the company's board chairman and largest shareholder, Lu Zhengyao, instructed Luckin executives to commit the fraud.

When news of the fraud was publicly reported on April 2, Luckin Coffee's stock price quickly plummeted 80 percent to about $6 per share. Trading in the company's stock on the Nasdaq was suspended on April 8, 2020, and shortly thereafter, Luckin's stock was delisted.

Luckin Coffee Survives and Restructures

Despite the filing of multiple lawsuits pertaining to the fraud, two years of investigations and multiple corrective rulings on the part of regulators in the United States and particularly China, Luckin's board of directors moved decisively to appoint several new independent board members, overhaul its corporate governance procedures, comply with a host of new regulatory requirements issued by Chinese authorities, recruit a capable new CEO, a new CFO, and several other new executives, and get the whole Luckin management team focused on executing the January 2020 strategy of automating its retail stores and continuing rapid expansion of the company's coffee shops in China's most populous cities. Two to three Luckin Coffee Express vending machines and a single Luckin Pop machine were installed in the company's existing and newly opened retail locations. Technology was developed and employed for all aspects of the company's operations—from customer engagement and storefront operations to supply chain management and data analytics. Luckin's full-featured mobile app enabled a 100 percent cashier-less store environment, had the ability to track each order placed, and allowed customers to ask questions, provide reviews, file complaints, and call customer service representatives; the app contained an artificial intelligence-powered automated customer service chatbot to answer frequently asked questions from customers efficiently. Fully-automated store operations reduced customer queuing times in stores, improved operating efficiency, lowered store operating costs, and boosted the profit margins on store sales. In 2021, after disappointingly low sales of bottled and can beverages and snacks, Luckin discontinued use of the Luckin Pop vending machines.

Luckin stores offered both hot and iced freshly brewed coffee in a variety of flavors such as Americano, Latte, Cappuccino, Macchiato, Flat White, and Mocha; special flavors were introduced seasonally. Coffee recipes were tailored to Chinese customers' taste and preferences based on its growing understanding of what its customers liked, and ongoing market tests of new recipes. To help attract new customers, stores began offering several hot and cold tea drinks.

To greatly enhance its product development capabilities, Luckin invested in a product development center that was staffed with 60 employees. In 2021, Luckin launched 113 new versions of freshly brewed drinks, a number of which became best sellers that boosted store traffic, partly because they were premium quality, widely publicized on social media, and effectively marketed. Launches of new and refreshed drink versions quickly became a much-used way to attract new and existing customers to visit Luckin locations. Management believed the company's product development capabilities were in the frontline of the coffee industry in China.

Luckin executives believed that in the four years since 2018, it had been successful in building an increasingly powerful brand name based on three customer value propositions—high quality, high convenience, and high affordability (due to its price discounts and frequent sales promotions). In 2021, Luckin was ranked No.1 in the coffee chain industry for the first time in China's "Topbrands" report.[24] Management believed that Luckin had "strong brand equity and a brand image of professionalism, youth, fashion, and wellness that was captured by our new slogan "Livin' Young, Luckin On."[25]

Starting in late 2020 and continuing thereafter, Luckin began recruiting scores of new franchisees to open "partnership stores" in China's less-populated "second-tier "cities. Luckin opted for a franchising approach to the second tier market because it lowered Luckin's investment requirements (franchisees were responsible for the investment costs of opening partnership stores). Luckin required franchisees to operate their stores according to its strictly enforced standards and it also controlled the types and quality of the products offered. Franchisees paid Luckin a franchise fee for each store opened and a percentage of each store's sales.

In 2022, Luckin ended the year with 8,214 store locations, which included 5,652 self-operated stores and 2,562 partnership stores. The company had net sales revenues of $1.93 billion and posted its first full-year GAAP-based operating profit of $167.6 million, equal to an operating margin of 8.7 percent (this compared favorably with an operating loss margin of 6.7 percent in 2021). Revenues from the company's self-operated stores was $1.36 billion (up 52 percent over 2021) and revenues from partnership stores was $445 million (up 135 percent over 2021).

As of July 1, 2023, Luckin Coffee had 10,829 store locations in China, of which 7,181 were self-operated and 3,648 were partnership stores. This compared to 6,480 store locations for Starbucks.[26] In its first international expansion effort in March 2023, Luckin opened 14 store locations in Singapore. The price of a cup of coffee at Luckin in 2023 ranged from about $1.40 to $2.75, depending on the coffee drink. At Starbucks, a coffee drink cost at least $4.10.

Is Hey Tea a Relevant Competitor of Starbucks? Back in June 2019, Jeffrey Towson, a private equity investor, author, and business professor at Peking University in Beijing, observed in a two-part article that, in China, Starbucks's most interesting competitor was not Luckin Coffee (whose coffee products were not something that many Chinese consumers drank) but rather Hey Tea, an upscale Starbucks-type business focused on tea (something Chinese consumers really, really like).[27] Towson noted that Hey Tea appeared to be focused on product development and continually thrilling its customers with their product offerings. He believed Hey Tea's high-priced creative tea drinks were becoming a consumer phenomenon in China, with people holding places in line for other people and with the average order being three drinks costing about $11. In January 2023, Hey Tea had an estimated 820 stores, a big majority of which were in 39 Chinese cities, and had recently completed raising $500 million in new capital.

STARBUCKS' FIRST MOVES TO COUNTER THE COMPETITIVE CHALLENGE FROM LUCKIN COFFEE

In July 2019, Starbucks opened its first Starbucks Now™ store in the central financial district of Beijing that combined the signature Starbucks café environment with Mobile Order & Pay and Starbucks Delivers™ to offer customers new levels of convenience and speed.[28] Customers entering the store were greeted by a Starbucks barista at an elevated concierge counter to assist with ordering or order pickup. They could choose from a menu of handcrafted beverage options tailored for on-the-go customers along with an assortment of popular food items. Limited seating was available for customers who chose to stay in the store and relax with their orders.

There was a dedicated area for Starbucks Delivers orders to facilitate barista-assisted quick and easy pickup by delivery drivers. Online orders that were ready for pickup were placed in an exterior wall system with designated portals for each order, which speeded drive-by pickup by delivery couriers. The Starbuck Now store also had a central kitchen where baristas could prepare handcrafted beverage orders for delivery within a certain radius. Enabling the kitchen to function as a central dispatch center at peak periods had the advantage of permitting baristas at neighboring cafes to focus on serving their in-store customers.

Starbucks had plans to open about 300 new Starbucks Now stores in high-traffic areas and business and transportation hubs in 10 cities in China.

Voice Ordering in Conjunction with Starbucks Delivery Begins in China

Two months after opening the first Starbucks Now store in Beijing, Starbucks and Alibaba, its delivery partner in China, jointly announced the launch of voice ordering within Alibaba's smart speaker, Tmall Genie, coupled with order delivery capabilities within a 30-minute timeframe.[29] Tmall Genie used cutting-edge Artificial Intelligence (AI) technology, along with voice print payment technology, to enable customers to place an order and pay for it using their voice and then track their order in real time during the 30-minute delivery timeframe. Starbucks® Rewards members could also earn Stars and receive Rewards membership updates, including benefits, via the Tmall Genie. Further, members were able to receive personalized recommendations when using voice commands to place orders that were tailored to previous order preferences and popular items from Starbucks seasonal menus. As yet another added benefit, Starbucks customers in China could listen to the latest Starbucks in-store playlists through Alibaba's music streaming app, Xiami Music.

An exclusive Starbucks-themed Tmall Genie was available through the Starbucks virtual store in China. This particular version of the Tmall Genie unified Starbucks offerings within Alibaba's mobile apps, including Taobao, Alipay, and Tmall.

ENDNOTES

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CASE 24

Nucor Corporation in 2023: Pursuing Efforts to Grow Sales and Market Share Despite Tough Market Conditions

McGraw Hill connect

Arthur A. Thompson,
The University of Alabama

In 1972, Nucor's first year as a public company, it had one steel mill, four plants that made steel joists, revenues of $83.6 million, and 1,800 employees. Fifty years later at year-end 2022, the company was the largest steel producer in the United States and among the 15 largest in the world based on tons shipped. It had 36 million tons of capacity to make steel and steel products, over 300 production locations, record-setting revenues of $41.5 billion, record profits of $7.6 billion, and 31,000 employees. Throughout its history, Nucor had invested aggressively in new facilities and capabilities to produce an ever-wider range of high-quality steel products, improve its cost competitiveness against rival steel producers, and serve a bigger number of the needs of steel buyers. Not only was Nucor Corp. regarded as a low-cost producer, but it also had a sterling reputation for being a global first-mover in investing in the latest steel-making technologies and production facilities and implementing the best practices to operate them very cost effectively.

Heading into 2023, Nucor had 25 steel mills with the capability to produce a diverse assortment of steel shapes (steel bars, sheet steel, steel plate, and structural steel) and two additional steel mills with 5 million tons of capacity under construction. In addition, it had nearly 6.5 million tons of capacity to make steel joists, steel decking, cold finish bars, steel tubing, steel buildings, steel mesh, steel grating, steel fasteners, overhead doors, steel towers, metal poles for utilities, highways signage, and fabricated steel reinforcing products. The company's lineup of product offerings was the broadest of any steel producer serving steel users in North America. In the United States, Nucor was the market share leader in sheet steel, steel bar products, structural steel, steel plate, cold finish steel products, steel joists and steel decking, and rebar fabrication. It had initiatives in place to rapidly grow its market shares in steel buildings, overhead doors, and towers for wind power, transmission lines, and utility poles.

COMPANY BACKGROUND

Nucor began its journey from obscurity to a steel industry leader in the 1960s. Operating under the name of Nuclear Corporation of America in the 1950s and early 1960s, the company was a maker of nuclear instruments and electronics products. After suffering through several money-losing years and facing bankruptcy in 1964, Nuclear Corporation of America's board of directors opted for new leadership and appointed F. Kenneth Iverson as president and CEO. Shortly thereafter, Iverson concluded that the best way to put the company on sound footing was to exit the nuclear instrument and electronics business and rebuild the company around its profitable South Carolina-based Vulcraft subsidiary that was in the steel joist business—Iverson had been the head of Vulcraft prior to being named president. Iverson moved the company's headquarters from Phoenix, Arizona, to Charlotte, North Carolina, in 1966 and proceeded to expand the joist business with new operations in Texas and Alabama. Then, in 1968, top management decided to integrate backwards into steelmaking, partly because of the benefits of supplying its own steel requirements for producing steel joists and partly because Iverson saw opportunities to capitalize on newly emerging technologies to produce steel more cheaply. In 1972 the company adopted the name Nucor Corporation, and Iverson initiated a long-term strategy to grow Nucor into a major player in the U.S. steel industry.

By 1985 Nucor had become the seventh largest steel company in North America, with revenues of $758 million, six joist plants, and four state-of-the-art steel mills that used electric arc furnaces to produce new steel products from recycled scrap steel. Moreover, Nucor had gained a reputation as an excellently managed company, an accomplished low-cost producer, and one of the most competitively successful manufacturing companies in the country.[1] A series of articles in *The New Yorker* related how Nucor, a relatively small American steel company, had built an enterprise that led the whole world into a new era of making steel with recycled scrap steel. Network broadcaster NBC did a business documentary that used Nucor to make the point that American manufacturers could be successful in competing against low-cost foreign manufacturers.

Under Iverson's leadership, Nucor came to be known for its aggressive pursuit of innovation and technical excellence in producing steel, rigorous quality systems, strong emphasis on work force productivity and job security for employees, a cost-conscious corporate culture, and skills in achieving low costs per ton produced. The company had a very streamlined organizational structure, incentive-based compensation systems, and steel mills that were among the most modern and efficient in the United States. Iverson proved himself as a master in crafting and executing a low-cost provider strategy, and he made a point of practicing what he preached when it came to holding down costs throughout the company. The offices of executives and division general managers were simply furnished. There were no company planes and no company cars, and executives were not provided with company-paid country club memberships, reserved parking spaces, executive dining facilities, or other perks. To save money on his own business expenses and set an example for other Nucor managers, Iverson flew coach class and took the subway when he was in New York City.

When Iverson left the company in 1998 following disagreements with the board of directors, he was succeeded briefly by John Correnti and then Dave Aycock, both of whom had worked in various roles under Iverson for a number of years. In 2000, Daniel R. DiMicco, who had joined Nucor in 1982 and risen up through the ranks to executive vice president, was named president and CEO. DiMicco was Nucor's chairman and CEO through 2012. Like his predecessors, DiMicco continued to pursue Nucor's longstanding strategy to aggressively grow the company's production capacity and product offerings via both acquisition and new plant construction; tons sold rose from 11.2 million in 2000 to 25.2 million in 2008. Then the unexpected financial crisis in the fourth quarter of 2008 and the subsequent economic fallout caused tons sold in 2009 to plunge to 17.6 million tons and revenues to nosedive from $23.7 billion in 2008 to $11.2 billion in 2009.

Even though the steel industry remained in the doldrums until he retired in 2012, DiMicco was undeterred by the depressed market demand for steel and proceeded to expand Nucor's production capabilities and range of product offerings. It was his strong belief that Nucor should be opportunistic in initiating actions to strengthen its competitive position despite slack market demand for steel because doing so put the company in even better position to significantly boost its financial performance when market demand for steel products grew stronger. DiMicco expressed his thinking thusly:[2]

> Nucor uses each economic downturn as an opportunity to grow stronger. We use the good times to prepare for the bad, and we use the bad times to prepare for the good. Emerging from downturns stronger than we enter them is how we build long-term value for our stockholders. We get stronger because our team is focused on continual improvement and because our financial strength allows us to invest in attractive growth opportunities throughout the economic cycle.

During DiMicco's 12-year tenure, Nucor completed more than 50 acquisitions, expanding Nucor's operations from 18 locations to more than 200, boosting revenues from $4.8 billion in 2000 to $19.4 billion at the end of 2012, and transforming Nucor into the undisputed leader in providing steel products to North American buyers. When DiMicco retired at the end of 2012, he was succeeded by John J. Ferriola, who had served as Nucor's president and COO since 2011. Ferriola immediately embraced Nucor's strategy of investing in down markets to better position Nucor for success when the economy strengthened and market demand for steel products became more robust. Ferriola retired at year-end 2019 and was succeeded as president and CEO by Leon J. Topalian, effective January 2020. Topalian previously served as president and chief operating officer beginning in September 2019, executive vice president of beam and plate products from 2017 to 2019, general manager of Nucor-Yamato from 2014 to 2017, and general manager of Nucor Steel Kankakee, Inc. from 2011 to 2014. He held several other positions after beginning his career as a project engineer and then as cold mill production supervisor.

With the exception of three quarters in 2009, one quarter in 2010, and the fourth quarter of 2015, Nucor earned a profit in every quarter of every year from 1966 through 2022—a truly remarkable accomplishment in a mature and cyclical business where it was common for industry members to post losses when demand for steel sagged. As of February 2023, Nucor had paid a dividend for 200 consecutive quarters and had raised the base dividend it paid to stockholders for 50 consecutive years (every year since 1973 when the company first began paying cash dividends). In years when earnings and cash flows permitted, Nucor had paid a supplemental year-end dividend in addition to the base quarterly dividend. Exhibit 1 provides highlights of Nucor's growth and performance from 1970 through 2022. Exhibit 2 shows Nucor's sales by product category for 1990–2022. Exhibit 3 contains a summary of Nucor's financial and operating performance during 2019–2022.

EXHIBIT 1 Nucor's Growing Presence in the Market for Steel, 1970–2022

Year	Total Tons Sold to Outside Customers	Average Price per Ton	Net Sales (in millions)	Earnings before Income Taxes (in millions)	Pretax Earnings per Ton	Net Earnings (in millions) Attributable to Nucor Shareholders
1970	207,000	$245	$ 50.8	$ 2.2	$ 10	$ 1.1
1975	387,000	314	121.5	11.7	30	7.6
1980	1,159,000	416	482.4	76.1	66	45.1
1985	1,902,000	399	758.5	106.2	56	58.5
1990	3,648,000	406	1,481.6	111.2	35	75.1
1995	7,943,000	436	3,462.0	432.3	62	274.5
2000	11,189,000	425	4,756.5	478.3	48	310.9
2001	12,237,000	354	4,333.7	179.4	16	113.0
2002	13,442,000	357	4,801.7	227.0	19	162.1
2003	17,473,000	359	6,265.8	70.0	4	62.8
2004	19,109,000	595	11,376.8	1,725.9	96	1,121.5
2005	20,465,000	621	12,701.0	2,027.1	104	1,310.3
2006	22,118,000	667	14,751.3	2,692.4	129	1,757.7
2007	22,940,000	723	16,593.0	2,253.3	104	1,471.9
2008	25,187,000	940	23,663.3	2,790.5	116	1,831.0
2009	17,576,000	637	11,190.3	(470.4)	(28)	(293.6)
2010	22,019,000	720	15,844.6	194.9	9	134.1
2011	23,044,000	869	20,023.6	1,169.9	53	778.2
2012	23,092,000	841	19,429.3	613.8	27	409.5

Year	Total Tons Sold to Outside Customers	Average Price per Ton	Net Sales (in millions)	Earnings before Income Taxes (in millions)	Pretax Earnings per Ton	Net Earnings (in millions) Attributable to Nucor Shareholders
2013	23,730,000	803	19,052.0	714.2	31	499.4
2014	25,413,000	830	21,105.1	1,048.1	42	679.3
2015	22,680,000	725	16,439.3	129.6	6	80.7
2016	24,309,000	667	16,208.1	1,298.6	50	796.3
2017	26,492,000	764	20,252.4	1,688.1	65	1,318.7
2018	27,899,000	899	25,067.3	3,109.1	114	2,360.8
2019	26,532,000	851	22,588.9	1,782.8	65	1,271.1
2020	22,843,000	882	20,139.7	721.0	29	721.5
2021	25,275,000	1,443	36,483.9	8.905.9	324	6,827.5
2022	23,215,000	1,788	41,512.5	9,772.5	401	7,607.3

Note: In 2016, Nucor changed its method of accounting for valuing certain inventories from the last-in, first-out (LIFO) method to the first-in, first out (FIFO) method. The information in this table for the years 2012–2022 reflects this change in accounting principle.

Source: Company records posted at **www.nucor.com**, accessed February 1, 2018, and April 28, 2023; Company 10-K Report, 2019, p. 47; Company 10-K Report 2022, pp. 35-36, and 56.

EXHIBIT 2 Nucor's Sales of Steel Mill and Finished Steel Products to Outside Customers, By Product Category, 1990–2022

	Tons Sold to Outside Customers (in thousands)									
	Steel Mill Products					Finished Steel Products				
Year	Sheet Steel (2022 capacity of ~13.8 million tons)	Steel Bars (2022 capacity of ~9.6 million tons)	Structural Steel (2022 capacity of ~3.25 million tons)	Steel Plate (2022 capacity of ~2.9 million tons)	Total Steel (2022 capacity of 29.5 million tons)	Steel Joists (2022 capacity of ~745,000 tons)	Steel Deck (2022 capacity of ~560,000 tons)	Cold Finished Steel (2022 capacity of ~1,069,000 tons)	Rebar Fabrication and Other Steel Products* (2022 capacity of ~4.1 million tons)	Total Tons Sold†
2022	8,664	6,091	1,882	1,563	18,200	671	515	467	3,362	25,524
2021	9,557	6,373	2,210	2,156	20,296	702	536	495	3,246	28,247
2020	8,481	5,831	1,891	1,846	18,049	557	496	406	3,322	25,519
2019	9,008	5,761	1,816	2,000	18,585	499	495	498	4,814	26,532
2018	9,153	6,389	2,064	2,284	19,890	490	479	569	4,846	27,889
2017	9,311	5,838	2,303	2,249	19,137	472	457	487	4,454	26,492
2016	9,119	5,304	2,319	2,023	18,160	445	442	426	3,524	24,309
2015	8,080	4,790	2,231	1,905	16,369	427	401	449	3,518	22,680
2014	8,153	5,526	2,560	2,442	17,934	421	396	504	3,618	25,413

(continued)

EXHIBIT 2 (continued)

	Tons Sold to Outside Customers (in thousands)									
	Steel Mill Products					Finished Steel Products				
Year	Sheet Steel (2022 capacity of ~13.8 million tons)	Steel Bars (2022 capacity of ~9.6 million tons)	Structural Steel (2022 capacity of ~3.25 million tons)	Steel Plate (2022 capacity of ~2.9 million tons)	Total Steel (2022 capacity of 29.5 million tons)	Steel Joists (2022 capacity of ~745,000 tons)	Steel Deck (2022 capacity of ~560,000 tons)	Cold Finished Steel (2022 capacity of ~1,069,000 tons)	Rebar Fabrication and Other Steel Products* (2022 capacity of ~4.1 million tons)	Total Tons Sold†
2013	7,491	5,184	2,695	2,363	16,976	342	334	474	3,658	23,730
2012	7,622	5,078	2,120	2,268	17,088	291	308	492	3,365	23,092
2011	7,500	4,680	2,338	2,278	17,460	288	312	494	3,073	23,044
2010	7,434	4,019	2,139	2,229	16,370	276	306	462	5,154	22,019
2005	8,026	5,983	2,866	2,145	19,020	554	380	342	2,360	20,465
2000	4,456	2,209	3,094	20	9,779	613	353	250	1,351	11,189
1995	2,994	1,799	1,952	—	6,745	552	234	234	1,198	7,943
1990	420	1,382	1,002	—	2,804	443	134	163	884	3,648

*Other products include steel piling, tubular steel products, and steel fasteners (steel screws, nuts, bolts, washers, and bolt assemblies), steel mesh, steel grates, metal building systems, and light gauge steel framing.

†Includes sale of raw materials, principally scrap metal, beginning in 2008 when Nucor acquired David J. Joseph Co., a leading supplier of scrap metal.

Source: Company records posted at **www.nucor.com**, accessed April 27, 2023.

EXHIBIT 3 Four-Year Financial and Operating Summary, Nucor Corporation, 2019–2022 ($ in millions, except per share data and sales per employee)

	2019	2020	2021	2022
FOR THE YEAR				
Net sales	$ 22,588.9	$20,139.7	$36,483.9	$ 41,512.5
Costs, expenses and other:				
Cost of products sold	19,909.8	17,911.7	25,458.5	29,009.2
Marketing, administrative and other expenses	711.2	615.0	1,706.6	1,997.2
Equity in (earnings) losses of minority-owned enterprises	(3.3)	(10.5)	(103.1)	(10.7)
Impairment and losses on assets	66.9	613.6	62.2	101.8
Interest expense, net	121.4	153.2	158.9	170.2
Total	20,806.0	19,304.1	27,283.1	31,267.6
Earnings before income taxes and non-controlling interests	1,782.8	835.5	9,200.9	10,244.8
Provision for income taxes	411.9	(490)	2,078.5	2,165.2
Net earnings	1,370.9	836.0	7,122.4	8,079.6
Less earnings attributable to the minority interest partners of Nucor's joint ventures*	99.8	114.6	294.9	472.3

	2019	2020	2021	2022
FOR THE YEAR				
Net earnings (loss) attributable to Nucor stockholders	$ 1,271.1	$ 721.5	$ 6,827.5	$ 7,607.3
Net earnings (loss) per share:				
Basic	$ 4.14	$ 2.37	$ 23.23	$ 28.88
Diluted	4.14	2.36	23.16	28.79
Dividends declared per share	$ 1.6025	1.6125	$ 1.7150	$ 2.01
Percentage of net earnings to net sales	5.6%	3.6%	18.7%	18.3%
Return on average stockholders' equity	12.6%	6.8%	55.0%	46.9%
Capital expenditures	$ 1,512.1	$1,527.1	$ 1,700.4	$ 1,952.5
Acquisitions (net of cash acquired)	83.1	88.1	1,426.4	3,553.2
Depreciation	648.9	702.1	735.4	826.7
Sales per employee (000s)	849	761	1,341	1,369
AT YEAR END				
Cash, cash equivalents, and short-term investments	$ 1,834.6	$2,640.0	$ 2,634.9	$ 2,046.0
Current assets	8,226.4	9,488.7	12,800.0	6,506.4
Current liabilities	2,463.8	2,627.9	5,157.4	2,390.0
Working capital	5,762.6	6,860.8	7,642.1	10,361.9
Cash provided by operating activities	2,809.4	2,696.9	2,809.4	1,737.5
Current ratio	3.3	3.6	2.5	2.72
Property, plant, and equipment	$ 6,178.6	$6,899.1	$ 8,114.8	$ 9,616.9
Total assets	18,344.7	20,125.4	25,823.1	15,223.5
Long-term debt (including current maturities)	4,320.6	5,282.7	5,577.1	6,642.3
Percentage of long-term debt to total capital**	28.6%	32.9%	28.5%	26.5%
Stockholders' equity	10,357.9	10,788.7	14,016.4	18,414.7
Shares outstanding (000s)	301,812	302,245	272.412	253,493
Employees	26,800	26,400	28,800	31,400

*The principal joint venture responsible for these earnings is the Nucor-Yamato Steel Company, of which Nucor owns 51 percent. This joint venture operates a structural steel mill in Blytheville Arkansas, and it is the largest producer of structural steel beams in the Western Hemisphere.

**Total capital is defined as stockholders' equity plus long-term debt.

Sources: Nucor's 2019 10-K, p. 23; Nucor's 2022 10-K, p. 56; Nucor's 2021 Annual Report, p. 3; Nucor's 2022 Annual Report, p .3.

NUCOR'S STRATEGY TO BECOME THE BIGGEST AND MOST DIVERSIFIED STEEL PRODUCER IN NORTH AMERICA, 1967–2022

In its 50-year march to become North America's biggest and most diversified steel producer, Nucor relentlessly expanded its production capabilities to include a wider range of steel shapes and more categories of finished steel products. However, most steel products that Nucor and its rivals produced were viewed by buyers as a "commodity." Indeed, the most competitively relevant feature of the various steel shapes and finished steel products made by the world's different producers was that, for any given steel item, there were very few, if any, substantial differences in the products of rival steel producers. While some steelmakers had plants where production quality was sometimes inconsistent or on occasions failed to meet customer-specified metallurgical characteristics, most steel plants turned out products of comparable metallurgical quality—one producer's reinforcing bar was essentially the same as another producer's reinforcing bar, a particular type and grade of sheet steel made at one company plant(s) was essentially identical to the same type and grade of sheet steel made at another company's plant(s).

The commodity nature of steel products meant that steel buyers typically shopped the market for the best price, awarding their business to whichever seller offered the best deal. The ease with which buyers could switch their orders from one supplier to another forced steel producers to be very price competitive. In virtually all instances, the going market price of each particular steel product was in constant flux, rising or falling in response to shifting market circumstances (or shifts in the terms that particular buyers or sellers were willing to accept). As a consequence, spot market prices for commodity steel products bounced around on a weekly or even daily basis. Because competition among rival steel producers was so strongly focused on price, it was incumbent on all industry participants to be cost-competitive and operate their production facilities as cost efficiently as they could.

Nucor's success over the years stemmed largely from its across-the-board prowess in cost-efficient operations for all the product categories in which it elected to compete. Nucor's top executives were very disciplined in executing Nucor's strategy to broaden the company's product offerings; no moves to enter new steel product categories were made unless management was confident that the company had the resources and capabilities need to operate the accompanying production facilities efficiently enough to be cost competitive.

Finished Steel Products

Steel Joists, Joist Girders, and Steel Deck Nucor's first venture into steel in the late 1960s, via its Vulcraft division, was principally one of fabricating steel joists and joist girders from steel that was purchased from various steelmakers. Vulcraft expanded into the fabrication of steel decking in 1977. The division expanded its operations over the years and became the largest producer and leading innovator of open-web steel joists, joist girders, and steel deck in the United States. In 2023, it had seven domestic plants and two Canadian plants with annual capacity of 745,000 tons that made steel joists and joist girders and ten plants with 560,000 tons of capacity that made steel deck; the steel needed to make these products was typically supplied by various Nucor steel-making plants. Vulcraft's joist, girder, and decking products were used mainly for roof and floor support systems in retail stores, shopping centers, warehouses, data centers, manufacturing facilities, schools, churches, hospitals, and, to a lesser extent, multi-story buildings and apartments. Customers for these products were principally nonresidential construction contractors.

Cold Finish Products In 1979, Nucor began fabricating cold finished steel products. These consisted mainly of cold drawn and turned, ground, and polished steel bars or rods of various shapes—rounds, hexagons, flats, channels, and squares—made from carbon, alloy, and leaded steels based on customer specifications or end-use requirements. These bar products were used in tens of thousands of products, including anchor bolts, hydraulic cylinders and shafting for air conditioner compressors, ceiling fan motors, garage door openers, electric motors, and lawn mowers. Nucor sold cold finish steel directly to large-quantity users in the appliance, automotive, farm machinery, construction equipment, hydraulic, and electric motor industries and to steel service centers that in turn supplied manufacturers needing only relatively small quantities.

In 2023, Nucor Cold Finish was the largest and most diversified producer of cold finished bar products in North America and had facilities in Missouri, Nebraska, South Carolina, Utah, Wisconsin, Ohio, Georgia, Mexico, and Canada with a capacity of about 1.1 million tons per year. The Cold Finish division also owned a precision casting facility in Mexico that produced complex castings and precision-machined products used by enterprises in the oil and gas, mining, and sugar processing industries.

This division obtained most of the steel for its products from Nucor's mills that made steel bar. This factor, along with the fact that all of Nucor's cold finished facilities employed the latest technology and were among the most modern in the world, resulted in Nucor Cold Finish having a highly competitive cost structure. It maintained sufficient inventories of cold finish products to fulfill anticipated orders.

Nucor's Buildings Group Nucor produced metal buildings and components throughout the United States under several brands: Nucor Building

Systems, American Buildings Company, Kirby Building Systems, and CBC Steel Buildings. It was the leading supplier of engineered metal buildings in the United States. In 2023, the Nucor Buildings Group had 9 metal buildings plants with an annual capacity of approximately 360,000 tons. Nucor's Buildings Group began operations in 1987 and currently had the capability to supply customers with buildings ranging from less than 1,000 square feet to more than 1,000,000 square feet. Complete metal building packages could be customized and combined with other materials such as glass, wood, and masonry to produce a cost-effective, aesthetically pleasing building built to a customer's particular requirements. The buildings were sold primarily through an independent builder distribution network. The primary markets served were commercial, industrial, and institutional buildings, including distribution centers, automobile dealerships, retail centers, schools, warehouses, and manufacturing facilities. Nucor's Buildings Group obtained a significant portion of its steel requirements from the company's bar and sheet mills.

Steel Mesh and Fasteners Nucor produced steel mesh, grates, and industrial fasteners at two facilities in the United States and one in Canada that had combined annual production capacity of about 128,000 tons. Steel and aluminum bar grating, safety grating, and expanded metal products were produced at several North American locations and shipped largely to construction and maintenance-related customers. The annual production capacity for manufacturing grating products was approximately 48,500 tons.

Nucor Fastener, located in Indiana, began operations in 1986 with the construction of a $25 million plant with annual capacity of about 75,000 tons. At the time, imported steel fasteners accounted for 90 percent of the U.S. market because U.S. manufacturers were not competitive on cost and price. Iverson said "We're going to bring that business back; we can make bolts as cheaply as foreign producers." Nucor Fastener's products included carbon and alloy steel hex head cap screws, hex bolts, structural bolts, nuts and washers, finished hex nuts, and custom-engineered fasteners that were used for automotive, machine tool, farm implement, construction, military, and various other applications. Nucor Fastener obtained much of the steel it needed from Nucor's mills that made steel bar.

Rebar Fabrication Beginning in 2007, Nucor—through its newly acquired Harris Steel subsidiary—began fabricating, installing, and distributing steel reinforcing bars (rebar) for highways, bridges, schools, hospitals, airports, stadiums, office buildings, high rise residential complexes, and other structures where steel reinforcing was essential to concrete construction. Harris Steel had over 70 fabrication facilities in the United States and Canada, with each facility serving the surrounding local market. Since acquiring Harris Steel, Nucor had more than doubled its rebar fabrication capacity to about 1,736,000 tons annually. Total fabricated rebar shipments in 2022 were 1,282,000 tons, up slightly from 1,232,000 tons in 2021. Rebar fabrication revenues were $2.2 billion in 2022, up from $1.8 billion in 2021. All of the steel used in making fabricated rebar products was obtained from Nucor's steel bar plants. Fabricated reinforcing products were sold only on a contract bid basis.

Tubular Products The Nucor Tubular Products (NTP) group had eight tubular facilities all of which were strategically located in close proximity to Nucor's sheet mills that supplied them with hot-rolled coil steel. The NTP group produced structural steel tubing (for bridges, buildings, and other load-bearing applications), mechanical steel tubing, piling, sprinkler pipe, heat-treated steel tubing, and electrical conduit, and galvanized solar torque tube. Mechanical steel tubing, pilings and sprinkler pipe were used for nonresidential construction, infrastructure projects, agricultural, automotive and construction equipment end-use markets. Heat-treated tubing and electrical conduit were primarily used to protect and route electrical wiring in such nonresidential structures as hospitals, schools, office buildings, hotels, stadiums, and shopping malls. Solar torque tube was an essential component for ground-mount solar systems. Shipments of tubular products to customers totaled 950,000 tons in 2022, down 6 percent from1,013,000 tons in 2021. Revenues from the sales of tubular products were $1.9 billion in 2022 versus $2.2 billion in 2021.

Piling Products Nucor's subsidiary Skyline Steel was a steel foundation distributor serving the North American market. Skyline distributed products to service marine construction, bridge and highway construction, heavy civil construction, flood protection, underground commercial parking, and environmental containment projects in the infrastructure and construction industries. Skyline also manufactured a complete line of structural foundation solutions, including threaded bar, micropile, strand anchors, and hollow bar. In addition, it processed and fabricated spiral weld pipe piling, rolled and welded pipe piling, and cold-formed sheet piling. In 2022, shipment to customers totaled 443,000 tons, down 20 percent from 554,000 tons in 2021.

Insulated Metal Panels Nucor entered this market segment when it acquired Truecore, LLC in 2019, and in August 2021, expanded significantly by purchasing the assets of the insulated metal panels business of Cornerstone Building Brands, Inc., which comprised two industry leading brands, CENTRIA and Meti-Span. Management believed these acquisitions would broaden the value-added solutions that its Buildings Group could provide to enterprises in the warehousing, distribution, and data centers market segments. It expected these end-use markets to continue to grow in the coming years, thereby growing the demand for insulated metal panels. Such panels facilitated cost-effective climate control in existing facilities in these end-use markets by reducing energy usage and operations-related greenhouse gas emissions for owners and lessees.

Overhead Doors In June 2022, Nucor acquired C.H.I. Overhead Doors, LLC (CHI), a leading manufacturer of overhead doors for residential and commercial markets in the United States and Canada. Nucor intended to grow CHI's business by gaining further market share in both residential and commercial markets. CHI had two manufacturing locations, one in Arthur, Illinois, and one in Terre Haute, Indiana. It also had regional distribution warehouses in California, Colorado, New Hampshire, and New Jersey.

Towers and Structures In August 2022, Nucor acquired Summit Utility Structures LLC and a related company, Sovereign Steel Manufacturing LLC, and combined their operations to form Nucor Towers & Structures (NTS). NTS produced metal poles and other steel structures for utility infrastructure and highway signage. NTS had one manufacturing location and annual production capacity of approximately 10,000 tons. In December 2022, Nucor announced it would build two new manufacturing locations to expand NTS at yet to be determined locations in the Midwest and Southeast.

Steel Mill Products

Bar Mills Nucor entered the market for steel mill products in 1968, when the decision was made to build a facility in Darlington, South Carolina, to manufacture steel reinforcing bars used primarily in concrete reinforcement for construction of roads , bridges, buildings and other structures. The Darlington mill was one of the first steel-making plants of major size in the United States to use electric arc furnace technology to melt scrap steel and cast molten metal into various shapes. Electric arc furnace technology was particularly appealing to Nucor because the labor and capital requirements to melt steel scrap and produce crude steel were far lower than those at conventional integrated steel mills where raw steel was produced using coke ovens, basic oxygen blast furnaces, ingot casters, and multiple types of finishing facilities to make crude steel from iron ore, coke, limestone, oxygen, scrap steel, and other ingredients. By 1981, Nucor had four steel mills making carbon and alloy steels in bars, angles, and light structural shapes; since then, Nucor had undertaken extensive capital projects to keep these facilities modernized and globally competitive. During 2000–2011, Nucor aggressively expanded its market presence in steel reinforcing bars (rebar)and by 2012 had 13 bar mills located across the United States that produced concrete reinforcing bars, hot-rolled bars, rods, light shapes, structural angles, channels and guard rail in carbon and alloy steels. Four of the 13 mills made hot-rolled special quality bar (SQB) manufactured to exacting specifications. Two new rebar micro mills with combined capacity of 330,000 tons per year began production in 2020, giving Nucor about 9,560,000 tons of capacity to produce a wide range of bar products. In April 2022, Nucor announced it would construct a third $350 million rebar micro mill with capacity of 430,000 tons The products of the Nucor's bar mills had wide usage and were sold primarily to customers in the agricultural, automotive, construction, energy, furniture, machinery, metal building, railroad, recreational equipment, shipbuilding, heavy truck, and trailer market segments.

Expansion into Mills Making Sheet Steel In the late 1980s, Nucor entered into the production of sheet steel at a newly constructed plant in Crawfordsville, Indiana. Flat-rolled sheet steel was used in the production of motor vehicles, appliances, steel pipe and tubes, and other durable goods. The Crawfordsville plant was the first in the world to employ a revolutionary thin slab casting process that substantially reduced the capital investment and costs to produce flat-rolled sheet steel. Thin-slab casting machines had a funnel-shaped mold to squeeze molten steel down to a thickness of 1.5–2.0 inches, compared to the typically 8- to 10-inch thick slabs produced by conventional casters. It was much cheaper to build and operate facilities to roll thin-gauge sheet steel from 1.5 to 2-inch thick slabs than from 8 to 10-inch thick slabs. When the Crawfordsville plant first opened in 1989, it was said to have costs $50 to $75 per ton below the costs of traditional sheet steel plants, a highly significant cost advantage in a commodity market where the going price at the time was $400 per ton. *Forbes* magazine described Nucor's pioneering use of thin slab casting as the most substantial, technological, industrial innovation in the past 50 years.[3] By 1996 two additional sheet steel mills that employed thin slab casting technology were constructed and a fourth mill was acquired in 2002.

Nucor also operated two Castrip sheet production facilities, one built in 2002 at the Crawfordsville plant and a second built in Arkansas in 2009; these facilities used breakthrough strip casting technology that involved the direct casting of molten steel into final shape and thickness without further hot or cold rolling. The process allowed for lower capital investment, reduced energy consumption, smaller scale plants, and improved environmental impact (because of significantly lower emissions).

A fifth sheet mill with annual capacity of 1.8 million tons, strategically located on the Ohio River in Kentucky, was acquired in 2014. In 2017, Nucor began construction of an $176 million 72-inch hot band galvanizing and pickling line at the Kentucky sheet mill. The new galvanizing line, which began operations in 2019, was the widest hot-rolled galvanizing line in North America and enabled Nucor to enter additional segments of the automotive market.

Going into 2023, Nucor operated six strategically located sheet mills with approximately 13.8 million tons of capacity in Alabama, Arkansas, Indiana, Kentucky, and South Carolina that utilized thin slab casters to produce flat-rolled steel for automotive, appliance, construction, pipe and tube, and many other industrial and consumer applications. All six sheet mills had galvanizing lines and four of them were equipped with cold-rolling mills for the further processing of hot-rolled sheet steel. In 2022, about 85 percent of Nucor's sheet steel sales in 2022 were to contract customers; the sheet sales contracts were noncancellable agreements that generally incorporated monthly or quarterly price adjustments reflecting changes in the current market-based indices and/or raw material costs, and typically had terms ranging from six to 12 months. The remaining 15 percent of Nucor's sheet steel sales were made in the spot market at prices prevailing at the time of sale.

In January 2022, Nucor announced it would construct a new 3,000,000-ton state-of-the-art sheet mill costing about $2.7 billion in West Virginia. When operational in 2024, the new mill would be able to produce 84-inch sheet products; the mill would also include a 76-inch tandem cold mill and two galvanizing lines capable of producing advanced high-end automotive and construction grades of sheet steel.

Entry into Structural Steel Products Also in the late 1980s, Nucor added wide-flange steel beams, pilings, and heavy structural steel products to its lineup of product offerings. Structural steel products were used in buildings, bridges, overpasses, and similar such projects where strong weight-bearing support was needed. Customers included construction companies, steel fabricators, manufacturers, and steel service centers. To gain entry to the structural steel segment, in 1988 Nucor entered into a joint venture with Yamato-Kogyo, one of Japan's major producers of wide-flange beams, to build a new structural steel mill in Arkansas; a second mill was built on the same site in the 1990s that made the Nucor-Yamato venture in Arkansas the largest structural beam facility in the Western Hemisphere. Nucor had a 51 percent interest in the Nucor-Yamato venture. In 1999, Nucor started operations at a third structural steel mill in South Carolina. In 2023, the mills in Arkansas and South Carolina had combined capacity to make 3,250,000-tons of structural steel products annually, and both used a special continuous casting method that was quite cost-effective.

Entry into the Market for Steel Plate Starting in 2000, Nucor began producing steel plate of various thicknesses and lengths that was sold to manufacturers of heavy equipment, ships, barges, bridges, rail cars, refinery tanks, pressure vessels, pipe and tube, wind towers, and similar products. Steel plate was made at three mills in Alabama, North Carolina, and Texas that had combined capacity of about 2,925,000 tons. In 2011–2013, Nucor greatly expanded its plate product capabilities by constructing a 125,000-ton heat treating facility and a 120,000-ton normalizing line at its North Carolina plate mill. These investments yielded two big strategic benefits: (1) enabling the North Carolina mill to produce higher-margin plate products sold to companies making pressure vessels, tank cars, tubular structures for offshore oil rigs, and naval and commercial ships and (2) reducing the mill's exposure to competition from foreign producers of steel plate who lacked the capability to match the features of the steel plate Nucor produced for these end-use customers.

Nucor completed construction of a $1.7 billion state-of-the-art plate mill in Kentucky in December 2022; shipments began in 2023. This mill, which had the ability to produce 1,200,000 tons annually, was the only steel mill in the United States capable of manufacturing a high volume of heavy gauge plate suitable for the foundations of offshore wind towers.

The Cost Efficiency of Nucor's Steel Mills All of Nucor's steel mills used electric arc furnaces, whereby scrap steel and other metals were melted and the molten metal then poured into continuous casting systems. Sophisticated rolling mills converted the billets, blooms, and slabs produced by various casting equipment into rebar, angles, rounds, channels, flats, sheet, beams, plate, and other finished steel products. Nucor's steel mill operations were highly automated, typically requiring fewer operating employees per ton produced than the mills of rival companies. High worker productivity at all Nucor steel mills resulted in labor costs roughly 50 percent lower than the labor costs at the integrated mills of companies using union labor and conventional blast furnace technology. Nucor's value chain (anchored in using electric arc furnace technology to recycle scrap steel) involved far fewer production steps, far less capital investment, and considerably less labor than the value chains of companies with integrated steel mills that made crude steel from iron ore.

Pricing and Sales

Nucor marketed the output of its steel mills and steel products facilities mainly through an in-house sales force; there were salespeople located at most every Nucor production facility. Going into 2020, approximately 75 percent of Nucor's sheet steel sales were to contract customers (versus 30 percent in 2009); these contracts for sheet steel were usually for periods of 6 to 12 months, were noncancellable, and permitted price adjustments to reflect changes in the market pricing for steel and/or raw material costs at the time of shipment. The other 25 percent of Nucor's sheet steel shipments and virtually all of the company's shipments of plate, structural, and bar steel were at the prevailing spot market price—customers not purchasing sheet steel rarely ever wanted to enter into a contract sales agreement. Nucor's spot pricing strategy was to charge external customers the going spot price on the day an order was placed. Shifting market demand-supply conditions and daily variations in spot market prices caused Nucor's average sales prices per ton to fluctuate from quarter to quarter, sometimes by considerable amounts—see Exhibit 4. It was Nucor's practice to quote the same payment terms to all external customers and for these customers to pay all shipping charges.

Nucor sold steel joists and joist girders, and steel deck on the basis of firm, fixed-price contracts that, in most cases, were won in competitive bidding against rival suppliers. Longer-term supply contracts for these items that were sometimes negotiated with customers contained clauses permitting price adjustments to reflect changes in prevailing raw materials costs. Steel joists, girders, and deck were manufactured to customers' specifications and shipped immediately; Nucor's plants did not maintain inventories of steel joists, girders, or steel deck. Nucor also sold fabricated reinforcing products only on a construction contract bid basis. However, cold finished steel, steel fasteners, steel grating, wire, and wire mesh were all manufactured in standard sizes, with each facility maintaining sufficient inventories of its products to fill anticipated orders; most all sales of these items were made at the prevailing spot price. The average prices Nucor received for its various finished steel products are shown in the last column of Exhibit 4.

EXHIBIT 4 Nucor's Average Quarterly Sales Prices for Steel Products, By Product Category, 2019–2022

	Average Sales Prices per Net Ton					
Period	Sheet Steel	Steel Bars	Structural Steel	Steel Plate	All Steel Mill Products	All Finished Steel Products*
2019						
Qtr 1	$ 797	$ 762	$ 921	$1,022	$ 826	$1,480
Qtr 2	758	742	900	969	788	1,462
Qtr 3	668	695	847	839	711	1,442
Qtr 4	623	651	796	748	663	1,427
2020						
Qtr 1	471	505	870	545	538	1,271
Qtr 2	550	561	845	604	593	1,285
Qtr 3	666	567	865	661	664	1,299
Qtr 4	603	544	837	584	614	1,337
2021						
Qtr 1	932	790	948	935	891	1,499
Qtr 2	1,228	900	1,089	1,192	1,107	1,708
Qtr 3	1,536	1,037	1,241	1,447	1,339	2,101
Qtr 4	1,724	1,073	1,412	1,748	1,478	2,541
2022						
Qtr 1	1,571	1,140	1,496	1,861	1,436	2,689
Qtr 2	1,441	1,226	1,583	1,913	1,429	2,931
Qtr 3	1,228	1,176	1,603	1,765	1,296	3,167
Qtr 4	961	1,063	1,543	1,564	1,102	3,203

*An average of the steel prices for steel deck, steel joists and girders, steel buildings, cold finished steel products, steel mesh, fasteners, fabricated rebar, and other finished steel products.

Source: Company records posted in the investor section at **www.nucor.com**, accessed May 3, 2023.

NUCOR'S STRATEGY TO GROW AND STRENGTHEN ITS BUSINESS AND COMPETITIVE CAPABILITIES, 2000–2023

Starting in 2000, Nucor embarked on a five-part growth strategy that involved new acquisitions, new plant construction, continued plant upgrades and cost reduction efforts, international growth through joint ventures, and greater control over raw materials costs. Going into 2023, this same five-part strategy was still in place.

Strategic Acquisitions

Beginning in the late 1990s, Nucor management concluded that growth-minded companies like Nucor might well be better off purchasing existing plant capacity rather than building new capacity, provided the acquired plants could be bought at bargain prices, economically retrofitted with new equipment if need be, and then operated at costs comparable to (or even below) those of newly-constructed state-of-the-art plants. At the time, the steel industry worldwide had far more production capacity than was needed to meet market demand, forcing many companies to operate in the red. Nucor had not made any acquisitions since about 1990, and a team of five people was assembled in 1998 to explore acquisition possibilities that would strengthen Nucor's customer base, geographic coverage, and lineup of product offerings.

For almost three years, no acquisitions were made. But then in 2001, despite tough conditions, Nucor management concluded that oversupplied steel industry conditions and the number of beleaguered U.S. companies made it attractive to expand Nucor's production capacity via acquisition. During 2001 and continuing through 2022, the company proceeded to make a series of strategic acquisitions to strengthen Nucor's competitiveness, selectively expand its product offerings, improve its ability to serve customers in particular geographic locations, and boost the company's financial performance in times when market demand for steel was strong enough to boost prices to more profitable levels:

- In 2001, Nucor paid $115 million to acquire substantially all of the assets of Auburn Steel Company's 400,000-ton steel bar facility in Auburn, New York. This acquisition gave Nucor expanded market presence in the Northeast and was seen as a good source of supply for a new Vulcraft joist plant being constructed in Chemung, New York.
- In November 2001, Nucor acquired ITEC Steel Inc. for a purchase price of $9 million. ITEC Steel had annual revenues of $10 million and produced load bearing light gauge steel framing for the residential and commercial market at its facilities in Texas and Georgia. Nucor was impressed with ITEC's dedication to continuous improvement and intended to grow ITEC's business via geographic and product line expansion.
- In July 2002, Nucor paid $120 million to purchase Trico Steel Company, which had a 2.2 million-ton sheet steel mill in Decatur, Alabama. Trico Steel was a joint venture of LTV (which owned a 50 percent interest), and two leading international steel companies—Sumitomo Metal Industries and British Steel. The joint venture partners had built the mill in 1997 at a cost of $465 million, but Trico was in Chapter 11 bankruptcy proceedings at the time of the acquisition and the mill was shut down. The Trico mill's capability to make thin sheet steel with a superior surface quality added competitive strength to Nucor's strategy to gain sales and market share in the flat-rolled sheet segment. In October 2002, Nucor restarted operations at the Decatur mill and began shipping products to customers.
- In December 2002, Nucor paid $615 million to purchase substantially all of the assets of Birmingham Steel Corporation, which included four bar mills in Alabama, Illinois, Washington, and Mississippi. The four plants had capacity of approximately 2 million tons annually. Top executives believed the Birmingham Steel acquisition would broaden Nucor's customer base and build profitable market share in bar steel products.
- In August 2004, Nucor acquired a cold-rolling mill in Decatur, Alabama, from Worthington Industries for $80 million. This 1 million-ton mill, which opened in 1998, was located adjacent to the previously acquired Trico mill and gave Nucor added ability to service the needs of sheet steel buyers located in the southeastern United States.
- In June 2004, Nucor paid a cash price of $80 million to acquire a plate mill owned by Britain-based Corus Steel that was located in Tuscaloosa, Alabama. The Tuscaloosa mill, which currently had capacity of 700,000 tons that Nucor management believed was expandable to 1 million tons, was the first U.S. mill to employ a special technology that enabled high quality wide steel plate to be produced from coiled steel plate. The mill produced coiled steel plate and plate products that were cut to customer-specified lengths. Nucor intended to offer these niche products to its commodity plate and coiled sheet customers.
- In February 2005, Nucor completed the purchase of Fort Howard Steel's operations in Oak Creek, Wisconsin, that produced cold finished bars in size ranges up to 6-inch rounds and had approximately 140,000 tons of annual capacity.
- In June 2005, Nucor purchased Marion Steel Company located in Marion, Ohio, for a cash price of $110 million. Marion operated a bar mill with annual capacity of about 400,000 tons; the Marion location was within close proximity to 60 percent of the steel consumption in the United States.
- In May 2006, Nucor acquired Connecticut Steel Corporation for $43 million in cash. Connecticut Steel's bar products mill in Wallingford had annual capacity to make 300,000 tons of wire rod and rebar and approximately 85,000 tons of wire mesh fabrication and structural mesh fabrication,

products that complemented Nucor's present lineup of steel bar products provided to construction customers.

- In late 2006, Nucor purchased Verco Manufacturing Co for approximately $180 million; Verco produced steel floor and roof decking at one location in Arizona and two locations in California. The Verco acquisition further solidified Vulcraft's market-leading position in steel decking, giving it total annual capacity of over 500,000 tons.
- In January 2007, Nucor acquired Canada-based Harris Steel for about $1.07 billion. Harris Steel had 2005 sales of Cdn$1.0 billion and earnings of Cdn$64 million. The company's operations consisted of (1) Harris Rebar, which was involved in the fabrication and placing of concrete reinforcing steel and the design and installation of concrete post-tensioning systems; (2) Laurel Steel, which manufactured and distributed wire and wire products, welded wire mesh, and cold finished bar; and (3) Fisher & Ludlow, which manufactured and distributed heavy industrial steel grating, aluminum grating, and expanded metal. In Canada, Harris Steel had 24 reinforcing steel fabricating plants, two steel grating distribution centers, and one cold finished bar and wire processing plant; in the United States, it had 10 reinforcing steel fabricating plants and three steel grating manufacturing plants. Harris had customers throughout Canada and the United States and employed about 3,000 people. For the past three years, Harris had purchased a big percentage of its steel requirements from Nucor. Nucor management opted to operate Harris Steel as an independent subsidiary.
- Following the Harris Steel acquisition in 2007, Nucor's Harris Steel subsidiary acquired rebar fabricator South Pacific Steel Corporation, Consolidated Rebar, Inc., a 90 percent equity interest in rebar fabricator Barker Steel Company, and several smaller operations—all aimed at growing its presence in the rebar fabrication marketplace.
- In August 2007, Nucor acquired LMP Steel & Wire Company for a cash purchase price of approximately $27.2 million, adding 100,000 tons of cold drawn steel capacity.
- In October 2007, Nucor completed the acquisition of Nelson Steel, Inc. for a cash purchase price of approximately $53.2 million, adding 120,000 tons of steel mesh capacity.
- In the third quarter of 2007, Nucor completed the acquisition of Magnatrax Corporation, a leading provider of custom-engineered metal buildings, for a cash purchase price of approximately $275.2 million. The Magnatrax acquisition enabled Nucor's Building System Group to become the second largest metal building producer in the United States.
- In August 2008, Nucor's Harris Steel subsidiary acquired Ambassador Steel Corporation for a cash purchase price of about $185.1 million. Ambassador Steel was a one of the largest independent fabricators and distributors of concrete reinforcing steel—in 2007, Ambassador shipped 422,000 tons of fabricated rebar and distributed another 228,000 tons of reinforcing steel. Its business complemented that of Harris Steel and represented another in a series of moves to greatly strengthen Nucor's competitive position in the rebar fabrication marketplace.
- In late 2009, Nucor acquired another small rebar fabrication company, Free State Steel, adding to its footprint in rebar fabrication.
- In June 2012, Nucor acquired Skyline Steel, LLC and its subsidiaries for a cash price of approximately $675.4 million. Skyline was a market-leading distributor of steel pilings, and it also processed and fabricated spiral weld pipe piling, rolled and welded pipe piling, cold-formed sheet piling, and threaded bar. The Skyline acquisition paired Skyline's leadership position in the steel piling distribution market with Nucor's own Nucor-Yamato plant in Arkansas that was the market leader in steel piling manufacturing. To capitalize upon the strategic fits between Skyline's business and Nucor's business, Nucor launched a $155 million capital project at the Nucor-Yamato mill to (a) add several new sheet piling sections, (b) increase the production of single sheet widths by 22 percent, and (c) produce a lighter, stronger sheet covering more area at a lower installed cost—outcomes that would broaden the range of hot-rolled steel piling products Nucor could market through Skyline's distribution network in the United States, Canada, Mexico, and the Caribbean. Nucor opted to operate Skyline as a subsidiary.
- In 2014, Nucor acquired Gallatin Steel Company for approximately $779 million. Gallatin produced a range of flat-rolled steel products (principally

steel pipe and tube) at a mill with annual production capacity of 1.8 million tons that was located on the Ohio River in Kentucky. The Gallatin mill strengthened Nucor's position as the North American market leader in hot-rolled steel products by boosting its capacity to supply customers in the Midwest region, the largest flat-rolled consuming market region in the United States.

- In 2015, Nucor acquired Gerdau Long Steel's two facilities in Ohio and Georgia that produced cold-drawn steel bars and had combined capacity of 75,000 tons per year. These facilities, purchased for about $75 million, strengthened Nucor's already strong competitive position in cold-finished steel bars by expanding Nucor's geographic coverage and range of cold-finished product offerings.
- In 2016, Nucor and JFE Steel of Japan entered into a 50–50 joint venture partnership agreement to construct and operate a 400,000 ton-per-year sheet steel production facility in central Mexico to produce hot-dip galvanized sheet steel for motor vehicle manufacturers who had built plants in central Mexico. The venture had two important attractions to the partners: (1) automotive production in Mexico was expected to continue to grow and (2) the new United States–Mexico–Canada Agreement (USMCA) increased the amount of North American content required in cars and trucks to avoid tariffs imposed by the United States. The plant began operations in March 2020.
- In October 2016, Nucor used cash on hand to acquire Independence Tube Corporation (ITC) for a purchase price of $430.1 million. ITC was a leading manufacturer of hollow structural section (HSS) tubing used primarily in nonresidential construction. ITC had the ability to produce approximately 650,000 tons of HSS tubing annually at its four facilities, two in Illinois and two in Alabama. This acquisition not only further expanded Nucor's product offerings to include a variety of tubular products but also provided a new channel for marketing Nucor's hot-rolled sheet steel, as ITC's plants (which used hot-rolled sheet steel to make tubular steel products) were located in close proximity to Nucor's sheet mills in Alabama, Indiana, and Kentucky.
- On January 9, 2017, Nucor used cash on hand to acquire Southland Tube for a purchase price of approximately $130 million. Southland Tube was also a manufacturer of HSS tubing and had one manufacturing facility in Birmingham, Alabama which shipped approximately 240,000 tons in 2016.
- Nucor further expanded its value-added product offerings to buyers of pipe and tubular products in January 2017 by purchasing Republic Conduit for a purchase price of approximately $335 million. Republic Conduit produced steel electrical conduit primarily used to protect and route electrical wiring in various nonresidential structures such as hospitals, office buildings and stadiums. Republic had two facilities located in Kentucky and Georgia with annual shipment volume in 2015–2016 of 146,000 tons.
- In December 2019, Nucor announced the acquisition of TrueCore, LLC, a manufacturer of insulated metal panels for cold storage and other applications. TrueCore's plant in Laurens, South Carolina, became part of the Nucor Buildings Group, which utilized a high volume of insulated panels for buildings it designed and manufactured.
- In August 2021, Nucor acquired the assets of the insulated metal panels business of Cornerstone Building Brands for $1 billion in cash. It then merged to operations of Cornerstone's two brands of insulated panels with the operations of TrueCore's metal panels business to form a newly created Insulated Metal Panels business group with sufficient competitive strength to grow Nucor's sales of insulated metal panels.
- Also in August 2021, Nucor acquired Hannibal Industries for $370 million. Hannibal was a leading national provider of racking solutions to warehouses in the e-commerce, industrial, food storage, and retail segments. Hannibal had manufacturing facilities in Los Angeles and Houston, as well as three distribution centers. It utilized sheet and bar steel, as well as steel decking, wire deck, and fasteners to produce its racking solutions, providing potential supply chain efficiencies with other Nucor businesses.
- In February 2022, Nucor acquired a 50 percent equity ownership interest in California Steel Industries, Inc. for a cash purchase price of $400 million plus a 1 percent equity ownership stake from JFE Steel of Japan. California Steel operated a flat-rolled steel converter located in Fontana, California; this acquisition extended Nucor's capabilities to supply flat-rolled steel to customers on the West Coast.

- In April 2022, Nucor expanded its steel racking capabilities by acquiring Elite Storage Solutions for $75 million. This acquisition combined with Nucor's initial steel racking business, Hannibal, form the NWS group.
- In June 2022, Nucor completed the largest acquisition in its history with the purchase of C.H.I. Overhead Doors for approximately $3 billion. CHI was a leading manufacturer of overhead doors for residential and commercial markets in the United States and Canada. Commercial overhead doors were used in warehousing and retail, areas that Nucor had focused its attention on recently through its acquisitions of businesses making insulated metal panels and steel racking for warehouses. Nucor expected the CHI acquisition would enable supply chain efficiencies due to strategic fits with Nucor's recent paint line investments at its sheet mills in Arkansas and Indiana. Because CHI had a nationwide customer network of professional garage door dealers, CHI was able to keep its inventory levels to a minimum and fulfill customer orders more quickly than rivals via direct delivery from its regional warehouses.

Aggressively Investing to Expand the Company's Internal Production Capabilities

Complementing Nucor's ongoing strategic efforts to grow its business via acquisitions was a strategy element to invest aggressively in (1) the construction of new plant capacity and (2) enhanced production capabilities at existing plants whenever management spotted opportunities to boost sales with an expanded range of product offerings and/or strengthen its competitive position vis-à-vis rivals by lowering costs per ton or expanding its geographic coverage. The purpose of making ongoing capital investments was to improve efficiency and lower production costs at each and every facility it operated.

This strategy element had been in place since Nucor's earliest days in the steel business. Nucor always built state-of-the-art facilities in the most economical fashion possible and then made it standard company practice to invest in plant modernization and efficiency improvements whenever cost-saving opportunities emerged.

Examples of Nucor's efforts included the following:

- In 2006, Nucor announced that it would construct a new $27 million facility to produce metal buildings systems in Brigham City, Utah. The new plant, Nucor's fourth building systems plant, had capacity of 45,000 tons and gave Nucor national market reach in building systems products.
- In 2006, Nucor initiated construction of a $230 million state-of-the-art steel mill in Memphis, Tennessee, with annual capacity to produce 850,000 tons of special quality steel bars. Management believed this mill, together with the company's other special bar quality mills in Nebraska and South Carolina, would give Nucor the broadest, highest quality, and lowest cost offering of special quality steel bar in North America.
- In 2009, Nucor opened an idle and newly renovated $50 million wire rod and bar mill in Kingman, Arizona, that had been acquired in 2003. Production of straight-length rebar, coiled rebar, and wire rod began in mid-2010; the plant had initial capacity of 100,000 tons, with the ability to increase annual production to 500,000 tons.
- The construction of a $150 million galvanizing facility located at the company's sheet steel mill in Decatur, Alabama, gave Nucor the ability to make 500,000 tons of 72-inch-wide galvanized sheet steel, a product used by motor vehicle and appliance producers and in various steel frame and steel stud buildings. The galvanizing process entailed dipping steel in melted zinc at extremely high temperatures; the zinc coating protected the steel surface from corrosion.
- In 2013 Nucor installed caster and hot mill upgrades at its Berkeley, South Carolina, sheet mill that enabled it to roll light-gauge sheet steel to a finished width of 74 inches. This new capability (which most foreign competitors did not have) opened opportunities to sell large quantities of wide-width, flat-rolled products to customers in a variety of industries while, at the same time, providing the mill with less exposure to competition from imports of less wide, flat-rolled products.
- In 2016, Nucor initiated a project to install a $75 million cooling process at the Nucor-Yamato mill in Arkansas that was expected to generate savings on alloy costs of $12 million annually.
- In 2017, Nucor began construction of a $230 million specialty cold mill complex in Hickman, Arkansas, to produce advanced high-strength and

motor lamination steel products for automotive customers. The mill began operations in October 2019.

- In 2017, Nucor initiated an $85 million project to modernize the rolling mill at Nucor's 400,000-ton steel bar mill in Marion, Ohio, that produced rebar and signposts.
- In November 2017, Nucor announced that it would construct a $250 million rebar micro mill in Sedalia, Missouri, about 90 miles from Kansas City, to give Nucor a sustained shipping cost advantage over other domestic producers in supplying rebar to customers in the Kansas City area and the upper Midwestern and Plains region. Rebar supply to customers in this geographic area currently traveled long distances, giving Nucor's micro mill a sustained shipping cost advantage. This location also allowed Nucor to take advantage of the abundant scrap supply in the immediate area provided by Nucor's scrap metal subsidiary, The David J. Joseph Co.
- In early 2018, Nucor initiated construction of a $185 million full-range merchant bar quality (MBQ) mill at its existing bar steel mill near Kankakee, Illinois. The MBQ mill would have an annual capacity of 500,000 tons, take approximately two years to complete, and begin production in Q2 of 2020. Nucor executives believed the new mill's strategic location mill would enable Nucor to capture costs savings by (1) optimizing the melt capacity and infrastructure that was already in place at the existing Kankakee mill (which would continue to be a supplier of quality reinforcing bar products) and (2) taking advantage of an abundant scrap supply in the region. These cost savings would enhance Nucor's cost-competitiveness and, in top management's opinion, position Nucor to capture a big fraction of the bar products tonnage currently being supplied by competitors outside the region and, also, fortify Nucor's market leadership in steel bars by enhancing the appeal of its product offerings of merchant bar, light shapes, structural angle bars, and channel bars used by customers in the central Midwest region of the United States–one of the largest markets for MBQ products.
- In March 2018, Nucor announced it would construct a $240 million rebar micro mill in Frostproof, Florida, with annual capacity of 350,000 tons, to complement the rebar micro mill project in Sedalia, Missouri, announced in November 2017. This second mill was in a market region with strong and growing demand, along with an abundant supply of scrap metal that could mostly be supplied by Nucor's David J. Joseph scrap metal subsidiary. Nucor management believed the Frostproof mill would have a cost advantage over competitors shipping rebar into the region from longer distances. The mill was expected to begin production in the latter part of 2020.
- In May 2018, Nucor announced it would construct a $240 million galvanizing line with annual capacity of 500,000 tons at the company's sheet mill in Arkansas to support Nucor's growth into a wider and more diverse set of advanced high-strength steel products for automotive customers. Nucor's CEO, John Ferriola, said, "This new galvanizing line, coupled with our new specialty cold mill complex, will allow us to efficiently produce products beyond the capability of any North American sheet mill."[4] The new galvanizing line was expected to be operational in the first half of 2021.
- In January 2019, Nucor announced that it would build a $1.35 billion state-of-the-art plate mill in Brandenburg, Kentucky, on the Ohio River that would be well placed to serve customers in the midwestern United States, the largest plate-consuming area in the country. The new plate mill had an annual capacity of approximately 1,200,000 tons and was expected to begin production in 2022.
- In May 2019, Nucor announced it would add vacuum degassing to its engineered bar capabilities at its bar mill in Darlington, South Carolina. Adding this capability would enable the mill to produce engineered bar products meeting some of the most stringent quality specifications in the industry and thereby growing demand in the region for higher quality automotive and other specialty steel applications. The vacuum degassing system was expected to begin operations in late 2020.
- In December 2019 Nucor announced an expansion project to add a coil paint line at the company's sheet mill in Hickman, Arkansas. The new coil paint line would have a capacity of 250,000 tons per year and was expected to start up in the first half of 2022. The new paint line further diversified the sheet mill's product and market mix by opening new sales opportunities to the makers of

roofing and siding, light fixtures, and appliances, while also strengthening its product offerings to steel service centers and the makers of HVAC equipment and garage doors.

- In 2022 Nucor completed construction of a new $352 million third-generation flexible galvanizing line with an annual capacity of approximately 500,000 tons at its steel mill and specialty cold mill in Arkansas. Management believed this project strengthened Nucor's competitiveness vis-à-vis rival steelmakers in providing high-strength, lightweight steels that were increasingly being used by the makers of motor vehicles and sheet steel customers in other market sectors.

Nucor's Strategy to Be a First-Mover in Adopting the Best, Most Cost-Efficient Production Methods

The third element of Nucor's competitive strategy was to be a technology leader and first-rate operator of all its production facilities—outcomes that senior executives had pursued since the company's earliest days. Two approaches to improving and expanding Nucor's steel-making capabilities and achieving low costs per ton were utilized:

1. Being quick to implement disruptive technological innovations that would give Nucor a sustainable competitive advantage because of the formidable barriers rivals would have to hurdle to match Nucor's cost competitiveness and/or product quality and/or range of products offered.
2. Being quick to implement ongoing advances in production methods and install the latest and best steel-making equipment, thus providing Nucor with a path to driving down costs per ton and/or leapfrogging competitors in terms of product quality, range of product offerings, and/or market share.

Nucor's biggest success in pioneering trailblazing technology had been at its Crawfordsville, Indiana, facilities where Nucor installed the world's first facility for direct strip casting of carbon sheet steel—a process called Castrip®. The Castrip process, which Nucor tested and refined for several years before implementing it in 2005, was a major technological breakthrough for producing flat-rolled, carbon, and stainless steels in very thin gauges because (1) it involved far fewer process steps to cast metal at or very near customer-desired thicknesses and shapes and (2) the process drastically reduced capital outlays for equipment and produced sizable savings on operating expenses (by enabling the use of cheaper grades of scrap metal and requiring 90 percent less energy to process liquid metal into hot-rolled steel sheets). An important environmental benefit of the Castrip process was cutting greenhouse gas emissions by up to 80 percent. Seeing these advantages earlier than rivals, Nucor management had the foresight to acquire exclusive rights to Castrip technology in the United States and Brazil. Once it was clear that the expected benefits of the Castrip facility at Crawfordsville were indeed going to become a reality, Nucor in 2006 launched construction of a second Castrip facility on the site of its structural steel mill in Arkansas, and later constructed Castrip capabilities at three other steel mills. It also had one Castrip ultra-thin cast production facility that used proprietary technology to cast molten steel directly into its final shape, thereby eliminating the need for any flat-rolling. In 2020, due to advancements in the capabilities of the new cold mill and galvanizing line under construction at Nucor Steel Arkansas, Nucor management concluded that the value of the Castrip technology and process had diminished to the point that it would no longer be materially utilized going forward. Consequently, Nucor wrote off $103.2 million in undepreciated Castrip-related assets at the Arkansas plant.

Since technological breakthroughs (like the Castrip process) were relatively rare, Nucor management made a point of scouring locations across the world for reports of possible cost-effective technologies, ways to improve production methods and efficiency, and new and better equipment that could be used to improve operations and/or lower costs in Nucor's facilities. All such reports were checked out thoroughly, including making trips to inspect promising new developments firsthand if circumstances warranted. Projects to improve production methods or install more efficient equipment were promptly undertaken when the investment payback was attractive.

The Drive for Improved Efficiency and Lower Production Costs When Nucor acquired plants, it drew upon its ample financial strength and cash flows from operations to immediately fund efforts to get them up to Nucor standards—a process that employees called "Nucorizing." This included not only revising production methods and installing better equipment but also striving to increase operational efficiency by reducing the amount of time, space, energy, and manpower it took to produce steel products and instituting better worker safety and environmental protection practices.

Simultaneously, Nucor's top-level executives insisted upon continual improvement in product quality and cost at every company facility. Most all of Nucor's production locations were ISO 9000 and ISO 14000 certified. The company had a "BESTmarking" program aimed at being the industrywide best performer on a variety of production and efficiency measures. Managers at all Nucor plants were accountable for demonstrating that their operations were competitive on both product quality and cost vis-à-vis the plants of rival companies. A deeply embedded trait of Nucor's corporate culture was the expectation that plant-level managers would be persistent in initiating actions to improve product quality and keep costs per ton low relative to rival plants.

Nucor management viewed the task of pursuing operating excellence in its manufacturing operations as a continuous process. According to former CEO Dan DiMicco[5]

> We talk about "climbing a mountain without a peak" to describe our constant improvements. We can take pride in what we have accomplished, but we are never satisfied.

The strength of top management's commitment to funding projects to improve plant efficiency, keep costs as low as possible, and achieve overall operating excellence was reflected in the company's capital expenditures for new technology, plant improvements, and equipment upgrades (see Exhibit 5). The beneficial outcomes of these expenditures, coupled with companywide vigilance and dedication to discovering and implementing ways to operate most cost-efficiently, were major contributors to Nucor's standing as North America's lowest-cost, most diversified provider of steel products.

Shifting Production from Lower-End Steel Products to Value-Added Products

During 2010–2022, Nucor undertook a number of actions to shift more of the production tonnage at its steel mills and steel products facilities to "value-added products" that could command higher prices and yield better profit margins than could be had by producing lower-end or commodity steel products. Examples included

- Adding new galvanizing capability at the Decatur, Alabama, mill that enabled Nucor to sell 500,000 tons of corrosion-resistant, galvanized sheet steel for high-end applications.
- Expanding the cut-to-length capabilities at the Tuscaloosa, Alabama, mill that put the mill in position to sell as many as 200,000 additional tons per year of cut-to-length and tempered steel plate.
- Shipping 250,000 tons of new steel plate and structural steel products in 2010 that were not offered in 2009, and further increasing shipments

EXHIBIT 5 Nucor's Capital Expenditures for New Plants, Plant Expansions, New Technology, Equipment Upgrades, and Other Operating Improvements, 2000–2022

Year	Capital Expenditures (in millions)	Year	Capital Expenditures (in millions)
2000	$ 415.0	2012	$1,019.3
2001	261.0	2013	1,230.4
2002	244.0	2014	568.9
2003	215.4	2015	364.8
2004	285.9	2016	617.7
2005	331.5	2017	507.1
2006	338.4	2018	997.3
2007	520.4	2019	1,512.1
2008	1,019.0	2020	1,527.1
2009	390.5	2021	1,700.4
2010	345.2	2022	1,952.5
2011	450.6		

Sources: Company records, accessed at **www.nucor.com**, various dates; data for 2009–2019 is from the 2013 10-K report, p. 43 and the 2019 10-K report, p. 23. Data for 2020–2022 is from the 2022 10-K Report, p. 59.

of these same new products to 500,000 tons in 2011.

- Completing installation of a heat treating facility at the Hertford County plate mill in 2011 that gave Nucor the capability to produce as much as 125,000 tons annually of heat-treated steel plate ranging from 3/16 of an inch through 2 inches thick.
- Installing new vacuum degassers at the Hickman, Arkansas, sheet mill and Hertford County, North Carolina, mill to enable production of increased volumes of higher-value sheet steel, steel plate, steel piping, and tubular products.
- Investing $290 million at its three steel bar mills to enable the production of steel bars and wire rod for the most demanding engineered bar applications and also put in place state-of-the-art quality inspection capabilities. The project enabled Nucor to offer higher-value steel bars and wire rod to customers in the energy, automotive, and heavy truck and equipment markets (where the demand for steel products had been relatively strong in recent years).
- Completing installation of a new 120,000-ton "normalizing" process for making steel plate at the Hertford County mill in June 2013; the new normalizing process allowed the mill to produce a higher grade of steel plate that was less brittle and had a more uniform fine-grained structure (which permitted the plate to be machined to more precise dimensions). Steel plate with these qualities was more suitable for armor plate applications and for certain uses in the energy, transportation, and shipbuilding industries. Going into 2014, the normalizing process, coupled with the company's recent investments in a vacuum tank degasser and a heat treating facility at this same plant, doubled the Hertford mill's capacity to produce higher-quality steel plate products that commanded a higher market price.
- Modernizing the casting, hot rolling, and downstream operations at the Berkeley, South Carolina, mill in 2013 to enable the production of 72-inch wide sheet steel and lighter gauge hot-rolled and cold-rolled steel products with a finished width of 74-inches, thereby opening opportunities for Nucor to sell higher-value sheet steel products to customers in the agricultural, pipe and tube, industrial equipment, automotive, and heavy-equipment industries.
- Instituting a $155 million project at the Nucor-Yamato mill in 2014 to produce lighter, wider, and stronger steel pilings and a second $75 million project in 2016 to produce structural steel sections with high-strength, low-alloy grade chemistry; both projects helped Nucor grow sales of value-added structural steel products that had above-average profitability.
- Acquiring two Gerdau Long Steel facilities in 2015 that produced higher-margin, value-added cold-finished bars sold to steel service centers and other customers across the United States.
- Acquiring a specialty steel plate mill in Longview, Texas, in 2016 that was capable of producing thicker and wider steel plate than the company's existing steel plate offerings, thereby opening opportunities for Nucor to compete for a growing share of the value-added plate market. Less than 12 months after the acquisition, production and shipments at the Longview plant had doubled.
- Investing in a $230 million specialty cold mill complex at Nucor Steel Arkansas to expand the company's capability to produce advanced high-strength, high-strength low-alloy, and motor lamination steel products for automotive customers.
- Investing $176 million to build a 72-inch hot band galvanizing and pickling line with annual capacity of 500,000 tons at its sheet mill in Ghent, Kentucky. The 72-inch galvanizing line would be the widest hot-rolled galvanizing line in North America and would enable Nucor to enter the marketplace for such heavy-gauge, high-quality, hot-rolled galvanized steel products as frames, control arms, supports, and brackets for automotive customers, a market segment it previously was unable to serve.
- Acquiring two plants in St. Louis, Missouri, and Monterrey, Mexico, in 2017 that produced higher-margin, value-added cold drawn rounds, hexagons, squares, and related products sold mainly to automotive and certain industrial customers in the United States and Mexico. The two facilities, with combined annual capacity of 200,000 tons, strengthened Nucor's position as the market leader in cold bar finished products by increasing the total capacity of Nucor's cold finished bar and wire facilities to more than 1.1 million tons annually, advancing Nucor's goal of growing its sales to automotive customers, and creating another channel for Nucor's existing special quality bars mills to market their products.

- Constructing a $240 million galvanizing line with annual capacity of 500,000 tons at the company's sheet mill in Arkansas in 2018 to support Nucor's growth into a wider and more diverse set of advanced high-strength steel products for automotive customers.
- Adding vacuum degassing to its engineered bar capabilities at its bar mill in Darlington, South Carolina in 2019. Adding this capability enabled the mill to produce engineered bar products meeting some of the most stringent quality specifications in the steel industry.

Product upgrades had also been undertaken at several Nucor facilities making cold-finished and fastener products. Senior management believed that all of these upgrades to higher-value product offerings would boost revenues and earnings in the years ahead.

Global Growth via Joint Ventures

In 2007, Nucor management decided it was time to begin building an international growth platform. The company's strategy to grow its international revenues had two elements:

1. Establishing foreign sales offices and exporting U.S-made steel products to foreign markets. Because about 60 percent of Nucor's steel-making capacity was located on rivers with deep water transportation access, management believed that the company could be competitive in shipping U.S.-made steel products to customers in a number of foreign locations.
2. Entering into joint ventures with foreign partners to invest in steel-making projects outside North America. Nucor executives believed that the success of this strategy element was finding the right partners to grow with internationally.

Nucor opened a Trading Office in Switzerland and proceeded to establish international sales offices in Mexico, Brazil, Colombia, the Middle East and Asia. The company's Trading Office bought and sold steel and steel products that Nucor and other steel producers had manufactured. In 2010, approximately 11 percent of the shipments from Nucor's steel mills were exported. Customers in South and Central America presented the most consistent opportunities for export sales, but there was growing interest from customers in Europe and other locations.

In January 2008, Nucor entered in a 50/50 joint venture with the European-based Duferco Group to establish the production of beams and other long products in Italy, with distribution in Europe and North Africa. A few months later, Nucor acquired 50 percent of the stock of Duferdofin-Nucor for approximately $667 million (Duferdofin was Duferco's Italy-based steel-making subsidiary). During 2011–2019, Duferdofin-Nucor operated a steel melt shop and bloom/billet caster with an annual capacity of 1.1 million tons and a 495,000-ton special quality merchant bar mill, and a 60,000-ton trackshoes/cutting edges mill. In May 2019, the joint venture announced it would begin construction of a new rolling mill in northern Italy to produce 1 million tons of steel beams and other rolled products using the latest technologies, with operations to begin in 2022. The new mill would be supplied by the venture's 1.1 million-ton melt shop and was expected to be a low-cost producer. The customers for the products produced by Duferdofin-Nucor were primarily steel service centers and distributors located both in Italy and throughout Europe. However, the whole joint venture project had never lived up to the partners' financial expectations because all of the venture's plants made construction-related products. The European construction industry had been hard hit by the economic events of 2008–2009, and the construction-related demand for steel products in Europe was still slowly creeping back toward pre-crisis levels in 2019. Ongoing losses and write-downs of the Nucor Duferdofin joint venture's assets prompted Nucor to sell its 50 percent ownership back to Duferco Italia in 2020; Nucor recorded 2020 total losses and asset impairments of $483.5 million in connection with its divestiture of its interest in Nucor Duferdofin.

In early 2010, Nucor invested $221.3 million to become a 50-50 joint venture partner with Mitsui USA to form NuMit LLC—Mitsui USA was the largest wholly owned subsidiary of Mitsui & Co., Ltd., a diversified global trading, investment, and service enterprise headquartered in Tokyo, Japan. NuMit LLC owned 100 percent of the equity interest in Steel Technologies LLC, an operator of 26 sheet-steel processing facilities throughout the United States, Canada, and Mexico. At the end of 2022, Nucor's investment in NuMit was $423.9 million, which consisted of the initial investment plus additional capital contributions and equity method earnings less distributions to Nucor. Nucor received distributions from NuMit of $36.5 million in 2019, $9.5 million in 2020, $0.2 million in 2021, and $55.6 million in 2022.

In 2016 Nucor announced a 50-50 joint venture with JFE Steel Corporation of Japan to build a $270 million galvanized sheet steel mill with a capacity of 400,000 tons in central Mexico to serve the motor vehicle manufacturers who had built or were building plants in central Mexico. Automotive production in Mexico is predicted to increase from 3.4 million to 5.3 million vehicles by 2020. In January 2020, operations began at the new plant to produce hot-dip galvanized sheet steel. The recently signed United States-Mexico-Canada Agreement (USMCA) increased the amount of North American content required in cars and trucks to avoid tariffs imposed by the United States, which enhanced the plant's competitiveness. Nucor's investment in the joint venture was valued at $91.8 million as of December 31, 2022 (versus $147.0 million at December 31, 2021); the venture had outstanding borrowings of $155.0 million, 50 percent of which was guaranteed by Nucor in the event the Nucor-JFE Steel joint venture failed to make payments when due.

Nucor's Raw Materials Strategy

Scrap metal and scrap substitutes were Nucor's single biggest cost—all of Nucor's steel mills used electric arc furnaces to make steel products from recycled scrap steel, scrap iron, pig iron, hot briquetted iron (HBI), and direct reduced iron (DRI). On average, it took approximately 1.1 tons of scrap and scrap substitutes to produce a ton of steel—the proportions averaged about 70 percent scrap steel and 30 percent scrap substitutes. Nucor was the biggest user of scrap metal in North America, and it also purchased millions of tons of pig iron, HBI, DRI, and other iron products annually—top-quality scrap substitutes were especially critical in making premium grades of sheet steel, steel plate, and special bar quality steel at various Nucor mills. Scrap prices were driven by market demand-supply conditions and could fluctuate significantly—see Exhibit 6. Rising scrap prices adversely impacted the company's costs and ability to compete against steel-makers that made steel from scratch using iron ore, coke, and traditional blast furnace technology.

EXHIBIT 6 Nucor's Costs for Scrap Steel and Scrap Substitute, 2000–2022

Period	Average Cost of Scrap and Scrap Substitute per Ton Used	Period	Average Cost of Scrap and Scrap Substitute per Gross Ton Used
2000	$120	**2021** Quarter 1	$405
2005	244	Quarter 2	457
2006	246	Quarter 3	511
2007	278	Quarter 4	508
2008	438	**Full-Year Average**	469
2009	303		
2010	351	**2022** Quarter 1	$495
2011	439	Quarter 2	534
2012	407	Quarter 3	502
2013	376	Quarter 4	427
2014	381	**Full-Year Average**	492
2015	270		
2016	228		
2017	307		
2018	361		
2019	314		

Source: Nucor's Annual Reports for 2007, 2009, 2011 and information posted in the investor relations section at **www.nucor.com**, accessed April 12, 2012, April 15, 2014, February 11, 2016, February 18, 2018, March 24, 2020, and April 19, 2023.

Nucor's raw materials strategy was aimed at achieving greater control over the costs of all types of metallic inputs (both scrap metal and iron-related substitutes) used at its steel plants. A key element of this strategy was to backward integrate into the production of 6,000,000 to 7,000,000 tons per year of high quality scrap substitutes (chiefly pig iron and direct reduced iron) at either its own wholly owned and operated plants or at plants jointly owned by Nucor and other partners—integrating backward into supplying a big fraction of its own iron requirements held promise of raw material savings and less reliance on outside iron suppliers. The costs of producing pig iron and direct reduced iron (DRI) were not as subject to steep swings as was the price of scrap steel.

Another raw-material sourcing initiative came in 2004 when it acquired an idled direct reduced iron (DRI) plant in Louisiana, relocated all of the plant assets to Trinidad (an island off the coast of South America near Venezuela), and expanded the project (named Nu-Iron Unlimited) to a capacity of 2 million tons. The plant used a proven technology that converted iron ore pellets into direct reduced iron. The Trinidad site was chosen because it had a long-term and very cost-attractive supply of natural gas (large volumes of natural gas were consumed in the plant's production process), along with favorable logistics for receiving iron ore and shipping direct reduced iron to the United States.

In September 2010, Nucor announced plans to build a $750 million DRI facility with annual capacity of 2.5 million tons on a 4,000-acre site in St. James Parish, Louisiana. Production began in late 2013 and was rapidly ramped up toward capacity in 2014. This second DRI plant in Louisiana also benefited from favorable logistics and its proximity to its steel mill customers in the United States. Nucor's investments in the two DRI plants moved it two-thirds of the way to its long-term objective of supplying 6 to 7 million tons of its requirements for high-quality scrap substitutes.

The Acquisition of the David J. Joseph Company In February 2008, Nucor acquired The David J. Joseph Company (DJJ) and related affiliates for a cash purchase price of approximately $1.44 billion. At the time, DJJ was one of the leading scrap metal companies in the United States, with 2007 revenues of $6.4 billion. It processed about 3.5 million tons of scrap iron and steel annually at some 35 scrap yards and brokered over 20 million tons of iron and steel scrap and over 500 million pounds of nonferrous materials in 2007. DJJ obtained scrap from industrial plants, the manufacturers of products that contained steel, independent scrap dealers, peddlers, auto junkyards, demolition firms, and other sources. DJJ also owned over 2,000 railcars dedicated to the movement of scrap metals and offered complete railcar fleet management and leasing services. Nucor was familiar with DJJ and its various operations because it had obtained scrap from DJJ since 1969.

As of year-end 2022, DJJ was the leading broker and processor of ferrous scrap in the United States, with had 88 operating facilities in 21 states (along with multiple domestic and foreign brokerage offices), six regional scrap recycling companies with shredders capable of processing 5.8 million tons annually. DJJ's fleet of open top railcars allowed it to quickly and cost-efficiently deliver scrap to Nucor's steel mills and to external customers. In 2022, approximately 92 percent of the ferrous and nonferrous metals and scrap substitute tons DJJ processed were delivered to Nucor's steel mills, with the balance sold to external customers. DJJ was also a global trader of scrap metal. pig iron and other metallics.

The Acquisition of Universal Gases Nucor acquired Universal Industrial Gases in 2019 to give it the capability to build and operate its own air separation units to serve its steel mills and thereby provide an option to using outside providers to perform the needed air separation function. At year-end 2022, Nucor had five industrial gas plants operating, and five others at various stages of commissioning, construction, or planning.

Nucor's Commitment to Being a Global Leader in Environmental Performance

Environmental sustainability had long been at the core of Nucor's business model. The company's electric arc furnaces had one of the lowest greenhouse gas footprints in the world at 0.44 tons of carbon dioxide per ton of steel—five times lower than the average blast furnace steel producer.[6] The company had for years invested aggressively to reduce its greenhouse gas emissions and to reduce emissions related to its use of electricity and natural gas. In 2022 nearly 40 percent of its electric power came from clean or renewable energy sources, and that percentage was expected grow in future years.[7] Nucor was the first major industrial company in the world to join the UN Carbon-Free Energy Global Compact. It was also a founding member of the Global Steel Climate Council—a coalition that advocated for a single transparent global greenhouse gas emission standard focused on steelmaking emissions; the goal was to make steel customers aware of which companies were producing the cleanest steel products. Nucor shipped the first tons of its net-zero emissions Econiq™ steel to General Motors early in 2022 and months later began supplying Econiq to Trane Technologies for Trane's HVAC products. At year-end 2022, Nucor had contracts to supply customers with approximately 600,000 tons of Econiq.

Several years earlier, Nucor began evaluating every one of its facilities for actions that could be taken to promote greater environmental sustainability. Measurable objectives and targets relating to such outcomes as reduced use of oil and grease, more efficient use of electricity, and site-wide recycling were in place at each plant. Computerized controls on large electric motors and pumps and energy-recovery equipment to capture and reuse energy that otherwise would be wasted had been installed throughout Nucor to lower energy usage—Nucor considered itself to be among the most energy-efficient steel companies in the world. All of Nucor's facilities had water-recycling systems. Nucor even recycled the dust from its electric arc furnaces because scrap metal contained enough zinc, lead, chrome, and other valuable metals to recycle into usable products; the dust was captured in each plant's state-of-the-art bag house air pollution control devices and then sent to a recycler that converted the dust into zinc oxide, steel slag, and pig iron. The first Nucor mill received ISO 14001 Environmental Management System certification in 2001; by year-end 2015, all of Nucor's facilities were ISO 14001 certified.

Nucor management considered that its emphasis on sustainability was an important factor that differentiated it from rivals and gave it a sustainability-based competitive advantage. This was because many Nucor customers were working to reduce the carbon footprint of their supply chains and were prioritizing their sourcing from companies making steel products with lower embedded carbon—exactly the type of products that Nucor made.[8]

Organization and Management Philosophy

Nucor had a simple, streamlined organizational structure to allow employees to innovate and make quick decisions. The company was highly decentralized, with most day-to-day operating decisions made by group or plant-level general managers and their staff. Each group or plant operated independently as a profit center and was headed by a general manager, who in most cases also had the title of vice president. The group manager or plant general manager had control of the day-to-day decisions that affected the group or plant's profitability.

The organizational structure at a typical plant had four layers:

1. General manager
2. Department manager
3. Supervisor/professional
4. Hourly employee

Group managers and plant managers reported to one of eight executive vice presidents with responsibility for their product category. Nucor's corporate staff was exceptionally small, consisting of fewer than 200 people in 2022, the philosophy being that corporate headquarters should consist of a small cadre of executives who would guide a decentralized operation where liberal authority was delegated to managers in the field. Each plant had a sales manager who was responsible for selling the products made at that particular plant; such staff functions as engineering, accounting, and personnel management were performed at the group/plant level. There was a minimum of paperwork and bureaucratic systems. Each group/plant was expected to earn about a 25 percent return on total assets before corporate expenses, taxes, interest, or profit-sharing. As long as plant managers met their profit targets, they were allowed to operate with minimal restrictions and interference from corporate headquarters. There was a very friendly spirit of competition from one plant to the next to see which facility could be the best performer, but since all of the vice presidents and general managers shared the same bonus systems, they functioned pretty much as a team despite operating their facilities individually. Top executives did not hesitate to replace group or plant managers who consistently struggled to achieve profitability and operating targets.

Nucor's Mission In recent years, Nucor had developed and adopted a simple nine-word mission statement: Grow the Core, Expand Beyond and Live Our Culture. The phrase "Grow the Core" meant putting a high priority on investing in projects that would enhance the company's capabilities in its core steelmaking market segments—sheet steel, steel bar, steel beams, and steel plate. Examples included the new Brandenburg steel plate mill which gave Nucor the capability to produce the first-of-its-kind heavy gauge steel plate product that wind energy producers needed to construct the foundations of offshore wind towers. A second example was the investment in the new West Virginia mill that was equipped to produce 84-inch sheet products and that also featured a 76-inch tandem cold mill and two galvanizing lines capable of producing advanced high-end automotive and construction grade steel products. A third example was the investment in a new caster at Nucor's Illinois bar mill that gave it the capability to provide a full array of merchant bar quality products to customers in the Midwest.

The phrase "Expand Beyond" was intended to address Nucor's challenge of how to grow its earnings when it was already the leader in a majority of the steel product segments where it already competed. The first Expand Beyond initiative occurred back in the 1960s when Nucor backward integrated into steelmaking to add to its joist and deck business. Most recently, Expand Beyond had evolved into finding new growth platforms in steel-adjacent businesses where it could apply its expertise as an efficient steel manufacturer. Specifically, management was looking for companies operating outside the traditional steel market cycle that could provide attractive long-term earnings growth, that had a performance-oriented entrepreneurial culture, and that could generate returns much greater than Nucor's cost of capital. Since 2020, Nucor had invested about $4.5 billion in its first four high-growth business platforms—Overhead Doors, Towers & Structures, Insulated Metal Panels, and Warehouse Systems.

The phrase "Live Our Culture" was intended to stress the importance of sustaining the company's strong cultural underpinnings and values, which include a dedication to low-cost operating efficiency, teamwork, giving workers the tools needed to do their job efficiently, a strong emphasis on satisfying the needs and requirements of customers, building core competencies and valuable competitive capabilities, delivering value to shareholders, being a leader in operating facilities in an environmentally sustainable manner, and putting top priority on the safety, health, and well-being of the workers who make up the Nucor family. In 2022, Nucor set a record low injury and illness rate for the fourth consecutive year. Twenty Nucor divisions went the entire year without a recordable injury, up from 16 in 2021. and the company set records across each of the four primary safety metrics it tracked.[9]

Workforce Compensation Practices

Nucor was a largely nonunion "pay for performance" company with an incentive compensation system that rewarded goal-oriented individuals and did not put a maximum on what they could earn. All employees, except those in the Harris Steel and DJJ subsidiaries that operated independently from the rest of Nucor, worked under one of four basic compensation plans, each featuring incentives related to meeting specific goals and targets:

1. *Production Incentive Plan*—Production line jobs were rated on degree of responsibility required and assigned a base wage comparable to the wages paid by other manufacturing plants in the area where a Nucor plant was located. But in addition to their base wage, operating and maintenance employees were paid weekly bonuses based on the number of tons by which the output of their production team or work group exceeded the "standard" number of tons. All operating and maintenance employees were members of a production team that included the team's production supervisor, and the tonnage produced by each work team was measured for each work shift and then totaled for all shifts during a given week. If a production team's weekly output beat the weekly standard, team members (including the team's production supervisor) earned a specified percentage bonus for each ton produced above the standard—production bonuses were paid weekly (rather than quarterly or annually) so that workers and supervisors would be rewarded immediately for their efforts. The standard rate was calculated based on the capabilities of the equipment employed (typically at the time plant operations began), and no bonus was paid if the equipment was not operating (which gave maintenance workers a big incentive to keep a plant's equipment in good working condition)—Nucor's philosophy was that when equipment was not operating everybody suffered and the bonus for downtime ought to be zero. Production standards at Nucor plants were seldom raised unless a plant underwent significant modernization or

important new pieces of equipment were installed that greatly boosted labor productivity. It was common for production incentive bonuses to run from 50 to 150 percent of an employee's base pay, thereby pushing compensation levels up well above those at other nearby manufacturing plants. Worker efforts to exceed the standard and get a bonus did not so much involve working harder as it involved good teamwork and close collaboration in resolving problems and figuring out how best to exceed the production standards.

2. *Department Manager Incentive Plan*—Department managers earned annual incentive bonuses based primarily on the percentage of net income to dollars of assets employed for their division. These bonuses could be as much as 80 percent of a department manager's base pay.
3. *Professional and Clerical Bonus Plan*—A bonus based on a division's net income return on assets was paid to employees that were not on the production worker or department manager plan.
4. *Senior Officers Annual Incentive Plan*—Nucor's senior officers did not have employment contracts and did not participate in any pension or retirement plans. Their base salaries were set at approximately 90 percent of the median base salary for comparable positions in other manufacturing companies with comparable assets, sales, and capital. The remainder of their compensation was based on Nucor's annual overall percentage of net income to stockholder's equity (ROE) and was paid out in cash and stock. Once Nucor's ROE reached a threshold of more than 3 percent, senior officers earned a bonus equal to 20 percent of their base salary. If Nucor's annual ROE was 20 percent or higher, senior officers earned a bonus equal to 225 percent of their base salary. Officers could earn an additional bonus up to 75 percent of their base salary based on a comparison of Nucor's net sales growth with the net sales growth of members of a steel industry peer group. There was also a long-term incentive plan that provided for stock awards and stock options. The structure of these officer incentives was such that bonus compensation for Nucor officers fluctuated widely—from close to zero (in years when industry conditions were bad and Nucor's performance was sub-par) to four hundred percent (or more) of base salary (when Nucor's performance was excellent).
5. *Senior Officers Long-Term Incentive Plan*—The long-term incentive was intended to balance the short-term focus of the annual incentive plan by rewarding performance over multi-year periods. These incentives were received in the form of cash (50 percent) and restricted stock (50 percent) and covered a performance period of three years; 50 percent of the long-term award was based on how Nucor's 3-year return on average invested capital (ROAIC) compared against the 3-year ROAIC of the steel industry peer group and 50 percent was based on how Nucor's 3-year ROAIC compared against a multi-industry group of well-respected companies in capital-intensive businesses similar to that of steel.

Nucor management had designed the company's incentive plans for employees so that bonus calculations involved no discretion on the part of a plant/division manager or top executives. This was done to eliminate any concerns on the part of workers that managers or executives might show favoritism or otherwise be unfair in calculating or awarding incentive awards.

There were two other types of extra compensation:

1. *Profit Sharing*—Each year, Nucor allocated at least 10 percent of its operating profits to profit-sharing bonuses for all employees (except senior officers). Depending on company performance, the bonuses could run anywhere from 1 percent to over 20 percent of pay. Twenty percent of the bonus amount was paid to employees in the following March as a cash bonus and the remaining 80 percent was put into a trust for each employee, with each employee's share being proportional to their earnings as a percent of total earnings by all workers covered by the plan. An employee's share of profit-sharing became vested after one full year of employment. Employees received a quarterly statement of their balance in profit sharing.
2. *401(k) Plan*—Both officers and employees participated in a 401(k) plan where the company matched from 5 percent to 25 percent of each employee's first 7 percent of contributions; the amount of the match was based on how well the company was doing.

Nucor's expense for these two types of extra compensation totaled $959 million in 2023, $994.2 million in 2022, $869.9 million in 2021, and $86.6 million in 2020.[10]

In 2023, entry-level, hourly workers at a Nucor plant could expect to earn $45,000 to $60,000 annually (including bonuses).[11] Earnings for more experienced production, engineering, and technical personnel were normally in the $70,000 to $120,000 range. Total compensation for salaried workers ranged from $90,000 to $250,000, depending on type of job (accounting, engineering, sales, information technology), years of experience, level of management, and geographic location. It was common for worker compensation at Nucor plants to be double or more the average earned by workers at other manufacturing companies in the states where Nucor's plants were located. As a rule of thumb, production workers in Nucor's steel mills earned three times the local average manufacturing wage. Nucor management philosophy was that these workers ought to be excellently compensated because the production jobs were strenuous and the work environment in a steel mill was relatively dangerous.

Employee turnover in Nucor mills was extremely low; absenteeism and tardiness were minimal. Each employee was allowed four days of absences and could also miss work for jury duty, military leave, or the death of close relatives. After this, a day's absence cost a worker the entire performance bonus pay for that week and being more than a half-hour late to work on a given day resulted in no bonus payment for the day. When job vacancies did occur, Nucor was flooded with applications from people wanting to get a job at Nucor; plant personnel screened job candidates very carefully, seeking people with initiative and a strong work ethic.

Employee Relations and Human Resources

The hallmarks of Nucor's human resources strategy were its incentive pay plan for production exceeding the standard and the job security provided to production workers—despite being in an industry with strong down-cycles, Nucor had made it a practice not to lay off workers. Instead, when market conditions were tough and production had to be cut back, workers were assigned to plant maintenance projects, cross-training programs, and other activities calculated to boost the plant's performance when market conditions improved. No Nucor employee had ever been laid off.

Nucor took an egalitarian approach to providing fringe benefits to its employees; employees had the same insurance programs, vacation schedules, and holidays as upper-level management. However, certain benefits were not available to Nucor's officers. The fringe benefit package at Nucor included

1. *Medical and Dental Plans*—The company had a flexible and comprehensive health benefit program for officers and employees that featured low premiums, no deductible, an out-of-pocket expense limit based on a percentage of the employee's earnings, a dental plan, a vision plan, healthcare spending accounts.
2. *Tuition Reimbursement*— Nucor reimbursed up to $4,000 of an employee's approved educational expenses each year and up to $2,000 of a spouse's educational expenses for a maximum of 2 years.
3. *Service Awards*—After each five years of service with the company, Nucor employees received a service award consisting of five shares of Nucor stock.
4. *Scholarships and Educational Disbursements*—Nucor provided the children of every employee (except senior officers) with college funding of $4,000 per year for four years to be used at accredited academic institutions. As of 2023, the company had paid out $97 million.
5. *Company Contributions to Profit-Sharing and Retirement Savings*—These contributions were made annually for qualified employees and were based on the company's profitability. Employees could contribute up to 4 percent of their salary to a 401(K) with Nucor matching 50 percent of the employee's contribution. The profit-sharing plan set aside at least 10 cents out of every dollar that Nucor earned before taxes.
6. *Other benefits*—Long-term disability, life insurance, paid vacation, paid volunteer time off, and parental leave.

Most of the changes Nucor made in work procedures came from employees. The prevailing view at Nucor was that the employees knew the problems of their jobs better than anyone else and were thus in the best position to identify ways to improve how things were done. Most plant-level managers spent considerable time in the plant, talking and meeting with frontline employees and listening carefully to suggestions. Promising ideas and suggestions were typically acted upon quickly and implemented—management was willing to take risks to try worker suggestions for doing things better and to accept the occasional failure when the results were disappointing. Teamwork, a vibrant team spirit, and a close worker-management partnership were much in evidence at Nucor plants.

Nucor plants did not utilize job descriptions. Management believed job descriptions caused more problems than they solved, given the teamwork atmosphere and the close collaboration among work group members. The company saw formal performance appraisal systems as a waste of time and added paperwork. If a Nucor employee was not performing well, the problem was dealt with directly by supervisory personnel and the peer pressure of work group members (whose bonuses were adversely affected).

Employees were kept informed about company and division performance. Charts showing the division's results in return-on-assets and bonus payoff were posted in prominent places in the plant. Most all employees were quite aware of the level of profits in their plant or division. Nucor had a formal grievance procedure, but grievances were few and far between. The corporate office sent all news releases to each division where they were posted on bulletin boards. Each employee received a copy of Nucor's annual report; it was company practice for the cover of the annual report to consist of the names of all Nucor employees.

All of these practices had created an egalitarian culture and a highly motivated workforce that grew out of former CEO Ken Iverson's radical insight: employees, even hourly clock punchers, would put forth extraordinary effort and be exceptionally productive if they were richly rewarded, treated with respect, and given real power to do their jobs as best they saw fit.[12] There were countless stories of occasions when managers and workers had gone beyond the call of duty to expedite equipment repairs (in many instances even using their weekends to go help personnel at other Nucor plants solve a crisis); the company's workforce was known for displaying unusual passion and company loyalty even when no personal financial stake was involved. As one Nucor worker put it, "At Nucor, we're not 'you guys' and 'us guys.' It's all of us guys. Wherever the bottleneck is, we go there, and everyone works on it."[13]

It was standard procedure for a team of Nucor veterans, including people who worked on the plant floor, to visit with their counterparts as part of the process of screening candidates for acquisition.[14] One of the purposes of such visits was to explain the Nucor compensation system and culture face-to-face, gauge reactions, and judge whether the plant would fit into "the Nucor way of doing things" if it was acquired. Shortly after making an acquisition, Nucor management moved swiftly to institute its pay-for-performance incentive system and to begin instilling the egalitarian Nucor culture and idea-sharing. Top priority was given to looking for ways to boost plant production using fewer people and without making substantial capital investments; the take-home pay of workers at newly acquired plants typically went up rather dramatically. At the Auburn Steel plant, acquired in 2001, it took Nucor about six months to convince workers that they would be better off under Nucor's pay system; during that time Nucor paid people under the old Auburn Steel system but posted what they would have earned under Nucor's system. Pretty soon, workers were convinced to make the changeover—one worker's pay climbed from $53,000 in the year prior to the acquisition to $67,000 in 2001 and to $92,000 in 2005.[15]

New Employees. Each plant/division had a "consul" responsible for providing new employees with general advice about becoming a Nucor teammate and serving as a resource for inquiries about how things were done at Nucor, how to navigate the division and company, and how to resolve issues that might come up. Nucor provided new employees with a personalized plan that set forth who would give them feedback about how well they were doing and when and how this feedback would be given; from time to time, new employees met with the plant manager for feedback and coaching. In addition, there was a new employee orientation session that provided a hands-on look at the plant/division operations; new employees also participated in product group meetings to provide exposure to broader business and technical issues. Each year, Nucor brought all recent college hires to the Charlotte headquarters for a forum intended to give the new hires a chance to network and provide senior management with guidance on how best to leverage their talent.

THE WORLD STEEL INDUSTRY

Global production of crude steel hit a record high of 1,962 million tons in 2021—see Exhibit 7. Steelmaking capacity worldwide was approximately 2,710 million tons in 2022, resulting in global excess capacity of roughly 750 million tons and a 2021 capacity utilization rate of 72.0 percent (up from a historically unprecedented low of 52 percent in 2009). Overcapacity was especially pronounced in China. Nonetheless, construction of new capacity additions was underway during 2022–2023, with more capacity additions in the planning stages; indications were that worldwide capacity would grow to about 2,820 million tons in 2025.[16] Global demand for finished steel products was forecast to grow 2.3 percent in 2023 and 1.7 percent in 2024.[17] The six biggest steel-producing countries in 2022 were[18]

Country	Total Production of Crude Steel	Percent of Worldwide Production
China	1,018 million tons	54.0%
India	125 million tons	6.6
Japan	89 million tons	4.7
United States	81 million tons	4.3
Russia	71 million tons	3.8
South Korea	66 million tons	3.5

Exhibit 8 shows the world's 15 largest producers of crude steel in 2021.

Steel-Making Technologies

Steel was produced either by integrated steel facilities or by mills that employed electric arc furnace (EAF) technology. Integrated mills used metallurgical coal fired in coke ovens to produce coke, a fuel with low impurities and high carbon content; the coke was then used to fire blast furnaces and provide needed carbon to react with iron ore, air, and other additives at high temperatures and produce a hot metal mixture (often called molten pig iron). The hot metal was then poured into a converter where the hot metal was pretreated with magnesium and subjected to a 20-minute bath of high-purity oxygen which created a lot of heat. To cool down the reaction heat created by the oxygen bath, charges of scrap metal and lime were added. Following completion of the oxygen bath, the converter was tilted and the resulting liquid crude steel was drained off. To make flat rolled steel products, liquid steel was either fed into a continuous caster machine and cast into slabs or else cooled in slab form for later processing. Slabs were further shaped or rolled at a plate mill or hot strip mill. In making certain sheet steel products, the hot strip mill process was followed by various finishing processes, including pickling, cold-rolling, annealing, tempering, galvanizing, or other coating procedures. These various processes for converting raw steel into finished steel products were often distinct steps undertaken at different times and in different on-site or off-site facilities rather than being done in a continuous process in a single plant facility—an integrated mill was thus one which had multiple facilities at a single plant site and could therefore not only produce crude (or raw) steel but also run the crude steel through various facilities and finishing processes to

EXHIBIT 7 Worldwide Production of Crude Steel, with Compound Average Growth Rates, 1975–2022

Year	World Crude Steel Production (millions of tons)	Compound Average Growth Rates in World Crude Steel Production: Period	Compound Average Growth Rate
1975	644	1975–1980	2.17%
1980	717	1980–1985	0.06
1985	719	1985–1990	1.38
1990	770	1990–1995	−0.45
1995	753	1995–2000	2.45
2000	850	2000–2005	6.20
2005	1,148	2005–2010	4.53
2010	1,433	2010–2015	2.51
2015	1,622	2015–2019	3.62
2016	1,629		
2017	1,732		
2018	1,817		
2019	1,877		
2020	1,882		
2021	1,962		
2022	1,885		

Source: Worldsteel Association, *Steel Statistical Yearbook, 2019* (Concise Version); Worldsteel Association press release, January 27, 2020, posted at **www.worldsteel.org**, accessed on March 26, 2020; and Worldsteel Association, "Total Production of Crude Steel, 2018–2022" posted at **www.worldsteel.org**, accessed May 9, 2023.

EXHIBIT 8 Top 15 Producers of Crude Steel Worldwide, 2021

Global Rank	Company (Headquarters Country)	Crude Steel Production (millions of metric tons)
1.	China Baowu Group (China)	120.0
2.	ArcelorMittal (Luxembourg)	79.3
3.	Ansteel Group (China)	55.6
4.	Nippon Steel Corp. (Japan)	49.5
5.	Shagang Group (China)	44.2
6.	POSCO (South Korea)	43.0
7.	HBIS Group (China)	41.6
8.	Jianlong Group (China)	36.7
9.	Shougang Group (China)	35.4
10.	Tata Steel Group (India)	30.6
11.	Shandong Steel Group (China)	28.3
12.	Delong Steel Group (China)	27.8
13.	JFE Steel (Japan)	26.9
14.	Valin Group (China)	23.0
15.	Nucor (USA)	25.7

Source: Worldsteel Association, *World Steel in Figures 2022,* posted at **www.worldsteel.org**, accessed May 9, 2023.

make hot-rolled and cold-rolled sheet steel products, steel bars and beams, stainless steel, steel wire and nails, steel pipes and tubes, and other finished steel products. But such facilities entailed high capital and energy costs and required a sizable work force to operate. The work forces at many integrated mills in Europe, the United States, and several other countries were often unionized.

Steel-making at mills using electric arc furnace technology was far simpler and quicker. High-powered electric arcs were thrust down into a vessel to melt scrap metal, scrap substitutes, and perhaps direct reduced iron pellets into molten metal which was then cast into crude steel slabs, billets, or blooms in a continuous casting process. As was the case at integrated mills, the crude steel at EAF mills was then run through various facilities and finishing processes to make hot-rolled and cold-rolled sheet steel products, steel bars and beams, stainless steel, steel wire and nails, steel pipes and tubes, and other finished steel products. EAF steel mills could accommodate short production runs and had relatively fast product change-over time. The electric arc technology employed by these mills offered two primary competitive advantages: capital investment requirements that were 75 percent lower than those of integrated mills and smaller work force requirements (which translated into lower labor costs per ton shipped).

Initially, companies with EAF mills were able to only make low-end steel products (such as reinforcing rods and steel bars). But when thin-slab casting technology came on the scene in the 1980s, EAF mills that invested in thin-slab casting facilities were able to compete in the market for flat-rolled carbon sheet and strip products; these products sold at substantially higher prices per ton and thus were attractive and profitable market segments to enter—as Nucor proved at its plants in Indiana and elsewhere. Other EAF steel mills in the United States and across the world were quick to follow Nucor's lead in adopting thin-slab casting technology because the low capital costs of thin-slab casting facilities, often coupled with lower labor costs per ton, gave EAF-mills a cost and pricing advantage over integrated steel producers, enabling them to grab a growing share of the global market for flat-rolled sheet steel and other carbon steel products. Many integrated producers also switched to thin-slab casting as a defensive measure to protect their profit margins and market shares. But the advent of thin-slab casting was by no means the only technological development that allowed EAF mills to enter market segments dominated by integrated mills. Since 1990, numerous production refinements and technological improvements had been introduced at various EAF mills (like those at Nucor) that permitted them to gradually invade other steel product segments and to produce higher quality steels capable of meeting the strict specifications of steel users in more and more industry categories. However, EAF mills were from time-to-time competitively challenged by rising prices for scrap metal.

In 2022, about 75 percent of the world's steel mill production was made at large integrated mills and about 25 percent was made at EAF mills.[19] In China 89 percent of the crude steel was produced at integrated mills using the basic oxygen process; the percentages of crude steel produced via basic oxygen furnace technology were 75 percent in Japan, 59 percent in Russia, 68 percent in South Korea, and 76 percent in Brazil. In the United States, however, 69.2 percent of the crude steel was produced at EAF mills and 30.8 percent at mills using blast furnaces and basic oxygen processes.[20] Large integrated steel mills using blast furnaces, basic oxygen furnaces, and assorted casting and rolling equipment typically had the ability to manufacture a wide variety of steel mill products but faced significantly higher capital costs and higher operating costs for labor and energy. While mills using electric-arc furnaces were sometimes challenged by high prices for scrap metal, they tended to have far lower capital and operating costs compared with the integrated steel producers. However, the quality of the steel produced using basic oxygen furnace technologies tended to be superior to that of electric arc furnaces unless, like at most of Nucor's facilities, the user of electric arc furnaces invested in additional facilities and processing equipment to enable the production of upgraded steel products.

Market Conditions in the Global Steel Market, 2021–2023

The global marketplace for steel was intensely price competitive and expected to remain so unless and until the estimated 750 million tons of excess steelmaking capacity across the world shrunk substantially and global demand for steel products rose sufficiently to more closely match global supply capabilities. Approximately 150 million tons of the world's excess steel-making capacity was in China, but there were sizable pockets of excess capacity in many other countries. Companies with excess production capacity were typically active in seeking to increase their exports of steel to foreign markets. Steel producers in some countries, particularly those in the European Union, Turkey, South Korea, and Canada, were both big exporters and big importers because domestic steel makers had more capacity to make certain types and grades of steel than was needed locally (and thus strove to export such products to other countries) but lacked sufficient domestic capability to produce certain types and grades of semifinished and finished steel products needed by domestic customers (which consequently had to be imported). In most countries of the world, the difference between steel exports and steel imports was a matter of a few million tons. But there were six countries that stood out as big *net* exporters of semifinished and finished steel products, of which China was by far the largest (Exhibit 9).

The major Chinese steelmakers, most of which were wholly or partly government-owned, had responded to the burden of having large amounts of unused capacity by aggressively seeking out buyers for their products in other countries and securing orders by offering prices that significantly undercut the prices of local steel makers and enabled the Chinese sellers to steal away sales and market share. The low prices offered by Chinese steelmakers were partly enabled by Chinese currency devaluations initiated by the Chinese government and partly enabled by subsidies and other financial assistance the Chinese government provided to domestic steelmakers. The success of Chinese steelmakers in capturing the business of foreign buyers resulted in total Chinese exports of semifinished and finished steel products of 102.4 million tons in 2014, 123.0 million tons

EXHIBIT 9 Major Net Exporters (Exports – Imports) of Semifinished and Finished Steel Products, By Country, 2015–2021 (in millions of metric tons)

Country	2015	2016	2017	2018	2019	2020	2021
China	98.4	94.5	60.9	54.4	48.3	13.5	38.4
Japan	34.9	34.5	31.2	29.8	26.7	24.8	28.3
Russia	25.4	26.7	24.9	27.0	22.7	26.4	27.6
India	—	—	—	—	4.4	12.1	14.5
Ukraine	16.9	17.1	13.8	13.5	14.0	13.9	14.4
South Korea	9.5	7.3	12.1	15.1	13.6	15.1	12.7
Brazil	10.5	11.5	13.0	11.6	11.0	8.7	6.6

Source: Worldsteel Association, *Steel Statistical Yearbook, 2017* and *World Steel in Figures, 2018, 2019, 2020, 2021*. Accessed at **www.worldsteel.org**, May 31, 2018, March 30, 2020, and May 9, 2023.

in 2015, 119.2 million tons in 2016, 86.4 million tons in 2017, 73.4 million tons in 2018, 63.8 million tons in 2019, 51.4 million tons in 2020, and 66.2 million tons in 2021.[21]

A flood of steel imports from China and certain other countries into the United States and many other countries across the world in 2015–2018, powered by price discounting on the part of the sellers, resulted in more than 130 antidumping tariffs and duties on Chinese steel producers (and Chinese manufacturers of aluminum and certain other metals as well) to protect their domestic steel companies from what they termed the unfair trade practices of Chinese producers to take sales away from domestic producers by selling at ultralow prices (typically enabled by subsidies from the Chinese government).[22] The average price of Chinese steel exports fell by about 50 percent between 2011 and 2016.

In 2016, the Chinese government agreed to pursue actions to reduce its domestic steel-making capacity by 150 million tons by 2020. But while some capacity reductions had occurred, Chinese producers began pursuing ways to escape the tariffs being imposed. One method was to sell steel to buyers in a country which had not been singled out for tariffs imposed by the United States and other countries; these buyers, participants in a Chinese-engineered scheme to disguise the origin of the Chinese-made steel products, in turn shipped the steel products tariff-free to buyers in the United States and other countries. China Zhongwang Holdings, China's largest producer of aluminum flat-rolled and extrusion products, used a different tariff-evading scheme. In 2016, China Zhongwang was discovered to have stockpiled more than 500,000 metric tons of aluminum products hidden under hay and tarpaulins in a Mexican desert just below the U.S. border, with alleged intentions of shipping them to the United States to avoid trade restrictions on Chinese exports of aluminum to the United States—provisions in the North American Free Trade Agreement allowed for aluminum products to be moved tariff-free from Mexico into the United States (reports and pictures of the stockpile in the media blew up the scheme).[23] In recent years, aluminum smelters in China had come to dominate the global aluminum market, reportedly supplying about half of the world's need for aluminum products in 2016–2017. Of the 23 aluminum smelters in operation in the United States in 2000, only 5 were still in operation in 2016, largely due to the fact that the Chinese manufacturers of aluminum products could use the subsidies they received from the Chinese government to undercut the prices of U.S. producers.

In 2018, the Trump administration announced 25 percent tariffs on certain steel and aluminum imports from China, the European Union, Canada, and Mexico. Within weeks, there were multiple media reports that, in an effort to escape these tariffs, various Chinese steelmakers had sold steel to Chinese brokers who then shipped the steel to buyers in various countries that were not confronted with tariffs on their steel exports to the United States and elsewhere; these buyers in turn promptly shipped the steel products to buyers in the United States. In 2017–2018, however, Chinese steel producers devised another way to skirt tariffs on steel. While they were shutting down some of their production in China, they had started aggressively expanding overseas, using tens of billions of dollars supplied by Chinese lenders owned by the Chinese government, to buy and build steel plants at locations around the world.[24] Already operational were plants with 3.85 million tons of capacity in Malaysia, 3.3 million tons in Indonesia, 2.4 million tons in Serbia, and 1.2 million tons in Zimbabwe. Under construction were plants with capacity of 6.6 million tons in Indonesia, 2.2 million tons in India, and 0.55-million tons in Texas. In 2022, Chinese steelmaking companies had a plant under construction in Malaysia with 10-million tons of capacity expected to come on line in 2024, a plant under construction in the Philippines with 3.5-million tons of capacity expected to come on line in 2026, an EAF plant in the Philippines with 500,000 tons of capacity expected to begin production 2024, and a plant in Pakistan under construction with 500,000-tons of capacity.[25] In addition, Chinese companies had announced plans to construct nearly 26-million more tons of steelmaking capacity in Egypt, Zimbabwe, Indonesia, Cambodia, Myanmar, Malaysia, the Philippines, and Vietnam.[26]

The steel plant in Serbia, owned and operated by a recently renamed Chinese company called the Hesteel Group, had begun selling wide hot-rolled steel coil to U.S. buyers through Duferco, a Swiss trading company that was 51 percent owned by Hesteel.[27] This same plant was also reportedly exporting tariff-free steel products into the 27-nation European Union. A new 2.2-million ton steel plant built on the Indonesian island of Sulawesi by Tsingshan Group

Holdings (that was funded by a $570 million loan from the government-backed China Development Bank) accounted for 4 percent of the world's stainless-steel production and had exported 300,000 metric tons to the United States through a joint venture with Pittsburgh-based stainless-steel producer Allegheny Technologies.[28]

Exhibit 10 shows the volumes of U.S. imports and exports of semi-finished and finished steel products for 2005–2021. The column showing "apparent domestic use of finished steel products" is obtained by adding up deliveries (defined as what comes out of the facility gates of domestic steel producers) minus exports of steel products plus imports of steel products; as such, it is a good approximation of total domestic consumption of steel products and is a commonly used metric in the steel industry. The last column shows the percentage of domestic steel use supplied by foreign steel producers.

NUCOR AND COMPETITION IN THE U.S. MARKET FOR STEEL

Nucor's broad product line-up meant that it was an active participant in the U.S. markets for a wide variety of unfinished and finished steel products, plus the markets for scrap steel and scrap substitutes. Nucor executives considered all the market segments and product categories in which it competed to be intensely competitive, many of which were populated with both domestic and foreign rivals. For the most part, competition for steel mill products and finished steel products was centered on price and the ability to meet customer delivery requirements. And, due to global overcapacity, many of the world's steelmakers in 2019–2023 were actively seeking new business in whatever geographic markets they could find willing buyers.

EXHIBIT 10 U.S. Exports and Imports of Semi-Finished and Finished Steel Products, 2005–2021 (in millions of metric tons)

Year	U.S. Exports	U.S. Imports	Net Imports (Exports – Imports)	Apparent Domestic Use of Finished Steel Products	U.S. Imports as a Percent of Domestic Apparent Use
2005	9.4	30.2	20.8	110.3	27.4%
2006	9.6	42.2	32.6	122.4	34.5
2007	9.8	27.7	17.9	111.2	24.9
2008	12.0	24.6	12.6	101.1	24.3
2009	9.2	15.3	6.1	59.3	25.8
2010	11.8	22.5	10.7	115.8	19.4
2011	13.3	26.6	13.3	89.2	29.8
2012	13.6	30.9	17.3	96.2	32.1
2013	12.5	29.8	17.3	95.7	31.1
2014	12.0	41.4	29.4	107.0	38.7
2015	10.0	36.5	26.5	96.1	38.0
2016	9.2	30.9	21.7	91.9	33.6
2017	10.2	35.4	25.2	97.7	36.2
2018	8.6	31.7	23.1	99.8	31.6
2019	7.3	27.1	19.8	97.6	27.8
2020	6.3	19.9	13.6	80.0	24.9
2021	8.2	29.7	21.5	97.1	30.6

Source: Worldsteel Association, *Steel Statistical Yearbook, 2017* and *World Steel in Figures, 2018, 2019, 2020, 2021* accessed at **www.worldsteel.org**, May 31, 2018 and May 9, 2023; and Worldsteel Association, *Steel Statistical Yearbook, 2010, accessed at* **www.steel-on-the-net.com**, May 31, 2018.

In 2020, with Section 232 tariffs (implemented in 2018) adding a 25 percent tariff on most steel imports from outside North America coupled with the adverse impacts of the COVID-19 pandemic on the steel industry globally and in the United States, net imports of semifinished and finished steel in the United States decreased by approximately 11.6 million tons (46.0 percent) from the levels of 2017. As a result, import penetration in the United States fell from 23.1 percent in 2018 to 13.6 percent in 2020—see Exhibit 10. Relative to other regions, imports from Canada and Mexico decreased by only approximately 15 percent in 2019 as Section 232 tariffs only applied until May 2019. Steel imports from such countries as Brazil, Ukraine, Australia, and South Korea, though not subject to 25 percent tariffs, were subject to quotas. However, a strong economic recovery in the steel industry across most of the world in 2021 enabled steel imports into the United States to increase 9.8 million tons and capture a 30.6 percent market share. In its 2022 annual report, Nucor stated that steel imports in the United States rose 11 percent in 2022 and accounted for a 24 percent share of the market for semifinished and finished steel products in the United States.[29] Furthermore, in December 2022, the World Trade Organization (WTO) ruled that the Section 232 tariffs imposed by the United States in 2018 violated earlier commitments the United States had made to the WTO regarding the imposition of tariffs aimed at protecting domestic steel producers from foreign competitive rivals charging lower prices.

Many foreign steel producers had costs on a par with or sometimes below those of Nucor, although their competitiveness in the U.S. market varied significantly according to the prevailing strength of their local currencies versus the U.S. dollar, the extent to which they received government subsidies, and prevailing tariffs and trade restrictions.

Nucor's Two Largest Domestic Competitors

Consolidation of both the global and domestic steel industries into a smaller number of larger and more efficient steel producers had heightened competitive pressures for Nucor and most other steelmakers. Nucor had many steelmaking rivals in the United States, but two of the most important were Cleveland-Cliffs and Steel Dynamics.

Cleveland-Cliffs In 2023, Cleveland-Cliffs was the largest flat-rolled steel producer in North America and the biggest supplier of steel to the North American automotive industry. In addition, it was the largest producer of direct reduced iron and iron ore pellets in North America and as of 2020 was the sole producer of hot briquetted iron in the Great Lakes region. The company was fully integrated from iron ore pellets, direct reduced iron, and ferrous scrap to primary steelmaking and the manufacture of assorted finished steel products.

Cleveland-Cliffs made two transformational acquisitions in 2020: AK Steel and ArcelorMittal USA. AK Steel operated five steel plants that made flat-rolled carbon steel, stainless steel, and electrical steel products and two plants that made finished tube steel products, plus it had a newly constructed facility ready to begin producing pig iron. (Pig iron was formed by smelting iron ore in a blast furnace and was used in making steel, wrought iron, and cast iron.) In 2019 AK Steel had total revenues of $6.4 billion, and it shipped 5.34 million tons of flat-rolled products at an average price of $1,078 per ton. The acquisition of ArcelorMittal USA provided Cleveland-Cliffs with six steelmaking facilities, eight facilities making finished steel products, two iron ore mining and pelletizing operations, and three coal and coke making operations. Prior to these two acquisitions, Cleveland-Cliffs was primarily an iron ore mining company (with four iron ore mines) and an operator of two plants that produced low-cost, high-quality iron ore pellets which were sold to blast furnace steel producers in the Great Lakes region. In late 2021, Cleveland-Cliffs acquired Detroit-based Ferrous Processing and Trading Co., which processed about 3 million tons of ferrous scrap annually, about half of which was prime grade. The purpose of the $775 million acquisition was to secure a reliable supply of scrap for the company's three EAF steel mills in Pennsylvania and 2 EAF steel mills in Ohio.

In 2023, Cleveland-Cliffs' primary steel-producing and finishing facilities were located in Illinois, Indiana, Michigan, Ohio, Pennsylvania, and West Virginia. It operated seven blast furnaces and 5 EAFs with combined capability to produce approximately 20.5 million tons of raw crude steel annually. Its raw crude steel output was generally cast into slabs and then flat rolled into finished steel products to meet customer specifications. Finishing was completed on site at either one of its integrated steel mill facilities or at one of its standalone finishing facilities. Ferrous raw materials for the production of steel were internally sourced from the company's iron ore mines in Michigan and Minnesota, its direct reduction iron plant in Ohio, and its scrap facilities in Florida, Michigan, Ohio, Ontario, and Tennessee. The company also operated a coal mining complex in West Virginia and produced coke at its facilities in Ohio, Pennsylvania, and Indiana.

Immediately following the two acquisitions Cleveland-Cliffs devoted significant resources to upgrade and maintain its facilities and equipment up to the standard required to be viewed by automotive and other demanding end-use customers as a reliable supplier of high-quality steel products tailored to their specific requirements.[30] It also devoted considerable efforts to developing unmatched customer service capabilities and the operational and technological infrastructure to meet demanding customer needs and specifications. Because the company's steel facilities used internally supplied iron ore pellets that were top quality to produce its flat-rolled products at its steel mills with blast furnaces, its products typically contained fewer residual copper or other metallic impurities (2 percent or less) compared to flat-rolled products made from steel scrap which typically had residual metallic impurities of about 4 percent.[31] Low residual metallics were necessary for automotive exposed panels. In 2022, 64 percent of the company's revenues came from the sale of flat-rolled products.

The company's top executives believed that Cleveland-Cliffs' primary competitive strength was its ability to supply automakers with a widely diversified range of high quality automotive-grade flat-rolled steel products. The company's broad range of product offerings was deemed to be a competitive advantage in contract negotiations because automakers could source the majority, if not all, of their steel product needs from Cleveland-Cliffs. Another competitive strength was being fully or partially self-sufficient with its production of raw materials (iron ore pellets, hot briquetted iron, scrap steel, and coking coal) for steel manufacturing; the company did, however, source some of its pig iron needs from Russia and Ukraine. Pig iron was used by the company's flat-rolling facilities at its 5 steel mills with electric arc furnaces.

Selected financial and operating data for Cleveland-Cliffs for 2020–2022 is shown in Exhibit 11.

EXHIBIT 11 Selected Financial and Operating Data for Cleveland-Cliffs, 2020–2022

Financial data (in millions of dollars)	2020	2021	2022
Total revenue	$5,354	$20,444	$22,989
Cost of goods sold	5,102	15,910	20,471
Selling, general ,and administrative expenses	244	422	465
Total operating costs	5,496	16,432	21,050
Interest expense, net	238	337	276
Net income (loss)	(81)	3,033	1,376
Long-term debt	5,390	5,238	4,249
Cash flows from operations	(258)	2,785	2,423
Capital additions	525	705	943
Operating data			
Total steel shipments (000s of tons)	4,965	15,686	14,751
Hot-rolled steel (000s of tons)	633	4,886	4,326
Cold-rolled steel (000s of tons)	682	2,790	2,286
Coated steel (000s of tons)	1,911	5,056	4,730
Stainless and electrical steel (000s of tons)	416	674	763
Plate (000s of tons)	62	1,020	880
Slab and other steel products (000s of tons)	79	1,460	1,766
Average selling price per ton	$947	$1,187	$1,360

Steel Dynamics Steel Dynamics was the fourth largest domestic steel producer and metals recycler in the United States with 16-million tons of steelmaking capacity and metals recycling capability.[32] It had five EAF steel mills with the capacity to ship 11.4 million tons of flat-rolled steel products; all five mills had galvanizing lines (with combined annual galvanizing capacity of 4.7 million tons) and three had paint lines (with painting capability of 1.5 million tons annually), enabling to company to supply coated sheet steel products as well as hot-roll and cold-roll sheet steel products. In addition, the company had four facilities with the capability to ship 2.2 million tons of structural steel beams/shapes and rail products; 950,000 tons of engineered special bar quality steel; 720,000 tons of merchant bar and reinforcing bar products; and 580,000 tons of specialty steel sections, steel joist, and steel deck.[33] In 2022, the company's mills that used steel to make finished steel products purchased 1.7 million tons of steel from the company's steel mills (equal to 14 percent of the company's 2022 steel shipments).

Steel Dynamics also produced liquid pig iron and processed and sold ferrous scrap, copper scrap, and aluminum scrap. In 2022, the company reused about 270 million pounds of scrap aluminum and 150 million pounds of scrap copper to make certified aluminum alloys, copper rod, and copper wire.[34] In 2023, Steel Dynamics was in the process of ramping up production at a new state-of-the-art 3 million-ton flat-roll steel mill in Texas that had a 300,000-ton galvanizing line and a 240,000-ton paint line; a second 300,000-ton galvanizing line and 240,000-ton paint line were being constructed at a site in Indiana. It was also investing $2.5 billion to construct a mill in Columbus, Mississippi, to produce flat-rolled aluminum out of recycled aluminum provided by two recycled aluminum slab centers—one in northern Mexico (to start production in 2024) and one at a location in the Southwestern United States (to start production in 2025). The 650,000-ton flat rolled aluminum mill was scheduled to begin production in the first half of 2025. A large percentage of the company's steel customers also used flat rolled aluminum products for automotive, appliance, construction, and other applications.

Like Nucor, Steel Dynamics was an industry leader in sustainability, operating exclusively with electric arc technology and putting top priority on implementing carbon reduction operating practices.[35] Energy usage at its steel mills was 77 percent less than worldwide averages.

Top executives at Steel Dynamics believed the company had a strongly embedded entrepreneurial culture that fostered a team of energetic, innovative, and driven individuals. The company also used performance-based compensation aligned with the company's performance targets and strategic focus. Over 60 percent of a production team member's total potential compensation was "at risk" to both quality production and cost effectiveness metrics. A profit-sharing plan and stock awards plan were also very important parts of the company's incentive compensation system. Steel Dynamics had been named to *Fortune*'s list of the World's Most Admired Companies for six straight years—2018–2023.

Selected financial data for Steel Dynamics is summarized in Exhibit 12.

EXHIBIT 12 Selected Financial Data for Steel Dynamics, 2018–2022 (in millions of dollars except per share amounts)

Selected Financial Data	2018	2019	2020	2021	2022
Net sales	$11,822	$10,465	$9,601	$18,409	$22,261
Selling, general, and administrative expenses	417	436	477	644	546
Profit sharing	156	78	62	388	453
Operating income	1,722	987	847	4,301	5,092
Net interest expense	104	99	85	56	62
Net income attributable to Steel Dynamics	1,258	671	551	3,214	3,863
Net income per diluted share	5.35	3.03	2.59	15.56	20.92
Cash flows from operations	1,415	1,396	987	2,204	4,460
Net debt (long-term debt including current portion less cash and short-term investments	1,320	1,091	1,790	1,912	857
Capital expenditures	239	452	1,198	1,006	909
Tons of steel shipped (in 000s)					
Flat-rolled sheet steel products	6,206	6,140	5,890	5,869	6,771
Structural and rail products	1,630	1,469	1,664	1,933	1,865
Engineered steel bar products	827	650	631	810	894
Merchant steel bar products	560	529	505	596	589
Fabricated steel products	316	359	328	356	364

Source: Company Annual Reports for 2019, 2020, and 2022.

ENDNOTES

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CASE 25

Vail Resorts, Inc. in 2023

Herman L. Boschken
San Jose State University

Vail Resorts (VR) celebrated its 60th anniversary season in 2022 and had achieved an esteemed reputation and commanding presence in the North American winter resort industry. But, in some ways, the company was approaching a crossroads in both strategy and context. Unlike the earlier years when linear growth pursuits were the norm, VR was facing new and more difficult choices, many posing significant conflicts in resort activities and tradeoffs in corporate strategic direction.

Vail Resorts was also facing some difficult industry and environmental challenges that had been evolving for several years. The most significant of these included and aging U.S. population leading to decreased demand for skiing and a growing number of injuries on the slopes originating from the recklessness of some snowboarders. In addition, industry rivals were upping the ante by bringing forth stunning new designs and making vast new investments in on-mountain and village facilities. Several consolidations and mergers had reduced the field of large multiresort providers to the Big Four—Vail Resorts, Aspen Skiing Company (SKICO), Alterra, and POWDR. Also of concern were climate effects on production and maintenance of resort ski operations, as well as feeding longer term variability and uncertainty in skier expectations.

Going into the 2023–2024 ski season, Vail Resorts would continue to focus on the implementation of its strategy to best sustain its position in the North American winter resort industry.

VAIL RESORTS' FAMILY OF WINTER RESORTS

VR's family of winter resorts includes (a) 10 North American year-round destination facilities, (b) 24 regional "urban" winter resorts located near major U.S. cities, which combine to form a feeder system for customer visits to its more remote destination resorts, and (c) a growing list of global destination resorts located in Australia and Switzerland. Locations of the facilities are shown in Exhibit 1.

The firm's North American destination resorts included combinations of owned properties (mostly in the villages) and long-term leases from both the U.S. Forest Service and private landowners for the mountain ski terrain. All these sites included centrally located retail and commercial structures contained in "ski-in ski-out" villages, embossed with quaint hotels and hotel/convention centers, some golf courses, and other unique entertainment facilities. Each resort was different in theme and atmosphere, but all ascribe to Vail Resorts' reputation for quality service, all-season excellence, and trademark in providing a unique upscale experience to discerning vacationers.

The firm's marquis resort was Vail, known by its slogan: "Like Nowhere Else on Earth." The resort

EXHIBIT 1 Vail Resorts' Family of Ski Resorts

Region	Resort
Pacific Northwest	Whistler Blackcom
	Stevens Pass
Tahoe	Heavenly
	Northstar
	Kirkwood
Rockies	Park City
	Crested Butte
	Beaver Creek
	Vail
	Breckenridge
	Keystone
Northeast	Stowe
	Attitash
	Wildcat
	Mount Sunapee
	Croched Mountain
	Okemo
	Mount Snow
	Hunter Mountain
Mid-Atlantic	Jack Frost
	Big Boulder
	Roundtop
	Whitetail
	Liberty Mountain
Midwest	Alpine Valley
	Brandywine
	Boston Mills
	Mad River Mountain
	Mt. Brighton
	Paoli Peaks
	Wilmot
	Hidden Valley
	Afton Alps
	Snow Creek
Australia	Perisher
	Falls Creek
	Hotham

Source: Vail Resorts, Inc., 2021 10-K Report was among the three largest single-site ski resorts in North America. With major design facelifts over the years, its village nevertheless retains the appearance and ambiance of a traditional European alpine setting. Paralleling the interstate, the resort provides all the conveniences of a large rural town. It had two primary pedestrian-only village centers, connected to each other and the town's outer areas (some of which are four miles up or down the freeway) by a complimentary bus system.

The town of Vail boasted accommodations for over 30,000 people and contains over 100 restaurants and bars, 225 shops and markets, two skating arenas, outdoor amphitheater, a PGA golf course, regional hospital, transportation center, schools, and a library. It was the primary or second home to professionals and executives from numerous blue-chip companies, high-tech firms, and Wall Street investment houses, most representing the "movers and shakers" of globalization. As a group, this clientele prefers anonymity outside of their professional careers and had chosen Vail because of the resort's relaxed but discrete atmosphere.

The resort had developed over 5,000 skiable acres within its permitted 12,500-acre terrain. Skiing was provided on both sides of a seven-mile ridge paralleling its villages, and in an adjacent back-bowl called Blue Ski Basin. Vertical drop (a measure of terrain steepness and ski-run length) was 3,450 feet and the longest run was 4.5 miles.

Ten miles west of Vail and located three miles off the interstate was the firm's smaller but most upscale Colorado resort, Beaver Creek. The resort actually contains three separate villages at different points along the base of the mountain. Originally conceived as Colorado's location for the 1976 Olympics (which was aborted by a state referendum), the core village opened in 1980 as a state-of-the-art CAD-designed facility with European alpine elegance and environmental sophistication tucked into a tiny valley and meadow.

With emphasis on exclusivity, first-class accommodations, and "family friendliness," the resort sports over 25 restaurants, 70 shops, an outdoor ice-skating arena, the Hyatt Regency and Conference Center, the Vilar Performing Arts Center, a Ritz-Carlton, and overnight capacity for 6,000 people (more accommodations are available in the town of Avon, about three miles down mountain from Beaver Creek). On the mountain, Beaver Creek provides 1,800 acres of skiable terrain with exceptional variety for families having different levels of skiing ability. Its "Birds of Prey" downhill course was recognized by World-Cup skiers as the most challenging in North America. Its 250-acre McCoy Park offers gentle-sloping terrain, dedicated exclusively to beginner and low-intermediate skiers.

Located off I-70, about an hour east of Vail and Beaver Creek along the Continental Divide, are VR's other two Colorado destination facilities. Opening as a ski resort in 1961, the largest of these was Breckenridge, consisting of a vast range of treeless peaks anchored by a historical western mining town. Although slightly rebranded to fit VR's multigenerational family clientele, this resort community's reputation had emphasized the youthful exuberance of singles and couples seeking an active social life. As a consequence, it had more bars (totaling over 50) but fewer restaurants than Vail and over 100 shops. In addition, the town had a performing-arts theater, museums, a golf course, and a large convention center. It had overnight accommodations for 25,000 people.

The clientele of this historically preserved year-around resort often cites the unique "sense of place and fabled Main Street experience" as a prime reason for coming. Added to the town's ambiance was a new "second" village completed in 2010 and situated on the mountain above the town. It was connected to the town by an enclosed gondola. Free buses also circulate throughout the resort. The resort's mountain contains 2,358 acres of skiable terrain and caters to all levels of skier proficiency at many of Colorado's highest elevations.

VR's fourth all-season destination resort in Colorado was Keystone. Like Beaver Creek in origin and family focus, its off-mountain village facilities were crafted along meadowland as a free-standing planned unit development. Opened in 1970, the resort had steadily expanded over the years but had acquired a reputation for putting guests close to nature. Its trademark, "Nature of the Rockies," indicates more rustic facilities and accommodations than VR's other destination resorts. It contains two villages—the original Keystone Village and the newer River Run surrounded by residential areas containing homes and condominiums.

The resort had accommodations for about 5,000 people and includes about 50 shops and restaurants, a convention center for 1,800 people, and a PGA golf course. Additional housing and amenities are located about two miles away in the town of Dillon. With 3,148 acres of skiable terrain, Keystone developed its ski mountain with an emphasis on intermediate skiers but provided skier access to very steep terrain at an adjacent ski area not owned by VR, called Arapahoe Basin.

THE WINTER RESORT INDUSTRY

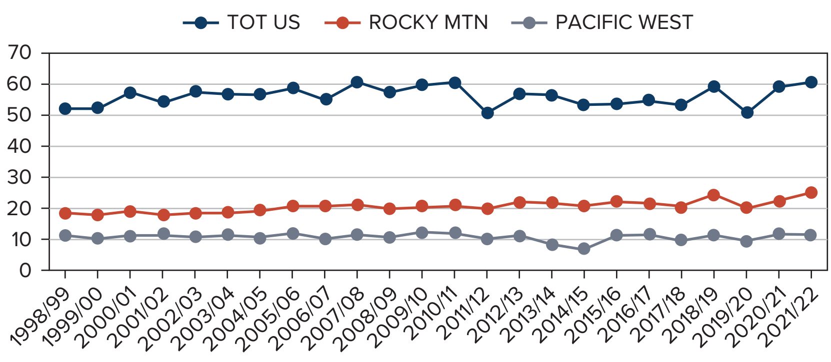
With an emphasis on skiing and mountain recreation, Vail Resorts operates its core business primarily in the "destination" segment of the recreation-resort industry. As part of the sprawling leisure, recreation and entertainment industry (i.e., NAICS 71 and 72, esp. 713, and 721), this destination segment was itself an agglomeration of subparts having no exact boundaries. According to the U.S. Department of Commerce, recreation resorts also overlap other related industries composed of such segments as amusement parks (e.g., Disney), gaming (e.g., Harrah's Entertainment), cruises (e.g., Carnival/ Princess Cruise Lines), and sporting events (e.g., the NFL and NBA). In this ill-defined setting, competition therefore includes a vast assemblage of directly competing and partially substitutable products and services. Moreover, with loosely segmented markets, strategic opportunities tend to be more elusive and potentially conflicting in that they consist of different but partially overlapping customer profiles and product-market relationships.

Nevertheless, unlike most of the other overlapping segments of leisure, recreation and entertainment, the ski resort industry segment (esp. NAICS 721110 and 713920) had faced strong headwinds. As reflected in Exhibit 2, the long-term trend in customer demand, as measured by U.S. skier/ snowboarder visits per day, had been persistently flat for more than two decades. Within regions where VR had destination facilities, the trends mostly reflect the flattening nationwide demand. Even During the initial two years of the COVID pandemic, demand varied downward temporarily and then recovered by 2022 to its long-term flat demand levels.

Traditionally, customers in the destination recreational-resort industry (of which skiing was but one subtype) have been distinguished in the population by income, age, and family status (i.e., married/ unmarried, with/without children). These factors often differentiated people inclined toward large scale or mass recreational services coupled with lesser expensive accommodations (like the destination profile of Disney World) from people seeking a more exclusive and intimate resort setting featuring high-value or high-status vacation venues (like those provided by VR's destination resorts).

In the case of destination ski resorts, a greater variety of demographic factors was weighing-in as determinants of customer demand during the first two decades of the 21st century. In addition to traditional ones mentioned above, more recent factors included age distribution (generational dynamics), education level attained (i.e., college degree vs. nondegree), occupational status (i.e., professional/

EXHIBIT 2 Annual U.S. Skier/Snowboarder Visits, 1997–2022 (in millions)



Data Source: National Ski Areas Association, Vail Resorts managerial employment vs. blue-collar/clerical jobs), lifestyle and other psychographic characteristics (e.g., cosmopolitan versus parochial awareness), and family makeup (i.e., singles/couples versus families).

In the instance of age distribution, the effects of generational evolution pose especially difficult strategic questions going forward. Historically, skiing demand and age have been correlated, with peak skiing interest occurring among people between 18 and 45. Hence, an aging population of post-war Baby Boomers (now mostly in their mid-60s) and late middle-age Gen Xers were thought to be a primary cause of the industry's maturing demand. However, a secondary cause can also be attributed to less physically active and less financially secure Millennials (ages 27 to 42 in 2023), who are currently the natural replacement stock for today's aging skier population. As an age group, it may be too early to predict the impact of Gen Z.

Skiing is a rigorous and potentially dangerous outdoor recreational activity and requires physical stamina and a dose of youthful abandon. As baby boomers move into their senior years and family responsibilities become more important in determining types of vacation venues, skiing's reputation as an expensive, singles-oriented and physically demanding sport may be coming up short when matching it with future demand profiles. Many former skiers and the like have been moving to other segments of the vacation and leisure industry where less physical activity was required.

Competition Among Winter Resorts in North America

In 2023, there were about 760 ski areas in North America of which 462 were located in the U.S. Most were small day-use "windshield" operations located near metropolitan areas. The rest, fewer than 30, could be classified as destination resorts. In combined industry figures (both windshield and destination) for the 2021–22 season, the United States had 60.7 million skier visits, and for all of North America, the total was 80.0 million. VR's share of these totals was 25.3 percent and 19.5 percent, respectively.

Looking forward, interaction among industry rivals (especially in contriving new winter experiences and imagining new customer profiles), was likely to intensify competition and keep the winter resort industry in flux. Indeed, by the mid-2000s, the structure of competition already had been changing in dramatic ways. For example, a shift had taken place from a market environment ruled by year-over-year growth in skier demand and positive-sum behavior among industry competitors, to one dominated by flat demand, zero-sum gaming, and strategic alliances pertaining to jointly-sponsored ski-lift passes, which in 2022, was extended to several European partnerships.

While competitors continued to devise programs to grow the overall-industry skier population, most recognized their dependency on such tactics described by VR as "attracting skiers away from other ski resorts, fending off competitors offering non-ski alternatives, generating loyalty incentives to attract more revenue per skier-visits, or encouraging more visits from each skier." This zero-sum mindset created what VR's president called an "arms race" among firms in developing on-mountain facilities, new village venues, social-media technologies, and skier incentive programs.

Adding to these factors was an evolving bifurcation of ski industry players, partly as a result of maturing demand. For those with limited access to capital, developing off-mountain amenities and overnight accommodations was sacrificed to favor on-mountain infrastructure development, such as high-speed chair lifts, enclosed gondolas and snowmaking equipment. As a result, most of these "old school" players became distinguished as "windshield" resorts, principally providing day-use ski slopes with few on-site accommodations, and usually requiring a same-day round-trip drive from an urban home.

For resorts with deep pockets, like VR, investment in new elegant European-style villages with "ski-in ski-out" access transformed their sites to "destination resorts," providing a complete recreation and entertainment experience, including upscale accommodations and "apre-skiing" activities for people who typically fly in to stay a week or longer. Extending upon this distinction, most of the better-financed destination resorts also had been shifting since the 2010s from a ski-resort image to an integrated "all-season" setting, featuring winter recreation as well as golf and tennis, on-mountain summer activities, convention venues, world-class performing arts, and international festivals.

The latest entry in this new 21st century approach had been Palisades (formerly Squaw Valley/Alpine), which in 2011 was sold to KSL

Partners (owned in part by former VR executives). With a well-publicized "retro-fit" strategy designed to join the "world class" destination market, KSL subsequently formed a joint venture with Aspen's SKICO to create a new firm called Alterra. By late 2016, the resort had received final government approvals for a massive $1 billion redevelopment with a 25-year build-out horizon. Focus of the makeover was on (1) connecting the previously separate resorts with a high-speed aerial tram, completed in 2022 and (2) a village expansion from 15 acres currently to over 100 acres, with visions of many new accommodations and entertainment venues. Phase 1 of the new Palisades was opened during the 2022–2023 ski season.

In contrast to windshield resorts which are ubiquitous across North America and make up most of the ski industry in site numbers and skier visits, the destination ski industry was more geographically confined to four "production" areas. These included the Rocky Mountains (Colorado, Utah, Idaho, and Montana), the California Sierras, southern Canada, and New England (especially Vermont and Maine). With destination resorts having the most market reach demographically and geographically, the Rockies claim to be the location of the best known and most visited because of its central and scenic locations, situated between population corridors on the east and west coasts.

Within the Rocky Mountain region, Vail Resorts held a 32.3 percent market share of the 25.3 million skier visits (combined destination and windshield) in the 2021–22 ski season. In the Colorado subset, VR accumulated more than a 50 percent share of the destination skier market, competing with the Aspen Ski Company (aka SKICO, which owned the Aspen-3 mountains and Snowmass, all proximally located in the Roaring Forks Valley), Alterra (which owned Steamboat and managed Winter Park), POWDR (which owned Copper), and several smaller destination operators, such as Telluride Golf & Ski. In the Utah subset, VR held the vast majority of the destination market with its Park City/Canons complex.

Beyond Colorado, the "big four" destination-resort firms held widely distributed operations, with most located in the Rockies, Pacific Northwest, the California Sierras, Northeastern U.S., and in Southern Canada (mostly Quebec and British Columbia). On the Pacific Coast, ski resorts draw fewer out-of-state destination visitors than Colorado, and industry competition tended to include smaller single-resort operators. Vail Resorts was the largest player on the Pacific, holding 25.4 percent of the region's 11.6 million skier visits, but more than 60 percent of its destination visits in the 2021–22 season. Direct competitors in the California destination ski resort market included Palisades Tahoe and Mammoth Mountain (both owned by Alterra).

The current market structure of destination ski-resort competitors came about in the years between 2005 and 2020, when a rash of consolidations and mergers reduced the field to a new "big four" (VR, Alterra, SKICO, and POWDR) and a few small specialized firms. Due to mismanagement and overspending on development projects during the first decade of the 2000s, one firm (American Ski) was reduced to a small player, another (Intrawest) was forced into bankruptcy and subsequently acquired by Alterra, and another previously smaller firm (POWDR Corp) entered the "Big 4" elite standing. POWDR subsequently lost its major assets in Park City to VR, leaving the industry's market power mostly to VR and newcomer Alterra (the SKICO/KSL joint venture). With few exceptions, other firms that remain outside the big-four are operators of day-use windshield resorts, which have lower capital costs and offer few off-mountain amenities, activities and accommodations. Exceptions to this included destination providers Sinclair Oil (Sun Valley, Idaho) and Telluride Ski and Golf.

Consolidation and Increasing Rivalry in the Winter Resorts Industry

During this period of industry consolidation, the technology-driven "arms race" in new capital-vintensive development sharpened the destination focus on such areas as (1) thematically planned villages at the ski-mountain base, (2) costly snowmaking equipment to guarantee visitors a quality skiing experience regardless of the vagaries of natural precipitation, (3) luxurious on-mountain restaurants to meet the cosmopolitan tastes of "high-end" skiers, and (4) mountaintop nonski recreation parks for tubing, ski biking, and other variant outdoor recreational activities.

However, even with these significant arms-race investments, the skier destination segment was not experiencing a corresponding response from the demand side of the market. Indeed, most of the big-four firms (and smaller ones as well) were showing continuing decline and further pressure to consolidate. In the case of VR, the flat market conditions would also have likely stunted its growth potential had it not been for the firm's acquisitions and promotion programs, especially its EPIC program. Indeed, the VR threat of preeminence in this period of stagnating demand and intensified rivalry led Alterra to introduce IKON to mimic the enlarged product-line image of VR's EPIC.

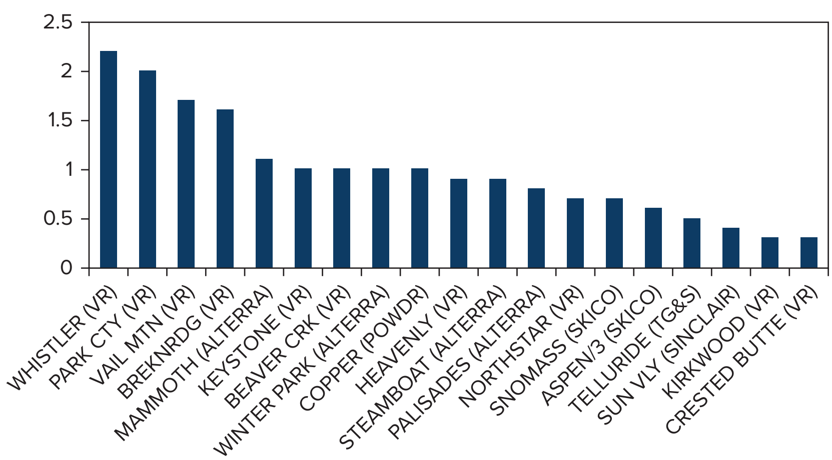
Moreover, destination-resort visitors were becoming choosier about the price-to-value of individual resorts. It had become clear that most destination visitors sought additional "creature comforts" both on and off the mountain, and were willing to pay for exceptional luxury where quality was assured. VR's industry leadership in moving toward this high-end market was reflected in Exhibit 3, which compares a selection of destination-resorts according to each resort's annual skier visits during the 2021–2022 ski season (calculated as one skier or snowboarder purchasing a lift ticket for one day). Consistent with this data, most of VR's resorts have ranked for many years in the industry's top 10 by annual ski magazine surveys. Upon the firm's acquisitions in 2017 of Park City and then of Whistler, VR solidified its position in holding the three most popular destination ski resorts in North America.

To a great extent, the firm's persistent market dominance was attributable to the fact that VR was the only firm in the industry able to achieve a "cooperative" administrative control over all aspects of its destination resort context (i.e., mountain activities, local accommodations, village concessions, entertainment venues, airline and ground transportation), even though much of it was owned or managed by a host of other firms acting as an integrated network of "co-producers." As a result of its management of these multiple-partner strategic alliances, VR stands out among its competition in creating a superbly-packaged seamless destination product for the customer. Increasingly, its peripheral feeder system of urban resorts was adding value as well to the EPIC whole.

In addition to its domestic-market skiers, Vail Resorts was also looking to global markets as an important source of new growth. Although 80 percent of the world's skiers live outside the United States (mainly in Canada, Europe, Oceania, Japan, parts of South America, and increasingly China), the firm's customer mix typically includes only about 12 percent foreign visitors. Since the turn of the century, VR pursued an ongoing but as yet unfulfilled goal of raising that figure to 15 percent.

The firm's global reach was marked by three of its resorts hosting past Winter Olympics.

EXHIBIT 3 Most Visited Destination Ski Resorts in North America, 2021–2022 Season (Annual Skier/Snowboarder Visits, in millions)



Data Source: National Ski Areas Association, Individual Resorts.

Augmenting this world status, it maintains an aggressive international marketing program. In part, VR expedites this program by annually hosting one or more of the several World Cup ski events held throughout the world. In addition, it had managed to acquire the rights about once a decade as the exclusive host of the World Ski Championships, which culminates the World Cup series every two years and was the worldwide equivalent to football's Super Bowl. Most recently, VR hosted the 2016 Championships at Vail and Beaver Creek, and followed this event with a worldwide "prestige and promotion" campaign promoting its North American destination resorts. Going forward, growth potential in international demand may come more from Asia (especially China) than from its historical draw in the Western Hemisphere.

The effort to promote its global markets, however, was partially blunted by continuing terrorist concerns worldwide and subsequent stringent security measures following September 11, 2001. The rise of global terrorism served not only to create resistance from a foreign market but also to cause a restructuring of destination ski-resort competition. In addition, the more recent COVID pandemic terrorism and gun violence added uncertainties to international travel and further resistance to intercontinental jaunts. The long-term outlook for a worldwide market demand remains unclear, partially due to these factors but also due to employment-based service disruptions, continually fluctuating foreign exchange rates, and persistent "nationalist" issues in a nascent global economy.

In addition to the industry characteristics described above, the ski resort business also had become more complex due to a growing environmental ethic among recreation and leisure customers concerned about biodiversity and ecological sustainability. Since landmark legislation in the 1970s, environmental awareness had not only become institutionalized (by the inception of new laws, organizations and processes), but also acquired much broader appeal culturally, especially among younger people. The impact of respectability for environmental sustainability was especially felt by firms dealing with or affecting natural resources, a prime example of which are ski-resort operators.

Much of the public's awareness of a human-altered and degraded environment came from individual experiences and personal knowledge of losses in biodiversity, growing pollution and threats of global warming. But some attention was also heightened by protests made directly against targeted firms, some involving "eco-terrorism." Most in the industry have been the subject of environmental litigation, varying degrees of non-violent demonstrations and media attention.

VAIL RESORTS' STRATEGY AND PERFORMANCE

Vail Resorts' mission recognized the linkage between employees and the guest experience and stated "Our mission is simple—to create the experience of a lifetime for our employees, so they can, in turn, provide exceptional experiences for our guests. Along with this declaration, five policy guidelines drove the firm's strategic-action agenda:

1. Create new attractions to enhance consumer appeal.
2. Broaden VR's participation in varied guest experiences (produce more services previously provided by co-producers).
3. Provide value through our passion for quality.
4. Leverage our strong market position.
5. Capitalize on industry consolidation opportunities.

Nearly all of these alluded to a need for new ways to improve integration of resort services and a development strategy involving significant on-mountain expansion and new venturing in the firm's destination ski-in/ski-out villages. Succeeding Aron in 2006, CEO Katz continued to reaffirm and embellish this action agenda. Indeed, much of this agenda remains intact going into the 2020s.

Financial performance

Vail Resorts was a mid-size corporation with $6.3 billion in assets and annual revenues of $2.5 billion in 2022—see Exhibit 4. The firm reports results according to three market segments it

EXHIBIT 4 Selected Financial Data for Vail Resorts, Inc., 2000, 2005, 2010, 2015, 2018–2022 ($ in millions, except per share data)

Fiscal Year Ended July 31:	2022	2021	2020	2019	2018	2015	2010	2005	2000
Statement of Operations:									
Revenue									
From Mountain	$2,213.1	$1,689.9	$1,710.4	$1,956.2	$1,722.9	$1,104.0	$ 638.5	$ 540.9	$ 373.8
From Lodging	312.1	218.1	248.4	314.7	284.6	254.6	195.3	196.4	116.6
From Real Estate	0.7	1.8	4.8	0.7	4.0	41.3	61.0	72.8	48.7
Total Revenue	2,525.9	1,909.7	1,963.7	2,271.6	2,011.6	1,400.0	894.8	810.1	531.1
Operating Expenses (excl. D&A)									
For Mountain	1,181.0	1,146.2	1,212.1	1,279.6	1,132.8	777.1	456.0	392.0	284.1
For Lodging	509.9	223.8	245.1	289.6	259.6	232.9	192.9	177.5	103.6
For Real Estate	5.9	6.7	9.2	5.6	3.5	48.4	71.4	58.3	42.1
Total Operating Expenses	1,696.8	1,376.7	1,466.4	1,571.7	1,396.0	1,058.4	720.3	627.8	298.8
Net Operating Income	$ 829.1	$ 533.0	$ 497.3	$ 699.9	$ 615.6	$ 341.6	$ 174.5	$ 182.3	$ 101.3
Gross Operating Margin									
For Mountain	46.6%	32.2%	29.1%	34.6%	34.2%	29.6%	28.5%	27.5%	24.0%
For Lodging	0.0%	(0.1)%	0.0%	8.0%	8.8%	8.5%	1.2%	9.6%	11.1%
For Real Estate	(742.9)%	(272.2)%	(91.6)%	(700.0)%	12.5%	(17.2)%	(17.0)%	19.9%	13.6%
Net Income	$368.3	$124.5	$109.1	$323.5	$401.3	$114.8	$30.4	$23.1	$10.0
Annual Capital Expenditures (Operations)	$193	$115	$172	$192	$141	$124	$130	$80	$57
Cash Flows									
Net Cash From Operations	$710.5	$525.3	$395.0	$634.2	$551.6	$303.7	$36.0	$148.2	$110.7
Net Cash Increase/ (Decrease)	$(132.5)	$856.5	$283.7	$(66.7)	$60.8	$(8.9)	$(54.6)	$90.3	$(9.5)
Balance Sheet Data									
Total Assets	$6,318.0	$6,251.1	$5,244.2	$4,426.1	$4,065.0	$2,487.3	$1,922.8	$1,525.9	$1,135.6
Long-Term Debt	2,670.3	2,850.3	2,450.8	1,576.3	1,272.7	814.5	526.7	521.7	394.2
Stockholders' Equity	1,612.4	1,594.6	1,316.7	1,500.6	1,589.4	866.6	788.8	540.5	475.8

(continued)

Fiscal Year Ended July 31:	2022	2021	2020	2019	2018	2015	2010	2005	2000
CEO Monetized Compensation (salary + other comp, in $000)									
Adam Aron, CEO (1997–2006)	-	-	-	-	-	-	-	$1,848.6	$ 686.3
Rob Katz, CEO (2007–2021)	-	$3,814.8	$2,789.9	$3,624.7	$7,995.0	$5,344.4	$2,999.4	-	-
Kirsten Lynch (since Nov. 2021)	$6,610.0	-	-	-	-	-	-	-	-
Average Stock Price Per Share	$240	$315	$212	$218	$250	$109	$43	$24	$23
Cash Dividend Per Share	$5.58	none	$5.28	$6.46	$5.05	$2.08	none	none	none

Data Source: Vail Resorts Annual 10-K Reports, 2000–2022.

identifies as mountain, lodging, and real estate. Its 10 destination resorts account for more than 80 percent of VR's revenues, with the remainder sourced from its 24 urban windshield resorts, its three Australian winter-destination resorts, and the Grand Tetons Summer Resort. Its most recent acquisition in the Swiss Alps occurred late in 2022, and therefore financial results for it that year were not reported.

The firm's financial results are greatly attributable to management's long-term strategic choices, as well as dynamic market conditions and growing weather uncertainties. Nevertheless, total revenues have improved more than five-fold over the last two decades, due principally to robust on-mountain sources as well as (1) the addition of new sources of off-mountain operating revenues (especially lodging), (2) the initiation of summer-season activities (reflecting movement to an "all-season" strategy), and (3) success of its EPIC program in integrating VR's customer image across its destination resorts and its North American feeder-network of urban windshield resorts.

Regarding a desire to spread financial risk, VR continues to diversify its product line. Historically, more than 95 percent of its revenues came from the five-month ski season. With implementation of its "all-season" strategy at its various ski resorts and expansion of activities at summer resorts like its Grand Tetons facilities, the winter contribution had been reduced to about 70 percent of total operating sources.

Although real estate sales make little direct contribution to VR's total revenues, they nevertheless are important to the firm's growth strategy because they feed future resort revenues by expanding the visitor bed base (especially from rental units known as "hot beds"). As a destination-resort provider, the firm depends on growth in total capacity of overnight accommodations and the occupancy rate. The hot-bed concept encourages rentals which maximize occupancy without requiring the resort owner to put up capital for bed capacity. VR's lodging control was maintained instead by dominating the guest reservation and hospitality systems which it operates on a fee basis.

For public firms, a comprehensive indicator of managerial success in implementing a well-designed strategy was usually found in the firm's long-term stock price. In VR's case, the picture had been an evolving work-in-progress, as shown in Exhibit 8. During the formative years of Aron's term as CEO, the firm designed much of the substance of its strategy that remains in place today. However, it wasn't until Katz took it to the next level, integrating all the pieces which Aron had put in play, that the results became publically recognized. Hence, the stock's current price, representing an eight-fold increase since 2010 was best understood as a reflection of their dual efforts.

STRATEGY IMPLEMENTATION AT VAIL RESORTS

With Vail Resorts' commitment in the mid-2000s to an all-season growth strategy, the ensuing years unleashed a cascade of managerial events and consequences. Indeed, the sheer complexity of combining and integrating internal capital investments and acquisition resources made necessary a massive reorganization of authority and a huge increase in the number of employees. Even though happening over 20 years, the changes in scale included a tripling of the firm's employment base by 2021. At seasonal peak, VR employs over 40,200 seasonal people on top of its permanent year-round employment base of 6,100.

As a result, the original organization structure progressively underwent a transformation that took into account the massive increase in the diversity of new resources, product-markets, managerial cultures, personalities, and expertise. VR was organized with a mix of structural forms including functional hierarchy, several kinds of divisions, and a partial matrix. A major accomplishment of the reorganization was separating management of the ski resorts and other product lines from general management functions. These production units were then divided into three activity segments, identified as "Mountain," "Lodging," and "Real Estate."

To preserve the simultaneous organizational needs for *differentiation* of organizational specializations and *integration* of authorities engendered by the firm's synergistic complexities, three structural components were put in place. First, at the core of the business, each ski resort was given a separate production authority headed by a chief operating officer (COO). This meant each had control over the management detail of designing and operating everything from grooming schedules, to customer reception activities, to ski-school programs, to food services, to purchasing and maintenance. Although marketing was shown as a corporate function, the firm uses a "brand management" scheme built around each resort operating as a distinct brand *within* the VR family of iconic products.

Second, to ensure consistency with Vail Resorts' overall corporate quality and image, each resort COO reports to the Mountain Segment vice president, who acts as a "peak coordinator" in making companywide policies pertaining to overall corporate production issues. Third, a partial matrix was set up consisting of the individual resorts and five corporatewide functions (highlighted on the organization chart in bold). For example, each resort had a marketing brand manager who simultaneously reports to their respective resort COO and to the senior vice-president for marketing at the corporate level.

Over the years, the progression of reorganizations created new corporate needs and expectations in human resource management. Driving these was the adoption of a new personnel credo:

> At Vail Resorts, we believe in Customer-Focused Teamwork striving to Continuously Improve our Process Management skills through Fact-Based Decision Making to Enhance Customer Satisfaction and Retention and Shareholder Value (i.e., company profits).

As part of implementing this managerial credo, the firm engaged in ongoing talent searches for more and different professional expertise, which would require new approaches to motivating, retaining, and directing the best managerial employees. In recent years, the firm would also make dramatic improvements in employee productivity at both management and nonmanagement levels. To control the more complex information flows, VR created a new position of chief information officer, which oversees MIS, web design, and the firm's cyber-technology subsidiary, called RTP.

VAIL RESORTS IN MID-2023

Over the last decade, however, the substantial corporate growth came with a "changing of the old guard." Attendant with CEO Aron's departure in 2006, other key executives also moved on, including Daly, the firm's original president (who went on to become a two-term mayor of the Town of Vail), one COO (lost to Telluride), several presidents of the Mountain Segment, one vice president of Vail operations (lost to KSL), three corporate CFOs (not counting one lateral transfer), four marketing vice presidents, three heads of lodging, and countless numbers of less senior executives. In 2006, a decision was also made to sever its corporate-level community ties to the Vail Valley by relocating its headquarters from Avon (near Vail) to Broomfield Hills (a Denver suburb).

The Katz leadership team would continue implementation of much of Aron's strategy by further leveraging off its earlier acquisitions, picking the fruits of industry consolidation, and investing heavily in resort development. Emphasizing continuity in the firm's strategy, Katz would ask rhetorically: "Why Vail Resorts?" On behalf of five stakeholders, he defined as "our guests, our employees, our communities, our natural environment, and our shareholders," he reiterated a long-standing theme of offering extraordinary resorts and exceptional experiences.

This vision continued into mid-2023 even though Katz transitioned in 2021 from VR's CEO to "Executive Chairperson of the Board," leaving the CEO role to his protégé, Kirsten Lynch, who as senior vice president of marketing, had spearheaded the firm's EPIC brand. However, given the considerable agitation and conflict at many of the firm's 24 feeder resorts, some observers were wondering whether the unfinished business of implementing the EPIC strategy lay principally with brand management or with an entrepreneurial approach to resort operations and local personnel. Equally concerning was whether the recent growth had made VR more "corporate" in focus, and further detached from its "ski town" local communities.

CASE 26

Meta Platforms, Inc. in 2023: Will the Company's Name Change Resolve Ethical Issues at Facebook and Instagram?

connect

John E. Gamble
Texas A&M University—Corpus Christi

Meta Platforms, Inc. was created in October 2021 through the renaming of Facebook, Inc. and reflected CEO Mark Zuckerberg's grand vision of the future of the internet. The newly named company would continue to operate Facebook's family of apps—Facebook, Instagram, Messenger, and WhatsApp and develop and market the company's Oculus VR goggles. Mark Zuckerberg called the renaming as "the beginning of the next chapter of the internet, and it's the next chapter for our company too."[1] His vision was an extensive online world that would exist across several technology platforms. The metaverse was a concept based upon science-fiction novels such as *Ready Player One* and *Snow Crash* and would allow people to exist in a shared digital space using avatars that would live as those in the physical world. Digital avatars of users would not only engage in video games but could attend digital concerts, try on digital clothes in digital stores, and work in digital offices. Meta Platforms CEO Mark Zuckerberg explained "We've gone from desktop to web to phones, from text to photos to video, but this isn't the end of the line. The next platform and medium will be even more immersive and embodied internet where you're in the experience, not just looking at it."[2]

Analysts believed that the company's shift to a focus on the metaverse was largely in response to the declining growth of its flagship apps, Facebook and Instagram. While the company had more than 3.74 billion monthly active person (MAP) users in 2023, the amount of time users spent on Facebook and Instagram was decreasing, new user growth was declining, and annual advertising revenue growth had reversed from a 37 percent increase between 2020 and 2021 to 1 percent decrease between 2021 and 2022. Opportunities for growth in social media usage in the United States and Canada were almost nonexistent since saturation rates were near 100 percent for Facebook and Instagram. Also, teens were reducing the number of sessions on Instagram as they shifted to new platforms. The amount of time users of all ages spent on TikTok doubled between 2020 and 2021 and continued to increase in 2022 and 2023. Meta expected the use of Facebook to experience an overall decline of 4 percent by 2024, with usage among teens expected to decline by 45 percent.

The company's name change also quickly followed the September–October 2021 publication of "The Facebook Files" by *The Wall Street Journal*—an investigative journalism series that chronicled information gathered from internal Facebook documents disclosed by whistleblowers within the company. The investigative series profiled unethical business practices at the company and focused on the company's algorithm changes that fostered discord, the company's rules that favored elites, the use of the company's apps by drug cartels and human traffickers, and Instagram's effects on teenage girls. "The Facebook Files" was followed in October 2021 by a U.S. Senate Hearing that further investigated Facebook's business practices and heard testimony by former Facebook product manager and whistleblower, Frances Haugen. Ms. Haugen met before investigative committees in the U.S. Congress and lawmakers in the United Kingdom and European Union. Ms. Haugen stated that her intention was not to bring harm to Facebook but to make it better and that "Until we bring in a counterweight, things will be operated for the shareholder's interest and not for the public interest."[3]

However, in mid-2023, it was not clear that Mr. Zuckerberg's vision of the metaverse was serving the interest of shareholders. The company had found that user interest in metaverse games and applications was less than anticipated. In fact, sales of its Quest 2 virtual reality headsets which were essential to the metaverse experience had declined during the first quarter of 2023. Also, Meta Platforms was coming off a 2022 fiscal year that marked its first annual decline in revenues. As a result of the declining revenue, net income and cash flow, Meta Platform's March 2023 common shares were trading at about 60 percent of their value in mid-2020. The company had eliminated approximately 13 percent of its workforce in 2022 and announced in mid-2023 that it would reduce its workforce by an additional 13 percent in what Mr. Zuckerberg had described as a "Year of Efficiency."[4]

COMPANY HISTORY AND BUSINESS MODEL

Facebook was founded in 2004 by Harvard University students, Mark Zuckerberg, Eduardo Saverin, Chris Hughes, and Dustin Moskovitz. The original functionality of the social media platform allowed Harvard University students to post a profile and photos using a template developed by Zuckerberg and his three friends. The site was extended beyond the Harvard campus and quickly grew in popularity as college students across the United States wished to keep in touch with out-of-town friends or share photos of their latest experiences. **Thefacebook.com** had more than 250,000 registered users from 34 universities by June 2004. Mastercard became Facebook's first source of revenue in 2004 when it began paying to place ads on the site. By year-end 2004, Zuckerberg had dropped out of Harvard and moved to Palo Alto, California, to concentrate on the Facebook business venture, became CEO of the startup and began to pitch the investment potential of the nascent business to Silicon Valley venture capitalists.

In 2005, Facebook dropped "The" from its "thefacebook.com" name, received $12.7 million in venture capital, and expanded account privileges to U.S. high school students and university students outside the United States. By 2006, anyone with a valid email address was allowed to have a Facebook account. Zuckerberg sold a 1.5 percent interest in the venture to Microsoft in 2007 for $240 million, which began a long-term friendship with Microsoft founder, Bill Gates. By 2008, Facebook had grown to be the largest social media platform and had made Zuckerberg a 24-year-old billionaire. The company's 2012 initial public offering (IPO) pushed Zuckerberg's net worth to an estimated $19 billion.

The company's business model primarily generated revenues from impression-based ads, with advertising fees based upon number of impressions displayed or number of clicks by users. Facebook's advertising model was especially powerful as marketers could target ads to Facebook users based upon information gathered by Facebook while the user scrolled posts from friends and read news stories. The company added its Messenger service in 2011 that allowed Facebook users to send private messages to other users. Facebook acquired rival Instagram in 2012 for $1 billion to gain access to a larger number of users and acquired the WhatsApp communications platform in 2014 for $19 billion. The company's Reality Labs division developed and marketed its Oculus virtual reality (VR) goggles and Facebook Portal video calling devices. The Reality Labs division was created after the 2014 acquisition of Oculus VR for $2 billion, Beat Games in 2019, and Ready at Dawn and Sanzaru Games in 2020.

In 2021, the company had more than 3.59 billion monthly active persons (MAPs) accessing Facebook, Instagram, WhatsApp, and Messenger worldwide and annual revenues of $117.9 billion. Approximately 97.5 percent of Facebook's 2021 revenues were generated from advertising. The company's Reality Labs division contributed revenues of approximately $2.3 billion in 2021. Facebook changed its name to Meta Platforms, Inc. in late 2021 to reflect its aspirations to capitalize on the virtual reality capabilities of its Reality Labs division and extend Internet connectivity into more aspects of daily life. Exhibit 1 presents Meta Platform's consolidated statements of income for 2019 through 2022. The company's consolidated balance sheets for 2021 and 2022 are presented in Exhibit 2. Revenues by source and segment for 2020–2022 are shown in Exhibit 3. The company's operating income by segment for 2020–2022 is provided in Exhibit 4.

EXHIBIT 1 Meta Platforms, Inc.'s Consolidated Statements of Income, 2019–2022 ($ in millions, except per share amounts)

	2022	2021	2020	2019
Revenue	$116,609	$117,929	$85,965	$70,697
Costs and expenses:				
Cost of revenue	25,249	22,649	16,692	12,770
Research and development	35,338	24,655	18,447	13,600
Marketing and sales	15,262	14,043	11,591	9,876
General and administrative	11,816	9,829	6,564	10,465
Total costs and expenses	87,665	71,176	53,294	46,711
Income from operations	28,944	46,753	32,671	23,986
Interest and other income, net	(125)	531	509	826
Income before provision for income taxes	28,819	47,284	33,180	24,812
Provision for income taxes	5,619	7,914	4,034	6,327
Net income	$ 23,200	$ 39,370	$29,146	$18,485
Earnings per share attributable to Class A and Class B common stockholders:				
Basic	$8.63	$13.99	$10.22	$6.48
Diluted	$8.59	$13.77	$10.09	$6.43
Weighted-average shares used to compute earnings per share attributable to Class A and Class B common stockholders:				
Basic	2,687	2,815	2,851	2,854
Diluted	2,702	2,859	2,888	2,876

Source: Meta Platforms, Inc.'s 2022 Annual Report.

EXHIBIT 2 Meta Platforms, Inc.'s Consolidated Balance Sheets, 2021–2022 ($ in millions)

	2022	2021
Assets		
Current assets:		
Cash and cash equivalents	$14,681	$16,601
Marketable securities	26,057	31,397
Accounts receivable, net	13,466	14,039
Prepaid expenses and other current assets	5,345	4,629
Total current assets	59,549	66,666
Non-marketable equity securities	6,201	6,775
Property and equipment, net	79,518	57,809
Operating lease right-of-use assets	12,673	12,155
Intangible assets, net	897	634
Goodwill	20,306	19,197
Other assets	6,583	2,751
Total assets	$185,727	$165,987

(*continued*)

EXHIBIT 2 *(continued)*

	2022	2021
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	$4,990	$4,083
Partners payable	1,117	1,052
Operating lease liabilities, current	1,367	1,127
Accrued expenses and other current liabilities	19,552	14,873
Total current liabilities	27,026	21,135
Operating lease liabilities, non-current	15,301	12,746
Long-term debt	9,923	—
Other liabilities	7,764	7,227
Total liabilities	60,014	41,108
Commitments and contingencies		
Stockholders' equity:		
Common stock, $0.000006 par value; 5,000 million Class A shares authorized, 2,247 million and 2,328 million shares issued and outstanding, as of December 31, 2022 and 2021, respectively; 4,141 million Class B shares authorized, 367 million and 413 million shares issued and outstanding, as of December 31, 2022 and 2021, respectively	—	—
Additional paid-in capital	64,444	55,811
Accumulated other comprehensive loss	(3,530)	(693)
Retained earnings	64,799	69,761
Total stockholders' equity	125,713	124,879
Total liabilities and stockholders' equity	$185,727	$165,987

Source: Meta Platforms, Inc. 2022 Annual Report.

EXHIBIT 3 Meta Platforms, Inc.'s Revenue by Source and Segment, 2020–2022 ($ in millions)

	2022	2021	2020	2022 vs. 2021 % change
Advertising	$113,642	$114,934	$84,169	−1%
Other revenue	808	721	657	12%
Family of Apps	114,450	115,655	84,826	−1%
Reality Labs	2,159	2,274	1,139	−5%
Total revenue	$116,609	$117,929	$85,965	−1%

Source: Meta Platforms, Inc. 2022 Annual Report.

EXHIBIT 4 Meta Platforms, Inc.'s Income from Operations by Segment, 2020–2022 ($ in millions)

	2022	2021	2020	2022 vs. 2021 % change
Family of Apps	$42,661	$56,946	$39,294	−25%
Reality Labs	(13,717)	(10,193)	(6,623)	−35%
Total income from operations	$28,944	$46,753	$32,671	−38%

Source: Meta Platforms, Inc. 2022 Annual Report.

FACEBOOK'S PRIVACY PROGRAM AND ALGORITHM CHANGES TO INCREASE USER ACTIVITY

Facebook and other social media companies required users to abide by terms of service agreements that were designed to protect other users from harmful content and also allowed Meta Platforms to sell data gathered from users. Data such as what kinds of groups a Facebook or Instagram user had joined, what pages they had liked, what news stories a person read, and online purchasing history was very valuable to advertisers wishing to target their products to social media users most likely to make a purchase. The company's ability to offer advertisers user data facilitating targeted ads allowed it to generate average revenue per person (ARPP) of $11.57 across its family of apps in 2021. ARPP generated by users in the United States and Canada amounted to $60.57 and ARPP for users in Europe was $19.68 in 2021.

A significant number of privacy concerns by users had emerged by 2010, which the company addressed by establishing a privacy program to protect user privacy, safety, security, and data protection. Meta's privacy controls allowed app users to control who could see what a user shared, manage what was shared, and control who could view their profile. The company also offered advice on staying safe while using social media, keeping user accounts secure, and shopping safely. Meta Platforms also abided by the requirements of the EU-U.S. Privacy Shield Framework and the Swiss-U.S. Privacy Shield Framework which required that "individual users have the right to opt out of (1) disclosures of their personal information to third parties; or (2) uses of their personal information for a purpose that is materially different from the purpose(s) for which it was originally collected or subsequently authorized by the individual."[5] The company's Privacy Shield notice also stated that "Meta may transfer data within the Meta family of companies and to third parties" should a user not opt out of personal data sharing.[6]

Meta's use of user data also helped the company direct relevant content to a user through its News Feed service. The delivery of interesting content to Facebook users was essential to driving daily average persons (DAPs) logged in and the amount of time a user remained engaged with the app. MAPs, DAPs, and user engagement were essential to gathering data helpful to advertisers and, ultimately, Meta's annual advertising revenues. Beginning in 2017, the company's key managers began to notice a decline in user engagement, with likes and reshares dropping at alarming rates. Facebook management "never really figured out why metrics declined" but decided to revise its News Feed algorithm to improve user engagement.[7]

The new algorithm deemphasized the importance of likes and added heavier weights on reactions, replies to invitations, lengthy comments, messages, and RSVPs. For example, the internal point system weighted a "like" as one point, a reaction as five points, and a significant comment as 30 points. The result of the algorithm change was that innocuous or largely positive posts would attract mostly basic "like" button clicks (earning one point), driving the post lower in the News Feed. Posts or articles introducing a controversial subject might elicit an anger reaction button (earning five points) or a lengthy, hostile comment (earning 30 points), placing the post higher in News Feeds. As more people saw the post and were drawn into the argument, the post or article could become viral. Facebook internal memos showed that the algorithm change had not affected the amount of time that users spend on the app but did significantly boost the DAP (daily active persons) metric for Facebook which was essential to generating advertising revenue.[8]

Online publishers began to complain to Facebook in early 2018 that the algorithm change had led to a decline in readership of news articles with a positive focus, with *BuzzFeed* suffering a 13 percent decline in traffic compared with the prior six months, *Topix* losing 53 percent of traffic, *Breitbart* losing 46 percent of traffic, and *ABC News* losing 12 percent of traffic according to online data firm, Comscore.[9] The CEO of *Buzzfeed* sent an email to a top official at Facebook to complain that the new algorithm was not rewarding content that "drives meaningful social interactions" but was pressuring publishers to "make bad content."[10] Facebook's CEO, Mark Zuckerberg, said that the algorithm change was to strengthen bonds between users and improve their well-being.[11]

An internal report developed by Facebook employees in 2019 also showed that the algorithm encouraged hostile, negative political environments in countries where politicians and political parties relied on social media to communicate with voters and constituents. Facebook's researchers surmised that in Poland "One party's social media management team estimates that they have shifted the proportion of their posts from a 50/50 positive/negative, to 80 percent negative, explicitly as a function of the change to the algorithm."[12] The report listed similar findings for Spain, Taiwan, and India and concluded "Engagement on positive and policy posts has severely reduced, leaving parties increasingly reliant on inflammatory posts and direct attacks on their competitors."[13]

FACEBOOK, INC.'S APPROACH TO COMBATTING HATE SPEECH AND DANGEROUS CONTENT

Facebook had long acknowledged that its platform attracted users who engaged in posts that violated its terms of service agreement and rules. CEO Mark Zuckerberg had stated in public comments that the company supported free speech and attempted to be neutral in refereeing public discourse.[14] The company used multiple tools to identify hate speech, hoaxes, conspiracy theories, and misleading news articles. The company's "Sparing Sharing" tool targeted hyper-posters or accounts that tended to disproportionately share false or incendiary information.

TRUSTED NEWS AND PUBLISHERS

The company also developed an internal trust rating that prioritized news articles in its News Tab based upon their trust rating. The rating system focused on quality news reporting and barred publishers that repeatedly shared misinformation or violated its list of community standards. The News Tab prioritized articles from publishers that paid Facebook to promote their content, but also listed articles from nonpaying publishers based upon users' interests and the trust rating. An internal study by Facebook researchers conducted in August 2019 found that the rating system tended to suppress articles from nonpaying publishers whose articles were accurate and not misinformation but were viewed as not consistent with the content of Facebook's paid news media clients.[15]

FACEBOOK'S USE OF ARTIFICIAL INTELLIGENCE TO IDENTIFY HARMFUL CONTENT

A major element of Facebook's user protection approach was the utilization of artificial intelligence (AI) to replace employees formerly assigned to the identification and removal of harmful content. Facebook employees had discovered that it was far more difficult to program AI to identify misinformation, violence, and gore than envisioned. For example, Facebook's AI could not consistently identify first-person shooting videos or racist rants or distinguish between a car crash and cockfighting. Facebook internal documents showed that its AI had missed close-up videos of a person shooting someone and videos of car crashes with "dismemberment and visible innards."[16] Facebook's internal review also found that AI had labeled a video of a carwash as a first-person shooter video, mistook a video of a shooting for a carwash, and could not distinguish between a fighting rooster and a non-fighting rooster.[17] Facebook researchers estimated that AI had successfully removed 3 percent to 5 percent of hate speech posts, and 0.6 percent of all content violating Facebook's policies against violence and incitement. CEO Mark Zuckerberg had expressed confidence in AI to detect "the vast majority of problematic content."[18] Despite the limitations of AI in detecting harmful content, a Facebook internal document showed that the shift from human content reviews to AI had saved the company $2 million per week or $52 million in personnel costs for the first half of 2019.

FACEBOOK, INC.'S RULES FOR ELITES

Mark Zuckerberg had stated publicly that Facebook treated its billions of users equally in terms of standards of behavior and freedom of expression, regardless of their status or fame.[19] The company's terms of service allowed it to assess whether posts met rules against bullying, hate speech, or incitement to violence and then take appropriate action. Such actions could range from deleting the content to disabling the user's account. When such instances occurred, Facebook was not obligated to notify the user of why the action was taken. In some cases, the company's automated systems might incorrectly flag a post as inappropriate. Nevertheless, the user had no recourse for a deleted post or suspended account. Mark Zuckerberg estimated in 2018 that Facebook gets 10 percent of its content removal decisions wrong.[20]

The company was very concerned about inappropriately removing posts made by high-profile users such as elected officials, entertainment celebrities, or journalists. The company developed a program called "Cross Check" or "XCheck" that shielded VIP users from the company's normal enforcement processes. Offending content posted by VIPs and identified by Facebook employees could be removed with approval of senior executives or, in some cases, the approval of Mark Zuckerberg or Facebook Chief Operating Officer Sheryl Sandberg. The privilege was not extended to candidates for public office, only current office holders—a practice that some suggested provided incumbents with an advantage in messaging to prospective voters. Facebook employees were baffled by XCheck, as elected officials might have a greater incentive to share misinformation. In addition, the accounts of politicians, celebrities, and other VIPs had the broadest reach, exposing far more users to misinformation than was possible through a post of a typical Facebook user. An internal memo by a Facebook researcher stated "We are knowingly exposing users to misinformation that we have the processes and resources to mitigate."[21]

An internal review at Facebook found that XCheck was "not publicly defensible" and that "Unlike the rest of our community, these people can violate our standards without any consequences."[22] By 2020, Facebook included nearly anyone with a large social media following in the XCheck program, which had grown to approximately 5.8 million account holders. In 2021, Facebook had informed its Oversight Board, which was created to ensure accountability in enforcement of its rules, that the number of XCheck accounts was small. Facebook spokesperson commented to *The Wall Street Journal* that XCheck "was designed for an important reason: to create an additional step so we can accurately enforce policies on content that could require more understanding."[23] Dissatisfied with lack of action on the XCheck program, the Oversight Board issued 32 recommendations to reform the program. In March 2023, Meta Platforms management agreed to implement some of the Oversight Board recommendations, but refused to implement provisions to enhance transparency and prevent political favoritism.[24]

USER PROTECTION FAILURES AT FACEBOOK AND INSTAGRAM

Facebook's unequal treatment of VIPs relative to typical users of the company's family of apps also seemed to apply to user protection for special groups of users such as users in developing markets and children. The company had also been criticized for the use of its apps by drug cartels and in facilitating human trafficking across the world.

FAILURES IN DEVELOPING MARKETS

While Facebook was aggressive in its efforts to identify and remove hate speech and misinformation in the United States, its efforts in developing markets appeared to be less of a priority. India was Facebook's largest market with 300 million Facebook users and 400 million WhatsApp users. Facebook users in the United States and Canada had fallen from about 30 percent of total users in 2010 to less than 10 percent of total users in 2021. The company's user base in India and Asia had increased from less than 20 percent of the company's total users in 2010 to more than 40 percent of total users in 2021. Despite the growth in users outside of the United States and Canada, the company devoted far fewer resources to combatting polarizing nationalist content, misinformation, violence, and gore in India and other developing country markets than was allocated to its United States geographic market. In 2020, Facebook employees and contractors spent more than 3.2 million hours searching and taking down posts the company deemed to be misinformation. Although more than 90 percent of Facebook's users were outside the United States, only 13 percent of those hours were spent working on content outside the United States. The limited resources allocated to Facebook's largest markets were inconsistent with laws in countries such as India that required social media companies to remove inflammatory content that had the potential to undermine national security, public order, and "decency and morality."[25]

Independent researchers had found that that inflammatory content on Facebook spiked 300 percent following religious protests in the country during late-2019 when more than 50 people were killed during riots. Facebook researchers had concluded that the company's algorithms were emphasizing posts promoting misinformation and violence. Calls for violence had also spread widely on WhatsApp.[26] India's government had threatened to jail Facebook and WhatsApp employees if their take-down requests of such inflammatory content were not honored. In 2020, India had temporarily banned TikTok and had instructed Twitter to block hundreds of accounts. A Facebook executive stated that the company had technical systems in place to catch offending content in five of the 22 languages spoken in India and that the company had human language expertise in many more languages and continued to work to improve its systems.[27] A former Facebook vice president commented to *The Wall Street Journal* that Facebook treats harm in developing countries as "simply the cost of doing business." He continued that Facebook focused its user protection efforts on wealthier markets with powerful governments and media institutions.[28]

DAMAGES TO CHILDREN AND TEENS

The effect of social media on teen mental health had long been of concern among the health care community, with bullying and other unhealthy dialog known to affect the self-esteem and emotional development of children and teens. As early as 2012, the United States National Institutes of Health published studies considering the link between social media and teen suicides, which were reaching historic highs.[29] A 10-year study of social media use and suicidality found that teenage girls who spent at least two to three hours per day on social media had a higher clinical risk for suicide as emerging adults. The lead author of the study summarized, "Research shows that girls and women in general are very relationally attuned and sensitive to interpersonal stressors, and social media is all about relationships. At 13, girls are just starting to be ready to handle the darker underbelly of social media such as FOMO (fear of missing out), constant comparisons, and cyberbullying. A 13-year-old is probably not developmentally ready for three hours of social media a day."[30] In 2022, *CNN Business* profiled the stories of dozens of families who believed their children's suicides were a result of social media platform algorithms that encouraged "never-ending" scrolling and exploited minor users' underdeveloped decision-making and impulse control capabilities.[31]

Facebook's number of teen users had dropped consistently since the launch of Instagram and declined at an accelerated rate as Snapchat and TikTok emerged. More than 22 million U.S. teens logged onto Instagram each day, compared to just 5 million U.S. teens logging onto Facebook each day. Also, more than 40 percent of Instagram users were under 22 years old. A 2021 Facebook internal document reported on by *The Wall Street Journal* stated, "Global teen penetration on FB is low, and acquisition appears to be slowing down."[32] The company's research indicated that the daily number of teens using Facebook had declined by 19 percent between 2019 and 2021 and that it would likely fall by an additional 45 percent by 2023.[33]

A 2018 Facebook internal document labeled as confidential had commented that "With the ubiquity of tablets and phones, kids are getting on the internet as young as six years old. We can't ignore this and we have a responsibility to figure it out . . . Imagine a Facebook experience designed for youth."[34] Facebook's first product developed for children was Messenger Kids that was launched in 2017 and was designed for children aged 6 to 12. The company's research showed that the product was not catching on with children and that Messenger Kids usage tapered off after age 10 and that tweens viewed Facebook as a product for old people.[35] A Facebook team was assigned to study preteens and given a three-year goal to increase usage among younger age groups. A Facebook internal document expressed that "Our ultimate goal is messaging primacy with U.S. tweens, which may also lead to winning with teens."[36]

Facebooks efforts to build its user base across younger age groups resulted in a recommendation to complement its family of apps with a six–age-bracket bundle of products targeted to adults, late teens aged over 16, teens aged 13 to 15, tweens aged 10 to 12, children aged 5 to 9, and children aged 0 to 4. The company's policies in 2021 complied with U.S. privacy laws forbidding data collection on children under age 13 and children were allowed to register only as a user for Messenger Kids. Adam Mosseri, head of Instagram, commented to *The Wall Street Journal,* "If kids are under 13, they're not allowed on Instagram and should not be using our service . . . It's not new and it's not a secret that social media companies try to understand how teens and preteens use technology. Like all technology companies, of course, we want to appeal to the next generation, but that's entirely different from the false assertion that we knowingly attempt to recruit people who aren't old enough to use our apps."[37] *The Wall Street Journal* noted however that Mr. Mosseri exclaimed "I don't want to hear it" when an 18-year-old Instagram influencer blurted out during an online Facebook event she had been active on Instagram for almost a decade.[38]

Between 2019 and 2021, Facebook conducted studies to determine how Instagram and Facebook affected its younger users. The conclusion of the interviews and surveys conducted by the company was that "We make body image issues worse for one in three teen girls" and that "teens blame Instagram for increases in the rate of anxiety and depression."[39] Similarly, an independent study of teens in the United States and United Kingdom found that more than 40 percent of Instagram users reported feeling unattractive and that 25 percent of the group of Instagram users said they were "not good enough."[40] A *Wall Street Journal* interview with a teen user of Instagram who joined the platform at age 13 and followed fitness influencers reflected on the experience by stating "When I went on Instagram, all I saw were images of chiseled bodies, perfect abs and women doing 100 burpees in 10 minutes." Another interviewed teen commented "Every time I feel good about myself, I go over to Instagram, and then it all goes away."[41] Other teens complained that a small number of followers was a "kick in the gut" and that using Instagram's Beautification filters "left a bitter taste in my mouth" since the images could be quite different from a user's unenhanced appearance. Instagram head, Adam Mosseri, told *Wall Street Journal* reporters in May 2021 that Instagram's internal research suggests the app's effects on teen well-being is likely "quite small."[42]

Mark Zuckerberg was called to testify before U.S. Congress during a March 2021 Congressional Hearing focused on Facebook's impact on children. During his testimony, Mr. Zuckerberg offered that "The research that we've seen is that using social apps to connect with other people can have positive mental health benefits."[43] When asked if the company had studied the likely effect of Instagram Kids, a product developed for children under age 13, Mr. Zuckerberg replied, "I believe the answer is yes."[44] Senators Richard Blumenthal and Marsha Blackburn followed up with a request that Mr. Zuckerberg release Facebook's internal research on the effect of the company's apps on children. Facebook responded to the Congressional request with a six-page letter that didn't include information from any internal studies conducted by the company and concluded "We are not aware of a consensus among studies or experts about how much screen time is too much."[45] As a result of the Congressional Hearings, Meta announced that it would delay the planned launch of Instagram Kids.

HUMAN TRAFFICKING

The International Labour Organization estimated that there were 24.9 million victims of human trafficking and exploitation worldwide in 2021, with 99 percent of victims being women and young girls. About 16 million of these individuals were trapped into private-sector domestic work or agriculture, 4.8 million were victims of sexual exploitation, and another 4 million were in forced labor imposed by a state.[46] Human trafficking was prevalent in almost every country, including the United States. In February 2022, U.S. Attorney General Merrick Garland announced a national strategy to combat human trafficking, which would include undercover operations carried out by the U.S. Department of Homeland Security and U.S. Immigration and Customs Enforcement. The two agencies made announcements in May 2022 about successful operations that led to arrests of 43 individuals accused of child sex trafficking in Arizona and the recovery of 70 missing children in West Texas.[47]

Facebook internal documents showed that when Facebook employees notified superiors of users using the company's apps to facilitate human trafficking, the alert may or may not be acted upon. These documents also revealed that Facebook employees were increasingly frustrated as decision-makers in the company that allowed users to post videos of murders, incitements to violence, threats against pro-democracy candidates, and advertisements for human trafficking.[48]

The BBC and Apple began pressuring Facebook in 2019 to detect and eliminate ads and posts for human trafficking after an investigative team found more than 300,000 instances of human trafficking violations. Facebook responded by launching a software tool that identified a dozen human trafficking networks by the end of 2020, but deactivated the program. *The Wall Street Journal* had notified Facebook that its employees had called for the software tool to be reactivated, but the company responded that “similar screening systems are in operation.”[49]

Nevertheless, a 28-year-old tutor in Nairobi detailed to *The Wall Street Journal* her experience that began by responding to a Facebook job recruiting ad in January 2021. The young woman was promised free airfare, a visa, and $300 per month to work with a cleaning service in Saudi Arabia. At the Nairobi airport, a recruiter provided the woman with a contract to sign, which was 10 percent less pay than promised in the ad, told only the employer could terminate the contract, and that her visa would be canceled if she quit. The young woman told the recruiter that she was not interested in the new terms and was backing out. The recruiter stated that her contract had already been sold to an employer and that she would need to immediately provide the recruiter with $2,000 to terminate the contract. With no money, the woman accepted the flight.[50]

Once in Saudi Arabia, the woman was forced to sleep in a storage room with no air conditioning and could not leave a locked courtyard on the property. The young woman also was provided no medical care when she became sick and was never paid anything for her work that began at 5:00 a.m. and ended at dusk. Still with no money to terminate the contract, the woman posted about her plight on Facebook at which point the employment agency retrieved her from the property and left her with no passport at a detention center. Eventually, her Facebook post was seen by an official at the United Nations International Organization for Migration which helped negotiate her release and return to Kenya in July 2021.[51]

USE OF FACEBOOK, INC.’S FAMILY OF APPS BY DRUG CARTELS

Facebook employees had discovered posts on Facebook and Instagram, as well as private messages using WhatsApp, by the notorious Cartél Jalisco Nueva Generación (CJNG) that captured vast criminal activity. The employee group found that CJNG was using Facebook’s family of apps to recruit hitmen, track payments to hitmen, post photos of bloody crime scenes, make shipments of lethal drugs, and conduct other illegal activity within Mexico and the United States. The Facebook employee group pointed specifically the CJNG’s Instagram account, which showed a video of a person with a gold pistol shooting a young man in the head, a photo of a beaten man tied to a chair, and another photo of a trash bag filled with severed hands.[52] Facebook employees complained that CJNG met all criteria for a “Dangerous Individuals and Organizations” designation by Facebook and should be removed from platforms. After five months, some CJNG content was removed although new CJNG pages and posts appeared. Facebook officials told reporters at *The Wall Street Journal* that “employees know that they can improve their anti-cartel efforts and that the company is investing in artificial intelligence to bolster enforcement against such groups.[53]

FINES AND LEGAL SETTLEMENTS IN 2022 AND 2023

In late-2022 and early-2023, Meta Platforms was hit with a series of fines and legal settlements related to U.S. and European privacy law violations. Ireland’s Data Protection Commissioner (DPC) levied a record $402 million fine against Meta Platforms in September 2022 after concluding a two-year investigation into Instagram’s handling of children’s data. The DPC found that Instagram had allowed teens aged 13 to 17 to operate business accounts and had disclosed personal phone numbers and email addresses of teen users, which was in violation of Europe’s privacy rules. Meta Platforms officials had stated that the company planned to appeal the fine.[54] The fine by Ireland’s DPC followed the August 2022 announcement of the settlement of a class-action lawsuit filed in 2018 that involved Cambridge Analytica’s harvesting of personal data of 87 million Facebook users. The data was collected from Facebook users who completed an online poll along with the data of their Facebook friends.[55] The attorneys representing Facebook users in the suit alleged that the privacy breach showed that Facebook was a ”data broker and surveillance firm,” as well as a social network.[56] Just days earlier in August 2022, Meta Platforms reached a $37.5 million settlement of a lawsuit accusing Facebook of violating users' privacy by gathering and selling data of users who had turned off Location Services on their smartphones. The lawsuit disclosed that despite users' intentions to block location tracking, Facebook tracked and sold user locations via Wi-Fi IP addresses to enable location-targeted advertising.[57]

Ireland's Data Protection Commission again found Meta Platforms in violation of the country's user data protection regulations in November 2022. The company was fined $300 million for allowing Messenger and Instagram data belonging to 533 million people in 106 countries to be extracted and used for potential spamming and phishing attacks.[58] The DPC of Ireland also fined Meta Platforms $414 million in January 2023 for the Facebook and Instagram terms of use language that required users to allow their data to be used for personalized ads. European Union regulations require social media firms to provide data collection and sale "opt out" options.[59]

Late in 2022, Meta Platforms announced that it would disband its Responsible Innovation Team, which had been tasked with assessing potential concerns about new products and changes to Facebook and Instagram. A Meta spokesperson had stated that most of the 20 individuals making up the former task force would be doing similar watchdog work elsewhere in the company but were not guaranteed continued employment with Meta.[60] Time would tell if Meta Platforms would be able to resolve the ethical concerns expressed by *The Wall Street Journal,* employee whistleblowers, user groups, and lawmakers in the United States, the United Kingdom, and the European Union.

THE FUTURE OF META PLATFORMS

As the name change of Facebook, Inc. to Meta Platforms, Inc. was announced in late-October 2021, Mark Zuckerberg concluded, "Today we're seen as a social media company. But in our DNA, we're a company that builds technology to connect people, and the metaverse is the next frontier."[61] Jason Zweig, an opinion writer for *The Wall Street Journal* cautioned that the name change may not resolve the company's declining numbers of users, slowing advertising revenue growth, or its extensive ethical failures. Mr. Zweig recalled that history had shown corporate name changes could add to a company's problems rather than make them disappear and that "the risk isn't that people won't like the name. It's that they'll like it too well—as a pithy incarnation of everything they dislike about the company."[62] Mr. Zweig also had doubts about the business prospects for the metaverse by commenting "Some consumers will love it. To others, it might sound like a dystopia of 'living' on a video screen while eating cold pizza alone in a windowless basement, almost never seeing another human face-to-face."[63] Mr. Zuckerberg's commitment to the transformation of Facebook as the platform for the metaverse was reflected in the company's $10 billion investment dedicated to the strategic goal.

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CASE 27

Nestlé in 2023: Reducing Plastic Waste?

Michael Schwartz
MBA student, Sonoma State University

Armand Gilinsky Jr.
Sonoma State University

By late winter 2023, single-use water bottles continued to be a source of plastic waste that heavily polluted the Earth's environment. The overwhelming amount of plastic waste generated and lack of resources to recycle plastic waste meant that most of it ended up in landfills or worse, out in the environment. Some major consumer goods manufacturers that contributed to plastic waste, like Nestlé, were attempting to reduce their impact on the environment, while other companies had not yet done so.

Founded in 1866, Nestlé was a food and drink manufacturing corporation based out of Vevey, Vaud, Switzerland.[1] The organization diversified its operations into many food and beverage markets by selling powdered and liquid beverages, pet care, nutrition and health science products, prepared dishes and cooking aids, milk products and ice cream, confectionery, and water.[2] Nestlé employed 276,000 personnel around the world and sold its products in 186 different countries.[3] As of 2021, Nestlé's water segment was its smallest segment in terms of sales, at CHF 4,040 million. Compared to 2018, Nestlé's 2021 water sales dropped 45.47 percent from CHF 7,409 million. In addition to being Nestlé's smallest segment, water sales also received the lowest profit margin compared to all other segments since 2018, with the only exception being a 2 percent profit margin from the Nutrition and Health Science segment in 2021. Exhibit 1 presents Nestlé's net sales and profits by product segment from 2018 to 2021. Exhibit 2 shows Nestlé's invested capital and return on invested capital by product segment for fiscal years 2021 and 2022. Nestlé's revenues, profits, and growth rates by geographical and by product line segment for fiscal years 2021 and 2022 is presented in Exhibit 3.

THE US BOTTLED WATER INDUSTRY

According to the most recent data from *IBISWorld* the US bottled water industry posted an annual revenue of $7.8 billion in 2021, which represented 2 percent annual growth from 2016.[4] In 2021, profit margins in the bottled water industry averaged 4 percent, or $312 million. Key players in the bottled water industry included PepsiCo Inc., Nestlé, Primo Water Corporation, and The Coca-Cola Company, with market shares of 19.9 percent, 16.5 percent, 10.1 percent, and 9.2 percent, respectively.[5] Combined, the key players held 55.7 percent of the total US bottled water market in 2021. The industry's key drivers as of 2021 were primarily per capita disposable income, per capita soft drink consumption, and the healthy eating index.

Nestlé, PepsiCo, and The Coca-Cola Company each possessed diversified product lines to help mitigate potential losses from sudden shifts in per capita soft drink consumption and per capita disposable income.[7] Nestlé's diversified bottled water products were thought to be less susceptible to the elasticity of demand for soft drinks since the company primarily produced bottled still water.[8] Exhibit 4 provides estimated U.S. sales for bottled waters in 2022.

By 2021, PepsiCo and The Coca-Cola Company had already made efforts to reduce the amount of

EXHIBIT 1 Nestlé SA revenues and profits by product line segment, 2018–2022

	2022		2021		2020		2019		2018	
(Millions of CHF)	Sales	% of total sales	Sales	% of total sales	Sales	% of total sales	Sales	% of total sales	Sales	% of total sales
Powdered and Liquid Beverages	25,218	27%	23,975	28%	22,256	26%	23,221	25%	21,620	24%
Water	3,536	4%	4,040	5%	6,421	8%	7,391	8%	7,409	8%
Milk products and ice cream	11,289	12%	10,700	12%	11,007	13%	13,268	14%	13,217	14%
Nutrition and Health Science	15,678	17%	13,157	15%	12,160	14%	14,990	16%	16,188	18%
Prepared dishes and cooking aids	12,484	13%	12,146	14%	11,523	14%	12,188	13%	12,065	13%
Confectionery	8,118	9%	7,514	9%	6,975	8%	7,888	9%	8,123	9%
PetCare	18,101	19%	15,556	18%	14,001	17%	13,622	15%	12,817	14%
Unallocated items	—	—	—	—	—	—		—		—
Total	94,424	100%	87,088	100%	84,343	100%	92,568	100%	91,439	100%

	2022		2021		2020		2019		2018	
(Millions of CHF)	Trading operating profit	Profit margin %	Trading operating profit	Profit margin %	Trading operating profit	Profit margin %	Trading operating profit	Profit margin %	Trading operating profit	Profit margin %
Powdered and Liquid Beverages	5,358	21%	5,406	23%	4,851	22%	4,701	20%	4,553	21%
Water	241	7%	257	6%	522	8%	667	9%	603	8%
Milk products and ice cream	2,508	22%	2,642	25%	2,615	24%	1,678	13%	2,397	18%
Nutrition and Health Science	1,323	8%	243	2%	2,490	20%	3,092	21%	2,795	17%
Prepared dishes and cooking aids	1,508	12%	1,931	16%	2,147	19%	1,857	15%	2,029	17%
Confectionery	1,259	16%	1,093	15%	874	13%	1,241	16%	1,279	16%
PetCare	3,494	19%	3,241	21%	3,089	22%	2,741	20%	2,562	20%
Unallocated items	(2,496)	—	(2,654)	—		—	—	—	—	—
Total	13,195	14%	12,159	14%	16,588	20%	15,977	17%	16,218	18%

Sources: Compiled by case writers based on reporting information from: Nestlé, *Financial statements 2019 – Nestlé,* retrieved April 30, 2022, from **https://www.Nestlé.com/sites/default/files/2020-02/2019-financial-statements-en.pdf** and Nestlé. (2022, March 8). *Financial statements 2021 – Nestlé,* retrieved April 30, 2022, from **https://www.Nestlé.com/sites/default/files/2022-03/2021-corp-governance-compention-financial-statements-en.pdf**, and *Financial statements 2022 – Nestlé,* retrieved March 4, 2023, from, **https://www.nestle.com/sites/default/files/2023-02/2022-financial-statements-en.pdf**, 92.

EXHIBIT 2 Nestlé SA invested capital and returns on invested capital by product line segment, 2022 v. 2021

	2022		2021	
(Millions of CHF)	Invested capital	Return on invested capital %	Invested capital	Return on invested capital %
Powdered and Liquid Beverages	6,377	84%	5,549	97%
Water	1,455	17%	1,745	15%
Milk products and ice cream	2,834	88%	2,526	105%
Nutrition and Health Science	5,906	22%	5,122	5%
Prepared dishes and cooking aids	2,943	51%	2,665	72%
Confectionery	2,431	52%	2,540	43%
PetCare	7,354	48%	5,714	57%
Unallocated items	1,700	−147%	1,623	−164%
Total	31,000	43%	27,484	44%

Source: Financial statements 2022 – Nestlé, retrieved March 4, 2023, from **https://www.nestle.com/sites/default/files/2023-02/2022-financial-statements-en.pdf**, 92–93.

plastic in their bottles by substituting polyethylene terephthalate (PET) with plant-based plastic.[9] Both of those companies pursued plans to replace 100 percent of the polyethylene terephthalate in their plastic bottles with plant-based plastics. Nestlé, on the other hand, had decided not to employ a similar strategy and instead, chose to incorporate more recycled PET (r-PET) to reduce the amount of new plastic being made.[10]

PLASTIC WASTE IN THE ENVIRONMENT

A Statista report showed that in 2016 approximately 91 million metric tons of plastic waste were mismanaged and disposed of improperly.[11] The same Statista report also estimated that if business is continued as normal, the amount of mismanaged plastic waste would climb to 239 million metric tons.[12] As of 2021, the largest producer of plastic waste was the United States while the largest producer of single-use plastic waste was China.[13] It is estimated that as of 2021, 14 percent of the plastic waste mismanaged came from plastic bottles.[14] According to the United States Environmental Protection Agency (EPA) only 8.6 percent of the plastic generated in the United States was recycled in 2018.[15] This number is expected to go down as of 2022, due to China's increasing refusal to accept plastic waste from the United States. Plastic waste in the environment has posed a threat to human life, as the toxins found in plastic tend to enter lower levels of the food chain.[16]

NESTLÉ PRIOR INITIATIVES TO REDUCE PLASTIC WASTE

On April 10, 2018, Nestlé announced that by 2025 100 percent of its packaging will be recyclable or reusable.[17] Nestlé also set a nonfinancial key performance indicator to cut the use of virgin plastics in their packaging by a third by 2025.[18] As of the end of 2021, Nestlé had reduced their use of virgin plastics by 8.1 percent, using 2018 usage as a baseline.[19] Nestlé claimed that as of 2021 it was on target for reaching its goal of reducing the use of virgin plastics by 2025. Nestlé also made efforts to reduce the amount of plastic waste by using less packaging, designing better packaging, and supporting infrastructure for better waste management.[20] Nestlé had already allocated CHF 1.5 billion to source up to 2 million metric tons of food-grade recycled plastics to be used in reducing virgin plastics by 2025.[21] On September 19, 2019, Nestlé inaugurated the Institute of Packaging Sciences to increase research and development in areas such as refillable or reusable packaging, simplified packaging material, recycled packaging material, high-performance barrier papers, and bio-based, compostable and biodegradable materials.[22] Most of Nestlé's efforts to reduce plastic waste have centered

EXHIBIT 3 Nestlé SA revenues, profits, and growth rates by geographical and by product line segment, 2022 versus 2021

(Millions of CHF unless otherwise stated)	Total Group	Zone North America	Zone Europe	Zone AOA	Zone Latin America	Zone Greater China	Nespresso	Nestlé Health Science	Other Businesses
Sales FY-2022	94 424	26 328	19 128	18 484	11 819	5 351	6 448	6 602	264
Sales FY-2021	87 088	23 693	18 794	17 894	10 086	5 175	6 418	4 822	206
Real internal growth (RIG)**	0.10%	− 1.3%	0.90%	0.10%	1.50%	1.00%	− 1.7%	0.60%	25.20%
Pricing**	8.20%	11.60%	6.40%	8.10%	11.60%	2.50%	5.20%	3.40%	3.20%
Organic growth**	8.30%	10.30%	7.20%	8.20%	13.10%	3.50%	3.50%	4.00%	28.40%
Net M&A**	1.10%	− 3.8%	2.10%	− 0.1%	0.10%	0.00%	− 0.3%	31.50%	0.00%
Foreign exchange**	− 0.9%	4.70%	− 7.6%	− 4.9%	4.00%	− 0.1%	− 2.7%	1.50%	− 0.1%
Reported sales growth	8.40%	11.10%	1.80%	3.30%	17.20%	3.40%	0.50%	36.90%	28.30%
FY-2022 Underlying TOP (CHF m)	16 103	5 528	3 138	4 237	2 501	862	1 388	899	− 17
FY-2021 Underlying TOP (CHF m)*	15 119	4 804	3 439	4 288	2 208	700	1 475	654	− 32
FY-2022 Underlying TOP Margin	17.10%	21.00%	16.40%	22.90%	21.20%	16.10%	21.50%	13.60%	− 6.1%
FY-2021 Underlying TOP Margin*	17.40%	20.30%	18.30%	24.00%	21.90%	13.50%	23.00%	13.60%	− 15.6%

	Total Group	Powdered & liquid beverages	Water	Milk products & ice cream	Nutrition & Health Science	Prepared dishes & cooking aids	Confec-tionery	PetCare
Sales FY-2022 (CHF m)	94 424	25 218	3 536	11 289	15 678	12 484	8 118	18 101
Sales FY-2021 (CHF m)	87 088	23 975	4 040	10 700	13 157	12 146	7 514	15 556
Real internal growth (RIG)**	0.10%	0.20%	2.20%	− 4.3%	1.70%	− 6.9%	4.80%	4.30%
Pricing**	8.20%	7.80%	8.90%	9.60%	5.70%	10.00%	4.70%	10.20%
Organic growth**	8.30%	8.00%	11.00%	5.40%	7.40%	3.10%	9.40%	14.50%
FY-2022 Underlying TOP (CHF m)	16 103	5 593	277	2 568	2 990	2 038	1 364	3 706
FY-2021 Underlying TOP (CHF m)	15 119	5 631	364	2 707	2 307	2 040	1 205	3 282
FY-2022 Underlying TOP Margin	17.10%	22.20%	7.80%	22.70%	19.10%	16.30%	16.80%	20.50%
FY-2021 Underlying TOP Margin	17.40%	23.50%	9.00%	25.30%	17.50%	16.80%	16.00%	21.10%

NOTES

**2021* figures restated following the creation of Zone North America (NA) and Zone Greater China (GC) as of January 1, 2022. Zone AOA includes Middle East and North Africa (MENA) previously included in Zone EMENA.

***RIG,* pricing and organic growth figures exclude the Russia region, with a corresponding impact on the M&A and foreign exchange lines.

Source: Nestlé SA financial reports for fiscal year 2022, retrieved March 5, 2023, from: **https://www.globenewswire.com/news-release/2023/02/16/2609327/0/en/Nestl%C3%A9-reports-full-year-results-for-2022.html**

EXHIBIT 4 Sales Value of Leading Bottled Water Brands in the United States, 2022 (USD in millions)

Private label	$ 4,579.88
Aquafina (Pepsi Co.)	1,295.77
Glacéau Smart Water (The Coca-Cola Company)	1,083.08
Dasani (The Coca-Cola Company)	995.18
Poland Spring (Nestlé)	864.61

Source: Beverage Industry Magazine. (September 30, 2022). Sales of the leading bottled still water brands in the United States in 2022 (in million U.S. dollars). In *Statista.* Retrieved February 02, 2023.

on recycling and reusing plastic materials. However, this strategy is reliant on the availability of ways to recycle and individuals' actually recycling.

NESTLÉ'S OPTIONS

Nestlé's management considered whether or not to follow the lead of PepsiCo and The Coca-Cola Company and switch to plant-based plastic for its bottled water in hopes that plant-based plastics would degrade more quickly as compost. However, due to the fact that it took hundreds of years for some materials to become reusable compost, it was unclear if plant-based plastics would be a superior solution to PET-based plastics which could be recycled into fabrics and other useful goods.[23] Nestlé also considered switching to aluminum bottles for its bottled water.

According to the EPA, 50.4 percent of aluminum cans that were put into recycle bins were processed and recycled into new beverage cans in 2018.[24] Aluminum also possessed an added benefit as it required 90 to 95 percent less energy to manufacture an aluminum can made out of recycled aluminum as opposed to a "virgin" aluminum can.[25] However, further studies were needed to compare which material—aluminum vs. plant-based plastic—was worse for marine life and wildlife.

Nestlé's management carefully considered the potential benefit of moving away from plastic- to aluminum-bottled water. In order to implement a new packaging strategy, the company could incrementally integrate aluminum as a replacement to plastic. Slowly integrating aluminum bottles would help Nestlé contract with aluminum bottle vendors that might not yet be capable of producing the large volumes that Nestlé required for its bottled waters. Company managers also debated what the relative carbon footprints of transporting water in aluminum as opposed to plastic bottles. As Nestlé's management pondered these costs and benefits, potential metrics to quantify removing plastic waste from the environment and reducing the total amount of plastic used in production remained as yet unknown.

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Guide to Case Analysis

I keep six honest serving men
(They taught me all I knew);
Their names are What and Why and When;
And How and Where and Who.

Rudyard Kipling

In most courses in strategic management, students use cases about actual companies to practice strategic analysis and to gain some experience in the tasks of crafting and implementing strategy. A case sets forth, in a factual manner, the events and organizational circumstances surrounding a particular managerial situation. It puts readers at the scene of the action and familiarizes them with all the relevant circumstances. A case on strategic management can concern a whole industry, a single organization, or some part of an organization; the organization involved can be either profit seeking or not-for-profit. The essence of the student's role in case analysis is to diagnose and size up the situation described in the case and then to recommend appropriate action steps.

WHY USE CASES TO PRACTICE STRATEGIC MANAGEMENT?

> A student of business with tact
> Absorbed many answers he lacked.
> But acquiring a job,
> He said with a sob,
> "How does one fit answer to fact?"

The foregoing limerick was used some years ago by Professor Charles Gragg to characterize the plight of business students who had no exposure to cases.[1] The facts are that the mere act of listening to lectures and sound advice about managing does little for anyone's management skills and that the accumulated managerial wisdom cannot effectively be passed on by lectures and assigned readings alone. If anything had been learned about the practice of management, it is that a storehouse of ready-made textbook answers does not exist. Each managerial situation has unique aspects, requiring its own diagnosis, judgment, and tailor-made actions. Cases provide would-be managers with a valuable way to practice wrestling with the actual problems of actual managers in actual companies.

The case approach to strategic analysis is, first and foremost, an exercise in learning by doing. Because cases provide you with detailed information about conditions and problems of different industries and companies, your task of analyzing company after company and situation after situation has the twin benefit of boosting your analytical skills and exposing you to the ways companies and managers actually do things. Most college students have limited managerial backgrounds and only fragmented knowledge about companies and real-life strategic situations. Cases help substitute for on-the-job experience by (1) giving you broader exposure to a variety of industries, organizations, and strategic problems; (2) forcing you to assume a managerial role (as opposed to that of just an onlooker); (3) providing a test of how to apply the tools and techniques of strategic management; and (4) asking you to come up with pragmatic managerial action plans to deal with the issues at hand.

Objectives of Case Analysis

Using cases to learn about the practice of strategic management is a powerful way for you to accomplish five things:[2]

1. Increase your understanding of what managers should and should not do in guiding a business to success.
2. Build your skills in sizing up company resource strengths and weaknesses and in conducting strategic analysis in a variety of industries and competitive situations.
3. Get valuable practice in identifying strategic issues that need to be addressed, evaluating strategic alternatives, and formulating workable plans of action.
4. Enhance your sense of business judgment, as opposed to uncritically accepting the authoritative crutch of the professor or "back-of-the-book" answers.
5. Gain in-depth exposure to different industries and companies, thereby acquiring something close to actual business experience.

If you understand that these are the objectives of case analysis, you are less likely to be consumed with curiosity about "the answer to the case." Students who have grown comfortable with and accustomed to textbook statements of fact and definitive lecture notes are often frustrated when discussions about a case do not produce concrete answers. Usually, case discussions produce good arguments for more than one course of action. Differences of opinion nearly always exist. Thus, should a class discussion conclude without a strong, unambiguous consensus on what to do, don't grumble too much when you are not told what the answer is or what the company actually did. Just remember that in the business world answers don't come in conclusive black-and-white terms.

There are nearly always several feasible courses of action and approaches, each of which may work out satisfactorily. Moreover, in the business world, when one elects a particular course of action, there is no peeking at the back of a book to see if you have chosen the best thing to do and no one to turn to for a provably correct answer. The best test of whether management action is "right" or "wrong" is results. If the results of an action turn out to be "good," the decision to take it may be presumed "right." If not, then the action chosen was "wrong" in the sense that it didn't work out.

Hence, the important thing for you to understand about analyzing cases is that the managerial exercise of identifying, diagnosing, and recommending is aimed at building your skills of business judgment. Discovering what the company actually did is no more than frosting on the cake—the actions that company managers actually took may or may not be "right" or best (unless there is accompanying evidence that the results of their actions were highly positive).

The point is this: The purpose of giving you a case assignment is not to cause you to run to the library or surf the Internet to discover what the company actually did but, rather, to enhance your skills in sizing up situations and developing your managerial judgment about what needs to be done and how to do it. The aim of case analysis is for you to become actively engaged in diagnosing the business issues and managerial problems posed in the case, to propose workable solutions, and to explain and defend your assessments—this is how cases provide you with meaningful practice at being a manager.

Preparing a Case for Class Discussion

If this is your first experience with the case method, you may have to reorient your study habits. Unlike lecture courses where you can get by without preparing intensively for each class and where you have latitude to work assigned readings and reviews of lecture notes into your schedule, a case assignment requires conscientious preparation before class. You will not get much out of hearing the class discuss a case you haven't read, and you certainly won't be able to contribute anything yourself to the discussion. What you have got to do to get ready for class discussion of a case is to study the case, reflect carefully on the situation presented, and develop some reasoned thoughts. Your goal in preparing the case should be to end up with what you think is a sound, well-supported analysis of the situation and a sound, defensible set of recommendations about which managerial actions need to be taken.

To prepare a case for class discussion, we suggest the following approach:

1. ***Skim the case rather quickly to get an overview of the situation it presents.*** This quick overview should give you the general flavor of the situation and indicate the kinds of issues and problems that you will need to wrestle with. If your instructor has provided you with study questions for the case, now is the time to read them carefully.
2. ***Read the case thoroughly to digest the facts and circumstances.*** On this reading, try to gain full command of the situation presented in the case. Begin to develop some tentative answers to the study questions your instructor has provided. If your instructor has elected not to give you assignment questions, then start forming your own picture of the overall situation being described.
3. ***Carefully review all the information presented in the exhibits.*** Often, there is an important story in the numbers contained in the exhibits. Expect the information in the case exhibits to be crucial enough to materially affect your diagnosis of the situation.
4. ***Decide what the strategic issues are.*** Until you have identified the strategic issues and problems in the case, you don't know what to analyze, which tools and analytical techniques are called for, or otherwise how to proceed. At times the strategic issues are clear—either being stated in the case or else obvious from reading the case. At other times you will have to dig them out from all the information given; if so, the study questions will guide you.
5. ***Start your analysis of the issues with some number crunching.*** A big majority of strategy cases call for some kind of number crunching—calculating assorted financial ratios to check out the company's financial condition and recent performance, calculating growth rates of sales or profits or unit volume, checking out profit margins and the makeup of the cost structure, and understanding whatever revenue-cost-profit relationships are present. See Table 1 for a summary of key financial ratios, how they are calculated, and what they show.

6. ***Apply the concepts and techniques of strategic analysis you have been studying.*** Strategic analysis is not just a collection of opinions; rather, it entails applying the concepts and analytical tools described in Chapters 1 through 12 to cut beneath the surface and produce sharp insight and understanding. Every case assigned is strategy related and presents you with an opportunity to usefully apply what you have learned. Your instructor is looking for you to demonstrate that you know how and when to use the material presented in the text chapters.
7. ***Check out conflicting opinions and make some judgments about the validity of all the data and information provided.*** Many times cases report views and contradictory opinions (after all, people don't always agree on things, and different people see the same things in different ways). Forcing you to evaluate the data and information presented in the case helps you develop your powers of inference and judgment. Asking you to resolve conflicting information "comes with the territory" because a great many managerial situations entail opposing points of view, conflicting trends, and sketchy information.
8. ***Support your diagnosis and opinions with reasons and evidence.*** The most important things to prepare for are your answers to the question "Why?" For instance, if after studying the case you are of the opinion that the company's managers are doing a poor job, then it is your answer to "Why?" that establishes just how good your analysis of the situation is. If your instructor has provided you with specific study questions for the case, by all means prepare answers that include all the reasons and number-crunching evidence you can muster to support your diagnosis. If you are using study questions provided by the instructor, generate at least two pages of notes!
9. ***Develop an appropriate action plan and set of recommendations.*** Diagnosis divorced from corrective action is sterile. The test of a manager is always to convert sound analysis into sound actions—actions that will produce the desired results. Hence, the final and most telling step in preparing a case is to develop an action agenda for management that lays out a set of specific recommendations on what to do. Bear in mind that proposing realistic, workable solutions is far preferable to casually tossing out off-the-top-of-your-head suggestions. Be prepared to argue why your recommendations are more attractive than other courses of action that are open.

As long as you are conscientious in preparing your analysis and recommendations, and have ample reasons, evidence, and arguments to support your views, you shouldn't fret unduly about whether what you've prepared is "the right answer" to the case. In case analysis, there is rarely just one right approach or set of recommendations. Managing companies and crafting and executing strategies are not such exact sciences that there exists a single provably correct analysis and action plan for each strategic situation. Of course, some analyses and action plans are better than others; but, in truth, there's nearly always more than one good way to analyze a situation and more than one good plan of action.

Participating in Class Discussion of a Case

Classroom discussions of cases are sharply different from attending a lecture class. In a case class, students do most of the talking. The instructor's role is to solicit student participation, keep the discussion on track, ask "Why?" often, offer alternative views, play the devil's advocate (if no students jump in to offer opposing views), and otherwise lead the discussion. The students in the class carry the burden for analyzing the situation and for being prepared to present and defend their diagnoses and recommendations. Expect a classroom environment, therefore, that calls for your size-up of the situation, your analysis, what actions you would take, and why you would take them. Do not be dismayed if, as the class discussion unfolds, some insightful things are said by your fellow classmates that you did not think of. It is normal for views and analyses to differ and for the comments of others in the class to expand your own thinking about the case. As the old adage goes, "Two heads are better than one." So it is to be expected that the class as a whole will do a more penetrating and searching job of case analysis than will any one person working alone. This is the power of group effort, and its virtues are that it will help you see more analytical applications, let you test your analyses and judgments against those of your peers, and force you to wrestle with differences of opinion and approaches.

TABLE 1 Key Financial Ratios: How to Calculate Them and What They Mean

Ratio	How Calculated	What It Shows
Profitability ratios		
1. Gross profit margin	$\frac{\text{Sales} - \text{Cost of goods sold}}{\text{Sales}}$	Shows the percentage of revenues available to cover operating expenses and yield a profit. Higher is better and the trend should be upward.
2. Operating profit margin (or return on sales)	$\frac{\text{Sales} - \text{Operating expenses}}{\text{Sales}}$ or $\frac{\text{Operating income}}{\text{Sales}}$	Shows the profitability of current operations without regard to interest charges and income taxes. Higher is better and the trend should be upward.
3. Net profit margin (or net return on sales)	$\frac{\text{Profits after taxes}}{\text{Sales}}$	Shows after-tax profits per dollar of sales. Higher is better and the trend should be upward.
4. Total return on assets	$\frac{\text{Profits after taxes} + \text{Interest}}{\text{Total assets}}$	A measure of the return on total monetary investment in the enterprise. Interest is added to after-tax profits to form the numerator since total assets are financed by creditors as well as by stockholders. Higher is better and the trend should be upward.
5. Net return on total assets (ROA)	$\frac{\text{Profits after taxes}}{\text{Total assets}}$	A measure of the return earned by stockholders on the firm's total assets. Higher is better, and the trend should be upward.
6. Return on stockholder's equity (ROE)	$\frac{\text{Profits after taxes}}{\text{Total stockholders' equity}}$	Shows the return stockholders are earning on their capital investment in the enterprise. A return in the 12–15% range is "average," and the trend should be upward.
7. Return on invested capital (ROIC)—sometimes referred to as return on capital employed (ROCE)	$\frac{\text{Profits after taxes}}{\text{Long-term debt} + \text{Total stockholders' equity}}$	A measure of the return shareholders are earning on the long-term monetary capital invested in the enterprise. A higher return reflects greater bottom-line effectiveness in the use of long-term capital, and the trend should be upward.
8. Earnings per share (EPS)	$\frac{\text{Profits after taxes}}{\text{Number of shares of common stock outstanding}}$	Shows the earnings for each share of common stock outstanding. The trend should be upward, and the bigger the annual percentage gains, the better.
Liquidity ratios		
1. Current ratio	$\frac{\text{Current assets}}{\text{Current liabilities}}$	Shows a firm's ability to pay current liabilities using assets that can be converted into cash in the near term. Ratio should definitely be higher than 1.0; ratios of 2 or higher are better still.
2. Working capital	Current assets – Current liabilities	Bigger amounts are better because the company has more internal funds available to (1) pay its current liabilities on a timely basis and (2) finance inventory expansion, additional accounts receivable, and a larger base of operations without resorting to borrowing or raising more equity capital.
Leverage ratios		
1. Total debt-to-assets ratio	$\frac{\text{Total liabilities}}{\text{Total assets}}$	Measures the extent to which borrowed funds have been used to finance the firm's operations. Low fractions or ratios are better—high fractions indicate overuse of debt and greater risk of bankruptcy.
2. Long-term debt-to-capital ratio	$\frac{\text{Long-term debt}}{\text{Long-term debt} + \text{Total stockholders' equity}}$	An important measure of creditworthiness and balance sheet strength. Indicates the percentage of capital investment that has been financed by creditors and bondholders. Fractions or ratios below .25 or 25% are usually quite satisfactory since monies invested

(*Continued*)

TABLE 1 (*Continued*)

Ratio	How Calculated	What It Shows
Leverage ratios (Continued)		
		by stockholders account for 75% or more of the company's total capital. The lower the ratio, the greater the capacity to borrow additional funds. Debt-to-capital ratios above 50% and certainly above 75% indicate a heavy and perhaps excessive reliance on debt, lower creditworthiness, and weak balance sheet strength.
3. Debt-to-equity ratio	$\frac{\text{Total liabilities}}{\text{Total stockholders' equity}}$	Should usually be less than 1.0. High ratios (especially above 1.0) signal excessive debt, lower creditworthiness, and weaker balance sheet strength.
4. Long-term debt-to-equity ratio	$\frac{\text{Long-term debt}}{\text{Total stockholders' equity}}$	Shows the balance between debt and equity in the firm's *long-term* capital structure. Low ratios indicate greater capacity to borrow additional funds if needed.
5. Times-interest-earned (or coverage) ratio	$\frac{\text{Operating income}}{\text{Interest expenses}}$	Measures the ability to pay annual interest charges. Lenders usually insist on a minimum ratio of 2.0, but ratios above 3.0 signal better creditworthiness.
Activity ratios		
1. Days of inventory	$\frac{\text{Inventory}}{\text{Cost of goods sold} \div 365}$	Measures inventory management efficiency. Fewer days of inventory are usually better.
2. Inventory turnover	$\frac{\text{Cost of goods sold}}{\text{Inventory}}$	Measures the number of inventory turns per year. Higher is better.
3. Average collection period	$\frac{\text{Accounts receivable}}{\text{Total sales revenues} \div 365}$ or $\frac{\text{Accounts receivable}}{\text{Average daily sales}}$	Indicates the average length of time the firm must wait after making a sale to receive cash payment. A shorter collection time is better.
Other important measures of financial performance		
1. Dividend yield on common stock	$\frac{\text{Annual dividends per share}}{\text{Current market price per share}}$	A measure of the return that shareholders receive in the form of dividends. A "typical" dividend yield is 2–3%. The dividend yield for fast-growth companies is often below 1% (maybe even 0); the dividend yield for slow-growth companies can run 4–5%.
2. Price-earnings ratio	$\frac{\text{Current market price per share}}{\text{Earnings per share}}$	P-E ratios above 20 indicate strong investor confidence in a firm's outlook and earnings growth; firms whose future earnings are at risk or likely to grow slowly typically have ratios below 12.
3. Dividend payout ratio	$\frac{\text{Annual dividends per share}}{\text{Earnings per share}}$	Indicates the percentage of after-tax profits paid out as dividends.
4. Internal cash flow	After-tax profits + Depreciation	A quick and rough estimate of the cash the business is generating after payment of operating expenses, interest, and taxes. Such amounts can be used for dividend payments or funding capital expenditures.
5. Free cash flow	After-tax profits + Depreciation – Capital expenditures – Dividends	A quick and rough estimate of the cash a company's business is generating after payment of operating expenses, interest, taxes, dividends, and desirable reinvestments in the business. The larger a company's free cash flow, the greater is its ability to internally fund new strategic initiatives, repay debt, make new acquisitions, repurchase shares of stock, or increase dividend payments.

To orient you to the classroom environment on the days a case discussion is scheduled, we compiled the following list of things to expect:

1. Expect the instructor to assume the role of extensive questioner and listener.
2. Expect students to do most of the talking. The case method enlists a maximum of individual participation in class discussion. It is not enough to be present as a silent observer; if every student took this approach, there would be no discussion. (Thus, expect a portion of your grade to be based on your participation in case discussions.)
3. Be prepared for the instructor to probe for reasons and supporting analysis.
4. Expect and tolerate challenges to the views expressed. All students have to be willing to submit their conclusions for scrutiny and rebuttal. Each student needs to learn to state his or her views without fear of disapproval and to overcome the hesitation of speaking out. Learning respect for the views and approaches of others is an integral part of case analysis exercises. But there are times when it is OK to swim against the tide of majority opinion. In the practice of management, there is always room for originality and unorthodox approaches. So while discussion of a case is a group process, there is no compulsion for you or anyone else to cave in and conform to group opinions and group consensus.
5. Don't be surprised if you change your mind about some things as the discussion unfolds. Be alert to how these changes affect your analysis and recommendations (in the event you get called on).
6. Expect to learn a lot in class as the discussion of a case progresses; furthermore, you will find that the cases build on one another—what you learn in one case helps prepare you for the next case discussion.

There are several things you can do on your own to be good and look good as a participant in class discussions:

- Although you should do your own independent work and independent thinking, don't hesitate before (and after) class to discuss the case with other students. In real life, managers often discuss the company's problems and situation with other people to refine their own thinking.
- In participating in the discussion, make a conscious effort to contribute, rather than just talk. There is a big difference between saying something that builds the discussion and offering a long-winded, off-the-cuff remark that leaves the class wondering what the point was.
- Avoid the use of "I think," "I believe," and "I feel"; instead, say, "My analysis shows _____" and "The company should do _____ because _____." Always give supporting reasons and evidence for your views; then your instructor won't have to ask you "Why?" every time you make a comment.
- In making your points, assume that everyone has read the case and knows what it says. Avoid reciting and rehashing information in the case—instead, use the data and information to explain your assessment of the situation and to support your position.
- Bring the printouts of the work you've done on Case-Tutor or the notes you've prepared (usually two or three pages' worth) to class and rely on them extensively when you speak. There's no way you can remember everything off the top of your head—especially the results of your number crunching. To reel off the numbers or to present all five reasons why, instead of one, you will need good notes. When you have prepared thoughtful answers to the study questions and use them as the basis for your comments, everybody in the room will know you are well prepared, and your contribution to the case discussion will stand out.

Preparing a Written Case Analysis

Preparing a written case analysis is much like preparing a case for class discussion, except that your analysis must be more complete and put in report form. Unfortunately, though, there is no ironclad procedure for doing a written case analysis. All we can offer are some general guidelines and words of wisdom—this is because company situations and management problems are so diverse that no one mechanical way to approach a written case assignment always works.

Your instructor may assign you a specific topic around which to prepare your written report. Or, alternatively, you may be asked to do a comprehensive written case analysis, where the expectation is that you will (1) identify all the pertinent issues that management needs to address, (2) perform whatever analysis and evaluation is appropriate, and (3) propose an action plan and set of recommendations addressing the issues you have identified. In going through the exercise of identify, evaluate, and recommend, keep the following pointers in mind.[3]

Identification It is essential early on in your written report that you provide a sharply focused diagnosis of strategic issues and key problems and that you demonstrate a good grasp of the company's present situation. Make sure you can identify the firm's strategy (use the concepts and tools in Chapters 1–8 as diagnostic aids) and that you can pinpoint whatever strategy implementation issues may exist (again, consult the material in Chapters 10–12 for diagnostic help). Consult the key points we have provided at the end of each chapter for further diagnostic suggestions. Consider beginning your report with an overview of the company's situation, its strategy, and the significant problems and issues that confront management. State problems/issues as clearly and precisely as you can. Unless it is necessary to do so for emphasis, avoid recounting facts and history about the company (assume your professor has read the case and is familiar with the organization).

Analysis and Evaluation This is usually the hardest part of the report. Analysis is hard work! Check out the firm's financial ratios, its profit margins and rates of return, and its capital structure, and decide how strong the firm is financially. Table 1 contains a summary of various financial ratios and how they are calculated. Use it to assist in your financial diagnosis. Similarly, look at marketing, production, managerial competence, and other factors underlying the organization's strategic successes and failures. Decide whether the firm has valuable resource strengths and competencies and, if so, whether it is capitalizing on them.

Check to see if the firm's strategy is producing satisfactory results and determine the reasons why or why not. Probe the nature and strength of the competitive forces confronting the company. Decide whether and why the firm's competitive position is getting stronger or weaker. Use the tools and concepts you have learned about to perform whatever analysis and evaluation is appropriate. Work through the case preparation exercise on Case-Tutor if one is available for the case you've been assigned.

In writing your analysis and evaluation, bear in mind four things:

1. You are obliged to offer analysis and evidence to back up your conclusions. Do not rely on unsupported opinions, over-generalizations, and platitudes as a substitute for tight, logical argument backed up with facts and figures.
2. If your analysis involves some important quantitative calculations, use tables and charts to present the calculations clearly and efficiently. Don't just tack the exhibits on at the end of your report and let the reader figure out what they mean and why they were included. Instead, in the body of your report cite some of the key numbers, highlight the conclusions to be drawn from the exhibits, and refer the reader to your charts and exhibits for more details.
3. Demonstrate that you have command of the strategic concepts and analytical tools to which you have been exposed. Use them in your report.
4. Your interpretation of the evidence should be reasonable and objective. Be wary of preparing a one-sided argument that omits all aspects not favorable to your conclusions. Likewise, try not to exaggerate or overdramatize. Endeavor to inject balance into your analysis and to avoid emotional rhetoric. Strike phrases such as "I think," "I feel," and "I believe" when you edit your first draft and write in "My analysis shows" instead.

Recommendations The final section of the written case analysis should consist of a set of definite recommendations and a plan of action. Your set of recommendations should address all of the problems/issues you identified and analyzed. If the recommendations come as a surprise or do not follow logically from the analysis, the effect is to weaken greatly your suggestions of what to do. Obviously, your recommendations for actions should offer a reasonable prospect of success. High-risk, bet-the-company recommendations should be made with caution. State how your recommendations will solve the problems you identified. Be sure the company is financially able to carry out what you recommend; also check to see if your recommendations are workable in terms of acceptance by the persons involved, the organization's competence to implement them, and prevailing market and environmental constraints. Try not to hedge or weasel on the actions you believe should be taken.

By all means state your recommendations in sufficient detail to be meaningful—get down to some definite nitty-gritty specifics. Avoid such unhelpful statements as "the organization should do more planning" or "the company should be more aggressive in marketing its product." For instance, if you determine that "the firm should improve its market position," then you need to set forth exactly how you think this should be done. Offer a definite agenda for action, stipulating a timetable and sequence for initiating actions, indicating priorities, and suggesting who should be responsible for doing what.

In proposing an action plan, remember there is a great deal of difference between, on the one hand, being responsible for a decision that may be costly if it proves in error and, on the other hand, casually suggesting courses of action that might be taken when you do not have to bear the responsibility for any of the consequences.

A good rule to follow in making your recommendations is: Avoid recommending anything you would not yourself be willing to do if you were in management's shoes. The importance of learning to develop good managerial judgment is indicated by the fact that, even though the same information and operating data may be available to every manager or executive in an organization, the quality of the judgments about what the information means and which actions need to be taken does vary from person to person.[4]

It goes without saying that your report should be well organized and well written. Great ideas amount to little unless others can be convinced of their merit—this takes tight logic, the presentation of convincing evidence, and persuasively written arguments.

Preparing an Oral Presentation

During the course of your business career it is very likely that you will be called upon to prepare and give a number of oral presentations. For this reason, it is common in courses of this nature to assign cases for oral presentation to the whole class. Such assignments give you an opportunity to hone your presentation skills.

The preparation of an oral presentation has much in common with that of a written case analysis. Both require identification of the strategic issues and problems confronting the company, analysis of industry conditions and the company's situation, and the development of a thorough, well-thought-out action plan. The substance of your analysis and quality of your recommendations in an oral presentation should be no different than in a written report. As with a written assignment, you'll need to demonstrate command of the relevant strategic concepts and tools of analysis and your recommendations should contain sufficient detail to provide clear direction for management. The main difference between an oral presentation and a written case is in the delivery format. Oral presentations rely principally on verbalizing your diagnosis, analysis, and recommendations and visually enhancing and supporting your oral discussion with colorful, snappy slides (usually created on Microsoft's PowerPoint software).

Typically, oral presentations involve group assignments. Your instructor will provide the details of the assignment—how work should be delegated among the group members and how the presentation should be conducted. Some instructors prefer that presentations begin with issue identification, followed by analysis of the industry and company situation analysis, and conclude with a recommended action plan to improve company performance. Other instructors prefer that the presenters assume that the class has a good understanding of the external industry environment and the company's competitive position and expect the presentation to be strongly focused on the group's recommended action plan and supporting analysis and arguments. The latter approach requires cutting straight to the heart of the case and supporting each recommendation with detailed analysis and persuasive reasoning. Still other instructors may give you the latitude to structure your presentation however you and your group members see fit.

Regardless of the style preferred by your instructor, you should take great care in preparing for the presentation. A good set of slides with good content and good visual appeal is essential to a first-rate presentation. Take some care to choose a nice slide design, font size and style, and color scheme. We suggest including slides covering each of the following areas:

- An opening slide covering the "title" of the presentation and names of the presenters.
- A slide showing an outline of the presentation (perhaps with presenters' names by each topic).
- One or more slides showing the key problems and strategic issues that management needs to address.
- A series of slides covering your analysis of the company's situation.
- A series of slides containing your recommendations and the supporting arguments and reasoning for each recommendation—one slide for each recommendation and the associated reasoning will give it a lot of merit.

You and your team members should carefully plan and rehearse your slide show to maximize impact and minimize distractions. The slide show should include all of the pizzazz necessary to garner the attention of the audience, but not so much that it distracts from the content of what group members are saying to the class. You should remember that the role of slides is to help you communicate your points to the audience. Too many graphics, images, colors, and transitions may divert the audience's attention from what is being said or disrupt the flow of the presentation. Keep in mind that visually dazzling slides rarely hide a shallow or superficial or otherwise flawed case analysis from a perceptive audience. Most instructors will tell you that first-rate slides will definitely enhance a well-delivered presentation, but that impressive visual aids, if accompanied by weak analysis and poor oral delivery, still add up to a substandard presentation.

Researching Companies and Industries via the Internet and Online Data Services

Very likely, there will be occasions when you need to get additional information about some of the assignee cases, perhaps because your instructor has asked you to do further research on the industry or company or because you are simply curious about what has happened to the company since the case was written. These days, it is relatively easy to run down recent industry developments and to find out whether a company's strategic and financial situation has improved, deteriorated, or changed little since the conclusion of the case. The amount of information about companies and industries available on the Internet and through online data services is formidable and expanding rapidly.

It is a fairly simple matter to go to company websites, click on the investor information offerings and press release files, and get quickly to useful information. Most company websites allow you to view or print the company's quarterly and annual reports, its 10-K and 10-Q filings with the Securities and Exchange Commission, and various company press releases of interest. Frequently, a company's website will also provide information about its mission and vision statements, values statements, codes of ethics, and strategy information, as well as charts of the company's stock price. The company's recent press releases typically contain reliable information about what of interest has been going on—new product introductions, recent alliances and partnership agreements, recent acquisitions, summaries of the latest financial results, tidbits about the company's strategy, guidance about future revenues and earnings, and other late-breaking company developments. Some company web pages also include links to the home pages of industry trade associations where you can find information about industry size, growth, recent industry news, statistical trends, and future outlook. Thus, an early step in researching a company on the Internet is always to go to its website and see what's available.

Online Data Services LexisNexis, Bloomberg Financial News Services, and other online subscription services available in many university libraries provide access to a wide array of business reference material. For example, the web-based LexisNexis Academic Universe contains business news articles from general news sources, business publications, and industry trade publications. Broadcast transcripts from financial news programs are also available through LexisNexis, as are full-text 10-Ks, 10-Qs, annual reports, and company profiles for more than 11,000 U.S. and international companies. Your business librarian should be able to direct you to the resources available through your library that will aid you in your research.

Public and Subscription Websites with Good Information Plainly, you can use a search engine such as Google or Yahoo! or MSN to find the latest news on a company or articles written by reporters that have appeared in the business media. These can be very valuable in running down information about recent company developments. However, keep in mind that the information retrieved by a search engine is "unfiltered" and may include sources that are not reliable or that contain inaccurate or misleading information. Be wary of information provided by authors who are unaffiliated with reputable organizations or publications and articles that were published in off-beat sources or on websites with an agenda. Be especially careful in relying on the accuracy of information you find posted on various bulletin boards. Articles covering a company or issue should be copyrighted or published by a reputable source. If you are turning in a paper containing information gathered from the Internet, you should cite your sources (providing the Internet address and date visited); it is also wise to print web pages for your research file (some web pages are updated frequently).

The Wall Street Journal, *Bloomberg Businessweek, Forbes, Barron's*, and *Fortune* are all good sources of articles on companies. The online edition of *The Wall Street Journal* contains the same information that is available daily in its print version of the paper, but the *WSJ* website also maintains a searchable database of all *The Wall Street Journal* articles published during the past few years. *Fortune* and *Bloomberg Businessweek* also make the content of the most current issue available online to subscribers as well as provide archives sections that allow you to search for articles published during the past few years that may be related to a particular keyword.

The following publications and websites are particularly good sources of company and industry information:

Securities and Exchange Commission EDGAR database (contains company 10-Ks, 10-Qs, etc.)
http://www.sec.gov/edgar/searchedgar/companysearch
Google Finance
http://finance.google.com
CNN Money
http://money.cnn.com
Hoover's Online
http://hoovers.com
The Wall Street Journal Interactive Edition
www.wsj.com
Bloomberg Businessweek
www.businessweek.com and www.bloomberg.com
Fortune
www.fortune.com
MSN Money Central
http://moneycentral.msn.com
Yahoo! Finance
http://finance.yahoo.com/

Some of these Internet sources require subscriptions in order to access their entire databases.

You should always explore the investor relations section of every public company's website. In today's world, these websites typically have a wealth of information concerning a company's mission, core values, performance targets, strategy, recent financial performance, and latest developments (as described in company press releases).

Learning Comes Quickly With a modest investment of time, you will learn how to use Internet sources and search engines to run down information on companies and industries quickly and efficiently. And it is a skill that will serve you well into the future. Once you become familiar with the data available at different websites mentioned above and learn how to use a search engine, you will know where to go to look for the particular information that you want. Search engines nearly always turn up too many information sources that match your request rather than too few. The trick is to learn to zero in on those most relevant to what you are looking for. Like most things, once you get a little experience under your belt on how to do company and industry research on the Internet, you will be able to readily find the information you need.

The Ten Commandments of Case Analysis

As a way of summarizing our suggestions about how to approach the task of case analysis, we have put together what we like to call "The Ten Commandments of Case Analysis." They are shown in Table 2. If you observe all or even most of these commandments faithfully as you prepare a case either for class discussion or for a written report, your chances of doing a good job on the assigned cases will be much improved. Hang in there, give it your best shot, and have some fun exploring what the real world of strategic management is all about.

TABLE 2 The Ten Commandments of Case Analysis

To be observed in written reports and oral presentations, and while participating in class discussions:

1. Go through the case twice, once for a quick overview and once to gain full command of the facts. Then take care to explore the information in every one of the case exhibits.
2. Make a complete list of the problems and issues that the company's management needs to address.
3. Be thorough in your analysis of the company's situation (make a minimum of one to two pages of notes detailing your diagnosis).

(*Continued*)

TABLE 2 (*Continued*)

4. Look for opportunities to apply the concepts and analytical tools in the text chapters—all of the cases in the book have very definite ties to the material in one or more of the text chapters!!!!
5. Do enough number crunching to discover the story told by the data presented in the case. (To help you comply with this commandment, consult Table 1 in this section to guide your probing of a company's financial condition and financial performance.)
6. Support any and all off-the-cuff opinions with well-reasoned arguments and numerical evidence. Don't stop until you can purge "I think" and "I feel" from your assessment and, instead, are able to rely completely on "My analysis shows."
7. Prioritize your recommendations and make sure they can be carried out in an acceptable time frame with the available resources.
8. Support each recommendation with persuasive argument and reasons as to why it makes sense and should result in improved company performance.
9. Review your recommended action plan to see if it addresses all of the problems and issues you identified. Any set of recommendations that does not address all of the issues and problems you identified is incomplete and insufficient.
10. Avoid recommending any course of action that could have disastrous consequences if it doesn't work out as planned. Therefore, be as alert to the downside risks of your recommendations as you are to their upside potential and appeal.

ENDNOTES

[1] Charles I. Gragg, "Because Wisdom Can't Be Told," in *The Case Method at the Harvard Business School,* ed. M. P. McNair (New York: McGraw-Hill, 1954), p. 11.
[2] Ibid., pp. 12–14; and D. R. Schoen and Philip A. Sprague, "What Is the Case Method?" in *The Case Method at the Harvard Business School,* ed. M. P. McNair, pp. 78–79.
[3] For some additional ideas and viewpoints, you may wish to consult Thomas J. Raymond, "Written Analysis of Cases," in *The Case Method at the Harvard Business School,* ed. M. P. McNair, pp. 139–63. Raymond's article includes an actual case, a sample analysis of the case, and a sample of a student's written report on the case.
[4] Gragg, "Because Wisdom Can't Be Told," p. 10.

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