Welcome to Mastering STRATEGY

Part 5 of 12

This is the fifth part of Mastering Strategy, a weekly series which will be published in all worldwide editions of the newspaper every Monday up to and including December 13th.
The aim of the series is to give readers an overview of this important business topic, to describe popular techniques for implementing business strategy, and to discuss the latest ideas from some of the world's leading strategic thinkers. In the process we hope it makes you a better and more informed manager. **Turn to page 15 if you want to catch up on the series so far and see what is coming up over the next few weeks.** **As regular readers will know we have already introduced many important themes among which pricing strategies and M&A are developed in Part Five today.**

- The Part opens on pp 2-3 with Judith Chevalier's highly readable account of how and why companies make price commitments - a piece which complements earlier articles on game theory and price competition (see the Signpost on this page).
- On page 4 Richard Whittington offers some thoughts on the "practice" of strategy and the different skills required to do it well - a mixture of inspiration and perspiration as he puts it. Note particularly the author's comment that effective strategists generally need more than the ability to conceptualise. Knowhow and know-who - both typically borne of organisational experience - are as important as know what.
- M&A was first introduced in Part Two (FT Oct 4) and the same tone of scepticism can be found in the articles both by Jay Anand on pp 6-7 and Philippe Haspeslagh on pp 12-13. Mindful of the takeover fever which continues to sweep financial markets Anand sets out some general principles based on past experience of the most common pitfalls. Haspeslagh focuses particularly on "mergers of equals" which tend to attract their own problems - chief executive egos, battles over name and location, and shared vision (or not as the case may be).
- Between the M&A articles (pp 8-10) you will find some provocative ideas on shareholder value in a joint contribution by Anjan Thakor, Jeff DeGraff and Robert Quinn. The authors dispel some of what they see as the most common myths surrounding this topic and offer one approach to value creation.
- Finally Rob Gertner and Andrew Rosenfield explain how real option techniques can be used to value some of the ambiguous, dynamic industry and competitive effects that are difficult to incorporate in financial projections using a traditional discounted cash flow (DCF) approach.

Mastering Strategy, regular readers already know, brings together four powerful and distinguished writing teams in the area. The collective wisdom and advice of top flight professors and other faculty from the University of Michigan Business School, the University of Chicago Graduate School of Business, Insead (based near Paris, France) and Oxford University's Saïd School of Business in the UK represents a rich mix of traditions and outlooks and a rare synthesis of North American and European views.
Please note that summaries and some additional reading ideas beyond those mentioned in the margins of the newspaper series are posted on www.ftmastering.com

As with previous FT Masterings we welcome feedback and letters which, space permitting, we will endeavour to publish. Please write to The Editor, FT Mastering, 3rd floor, Financial Times, Number One Southwark Bridge, London SE1 9HL or e-mail editor.masteringstrategy@ft.com.

When it can be good to burn your boats

Summary

Irreversible commitments can have an important strategic value, explains **Judith A. Chevalier.** In this article she describes two broad categories of commitment – the "tough" and the "soft". The tough approach can be used to deter a competitor from entering a market or to force him out. The soft approach may be more appropriate where exiting the market is not an option for a competitor and no players would benefit from heavy competition on price. The benefits of making a strategic commitment – never more dramatically illustrated than by the Spanish conquistador Hernán Cortés's decision to scuttle his ships - needs to be weighed carefully against the advantages of maintaining flexibility. Neither strategy provides insurance against later regret.

Judith A. Chevalier is Professor of Economics at the University of Chicago Graduate School of Business and a Faculty Research Fellow at the National Bureau of Economic Research.

Signpost

See a related article by Prof. John Kay, *Inside Track*, Ford puts its faith in prices, (FT Sep 15 1999) and see also related articles on pricing in Mastering Strategy Part Three (FT Oct 11) and Part Four (FT Oct 18).

Maintaining the flexibility to change its course of action might seen a valuable requirement for a business at all times. But there are situations in which making irreversible commitments can have important strategic value. In this article I consider two types of commitments: commitments to being a "tough" competitor and commitments to being a "soft" competitor..

Commitments to be tough

The classic example of the strategic value of commitment comes not from business, but from war. In 400 BC Sun-tzu in The Art of War wrote: "At the critical moment, the leader of an army acts like one who has climbed up a height, and then kicks away the ladder behind him."

The Spanish conquistador Hernán Cortés took this advice to heart in 1519. On landing in Mexico, in preparation for his invasion of the Aztec city of Tenochtitlan, Cortés sunk most of his ships. As Cortés's companion Bernal Diaz de Castillo wrote, "we could look for no help or assistance except from God for we now had no ships in which to return." Clearly, the sinking of the ships would have provided extra motivation for his army. However, it also sent a powerful signal to the opponent. It was clear to the Aztec king Moctezuma that resistance to Cortés's invasion would lead to a bloody fight to the death, not to the retreat of Cortés's men. The Aztecs chose not to resist Cortés's invasion of Tenochtitlan. Thus the commitment to act aggressively engendered the desired passive response from the opponent. Quoting Sun-tzu again: "the skilful leader subdues the enemy's troops without any fighting."

Reversibility

A strategic commitment, like the sinking of a ship, is a decision that is difficult to reverse. When companies build factories, sign contracts, and launch advertising campaigns, they are making decisions that might be difficult to go back on. This irreversibility can have both benefits and costs. The main benefit of an irreversible commitment is the effect it has on competitors.

Consider this example:

A new trucking company is contemplating entering two local markets to haul agricultural products. Suppose the two local markets are identical in every respect, except for the identity of the incumbent company operating in the market. In the first market, the incumbent company is a railroad. The incumbent spent \$20m to construct the railroad and the operating cost of hauling grain for the railroad is \$0.20 per ton-mile. In the second market, the incumbent is another trucking company. The trucking company has \$20m worth of trucks operating on the route. The operating cost of hauling grain for the incumbent trucking company is \$0.20 per ton-mile. Which market is the new trucking company more likely to enter?

At first, the conditions in the two markets seem identical. However, there is an important difference. Most of the costs in constructing the railroad relate to clearing the land and laying the track; these are irrecoverable should the railroad decide to shut down. In contrast, if the incumbent trucking company decides to close, it could almost fully recover its \$20m investment. Trucks obviously are easy to move from place to place, and there is a fairly liquid market for them. Thus, for the incumbent trucking company to want to remain in the market, it needs to cover its operating cost, and earn a return on its investment in the trucks. If it is not earning an adequate return on its trucks, it will sell them or take them elsewhere.

For the incumbent railroad company to choose to stay in the market, it needs to cover its operating cost and earn a return only on the (relatively small) scrap value of the railroad. The track investments are totally irrecoverable or, "sunk", and thus, the railroad does not consider their value when deciding whether or not to stay in business. Should prices and quantities fall in the market, it is quite likely the railroad will wish that it had never made the investments in laying track. However, as the track is there, unless market conditions are extremely poor, it makes sense to continue operating the railroad. Thus, the entrant will have a much easier time inducing the trucking company to exit than it will have inducing the railroad company to exit. Entering the market currently occupied by the trucking company is, therefore, more attractive.

The irreversibility of the railroad's investments acts as a commitment by the railroad to stay in the market, and may deter the entrant from entering the market. Thus, the commitment allows the railroad company to "subdue the enemy's troops without any fighting."

Commitments to be soft

When thinking about commitments in the context of strategic management, a manager has first to determine what kind of commitments might be valuable and then determine whether the strategic advantages of commitment outweigh the benefits of retaining flexibility. The types of commitments that managers might want to make fall into two broad categories: commitments to be "tough" and commitments to be "soft".

A company might benefit from a commitment to

CORBIS

Cortés and Moctezuma: irreversible commitment by a conquistador

be tough when it wants to deter entry into its markets, encourage a rival to build only small capacity, or even induce exit. The Cortés and railroad examples above, are examples of commitments to be tough. Alternatively, a company might benefit from a commitment to be "soft." If two competitors are competing by setting prices in a market in which exit is unlikely, commitments to be "soft" might be valuable. Consider, for example, the fierce competition between mass market discount department stores. A number of these are now adopting "frequent customer cards" and other loyalty programmes. In order to encourage the customer not to shop around these programmmes give rewards to those who accumulate a large number of purchases with the retailer. However, introduction of such programmes raises a question to outside observers: wouldn't the cost of the awards and the infrastructure for the programme be better spent simply lowering prices? Wouldn't customers appreciate this just as much or more than prizes?

Club Z

Well, customers might appreciate lower prices just as much as "loyalty rewards", but the effect on competition would be very different. Consider the largest, and perhaps most successful, retail loyalty programme in North America. Approximately one-third of all Canadian residents belong to Club Z, the loyalty programme for the Canadian mass-merchandiser, Zeller Stores. Eight out of 10 Zeller's shoppers are estimated to be members. What signal does the adoption and maintenance of this loyalty programme send to Zeller's competitors?

Well, at first one might guess that the fact that Zeller's has customers who don't like to shop around is unambiguously bad news for Zeller's competitors like the US retailers Wal-Mart and Sears Roebuck. However, Zeller's customer loyalty also has a positive side for Zeller's competitors. As Zeller's president Thomas Haig noted in a recent issue of Discount Store News, "we can position ourselves a bit above Wal-Mart in price." If Zeller's customers are loyal and unwilling to shop around, this would tend to make Zeller's reluctant to compete fiercely by cutting prices.

After all, cutting prices might help Zeller's to pick up a few new customers, but Zeller's would be giving up margins on all of the customers who were willing to pay a bit more. Thus, Zeller's strong customer loyalty programme serves as a commitment on Zeller's part not to cut prices too fiercely. How should Wal-Mart respond to this? Wal-Mart will surely choose prices that are lower than Zeller's prices, but it will not compete as fiercely on price as it might otherwise. After all, it will be very costly to dislodge those customers from Zeller's who don't shop around much. And, if Zeller's isn't competing too hard to attract those "non-loyal" customers, Wal-Mart doesn't have to charge extremely low prices to capture them. Wal-Mart competes less aggressively due to Zeller's loyalty programme, and this less aggressive competition benefits Zeller's.

In considering what kinds of commitments to make it is important to figure out what one's objectives are and how competition is taking place in the market. For example, Zeller's loyalty programme is a good strategy because Zeller's is engaged in price competition with a competitor that it cannot hope to try to induce to exit. Maintaining "soft" price competition is probably the most profitable tactic for Zeller's. However, if Zeller's were trying to induce WalMart's exit, the loyalty programme might prove a hindrance. Suppose Zeller's cut its prices to try to persuade Wal-Mart to exit. Wal-Mart would probably stand firm, knowing that the existence of loyal customers who are willing to pay higher prices makes price-cutting a very expensive strategy for Zeller's. Wal-Mart knows that Zeller's won't want to keep up a price war for too long. Foreseeing that Wal-Mart can see through its motivations, Zeller's would probably never attempt to cut prices to induce Wal-Mart to exit.

It is important to stress that an easily reversible decision does not function as a credible commitment that will alter a competitor's behaviour. Moctezuma might not have been impressed had Cortés merely announced "we will not return to Cuba". The scuttling of the ships convinced Moctezuma that, even if the invasion turned out very poorly making Cortés want to retreat to Cuba, he could not do so. Moctezuma would not have considered an announcement by Cortés to be credible. In June 1999, for example, Amazon.com, the online booksellers announced it was building a new 800,000 sq ft distribution facility in the state of Georgia that would employ 1,000 people. While this represents a measurable capacity expansion for Amazon, it does not represent a commitment to expand. A distribution facility's infrastructure does not tend to be specialised, and the site could easily be sold as a distribution/warehouse facility for some other type of business. Thus, when competitors consider whether to expand into Amazon's markets, they would not consider the distribution facility as a commitment on Amazon's part not to reduce capacity in the future.

One might argue that Zeller's could easily discontinue its loyalty programme. However, Zeller's has made considerable investments in setting up infrastructure for this programme. These investments are unrecoverable. The loyalty programme functions as a commitment because it affects Zeller's incentives in the future. Zeller's understands, and Zeller's competitors understand that, having created loyal customers through this programme, maintaining this loyalty by continuing the programme is relatively cheap. The loyal customer base Zeller's has created functions like an asset purchased by Zeller's and with very little scrap value. The fact that the major investments in creating a loyalty programme have already been made means Zeller's is likely to remain on the path of promoting customer loyalty rather than switch to that of fierce price competition.

CD technology

Commitments then, can often be valuable in altering a competitor's responses. However, when considering a commitment, it is crucially important to consider the value of the flexibility foregone by undertaking the commitment. Harvard Business School Professor Anita McGahan considers an example of a company facing the decision of whether to build a large factory ahead of demand, in an article entitled, The Incentive not to Invest: Capacity Commitments in the Compact Disk Introduction. In 1982, on the eve of the launch of its compact disc in the US market, the Dutch electronics group Philips NV, inventors of CD technology, had to decide whether to build a large local facility immediately to press disks. As the innovator of the CD, Philips could bring a facility into production in 1983, much faster than any rival presser could enter the market. If the compact disc achieved US acceptance, Philips's lead in moving down the learning curve and its large installed capacity might deter others from building their own pressing facilities. By moving early, Philips might be able to deter others from entry and protect itself from destructive price competition in the future.

However, there was an important downside to this option. In 1982, it was not at all clear that CDs would achieve popular acceptance. After all, consumers already had record players and libraries of LPs. The next innovation, digital audio tape was only a few years down the line. Should the CD not catch on, Philips would be saddled with a $25m facility with almost no alternative uses.

Excluding the possibility of competition, it seemed to make sense for Philips to import CDs from existing facilities in Europe and not to invest in US capacity until it became clear that CDs would be accepted in that market. By waiting to see whether US consumers would be attracted to the CD, Philips could preserve the valuable option not to invest if acceptance were too low.

Philips, fearing that popular acceptance of the CD might be low, chose to wait and see how the US CD market evolved. Unfortunately for the company, however, Sony built a CD facility in the US in 1984. CDs were, of course, a great commercial success, and Philips and others entered with rival plants soon after.

While CD prices themselves have held fairly steady over the years, the prices charged to the record labels by the pressing facilities have declined precipitously, due to over capacity and fierce price competition in the pressing market.

An earlier move by Philips may well have resulted in a different market outcome. However, opting for flexibility may have been the right decision given the information available at the time. This example illustrates the difficult trade off between undertaking a commitment strategy and maintaining flexibility. While both strategies can be valuable, neither strategy provides insurance against regret later.

This week

COVER ILLUSTRATION
Darren Raven