Summary Strategic Management - Chapter 1-9

Strategic Management (King's College London)

STRATEGIC MANAGEMENT

Chapter 1

Developing the competitive strategic process

A strategy is a **set of actions** that **managers** take to increase their **company's performance relative to rivals**. If a company's strategy does result in superior performance, it is said to have ***competitive advantage***.

Competitive advantage and superior performance

Superior performance = one's company profitability relative to that of other companies in the same or a similar kind of business or industry.

***Profitability**:* the return that a company makes on the capital invested in the enterprise.

A company's profitability is determined by the strategies its managers adopt.

A company is said to have a competitive advantage over its rivals when its **profitability** is **greater** than the **average profitability** for all firm in its industry. A company is said to have a **sustained competitive advantage** when it is able to maintain **above-average profitability** for a number of years.

It is important to note that in addition to strategies, firms' profitability is determined by characteristics of the industry.

Strategic Managers

In most companies there are 2 main types of managers:

- General managers: bear responsibility for the overall performance of the company or one of its subunits or divisions

- Functional managers: responsible for supervising a particular function (e.g. accounting, marketing, R&D).

Company is a collection of functions or departments that work together to bring a particular product or service to the market.

Figure on the next page shows the organization of multidivisional company – a company that competes in several different businesses and has created a separate, self-contained division to manage each of them.

Corporate level managers

Corporate level of management consists of the CEO (chief executive officer), other senior executives, the BoD and corporate staff.

The role includes:

- Defining the goals of the organization
- Determining what businesses it should be in
- Allocating resources among different businesses
- Formulating and implementing strategies that span individual businesses
- Providing leadership for the entire organization

Corporate level managers also provide a link between the people who oversee the strategic development of a firm and those who own it (shareholders) => they can be viewed as agents of the shareholders. = responsibility to ensure that corporate business and corporate level strategies are consistent with maximizing profitability.

Business level managers

Business unit – a self-contained division (with its own function – e.g. finance, marketing) that provides a product or service for a particular market.

The principal general manager of the business unit is the **head of the division**.

Functional level managers

Functional managers' sphere of responsibility is generally confined to one organisational activity, whereas general managers oversee the operation of a whole company or division.

The model of the strategic planning process:

1) Select the corporate mission and major corporate goals
2) Analyze the organization's external competitive environment to identify opportunities and threats
3) Analyze the organization's internal operating environment to identify the organization's strengths and weaknesses
4) Select strategies that build on organization's strengths and correct its weaknesses in order to take advantage of external opportunities and

counter external threats. They should be congruent and constitute a viable business model

5) Implement the strategies
6) Progress Review

1) Each round of the planning process begins with a statement of the corporate mission and major corporate goals
2) Mission statement is followed by external analysis, internal analysis and strategic choice.
3) Strategy-making process ends up with the organization of the design of the organisational structure, culture and control systems necessary to implement the organization's chosen strategy.

Functional level strategy is directed at **improving** the **effectiveness** of **operations** within company, such as manufacturing, **marketing**, materials management, **product development** and customer service.

Business-level strategy encompasses the **business's overall competitive theme**, the way it **positions itself** in the **marketplace** to **gain competitive advantage**: cost leadership, differentiation, niche/segment focus within the industry, or a combination of all.

Global strategy is **addressing** how to **expand operations outside the home country to grow** and prosper in a world where competitive advantage is determined at the global level.

Corporate level strategy what business/businesses should the company be to maximize the long-run profitability and profit growth of the organization and how should the company enter and increase the presence of the company in these businesses to gain a competitive advantages.

Strategic planning is ongoing process. Once strategy has been implemented, its **execution must be monitored to determine the extent to which strategic goals** and objectives are **actually being achieved** and the extent to which strategic goals and objectives are actually being achieved and to what degree competitive advantage is being created and sustained.

Strategy As An Emergent Process

Several scholars have critics an assumption that **strategic planning is rational and highly structured, and orchestrated by top management**. Main reasons for criticism:

- The unpredictability of the real world
- The role that lower-level managers can play in the strategic management process
- The fact that many successful strategies are a result of serendipity, not rational strategizing

Strategy Making in an Unpredictable World

Critics of formal planning systems argue that we live in highly dynamic, uncertain and globalized world = premium for adopt quickly

Autonomous Action: Strategy Making by Lower-Level Managers

<u>*Autonomous Action*</u> is an action taken by lower-level managers who, on their own initiative, formulate new strategies and work to persuade top-level managers to alter the strategic priorities of a company

Lower-level managers might be less likely to have the same commitment to status quo, as top managers might have, and thus might be more keen to support new technologies and strategies within the firm.

Serendipity and Strategy

Some companies have missed out on profitable opportunities because serendipitous discoveries or events were inconsistent with their prior (planned) conception of what their strategy should be.

Intended and Emergent Strategies

Henry Mintzberg's model of Emergent and Deliberate Strategies:

A company's realized strategy is the **product** of whatever **planned strategies** are actually put into action (the company's deliberate strategies) and of any unplanned, or emergent, strategies. In Mintzberg's view, many planned strategies are not implemented due to unpredicted changes in the environment (unrealized).

Emergent strategies are the **unplanned responses to unforeseen circumstances.** They arise from **autonomous action by individual managers** deep within organization, from **serendipitous discoveries** or events, or from an unplanned strategic shift by top-level managers in response to changed circumstances = *not* a product of formal top-down planning mechanisms. = **usually successful and may be more appropriate than intended strategies.**

<u>Strategic Planning In Practice</u>

Despite criticism, research suggests that formal planning systems do help managers make better strategic decision. For strategic planning to work, however, I is important that top-level managers plan not just in the context of the current competitive environment but also try to find strategy that will best allow them to achieve a competitive advantage in the future competitive environment.

Scenario Planning

Scenario planning is formulating **plans that are based upon realization that the future is inherently unpredictable,** and that an organization should plan a range of possible futures.

Decentralized Planning

The Ivory Tower approach is treating **planning as an exclusively top management responsibility**. This approach can **result in strategic plans formulated in a vacuum by top managers who have little understanding** or appreciation of current operating realities. It can **also lead to tensions between corporate-, business-,** and functional-level managers.

Finally Ivory tower planning **ignores** the important strategic role of **autonomous action by lower-level managers and serendipity.**

<u>Strategic Decision Making</u>

One important way in which managers can make better use of their knowledge is to understand and manage their emotions during the course of decision-making.

Cognitive Biases

They seem to arise from a series of **cognitive biases** in the way that human decision makers process information and reach decisions – because of which bad decisions are still made even when good information is at disposal.

Prior Hypothesis Bias is a cognitive bias that occurs when decision-makers who have strong prior beliefs tend to make decisions on the basis of these beliefs, even when presented with evidence that their beliefs are wrong – in this way CEO might continue to pursues the strategy prior to his belief even if he has evidence that its falling

Escalating Commitment - a cognitive bias that occurs when decision makers, having already committed significant resources to a project commit even more resources after receiving feedback that the project is falling – personal responsibility induce decision-makers to stick with a project despite evidence that it is falling

Reasoning by analogy – a cognitive bias that involves the use of simple analogies to make sense out of complex problems – analogy may not be valid to solve it.

Representativeness – bias rooted in the tendency to generalize from a small sample or even a single vivid anecdote – dot-com boom when entrepreneurs saw success of Yahoo and Amazon as definite success for any start up leading to many going bankrupt.

Illusion of control – a cognitive bias rooted in the tendency to overestimate one's ability to control events – tendency to attribute their success in life to their own good decision making and their failures to bad luck. Popular with having too much confidence to create value by acquiring another company which usually fails.

Improving Decision Making

Two techniques known to enhance strategic thinking and counteract groupthink and cognitive biases:

Devil's Advocacy – a technique in which one member of a decision making group acts as a devils advocate, brining out all the considerations that might make the proposal unacceptable = one member of the decision-making group act as the devils advocate, bringing out all the reasons that might make the proposal unacceptable.

Dialectic inquiry – is more complex, for it requires the generation of a plan (a thesis) and a counterplan (an antithesis) that reflect plausible but conflicting courses of action = strategic manager listen to debate between the advocates and then make the decision on which judgment will lead to higher performance. As a result of this exercise, strategic managers are able to form a new and more encompassing conceptualization of the problem, which becomes the final plan

Strategic Leadership

One of the key strategic roles of both general and functional managers is to use all their knowledge, energy, and enthusiasm to provide strategic leadership for their subordinates and develop a high-performing organisation.

Key Characteristics of good strategic leaders that lead to high performance:

Vision, eloquence and Consistency – key leadership task is to give sense of direction and strong leaders have the clear vision of where their organisation should go and are eloquent enough to communicate their visions to others within their organisation in terms that energize people and consistently articulate their visions until they become part of the organisations culture. – Example Bill Gates with his vision of the world in which there would be a Windows based personal computer on every desk was a driving force at Microsoft.

Commitment – strong leaders demonstrate their commitment to their vision and business model by actions and words, and they often lead by example. Ken Iverson former Nucor's CEO had lowest salary, drove an old car etc.

Being Well Informed – effective strategic leaders develop a network of formal and informal sources who keep them well informed about what is going on within their company. For example Herb Kelleher at Southwest Airlines was able to find out a lot about the health of his company by dropping in unannounced on aircraft maintenance facilities and helping workers there to perform their tasks.

Willingness to Delegate and Empower – high-performance leaders are skilled at delegation. They recognize that unless they learn how to delegate effectively they can quickly become overloaded with responsibilities. They also recognize that empowering subordinates to make decisions is a good motivation tool. However, its important to keep the most important decisions for themselves.

The Astute Use of power – effective leaders tend to be very wisw in their use of power. He argued that strategic leaders must often play the power game with skill and attempt to build consensus for their ideas rather than use their authority to force ideas through – act as members or democratic members of coalition rather than as directors.

Emotional Intelligence – emotional intelligence is a term that describe a bundle of psychological attributes that many strong and effective leaders exhibit such as:

- Self-awareness.
- Self-regulation

Both help elicit the trust and confidence of subordinates

- Motivation
- Empathy
- Social Skills

STRATEGIC MANAGEMENT

CHAPTER 2

Governing stakeholders and business ethics

Stakeholders

Successful strategies consider their key constituencies that impact the functioning and ultimate survival of the company.

Corporate governance - mechanisms to monitor managers making sure they pursue strategies in the interest of shareholders.

Stakeholders

◦ Individuals or groups with an interest, claim, or stake in the company and how well it performs

◦ Anyone in an exchange relationship with the company *Why consider stakeholders?* ⏩ Stakeholders are key to the success of company ⏩ If their claims are not considered, stakeholders withdraw support ⏩ Stakeholders are in an exchange relationship with the company, therefore the company would not function as well if they lost the support Companies cannot satisfy all stakeholders, therefore companies must make choices. The impact analysis helps companies decide what stakeholders are most critical to survival. Steps of an Impact Analysis:

◦ Identify stakeholders

◦ Identify their interests and concerns

◦ Identify what claims they are likely to make

◦ Identify most important stakeholders

◦ Identify the resulting strategic challenges Most companies find that customers, employees, and stockholders are most important stakeholders.

The mission statement Purpose: To establish the guiding principles for strategic decision making. Includes 4 main elements:

◦ The Mission

◦ The Vision

◦ Values

◦ Goal of the Corporation The mission statement is a key indicator of how an organization views the claims of stakeholders. Describes what the company does.

▶▶ Can be *product oriented:*

◦ Focus on the product the company produces

▶▶ Can be *customer oriented:* ◦ Focus on satisfying customers' needs ◦ Example: Kodak focuses on providing imaging solutions to

customers, instead of focusing on the products that the company produces

---

The mission

Defining the business

Product orientation: · Only a physical manifestation

The need to take a customer-oriented view of a company's business has often been ignored. It helps to provide customers with the solutions they need and assists companies to capitalize on changes in their environment.

· E.g. Kodak – customer-oriented approach that helps customers to capture, store, process, output and communicate image.

The vision

The vision tells what the company would like to achieve, lays out some desired future state.

⏩ Intended to stretch a company by articulating its ambitions. ⏩ Meant to be an attainable goal that will motivate employees.

Values

Values tell how managers and employees should conduct themselves, how they should do business and what kind of organization they should build to help a company to achieve its mission.

Values establish the basis of the *organizational culture:*

◦ Organizational culture is the set of values, norms, and standards that control how employees work to achieve an organization's mission and goals.

◦ Organizational culture is an important source of competitive advantage. *Major goals* Having stated the mission, vision and key values, strategic managers an take the next step in the formulation of a mission statement: establishing major goals. Goal – is a precise and measurable desired future state that a company attempts to realize. Characteristics of well-constructed goals: ▶▶ Precise and measurable ▶▶ Address crucial issues ▶▶ Challenging but realistic ▶▶ Specify a time period

---

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

Most companies operate with goals of profitability and profit growth (as central goal of most organizations is to maximize shareholders' values). Problems arise when managers overemphasize profit growth.

Some companies tend to cut costs to increase short-term profits, but the cuts can be detrimental to the company in the long run.

It is worth noting that pressures to maximize short-term profitability may result in managers' acting in an unethical manner (e.g. Enron in 1990s).

Corporate governance and strategy

Stockholders are the legal owners of a company and the providers of risk capital.

The capital that stockholders provide is seen as risk capital - stockholder equity with no guarantee of profit or even recoupment.

Agency relationship - whenever one party delegates decision-making authority or control over resources to another person.

▶▶ Stockholders delegate control to agents ▶▶ Stockholders' agents = Managers

Agency problem

As agents for stockholders, managers should pursue strategies that maximize long run return for stockholders. However, managers sometimes pursue strategies that are not in the interest of stockholders.

Agency Theory offers an explanation for this behavior. Information asymmetry exists between the agent and the principal, because the agents almost always have more information.

To an extent, principal has to trust the agent to do the right thing. This trust is not blind: principals do put governance mechanisms in place whose purpose is to monitor agents, evaluate their performance, and if necessary, take corrective action.

Confronted with agency problems, the challenge for principals is to:

- Shape the behavior of agents so that they act in accordance with the goals set by principles

- Reduce the information asymmetry between agents and principals

- Develop mechanisms for removing agents who do not act in accordance with the goals of principals, or mislead principals

Monitoring managers – Governance mechanisms

Purpose is to monitor agents, evaluate their performance, and take corrective action to reduce the scope and frequency of agency problems. Goal is to align stockholder and management interests.

1. The board of directors

Board of directors **-** members elected by shareholders to make sure business decisions are in the shareholder's best interest.

- It can apply sanctions, such as voting against management nominations to the board of directors or submitting its own nominees. In addition, the board has legal authority to hire, fire, and compensate corporate employees, including, most importantly, the CEO.

- The board is also responsible for making sure that audited financial statements of the company present a true picture of its financial situation. (The typical board of directors is composed of a mix of inside and outside directors.

- *Inside directors* – senior employees of the company, such as CEO. They are required for the board because they have valuable information about the company's activities.

- *Outside directors* – not full-time employees of the company. Many of them are full-time professional directors who hold positions on the boards of several companies. Outside directors are needed to bring objectivity to the monitoring and evaluating processes. (Inside directors often dominate the outsiders on the board because of their superior knowledge and control over information are sources of power; they consequently may be better positioned than outsiders to influence boardroom decision making. (In the aftermath of a wave of corporate scandals in early 2000s, BoD are beginning to play a much more active role in corporate governance.

· E.g. growing trend on the part of the courts to hold directors liable for corporate misstatements.

2. Stock-based compensation

Stock-based compensation **-** pay-for-performance systems to reward ethical managers. = long-run profitability.

Some research studies suggest that stock-based compensation schemes for executives, such as stock options, can align management and stockholder interests.

3. Financial statements and auditors

Financial statements **-** reports that give consistent, detailed, and accurate information about how efficiently and effectively the company is run.

In the US – all publicly traded companies are required to file reports according to GAAT (generally agreed accounting principles). To make sure that they are adequate audits would be done by independent and accredited accounting firms.

BUT: e.g. in the US the system has not been working as intended => Enron's auditor – Arthur Anderson.

4. The takeover constraint

The takeover constraint **-** the risk of being taken over by another company. The takeover constraint limits the extent to which managers can pursue strategies to actions that put their own interests above those of stakeholders. If they ignore stakeholder interests and the company is acquired, senior managers typically lose their independence and probably their jobs as well.

Ethics and strategy

Ethics – refers to accepted principles of right and wrong that govern the conduct of a person, the members of a profession, or the actions of an organization.

Business ethics – accepted principles or right and wrong governing the conduct of business people.

Ethical dilemmas – situations where there is no agreement over exactly what the accepted principles of right and wrong are, or where none of the available alternatives seems ethically acceptable.

It is important to note, however, that behaving ethically goes beyond staying within the bounds of the law (e.g. in 1990s managers at Nike contracted out the production of sports shoes to producers in the developing world; Nike did not break laws, but there were ethical issues with regard to 'sweatshop labor'.

.

Ethical Issues:

- **Self Dealing** (occurs when managers find a way to feather their own nests with corporate money, e.g. Tyco)

- **Information Manipulation** (occurs when managers use their control over corporate data to distort or hide information in order to enhance their own financial situation, or the competitive position of the firm)

- **Anti-Competitive Behavior** (covers a range of actions aimed at harming actual or potential competitors, most often by using monopoly power, thereby enhancing the long-run prospects of the firm)

◦ **Opportunistic Exploitation** (occurs when the managers of a firm seek to unilaterally rewrite the terms of a contract with suppliers, buyers, or competent providers in a way that is more favorable to the firm, often using their power to force the revision through).

◦ **Environmental Degradation** (occurs when a firm takes actions that directly or indirectly result in pollution or other forms of environmental harm).

◦ **Corruption** (arises in a business context when managers pay bribes to gain access to lucrative (profitable) business contracts.

◦ **Substandard working conditions** (occurs when managers underinvest in working conditions, or pay employees below market rates, in order to reduce their costs of production).

The roots of unethical behavior

Business ethics are not divorced from personal ethics.

⏩ ↓A lack of separation between one's business ethics and personal ethics

⏩ ↓Failure to ask relevant questions

⏩ ↓Purely economical organizational culture

⏩ ↓Pressure from top managers

⏩ ↓Unethical behavior by company leaders. It is not what leaders preach that matters most, rather the example they set by their actions. *Behaving ethically*

Hiring and promotions: the act of hiring employees whose ethical principles are in line with the company's ethics.

Organizational culture: the culture within the business that should explicitly articulate ethical values and place a strong emphasis on ethical behavior.

Organizational leadership: once these values are explicated, it is important that leaders give life and meaning to these words by acting upon them.

Ethical officers: individuals responsible for making sure employees are trained to be ethically aware and that ethical considerations enter the business decision making process.

Strong corporate governance: rules that are established to make sure that managers adhere to ethical norms, and in particular, to make sure that senior managers do not engage in self-dealing or information manipulation.

Moral courage: courage that enables managers to walk away from a decision that is profitable, but unethical.

Decision making processes: business people must be able to think through the ethical implications of decisions in a systematic way. Moral compasses should be in place – ethical algorithms.

CHAPTER 3

INDENTIFYING OPPORTUNITIES AND THREATS THROUGH EXTERNAL ANALYSIS

The starting **point of strategy formulation is an analysis of the forces that shape competition** in the industry in which a company is based.

Opportunities – arise when a company can take advantage of conditions in its environment to formulate and implement strategies that enable it to become more profitable.

Threats – arise when conditions in the external environment endanger the integrity and profitability of the company's business.

Analyzing industry structure   **Industry** - a group of companies offering products or services that are close substitutes for each other.

Company's closest competitors – are **those that serve the same basic customer needs.**

The **starting point of external analysis is to identify the industry that a company competes** in. To do this, managers must begin by looking at the basic customer needs their company is serving, they must take customer-oriented view.

⇨⇨ It is highly important to define boundaries of industry correctly.

Once boundaries are defined, the task facing managers is to analyze competitive forces in the industry environment to identify opportunities and threats.

<u>Porters 5 forces</u>

Porter argues that the stronger each of these forces, the more limited the ability of established companies to raise prices and earn greater profits.

Risk of entry by potential competitors

Potential competitors – are companies that are not currently competing in an industry but have the capability to do so if they choose.

Established companies already operating in an industry often attempt to discourage potential competitors from entering the industry because the more companies enter, the more difficult it becomes for established companies to protect their share of the market and generate profits.

The risk of entry by potential competitors is a function if the height of **barriers to entry –** factors that make it costly for companies to enter an industry.

⇨⇨ High barriers to entry may keep potential competitors out of an industry. Economies of scale Arise when unit costs fall as a firm expands its output.

Sources of economies of scale:

- Cost reductions gained through mass-producing a standardized output
- Discounts on bulk purchases of raw material inputs and component parts
- Advantages gained by spreading fixed production costs over a large (production volume
- Cost savings associated with spreading marketing and

advertisement (costs over a large volume of output. (Brand loyalty (Exists when consumers have a preference for the products of established companies. (A company can create brand loyalty through:

- continuous advertisement
- patent protection of products
- product innovation achieved through company research and (development programs
- emphasis on high product quality
- good after sales service (Absolute cost advantages (Absolute cost advantage - a cost advantage that is enjoyed by incumbents in an industry and that new entrants cannot expect to match. (They arise from 3 main sources:
- Superior production operations and processes due to accumulated experience in an industry, patents, or secret processes
- Control of particular inputs required for production, such as labour, materials, equipment or management skills, that are limited in their supply
- Access to cheaper funds because exiting companies represent lower risks than new entrants (Customer switching costs (Switching costs arise when it costs a customer time, energy and money to switch from the products offered by one established company.

⇨⇨ Faced with high expense of money and time, most people are unwilling to make the switch unless competing product offers a substantial step forward in performance.

Government regulation

- Historically, government regulation has constituted a major entry barrier into many industries.

- Nowadays, institutional context matters in certain industries.

Rivalry among established companies (**Rivalry** refers to the competitive struggle between companies in an industry to gain market share from each other. (Companies struggle can be fought using:

- Price

- Product design

- Advertising and promotion spending

- Direct selling efforts

- After-sales service and support (The intensity of rivalry among existing firms within an industry is largely a function of 4 factors:

1. Industry competitive structure

Competitive structure of an industry refers to the number and size distribution of companies in it.

- **Fragmented industry –** consists of a large number of small- and medium- sized companies, none of which is in a position to determine industry price.

- **Consolidated industry –** is dominated by a small number of large companies (an oligopoly), or in extreme cases, by just one company (a monopoly) in which companies often are in a position to determine industry prices. (Many *fragmented industries* are characterized by low entry barriers and commodity-type products that are hard to differentiate.

- Often flood of new entrants into booming fragmented industries creates excess capacity and as a result – price war.

- A fragmented industry structure, then, constitutes a threat rather than an opportunity.

In *consolidated industries,* companies are interdependent, because one company's competitive actions or moves directly affect the market share of its rivals, and thus their profitability.

- Risk of dangerous competitive spiral

- Price fixing is illegal; instead companies set prices by watching, (interpreting, anticipating, and responding to each other's behavior. Industry demand (Growing demand from new customers or additional purchases by exiting customers tend to reasonable competition by providing greater scope for companies to compete for customers. (⇨⇨ Growing demand tends to reduce rivalry because all companies can sell more without taking market share away from other companies. (⇨⇨ Declining demand constitutes a major threat for it increases the extent between established companies. (Cost conditions (In industries where fixed costs are high, profitability tends to be highly leveraged to sales volume, and the desire to grow volume can spark off intense rivalry.

· When fixed costs are high and sales volume is not sufficient to cover costs, it will lead to intense rivalry.

Exit barriers

Exit barriers – economic, strategic, and emotional factors that prevent companies from leaving an industry.

If exit barriers are high, companies become locked into an unprofitable industry where overall demand is static or declining.

⇨⇨ Result is often excess capacity and intensified rivalry. Common exit barriers:

- Investment in assets such as specific machines, equipment, and operating facilities when it cannot be sold or used alternatively
- High fixed costs of exit, such as pensions paid to workers
- Emotional attachments to the industry
- Economic dependence on an industry because a company relies on a single industry for its revenue and profit

---

· Bankruptcy regulations ***The bargaining power of buyers***

An industry **buyers may be the individual customers who ultimately consume its products or the companies that distribute an industry's products to end users, such retailers and wholesalers.**

Bargaining power of buyers – refers to **the ability of buyers to**

bargain down prices charged by companies in the industry or to raise the costs of companies in the industry by demanding better product quality and service.

⇨⇨ Powerful buyers should be viewed as a threat. Buyers are most powerful in the following circumstances:

□When buyers are large and few in numbers, while suppliers are big in numbers

□When buyers purchase is big in quantities

□When switching costs are low

□When buyers can threaten to enter the industry and produce the product (themselves (***The bargaining power of suppliers*** (*Bargaining power of suppliers* – refers to the ability of suppliers to raise input prices, or to raise the costs of the industry in other ways. (⇨⇨ Powerful suppliers are a threat. Suppliers are most powerful in the following situations:

□The product that suppliers sell has few substitutes and is vital to the companies in an industry.

□The profitability of suppliers is not significantly affected by the purchases of companies in a particular industry.

□Companies in an industry would experience significant switching costs if they moved to the product of a different supplier.

□Suppliers can threaten to enter their customers industry. ***Substitute products*** (*Substitute products* – products of different businesses and industries that can satisfy similar customer needs (e.g. companies in coffee industry compete indirectly with tea companies).

⇨⇨ The existence of close substitutes is a strong competitive threat. **Strategic groups within industries**

Strategic groups - groups of companies within an industry that follow a similar strategy (e.g. high risk, high return strategy).

The closest competitors for a company are those in its strategic group. The most immediate *threat to profitability* comes from rivals within the strategic group.

Each strategic group may face a different set of opportunities and threats.

⏵⏵ Varied threats include:

◦ Risk of new entry

◦ Degree of rivalry

◦ Bargaining power of buyers and sellers

◦ Competitive force of substitute and complementary goods

Moving from one strategic group to another may be difficult or impossible. Mobility Barriers: Within-industry factors that inhibit movement between strategic groups (e.g. forest Labs entering the pharmaceutical industry: they would encounter barriers because they lack resources and competencies necessary to compete).

Pharmaceutical industry:

Industry life cycle analysis

The industry life cycle is important in analyzing the strength of competition in an industry.

⏵⏵ Competition increases as the industry progresses through the cycle.

Embryonic:

◦ The industry is just beginning to develop

◦ Development is slow as buyers are unfamiliar with product

◦ High prices due to absence of scale economies

◦ Rivalry based not on prices rather on educating customers

◦ Competition might be intense

Growth:

◦ Demand is expanding rapidly

◦ Many new customers

◦ Prices fall with development and higher volume (scale economies)

◦ Entry barriers are relatively low (as insignificant scale economies and brand loyalty)

◦ Relatively low competition (as industry is growing new competitors might be absorbed into industry without much loss to profitability of others)

Shakeout:

◦ Rate of growth slows

◦ Demand approaches saturation levels

◦ Few potential first-time buyers

◦ Rivalries become intense

◦ Excess capacity may exist

Mature:

◦ Market is totally saturated

◦ Demand is limited to replacement demand

◦ Growth is low or zero

◦ Barriers increase

◦ Threat of new entries decrease

◦ Competition drives prices down, often resulting in price wars (e.g. airline industry)

◦ Most industries become consolidated

Decline:

◦ Falling demand = Excess capacity

◦ Growth becomes negative due to: ⏩ Technology substitution ⏩ Demographics ⏩ International competition

The macroenvironment **Macroenvironment -** the broader economic, global, technological, demographic,

social, and political contexts of business.

The macro-environment impacts the strength of forces in Porter's model and ultimately, the attractiveness of the industry.

It is important for managers to pay close attention to external forces on their industry due to their direct impact.

Macroeconomic forces

◦ Forces at the national or regional level

◦ Most important forces to monitor are: •• growth rate of the economy •• interest rate •• currency exchange rates •• price inflation

Global forces

◦ Many countries experiencing economic growth since barriers to international trade have tumbled.

◦ Growth in places like Brazil, China, and India is creating large new markets for goods and services. **Technological forces**

◦ Technological changes are destructive to some companies (threats) and creative for others (opportunities.)

◦ They can affect the height of barriers of entry and reshape an industry. **Demographic forces**

◦ Outcomes of change in characteristics of the population such as: ▶▶ Age - ▶▶ Gender ▶▶ Ethnic origin

▸▸ Social class ▸▸ Race ▸▸ Sexual orientation

◦ Currently there is a growing aging population, which is an opportunity for organizations to cater to an older age group. **Social forces**

◦ Changing social mores and values affect industry, such as the trend toward health conscientiousness that causes customers to pay attention to different characteristics of products.

Political and legal forces

◦ Changes in laws and regulations that impact managers and companies.

◦ Result from political and legal developments within society and significantly affect businesses.

◦ Firms and industries strive to influence the regulations that government enacts.

Strategic Management
Chapter 4
Building Competitive Advantage

Two basic conditions determine a company's profitability:

- <u>Amount of value customers place on the company's goods or services</u>
  - Value creation is at the heart of competitive advantage
  - The greater the value customers place on a product, the more the company can charge.
  - A product's price is usually less than the value placed on it by the average customer.
  - This causes customers to capture consumer surplus.

- <u>Company's costs of production</u>

  A company will look for ways to increase productivity of capital and labor through:
  - Economies of Scale
  - Spread fixed cost over large product volume
  - Greater division of labor and specialization

Profit margin is equal to P-C, where P is price, C is Cost

Company makes profit as long as P > C, and its profit rate will be greater the lower is C relative to P

Difference between V (value per customer) is in part determined by the intensity of competitive pressure in the market place. The lower the intensity of competitive pressure, the higher the price that can be charged relative to V^2

A Company can create more value for customers either by lowering C or by making product more attractive through superior design, functionality, quality etc, so that customers place greater value on it (V increases) and thus are willing to pay higher price (P increases)

The concept of value creation lies at the heart of competitive advantage

- *Competitive Advantage* occurs when a company's profitability is greater than the industry's average profitability
- *Competitive advantage* over several years is considered ***Sustained***

Resource-Based View of Competitive Advantage

- Suggests that competitive advantage is attained through firm resources that are:
  - Valuable - they enable a firm to implement strategies that improve its efficiency and effectiveness
  - Rare - not available to other competitors
  - Imperfectly imitable - not easily implemented by others
  - Non-substitutable - not able to be replaced by some other non-rare resource

Superior value creation require that the gap between perceived value V and costs of production C be greater than the gap attained by competitors

According to Porter, competitive advantage (and higher profitability) goes to those companies that can create superior value by driving down costs of production and/or differentiate the product in some way so that consumers value it more and are prepared to pay a premium price.

The Competitive Building Blocks Of Competitive Advantage

- Four Factors:
  - Efficiency
  - Quality
  - Innovation
  - Customer Responsiveness

These are the generic building blocks of competitive advantage that any company in any industry can adopt.

Efficiency

Efficiency is the quantity of inputs that it takes to produce a given output.

Efficiency = outputs/inputs. The more efficient a company is, the fewer inputs are required to produce a given output.

The most important components of efficiency for many companies are *employee productivity* (output per employee) and *capital productivity* (output per unit of invested capital)

Quality as Excellence and Reliability

From a *Quality as Excellence* perspective, the important attributes are things such as a product's design and styling, features and functions, and level of service associated with the delivery of a product. When excellence is built into product offering, consumers have to pay more to own or consume the product

Quality as Reliability

- A product is reliable if it:
  - Consistently does the job it was designed for
  - Does the job well
  - Rarely, if ever, breaks down
- Less time is spent of defective products and fixing mistakes

Reliability increases the value a consumer gets from the product and increases the price that the company can charge

Providing high quality products increases customers' perceived value and allows Bs to charge higher prices; also, the more products are reliable, the greater efficiency and lower unit costs.

Innovation

- The act of creating new products or processes
  - Innovations give a company something *unique* that their competitors lack
  - In the long run, innovation is perhaps the most important part of competitive advantage
- <u>Product Innovation-</u> The development of products that are new to the world or have superior attributes to existing products.
- <u>Process Innovation</u>-The development of a new process for producing products and delivering them.

Customer Responsiveness

- If a customer's need is satisfied better by a certain product, the customer will attribute more value to the product.
- More value creates a differentiation and ultimately a competitive advantage

Customer Response Time- that time it takes for a good to be delivered or a service to be performed.

Functional Strategies and The Generic Building Blocks of Competitive Advantage

Increasing Efficiency

- By simplifying the design of a product, R&D can dramatically decrease the required assembly time, which translates into higher employee productivity, lower costs, and higher profitability
- *Economies of scale*: a major source of EoS is the ability to spread FC over a production volume; another source is Specialization, which is said to positively impact productivity because employees become more skilled at performing particular task
- *Learning Effects*- costs savings that come from learning by doing. Labor productivity increases over time, and unit costs fall as individuals learn the most efficient way to perform a particular task
- *Lean Production*- a range of manufacturing technologies designed to reduce setup times for complex equipment, increase the use of individual machines through better scheduling, and improve quality control at all stages of the manufacturing process
- *Mass Customization*- the ability of companies to use flexible manufacturing technology to customize output at costs normally associated with mass production
- *Marketing Strategy*- the position that a company takes with regard to pricing, promotion, advertising, product design and distribution
- *Customer Defection Rate*- the percentage of a company's customers who defect every year to competitors
- *Material Management and Efficiency*- for a typical manufacturing company, materials and transportation costs account for 50-70% of its revenues, so even small reduction in these costs can have a substantial impact on profitability
- *With JIT*- major cost saving comes from increasing inventory turnover, which reduces inventory holding costs, such as warehousing and storage costs, and the company's need for working capital
- *HR and Efficiency/ Self-Managing Team- a team wherein members coordinate their own activities*
- *The effect of introducing self-managing teams*- increase in productivity of 30% or more and also a substantial increase in product quality
- *Infrastructure*- can foster companywide commitment to efficiency and promote cooperation among departments

Increasing Quality

Improved quality means:

- Decreased costs due better use of time and materials=> productivity improves=> better quality leads to higher market share and allows the company to raise prices=> increase in profitability

In order to improve quality management needs to identify defect, from which process it arises, what causes this defect, and after, management should make correction

One key to quality improvement is to create a metric to measure quality.

It is important to identify which product attributes are the most valuable to customers and then to design products and associated services to satisfy customer needs. Also it is essential to remember that competition also produces continual improvement

Increasing Innovation

Research suggests that only 10-20% of major R&D projects give rise to commercial products.
Reasons for Innovation failures:

- Demand for innovation is inherently uncertain
- Technology is poorly commercialized
- Poor positioning strategy. Positioning Strategy- the specific set of option a company adopts for a product on four main dimensions: price, distribution, advertising, promotion and product features

Tight cross-functional integration can help a company to successfully implement product innovation:

- Market research=>better understand customer needs
- Design hat allows ease of manufacture
- Control of costs
- Time to market is minimized

Management can form teams of employees form key departments. Team members should have an ability to contribute functional expertise and willingness to share responsibility for team results and an ability to put functional advocacy aside. Team members should be co-located and have a clear plan and set of goals

Heavyweight Project Manager-a project manager who has status within the organization and the power to and authority required to get the financial and HR that a team needs to succeed.

Increasing Customer Responsiveness

Superior efficiency, quality, innovation are all part of achieving superior customer responsiveness.

Product can be differentiated by customization, which refers to varying the features of a good or service to tailor to unique needs and tastes of groups of customers; and reducing the time it takes to respond to or satisfy customer needs.

The Value Chain

- Idea that a company is a chain of activities for transforming inputs into outputs that customers value
- Consists of *primary* and *support* activities

Primary Activities

Primary Activities are those related to the design, creation, and delivery of the product, its marketing, and its support activities.

- Research and Development
- Production
- Marketing and Sales- Through brand positioning and advertising, the marketing function can increase the value customers perceive to be contained in a company's product
- Customer Service- after-sales service and support

Support Activities

- Provide inputs for primary activities
    - Material Management (logistics)- controls the transmission of physical materials through the value chain, form procurement through production into distribution
    - Human Resources
    - Information Systems-electronic systems for managing inventory, tracking sales, products, dealing with customer service inquires
    - Company Infrastructure – the companywide context within which all the other value creation activities take place: the organizational structure, control systems, and company culture

Distinctive Competencies and Competitive Advantage

- Distinctive Competency is a unique firm-specific strength that allows a company to better *differentiate* or achieve *lower cost* than rivals
- Arise from Resources and Capabilities

- Resources- Financial, physical, social or human, technological, and organizational factors that create value to customers.
- Can be *Tangible* or *Intangible*
  Example:
  Tangible = land, building, equipment
  Intangible = brand names, reputations

- Capabilities- a company's skills at coordinating its resources and putting them into productive use.
- Capacities are needed to *utilize* resources

A company's distinctive competency is the strongest when it possesses both firm specific and valuable resources and firm specific capabilities to manage those resources

Durability

- When a company has superior profitability, other companies are inclined to imitate the successful strategy.
- Durability of competitive advantage depends on the ease or difficulty to copy distinctive competencies.
- Barriers of Imitation are the factors that make copying difficult for competitors.
- Even if a company's distinctive competencies are protected by higher barriers to imitation, it should act as if rivals are continually trying to nullify its source of advantage

Strategic Management
Chapter 5
Positioning for Competitive Business-Level Strategy

Business-Level Strategy- The plan of action that managers adopt to use resources and distinctive competencies to gain a competitive advantage

- Basis of choosing a business level strategy by determining how well a company can compete
    - ***What*** customer need will be satisfied?
    - ***Who*** is to be satisfied?
    - ***How*** will the need be satisfied?

Customer Needs- Desires, wants, or cravings that can be satisfied by means of the characteristics of a product or service

Product Differentiation- the process of creating a competitive advantage by designing goods or services to satisfy customers needs. The greater the differentiation, the more money a customer will pay for the product

Customer Groups

Market Segmentation- the way a company decides to group customers, based on important differences in their needs or preferences

Alternatives to Market Segmentation:
- Choose not to recognize different needs; just aim to serve the average customer.
- Separate markets and create a product to suit each group.
- Concentrate on serving only one segment.

Distinctive Competencies:
- Decide which distinctive competencies to pursue to satisfy customers
- Decide how to organize and combine distinctive competencies to gain a competitive advantage

Choosing a Business-Level Strategy

- *Three basic competitive approaches:*
    - Cost Leadership- to outperform competitors by doing everything it can to produce goods or services at the lowest possible cost.
    - Differentiation- the differentiated product has the ability to satisfy a customer's need in a way that competitors cannot.
    - Focus- directed toward serving the needs of a limited customer group or segment

Cost-Leadership Strategy

- Goal: Outperform competitors by increasing efficiency at a lower cost
- Cost leader chooses low level of differentiation
- Positions the product to appeal to the average customer
- Does not try to be the industry leader in differentiation; it waits until customers want a feature or service before providing it
- Usually ignores market segments; engages in only a limited amount of market segmentation, lower price attracts wider target population

Advantages:
Charge lower price than competitors but make the same level of profit

Withstand competition based on price
Lower costs=>less affected by powerful suppliers and buyers
Large quantity of production=> increasing bargaining power over suppliers
Can reduce price in case substitute products start to enter the market=> barriers to entry

Disadvantages:
Easy to lose sight of changes in customers' taste
Competitors will try to beat the cost leader at its own game by finding ways of lowering prices such as imitating the processes. E.g. ability of Dell's major competitors HP, Acer and Lenovo to imitate Dell's low-cost materials management practices has eroded its competitive advantage and Dell is struggling to find new ways to compete

Differentiation Strategy

Differentiation Strategy- a strategy of trying to achieve a competitive advantage by creating a product that is perceived by customers as unique in some important way

Broad Differentiator-a company that offers a product designed for each market niche.

- Goal: To achieve a competitive advantage by creating a product that customers perceive as unique in some important way
- A differentiated company can charge a premium price based on psychological appeal to customers e.g. status and prestige; innovation, customer responsiveness and quality

Advantages
Customers develop brand loyalty for a product
Less likely to be put under pressure of powerful buyer because company offers unique product and also moderate price increases of components can be tolerated
Differentiation creates barriers to entry for other companies

Disadvantages
Difficult to maintain uniqueness in the customer's eye
Threat of substitute products

Cost Leadership and Differentiation

- Flexible manufacturing strategies make the choice between these two strategies less clear-cut
- The new flexible manufacturing technologies makes diversification inexpensive for firms, allowing firms to obtain benefits of both strategies
- E.g. expanding markets=> differentiated producer can also enjoy economies of scale e.g. iPhone

Focus Strategy

Focus Strategy-a strategy of serving the needs of one or a few customer groups or segments

- Goal: To serve the needs of a *limited customer group or segment*
- Concentrate on serving a:
  - Geographic area
  - Type of customer
  - Segment of the product line

Advantages
Customer loyalty lessens the threat of substitutes (high barriers to entry created by product uniqueness) and of powerful buyers
Power over buyers because they cannot get the same product elsewhere

Disadvantages
Suppliers have power over focused firms, making the firms vulnerable to changes
Vulnerable to attack, therefore must define its niche constantly e.g. Ford's new luxury cars are aimed to compete within BMW, Mercedes-Benz and Audi
Higher costs involved that might reduce profitability

Stuck in the Middle

Stuck in the Middle – a problem which occurs when company's strategy fails because it has made product/market choices in a way that does not lead to a sustained competitive advantage

<u>Competitive Positioning In Different Industry Environments</u>

Strategies in Fragmented and Growing Industries

- Focus strategy stands out as the best choice through:
    - *Chaining* allows cost advantage and amazing buying power to promote competitive advantage e.g. Wal-Mart and Midas International uses this strategy. They establish networks of linked merchandising outlets that are so interconnected that they function as one large entity
    - *Franchising* solves the problem of maintaining control over each location and retaining uniqueness.
    - Horizontal Mergers consolidate an industry to secure a market.
    - Using the Internet consolidates fragmented industries globally.

Strategy in Mature Industries

- In a mature industry it is crucial to adopt a strategy that will simultaneously preserve competitive advantages while preserving industry profitability
- Interdependent companies adopt strategies to:
    - Manage rivalry
    - Deter entry

Strategies to Deter Entry in Mature Industries

Product Proliferation- a strategy in which leading companies in an industry all make a product in each segment or niche and compete head-to-head for customers.
This creates a barrier to entry because potential competitors now find it harder to break into an industry in which all niches are filled. E.g. Toyota

Price Cutting- Most evidence suggests that companies first skim the market and charge high prices during the growth stage, maximizing short-run profits. Then they can more to increase their market share and charge a lower price to expand the market rapidly; develop a reputation; and obtain economies of scale, driving down costs and barring entry. As competitors do enter, incumbent companies reduce prices to retard entry and give up market share to create a stable industry context- one in which they can use nonprice competitive tactics, such as product differentiation, to maximize long-run profits.

Maintaining Excess Capacity- producing more of a product that customers currently demand

Strategies to Manage rivalry in Mature Industries

Price Signaling- the process by which companies increase or decrease product prices to convey their competitive intentions to other companies. Then companies move to Tit-for-Tat strategy if one company starts to cut prices more aggressively

Tit-for-Tat Strategy- a form of market signaling in which one company starts to cut prices aggressively, and then competitors respond in a similar way; when this occurs, nobody gains

Price Leadership- the process by which one company informally takes the responsibility for setting industry prices. Although price leadership can stabilize industry relationships by preventing head-to-head competition and thus raise profitability within an industry, it ha s a problem of helping companies with higher costs by allowing them to survive without becoming more productive and more efficient, this can be dangerous in the long run.

Market Penetration- a strategy in which a company concentrates on expanding market share in its existing product markets. Involves heavy advertising to promote and build product differentiation. In consumer goods industries market penetration becomes a way of life for many products (e.g. diapers and deodorants)

Product Development- a strategy involving the constant creation of new or improved products to replace existing ones

Market Development- a strategy involving a search for a new market segments, and therefore new uses, for a company's products

Product Proliferation- a strategy in which leading companies in an industry all make a product in each segment or niche and compete head-to-head for customers.
This creates a barrier to entry because potential competitors now find it harder to break into an industry in which all niches are filled. E.g. Toyota

Strategies in Declining Industries

- When market is shrinking, competition tends to intensify and profit rates tend to fall
- Strategies to deal with decline include:
  - Leadership Strategy- involves a company seeking to become the dominant player in the industry
  - Niche Strategy- focuses on pockets of demands that are declining more slowly
  - Harvest Strategy- optimizes cash flow for a short period of time
  - Divestment Strategy- occurs when a company sells off its business to others

Strategy Selection in a Declining Industry

Leadership Strategy- a strategy through which a company seeks to become the dominant player in a declining industry via aggressive advertising and marketing to build market share; acquiring established companies to consolidate the industry

Niche Strategy- the strategy of focusing on pockets of demand that are declining more slowly than demand in the industry as a whole

Harvest Strategy- a strategy that optimizes cash flow; requires to cut all investments on R&D, advertising etc. Company will be most likely to loose market share but it might improve cash flow, however, ultimately cash flow will decline.

Divestment Strategy- a strategy in which a company sells off its business assets and resources to other companies. The success of the strategy depends on the ability of a company to foresee industry's decline before it becomes too serious and thus to sell out while the company's assets are still valued by others.

Using SWOT Analysis to Understand Whether a Given Industry is Viable for New Entry

- Identify
  - Strengths
  - Weaknesses
  - Opportunities
  - Threats

  - How can we **Use** each **Strength**?
  - How can we **Stop** each **Weakness**?
  - How can we **Exploit** each **Opportunity**?
  - How can we **Defend** against each **Threat**?

Strategic Management
Chapter 6
Global Strategy

The Global Environment

Fifty years ago most national markets were isolated from each other by significant barriers to international trade and investment – managers could only focus on analyzing just those national markets in which their companies competed. They did not need to pay much attention to entry by global competitors, as there were few and entry was difficult + no attention was paid to foreign markets at it was often expensive. However, from now it has changed with the rise of many Multinationals i.e. MacDonald's etc. intensifying rivalry from industry to industry. Now we are going to look at different ways of how global expansion can benefit companies.

Increasing Profitability Through Global Expansion

There are number of ways in which expanding globally can enable companies to increase their profitability and grow their profits more rapidly. At the most basic level, global expansion increase the size of the market a company is addressing thereby boosting profit growth. Moreover, global expansion offers opportunities for reducing the cost structure of the enterprise, or adding value through differentiation, thereby potentially boosting profitability.

Expanding the Market: Leveraging Products and Competencies

A company can increase its growth by taking goods or services developed at home and selling them internationally – most multinationals do so. Procter and Gamble, for example, developed most of its best selling products at home, and then sold them around the World. The returns from such a strategy are likely to be greater if indigenous (homegrown) competitors in the nations a company enters lack comparable products. For e.g. Toyota has grown its profits by entering the large automobile markets of North America and Europe, offering products that are differentiated from those offered by local rivals

It is important to note that the success of many multinational companies is based not just upon the goods and services that they sell in foreign nations, but also upon the distinctive competencies that underlie the production and marketing of those goods and services. Pushing this further, one could say that since distinctive competencies are in essence the most valuable aspects of a company's business, successful global expansion by manufacturing companies like Toyota and P&G was based upon their ability to take their distinctive competencies and apply them to foreign markets.

The same can be said of companies engaged in the services sectors of an economy – such as financial institutions, retailers, restaurant chains and hotels. Expanding the market for their services often means replicating their basis business model in foreign nations – Starbucks is expanding rapidly outside of the United States by taking the basic business model it developed at home.

Realizing Economies of Scale

In addition to above company can expand its sales volume through international expansion a company can realize cost savings from economies of scale, thereby boosting profitability – scale economies come from several sources. First, by spreading the fixed costs associated with developing a product and setting up production facilities over its global sales volume, a company can lower its average unit cost. – Microsoft garner significant economies of scale by spreading the $5 billion it cost to develop Windows Vista over global demand.

Second, by serving a global market, a company can potentially utilize its products facilities more intensively, which leads to higher productivity, lower costs and greater profitability – Intel able to produce microchips 7 days a week in 2 shifts by expanding globally in different markets = Capital invested is used more intensively. Third, as global sales increase the size of the enterprise, so its bargaining power with suppliers increases, which may allow it to bargain down the cost of key inputs and boost profitability.

Realizing Location Economies

We already discussed how countries differ from each other along a number of dimensions, including differences in the cost and quality of factors of production. These differences imply that some locations are more suited than others for producing certain goods and services. **Location economies** – are the economic benefits that arise from performing a value creation activity in the optimal location for that activity, wherever in the world that might be. Locating a value creation activity in the optimal location for that activity cab have one of two effects: **(1)** it can lower the costs of value creation, helping the company achieve a low-cost position, **(2)** it can enable a company to differentiate its product offering, which gives it the option of charging a premium price or keeping price low and using differentiation as a means of increasing sales volume. Thus, efforts to realize location economies are consistent with the business-level strategies of low cost and differentiation. For example IMB think pad – designed in US, keyboard in South Korea, wireless card built in Malaysia.

Leveraging the Skills of Global Subsidiaries

Initially, many multinationals companies develop the valuable competencies and skills that underpin their business in their home nation then expand internationally, primarily by selling product and services based on those competencies. Thus, Walmart honed its retailing skills in the United States before transferring them to foreign locations. However, for more mature multinationals enterprises that have already established a network of subsidiary operations in foreign markets, the development of valuable skills can just as well occur in foreign subsidiaries. – McDonalds find that its foreign franchisees are a source of valuable new ideas.

Cost Pressures and Pressures for Local Responsiveness

Companies that compete in the global marketplace typically face two types of competitive pressures*: pressure for cost reductions and pressures to be locally responsive.*

Pressures for Cost Reductions

In competitive global markets, international business often face pressures for cost reductions. Responding to pressures for cost reduction requires a firm to try to lower the costs of value creation. A manufacturer, for example, might mass-producing a standardized product at the optimal location in the world, wherever that might be, to realize economies of scale and locations economies. Alternatively, they might outsource certain functions to low cost foreign suppliers in an attempt to reduce costs. – Banks outsourcing telephone service etc. Cost-reduction pressures can be particularly intense in industries producing commodity-type products where meaningful differentiation on nonprice factors is difficult and price is the main competitive weapon. This tends to be the case for products that serve **Universal needs** – needs arising from the similar, if not identical tastes and preferences of consumers in different nations.

Pressures for Local Responsiveness

Pressures for local responsiveness arise from differences in consumer tastes and preferences, infrastructure and traditional practices, distribution channels and host government demands. Responding to pressures to be locally responsive requires that a company differentiate its products and marketing strategy from country to country to accommodate these factors, all of which tends to raise a company's cost structure.

Differences in consumer tastes – when customer tastes and preferences differ significantly between countries for historic or cultural reasons – in such cases a multinational company' products and marketing message have to customized to appeal to the tastes and preferences of local customers hence putting pressure of production and marketing responsibilities to a company's overseas subsidiaries. – Example is the differences of car industry around the globe – for example somewhere Trucks are purchased as family cars where as elsewhere it may strictly be firms vehicle.

Differences in Infrastructure and Traditional Practices – arise from differences in infrastructure or traditional practices among countries, creating a need to customize product accordingly. Fulfilling this need may require the delegation of manufacturing and production functions to foreign subsidiaries. – Example: Left-or-right hand wheel varies from country to country

Differences in Distribution Channels – a company's marketing strategies may have to be responsive to differences in distribution channels among countries, which may necessitate the delegation of marketing functions to national subsidiaries.

Differences in Host Government Demands – Economic and political demands imposed by host country governments may require local responsiveness. For example, pharmaceutical companies are subject to local clinical testing, registration procedures, and pricing restrictions all of which make it necessary that the manufacturing and marketing of a drug should meet local requirements.

Choosing a Global Strategy

Pressures for local responsiveness imply that it may not be possible for a firm to realize the full benefits from economies of scale and location economies. It may not be possible to serve the global marketplace from a single low cost location, producing a globally standardized product, and marketing it worldwide to achieve economies of scale – in practice, the need to customize the product offering to local conditions may work against the implementation of such strategy. For example, automobile firms have found that Japanese, American, and European consumers demand different kinds of cars, and this necessitates producing products that are customized for local markets. – hence Automobile industries use top-to-bottom design and production facilities in each of these regions so that they can better serve local demands

Global Standardization Strategy

Companies that pursue **a global standardization strategy** focus on increasing profitability by reaping the cost reductions that come from economies of scale and location economies – strategy is to pursue a low-cost strategy on a global scale.

- Production, marketing and R&D are concentrated in a few favorable locations
- Companies pursuing a global standardization strategy try not to customize their product offering and marketing strategy to local conditions because customization, which involves shorter production runs and the duplication of functions, can raise costs - hence some companies choose to market standardized product worldwide so that they can reap the maximum benefits from economies of scale.
- This Strategy makes more sense when there are strong pressures for cost reductions and demand for local responsiveness is minimal – increasingly these conditions prevail in many industrial good industries, whose products often serve universal needs.

Localization Strategy

Localization strategy is a strategy that focuses on increasing profitability by customizing the company's goods or services so that they provide a good match to tastes and preferences in different national markets.

- Most appropriate strategy when there are substantial differences across nations with regard to consumer tastes and preferences, and where cost pressures are not too intense

- By customizing product to local demand the company increases the value of that product to local market

- However its more costly to customize as mass production is not possible

- MTV is the best example - each country own channel.

Transnational Strategy

Transnational Strategy – a strategy in which firms try to simultaneously achieve low costs, differentiate the product offering across geographic markets, and foster a flow of skills among different subsidiaries the company's global network of operations.

- Not an easy strategy to pursue since it places conflicting demands on the company

- Differentiating the product to respond to local demand in different geographic markers raises costs, which runs counter to the goal of reducing costs. – Ford found it difficult to implement

International Strategy

Sometimes its possible to identify multinational companies that find themselves that find themselves in the fortunate position of being confronted with low cost pressures and low pressures for local responsiveness. Typically these are enterprises that are selling a product that serves universal needs, but who do not face significant competitors, and thus are not confronted with pressured to reduce their cost structure. – Xerox

Companies pursuing an **international strategy** tend to centralize product development functions such as R&D at home. However, they also tend to establish manufacturing and marketing functions in each major country or geographic region in which they do business – although they may undertake some local customizations of product offering and marketing strategy, this tends to be rather limited in scope. = head office usually retains control of marketing an product strategy.

Chancing in Strategy Over Time

The problem with international strategy is that over time, competitors inevitably emerge, and if managers do not take proactive steps to reduce their cost structure, their company may be rapidly outflanked by efficient global competitors. Exactly what happened to Xerox ad other companies invented ways of going around their patents hence. Therefore strategies may change from time to time.

Choices of Entry Mode

Another key strategic issue confronting managers in a multinational enterprise is deciding upon the best strategy for entering a market. 5 main choice:

Exporting

Most manufacturing companies begin their global expansion as exporters and only later switch to one of the other modes for serving a foreign market. Exporting has to distinct advantages:

- It avoids the costs of establishing manufacturing operations in the host country, which are often substantial

- and it may be consistent with scale economies and location economies. By manufacturing the product in a centralized location and then exporting it to other national markets, the company may be able to realize substantial scale economies from its global sales volume

There are also a number of drawbacks to exporting:

- First, exporting from the company's home base may not be appropriate if there are lower-cost locations for manufacturing the product abroad. Thus, particularly in the case of a company pursuing a global standardization or transnational strategy, it may pay to manufacture in a location where conditions are most favorable from a value creation perspective and then export from that location to the rest of the globe – argument against exporting from the company's home country

- Another drawback is that high transport costs can make exporting uneconomical, particularly in the case of bulk products – way of getting around it to manufacture bulk products on a regional basis, realizing some economies from large-scale production while limiting transport costs.

- Tariff barriers – can make exporting uneconomical and a government threat to impose tariff barriers can make the strategy very risk

- Finally, exporting through agents – delegate marketing activities in each country in which it does business to a local agent however no guarantee that that agent will act in the best interest of the company.

Licensing

International Licensing is an arrangement whereby a foreign licensee buys the rights to produce a company's product in the licensee's country for a negotiated fee. –the license then puts up most of the capital necessary to get the overseas operation going.

Advantage of licensing is that the company does not have to bear the development costs and risks associated with opening up a foreign market. Licensing therefore can be a very attractive option companies that lack the capital to develop operations overseas. It can also be an attractive option for companies that are unwilling to commit substantial financial resources to an unfamiliar or politically volatile foreign market where political risks are particular high

Licensing has three serious drawbacks:

- 1. It does not give a company the tight control over manufacturing, marketing, and strategic functions in foreign countries that it need to have in order to realize scale economies and location economies – as companies pursuing both global standardization and transnational strategies try to do. Typically, each licensee sets up its own manufacturing operations – hence company stands little chance of realizing scale economies by manufacturing its product in a centralized location.

- Second, competing in a global marketplace may make it necessary for a company to coordinate strategic moves across countries so that the profits earned in one country can be used to support competitive attacks in another. Licensing, by its very nature limits a company's ability to coordinate strategy in this way. A license is unlikely to let a multinational company take its profits and use them to support an entirely different licensee operating in another country

- A third problem with licensing is the risk associated with licensing technological know-how to foreign companies. – by licensing its technology a company can quickly lose control over it

Franchising

Franchising – a specialized from of licensing in which the franchiser sell the franchisee intangible property and insists that the franchisee agree to abide by strict rules about how it does business. – Franchiser will also often assist the franchisee to run the business on an ongoing basis

Advantages: franchiser does not have to bear the development costs and risks of opening up a foreign market on its own, for the franchisee typically assumes those costs and risks. Thus, using a franchising strategy, a service company can build up a global presence quickly and at a low cost.

Disadvantages: lack of quality control.

Joint Ventures

Joint Venture – a separate corporate entity I which two or more companies have an ownership stake.

Advantages:

- A company may feel that it can benefit from a local partners knowledge of a host country's competitive conditions, culture, language, political systems, and business systems.

- Second, when the development costs and risks of opening up a foreign market are high, a company might gain by sharing these costs and risks with local partner.

- Third, in some countries political considerations make joint ventures the only feasible entry mode.

Drawbacks:

- A Company that enters into a joint venture risks losing control over its technology to its revenue partner.

- Joint venture does not give a company the tight control over it subsidiaries that it might need in order to realize scale economies or location economies.

Wholly Owned Subsidiaries

Wholly Owned Subsidiary – a subsidiary where the parent company owns 100% of the subsidiary stock

3 advantages:

- When company's competitive advantage is based on its control of a technological competency, a wholly owned subsidiary will normally be preferred entry mode, since it reduces the company's risk of losing this control – high tech companies prefer this

- Gives a company the kind of tight control over operations in different in different countries that it needs if it is going to engage in global strategic coordination – taking profits from one country to support competitive attacks in another

- May also be the best choice if a company wants to realize location economies and the scale economies that flow from producing a standardized output from a single or limited number if manufacturing plants. = Different subsidiaries producing different parts of eventual product.

Disadvantage:

- Most costly method of serving a foreign market. Parent company must bear all the costs and risks of setting up overseas operations. Risk of learning to do business in a new culture diminish if the company acquires an established host country enterprise. – however problems with different corporate cultures arise.

STRATEGIC MANAGEMENT

Chapter 7

Long-Run Profitability Through Corporate-Level Strategy

Concentration On a Single Industry

For many companies this appropriate choice-level strategy entails **concentration on a single industry,** whereby a company focuses its resources and capabilities on competing successfully within the confines of a particular product market – for e.g. McDonalds.

Advantage:

- Doing so enables a company to focus all its managerial, financial, technological, and functional resources and capabilities on developing strategies to strengthen its competitive position in just one business – this strategy is important in fast-growing industries that make strong demands on company's resources and capabilities but also offer the prospect of substantial long-term profits if a company can sustain its competitive advantage.

Disadvantage:

- Concentrating on just one market or industry can result in disadvantages emerging over time. – certain amount of vertical integration may be necessary to strengthen a company's competitive advantage within its core industry.

- Moreover, companies that concentrate on just one industry may miss out on opportunities to create more value and increase their profitability by using their resources and capabilities to make and sell products in other markets or industries

Horizontal Integration

Horizontal Integration – acquiring or merging with industry competitors to achieve the competitive advantages that come with large size. **Acquisition** occurs when one company uses its capital resources to purchase another company, and a **merger** is an agreement between two companies to pool their resources in a combined operation. – For e.g. Rupert Murdock buying different newspapers .

Benefits and Costs of Horizontal Integration

Lower Operating Costs

- HI lowers a companies operating costs when it results increasing economies of scale – for example buying a competitor and closing his manufacturing plan and use it for own production

- Achieving economies of scale is very important in industries that have high fixed costs, because large-scale production allows a company to spread its fixed costs over a large volume, which drives down average operating costs.

Increased Product Differentiation

- Horizontal integration may also boost profitability when it increases product differentiation, for example, by allowing a company to combine the product lines of merged companies in order to offer customers a wider range of products that can be bundled together. **Product bundling** is the strategy of offering customers the opportunity to buy a complete range of products at a single combined price

- From this value is added as usually price discount is obtained and they get used to dealing with just one company – hence competitive advantage may be achieved

- Example – Microsoft Office

Reduced Industry Rivalry

- Rivalry through horizontal integration can be reduced in 2 ways: 1st – acquiring or merging with a competitor helps to eliminate excess capacity in an industry

- 2nd Less competitors = easier to agree on prices agreement hence no price wars

Increased Bargaining Power

- Final reason to be horizontal is to achieve more bargaining power over suppliers or buyers, which strengthens its competitive position and increases its profitability at their expense.

- Company becomes a much larger buyer of a supplier's product; it can use this buying power as leverage to bargain down the price it pays for inputs, and this also lowers its costs.

Disadvantages

- Problems with merging cultures, managers and operations – high management turnover possible, tendency to overestimate benefits of the merger etc.

- Problems with the Federal Trade Commission if a company grows too large – against monopoly's'!

Outsourcing Functional Activities

- To improve its competitive position in an industry company can outsource one or more of its own value creation functions and contract with another company to perform that activity on its behalf

- **Virtual corporation –** has been coined to describe companies that outsource most of their functional activities and focus on one or a few core value chain

Advantages and Disadvantages of Outsourcing

Advantages:

- Outsourcing a particular noncore activity to a specialist company that is more efficient at performing that activity than the company itself lowers a company's operating costs.

- A specialist often has a distinctive competency in a particular functional activity, so the specialist can help the company better differentiate its products.

- Third advantage is that it enables a company to concentrate scarce human , financial, and physical resources on further strengthening its core competencies.

Disadvantages:

- Company loses both the ability to learn from that activity and the opportunity to transform that activity into one of its distinctive competencies

- Outsourcing may go to far, hence potential value creation can be outsourced and loss of competitive advantage.

- Company may become too dependent on the subcontractor, which may start to demand prices etc.

Vertical Integration

Vertical Integration – a strategy in which a company expands its operations either backward into industries that produce inputs for its core products (backward vertical integration) or forward into industries that use, distribute or sell its products (forward vertical integration). To enter a new industry, company may establish its own operations and create the set of value chain functions it needs to compete that is already in the industry. For e.g. Apple and its apple stores

Advantages:

- Enables company to build barriers to new competition – limits competition in company's industry.

- Facilitates investments in specialized assets – a value creation tool that is designed to perform a specific set of activities and whose value creation potential is significantly lower in its next-best use. Companies invest in specialized assets because these assets allow them to lower the costs of value creation and differentiate their products from those of competitors – permitting premium pricing

- Protects product quality – enables a company to become a differentiated player in its core business – McDonalds in Russia setting up its own farms to protect meat quality.

- Results in improved scheduling

Disadvantages:

- May actually increase cost of inputs when a company has to purchase high-cost inputs from company owned suppliers despite the existence of low-cost external sources of supply

- Suppliers have less incentive to be efficient – managers of supply divisions may be tempted to pass on any cost increases to other company divisions in the form of higher prices for components, rather than looking for ways to lower costs.

- Ties a company into old, obsolescent, and high cost technology – too much investments may be needed

Thus, on the one hand, vertical integration may create value and increase profitability when it lowers operating costs or increases differentiation. On the other hand, it can reduce profitability if a lack of cost-cutting incentive on the part of company owned suppliers increases operating costs, or if he inability to change its technology quickly results in lower quality and reduced differentiation.

In general, company should pursue vertical integration only if the extra value created by entering a new industry in the value chain exceeds the extra costs involved in managing its new operations when it decides to perform additional upstream or downstream value creation activities. Not all vertical integration opportunities have the same potential the same potential for value creation.

Entering new Industries Through Diversification

Diversification – the process of entering into one or more industries that are distinct or different from a company's core or original industry to find ways to use the company's distinctive competencies to increase the value to customers of the products it offers in those industries. A **diversified company** is the one that operates in two or more different or distinct industries to find ways to increase its long-run profitability.

- Diversification can help a company create value in 3 main ways:
    - Permitting superior internal governance – refer to the manner in which the top executive of a company manage its business units, divisions, and functions. In a diversified company, effective or superior governance resolves around how well top managers can develop strategies that improve the competitive positioning of its business units in the industries where they compete.
    - Transferring competencies among businesses – a second way for a company to create value from diversification is to transfer its existing distinctive competencies in one or more value creation functions to other industries. Top managers seek out companies in new industries where they believe they can apply these competencies to create value and increase profitability
    - Realizing economies of scope – phrase "two can live cheaper than one" expresses the idea behind economies of scope. When two or more business units or capabilities such as manufacturing facilities, distribution channels, advertising campaigns, and R&D costs, total operating costs fall because of economies of scope.

Restructuring

Restructuring- implementing strategies for reducing the scope of the company by removing exiting business areas

Why restructure?

- Because the stock of highly diversified companies is often assigned a lower valuation relative to earnings than stocks of less diversified enterprises

- In an attempt to boost returns to shareholders

Restructuring can be beneficial due to diminished advantages of vertical integration or diversification

Restructuring can be a reaction to:

- Managers pursuing too much diversification
- Diversification for the wrong reasons
- Failed Acquisition

Exit Strategies

Divestment – the sale a business unit to the highest bidder. Three types of buyers are independent investors, other companies, and the management of the unit to be divested. Selling off a business makes goo sense when the unit to be sold is profitable and when the stock market has an appetite for net stock is sues. However, spinoffs do not work if the unit to be spun off is unprofitable and unattractive to independent investors or if the stock market is slumping and unresponsive to new issues.

Harvest Strategy – involves halting investment in a unit in order to maximize short-to-medium term cash flow from that unit. Although this strategy seems fine in theory, it is often a poor one to apply in practice. Once it becomes apparent that the unit is pursuing a harvest strategy, the morale of the units' employees, as well as the confidence of the units' customers and suppliers in its continuing operation, can sink very quickly. If this occurs, as it often does, the rapid decline in the unit's revenues can make the strategy untenable

Liquidation Strategy – involves shutting down the operations of a business unit. A pure liquidation strategy is the least attractive of all to pursue, because it requires that the company write offs its investment in a business unit, often at considerable cost.

PART FOUR – STRATEGY IMPLEMENTATION

Chapter 8: Strategic Change (Managing Change)

Firstly this chapter examines the nature of strategic change and the obstacles that may hinder managers' attempts to change the company's strategy and structure, and ultimately, the steps that managers can take to overcome these obstacles **(8.1)**. Secondly, it will provide an overview of an important technique used to identify a company's desired future state: analyzing the company as a portfolio of *core competencies*, as opposed to a simple portfolio of businesses **(8.2)**. Finally an analysis of the different methods that managers can use to enter new business or industries, will be provided **(8.3, 8.4 & 8.5)**.

8.1 Strategic Change

Strategic change is the movement of a company away from its present state toward some desired future state to increase its competitive advantage and profitability. More often than not, the push for strategic change comes from the changing external competitive environment, rather than internal operating environment.

One way of changing the company to enable it to operate more effectively is by **reengineering**, a process in which managers focus ***not*** on the company's functional activities, but on the business processes underlying the *business value creation process*. A **business process** is any activity (such as order processing, inventory control, or product design) that is vital to delivering products to customers quickly, or that promotes high quality or low costs. *Business processes are **not** the responsibility of any one function in the firm's value chain, but they cut across functions*.

Another way is to pursue **restructuring**, the process through which managers simplify organizational structure by eliminating divisions, departments, or levels in the hierarchy, and *downsize* by terminating employees; thereby lowering operating costs. Restructuring may also involve outsourcing the company's non-core functional activities.

In order to understand **issues involved in implementing strategic change**, we focus on the series of distinct steps that strategic managers must follow if the change process is to succeed (shown below):

The first step in the change process is for strategic managers to **recognize the need for change**. Sometimes problems can be obvious, but more often they are unnoticeable, because problems develop silently/gradually, and organizational performance may slip for quite some time, before the decline becomes obvious. Once, managers realize that there is something wrong, they conduct external and internal (i.e. SWOT) analysis discussed in chapters 3 & 4. Ultimately, when the source of the problem has been identified, strategic managers must determine the desired future state of the company, i.e. how it should change its strategy to achieve the newly set goals.

Given that the decisions to reengineering and restructuring requires the establishment of new set of roles, rewards and authority relationships among managers/employees in different functions/division, there will be *resistance to change* due to inherent *organizational inertia*. Therefore strategic managers must **identify potential obstacles to change** as they design and implement new strategies. These obstacles can be found in all levels of the organization: *corporate, divisional, functional and individual*.

Generally a company can take one of two main approaches to implementing and **managing change**: *top-down change* or *bottom-up change*. With **top-down change**, a strong CEO or top management team (TMT) analyses what strategies need to be pursued, recommends a course of action, and then moves quickly to implementing the changes. The emphasis is on *speed of response to problems* as they emerge. **Bottom-up change** is much more gradual in that TMT consults with managers/employees at all levels in the organization. Then over time as the strategic change plan develops, it is gradually implemented. The emphasis is on participation and keeping people informed. The advantage of bottom-up change is that it removes some of the obstacles to change by including them in the strategic planning process. It could also reveal more hidden potential problems, because the whole organization is being consulted. However, when speedier response is required, top-down change should be utilized.

The last step in the change process is to **evaluate the effects of strategic change** on organizational performance. The company must compare the way it operates after implementing the changes vis-à- vis the way it operated before, which could be done using proxies, such as changes in stock market price, market share, and higher revenues. The company's performance can also be benchmarked against the market leaders, to see if further improvement is needed.

8.2 Analyzing a Company as a Portfolio of Core Competencies

According to *Hamel and Prahalad*, the company must be analyzed as a portfolio of core competencies, as opposed to a portfolio of actual businesses (e.g. the BCG Matrix). After all, the goal of most companies is to achieve long-run growth and profitability, the key to which are the companies' core competencies. Hence the corporate development should be oriented towards maintaining and building new competencies, as well as leveraging existing competencies by applying them to new business opportunities.

(1) **Fill in the blanks** refers to the opportunity to improve the company's competitive position in its existing markets by leveraging existing core competencies. For example, Canon was able to improve the position of its camera business by leveraging microelectronics skills from its copier business to support the development of cameras with electronic features, such as autofocus capabilities.

(2) **Premier plus 10** raises an important question for the company: "What new core competencies must be built today to ensure that the company remains a premier provider of its existing products in 10 years' time?". For example, Canon decided that in order to maintain a competitive edge in its copier business, it was going to have to build a new competency in digital imaging. This new competency subsequently helped Cannon to extend its product range to include laser copiers, colour copiers, and digital cameras.

(3) **White spaces** raises the question: "How best to fill the *white space* by creatively redeploying or recombining our current core competencies. For example, Canon has been

able to recombine its established core competencies in precision mechanics, fine optics, microelectronics and digital imaging, to enter the market for computer printers and scanners.

(4) **Mega-opportunities** do not overlap with the company's current market position or with its current endowment of core competencies. Nonetheless, the company may choose to pursue such opportunities, because they are particularly attractive or relevant to the company's existing business opportunities. For example, in 1979 Monsanto, manufacturer of chemicals, saw enormous opportunities in the emerging field of biotechnology. It made an investment of around $1.0bil, believing that it could produce genetically engineered crops, which would produce their own organic pesticides. Ultimately, the investment earned the company hundreds of billions of dollars in profit.

The biggest advantage of Hamel & Prahald's framework is that it recognizes the interdependencies among the company's businesses and focuses on opportunities to create value by building and leveraging competencies, unlike traditional portfolio tools that treat businesses as independent.

8.3 Implementing Strategy through Internal New Ventures

Internal new ventures involve creating the value chain functions necessary to start a new business scratch. Internal new venturing is typically used to execute corporate-level strategy, when the company possesses a set of valuable competencies (resources & capabilities) in its existing businesses that can be leveraged or recombined to enter new business areas. In general, science-based companies tend to favour internal new venturing as an entry strategy.

Despite the popularity of internal new venturing, there is a **high risk of failure** (33% - 60%). Three main reasons are often put forward to explain this relatively high failure rate: *(1) market entry on too small a scale; (2) poor commercialization of the new-venture product; (3) poor corporate management of the new-venture division*.

(1) Vis-à-vis the less risky **small-scale entry**, large-scale entry can more rapidly realize scale economies, build brand loyalty and good distribution channels in the new industry, all of which would increase the probability of the new venture's success. In contrast, small-scale investments are more prone to failure, because they lack the capacity to achieve these advantages, which are especially important when entering an established/mature industry. However, because of the high costs and risks associated with large-scale entry, many companies make the mistake of choosing the small-scale entry strategy, which often results in failure to build the market share necessary for long-term success (see diagram below).

(2) To be **commercially successful**, science-based innovations must be developed with market requirements in mind. Many internal new ventures fail, because the company gets fixated on the innovative and technological myopia, which leads it the improper analysis of market opportunities. Thus a new venture can fail, because of a lack of commercialization, or because it is marketing a technology for which there is no demand (e.g. Motorola's failure with satellite phone Iridium).

(3) **Poor corporate management** examples include: the company stretching its resources and management attention too thin over too many new ventures; failure to establish the strategic context within which new-venture projects should be developed (e.g. the company

cannot simply allow R&D team to do research on whatever they find interesting); failure to anticipate the time and costs involved in the new-venture process (e.g. killing the project too early).

To avoid pitfalls of internal new ventures, the company should adopt a structured approach to managing internal new venturing. *Firstly*, the entry into new industry should be on a large scale to increase the probability of long-run profitability. *Secondly*, to improve the commercialization of the new venture idea, the company should foster close links between R&D and market, and R&D and manufacturing. *Finally,* the company must employ a structured approach to project selection (with the greatest chance of commercial success) and set clear targets for that new venture (preferably market share and not profit targets).

8.4 Implementing Strategy through Acquisitions

Acquisitions involve one company purchasing another company. The company may use acquisitions in two ways: to strengthen its competitive position in an existing business by purchasing a competitor (i.e. horizontal integration), and to enter a new business/industry (i.e. vertical integration & diversification).

Companies have a preference for acquisitions as an entry mode, when they feel the need to *move in fast*. Acquisitions are also somewhat *less risky than internal new ventures*, because they involve less commercial uncertainty. Acquisitions also allow the company to *circumvent the barriers to entry*.

4

Nevertheless acquisitions **often fail**. There are appears to be 4 major reasons: *(1) difficulties with integrating divergent corporate cultures; (2) managers overestimate the potential economic benefits from an acquisition; (3) acquisitions tend to be very expensive; (4) companies often do not adequately screen their acquisition targets.*

(1) **Post-acquisition integration** can be very challenging, because the companies might have very different corporate cultures, which makes it difficult to adopt a common financial control system and to join the companies' operations. What's more high management turnover stymies the benefits of integration.

(2) Companies often **overestimate the strategic advantages** that can be derived from the acquisition, because top managers tend to overestimate their abilities to create value from an acquisition (e.g. Time Warner acquisition of AOL in 2001, and spinning it off in 2009).

(3) Acquisitions also **tend be to very expensive**, because the stock price of the target company usually get bid up in the acquisition process. Oftentimes, the company has to pay a premium of 50% - 100%, meaning that the company has to improve the performance of the acquired unit by just as much, if it is to reap a positive return on its investment! This can be particularly hard.

(4) Sometimes the management does an **inadequate job of pre-acquisition screening**, and decide to acquire other firms without thoroughly analyzing the potential benefits and costs. After the acquisition has been completed, the management might discover that instead of buying a well-run business, they have purchased a troubled organization.

To avoid pitfalls, and make successful acquisitions, companies need to take a structured approach with three main components:

(1) Prudent target identification and careful pre-acquisition screening; (2) Competitive bidding strategy with the right timing

(3) Integration centred on the source of the potential strategic advantages of the acquisition (e.g. share functional activities and eliminate duplications of facilities/functions).

8.5 Implementing Strategy through Strategic Alliances

Strategic alliances are cooperative agreements between two or more companies to work together and share resources to achieve a common business objective. A **joint venture** is a formal type of strategic alliance in which two companies jointly create a new, separate company to enter a new business area.

Strategic alliances can take the form of short-term informal agreements (e.g. to share know-how), or the long-term contractual agreement, such as long-term outsourcing or JTs. Strategic alliances may be the preferred entry strategy when (1) the risks and costs associated with setting a new venture/business unit are more than the company is willing to assume on its own, and (2) the company can increase the probability of success of the new business by teaming up with another company that has resources and capabilities complementing its own.

Strategic alliances can: (1) facilitate entry into markets (e.g. Motorola forming alliance with Toshiba to overcome the Japanese trade barriers, i.e. barrier to entry); (2) enable partners to share the fixed costs and risk associated with the development of new products and processes; (3) facilitate the transfer of complementary skills and assets that neither company could easily develop on its own (e.g. Microsoft & Toshiba alliance to develop microprocessors = software engineering + microprocessors expertise).

5

The drawbacks of formal strategic alliances (particularly JTs) include: (1) the risk that the company may give away technological know-how and its market access to the alliance partner, without getting much in return; (2) sharing profits, if the alliance proves to be very successful; (3) sharing control meaning harder global strategic coordination of retained profits (see chapter 6).

The success of a strategic alliance seems to be a function of three main factors: *(1) partner selection; (2) alliance structure; (3) the manner in which the alliance is managed.*

(1) A **good partner** has three principal characteristics. *Firstly*, the partner must have resources and capabilities that the company lacks and values. *Secondly,* the partner shares the firm's long-term vision for the purpose of the alliance. *Thirdly*, the partner is unlikely to try to exploit the alliance opportunistically (e.g. steal technological know-how); for example, IBM has to keep its good reputation, in order to further attract important alliance partners in the future.

(2) Once the partner has been selected, the **alliance should be structured** so that the company's risk of giving too much away to partner is reduced to an acceptable level. The

figure below depicts the four safeguards against opportunism of cheating by alliance partners.

Establishing contractual safeguards can include agreements that prohibits the partner to enter the company's home market and utilize the shared technology and managerial know-how to compete against it.

Seeking credible commitments can include factors, such as pushing the bigger partner to buy equity stake in the smaller partner, or making the bigger partner take the minority ownership position in the JT.

(3) Ultimately **managing the alliance effectively** requires *sensitivity to cultural differences, building trust between partners* and *learning from each other.* The alliance also needs *relational capital,* i.e. building interpersonal relationships between the firms' managers.

Chapter 9: Implementing Strategy through Organizational Design

Strategy implementation refers to the way a company creates the *organizational arrangements/design* that enable it to pursue its strategy most effectively. **Organizational design** is the process through which managers select the combination of or*ganizational structure* and *control systems* that allows it to effectively create and sustain a competitive advantage. Therefore the primary role of organizational structure and control is to motivate employees to achieve superior efficiency, quality, innovation, and customer responsiveness (the 4 building blocks of competitive advantage). Ultimately, *organizational structure and control shape the way people behave and act in the organizational setting*.

9.1 The Role of Organizational Structure

Once the company's strategy has been formulated, management must design the organizational structure. The role of organization structure is to provide the vehicle through which managers can coordinate the activities of the company's various functions, division and business units to take advantage of their skills and competencies (to develop and sustain competitive advantage).

The basic building blocks of organizational structure are *differentiation* and *integration*.

Differentiation is the way in which the company allocates people and resources to organizational tasks, in order to create value. Generally, the greater the number of different functions/division in the organization and the more skilled/specialized they are, the higher is the level of differentiation (e.g. GE). *Firstly,* strategic managers must choose how to distribute *decision-making authority* in the organization to control value creation activities best, i.e. **vertical differentiation** choices (e.g. how much authority to delegate to managers at the divisional and functional level). *Secondly,* corporate managers must choose how to group people and tasks into functions/divisions to increase their value- creation ability, i.e. **horizontal differentiation** choices (e.g. should there be separate sales and marketing departments?).

Integration is the means by which the company seeks to coordinate people and functions to accomplish organizational tasks. When separate/distinct value creation functions/division exist, they tend to pursue their own goals and objectives; therefore the company has to create an organizational structure that encourages different functions/divisions to coordinate their activities, by use of *integrating mechanisms* and *control systems*.

Ultimately, differentiation consists of the way the company divides itself into parts (functions/divisions), whereas integration consists of the way those parts are then combined for enhanced value creation. Together, the two processes determine how an organizational structure will operate, and how successfully strategic managers will be able to create value through their chosen strategies.

9.2 Vertical Differentiation

The aim of vertical differentiation is to specify the reporting relationships that link people, tasks, and functions at all levels within the company. This entails choosing the appropriate number of *hierarchical levels* and the correct *span of control* for implementing the company's strategy most effectively.

The organizational **hierarchy** establishes the authority structure from the top to the bottom of the organization. The **span of control** is defined as the number of subordinates a manager directly manages. The basic choice is whether to aim for a **flat structure**, with a few hierarchical levels and thus relatively wide span of control; or a **tall structure**, with many levels and thus a relatively narrow

---

1

span of control. The average number of hierarchical levels for a company employing 3,000 people is 7 – 8.

As the company grows, the number of levels in its hierarchy of authority increases, to allow it to monitor and coordinate employee activities more efficiently. Though managers should try to keep the organization as flat as possible and follow the **principle of the minimum chain of command**, which states that an organization should choose a hierarchy with minimum number of levels of authority necessary to achieve its strategy (demonstrated below with the levelling of the curve).

Managers try to keep the hierarchy as flat as possible, because when companies become too tall, several problems arise that make strategy more difficult to implement.

Coordination problems. Having too many hierarchical levels impedes communication and coordination between employees and functions, and also raises costs, as communication between the top and the bottom of the hierarchy takes much longer.

Information distortion. The greater the number of hierarchical levels, the more scope employees and managers have, to distort facts; as a consequence, the costs of managing the hierarchy increases. The managers at different levels (functional, divisional & corporate) may misinterpret information, either accidentally or on purpose, to suit their own interests.

Motivational problems. As the number of levels in the hierarchy increases, the amount of authority and autonomy possessed by managers at each hierarchical levels diminishes, while the promotional steps up the corporate ladder increases. Ultimately, the managers tend to refuse to take the risks that are often necessary when new strategies are pursued. This further increases the costs of coordination, because more corporate/strategic managerial time must be spent coordinating tasks.

Too many middle managers = high costs. Having many hierarchical levels implies having many middle managers, and employing managers is expensive.

Decentralization can help overcome some of these problems. Authority is **centralized** when managers at the upper levels of the organizational hierarchy retain the authority to make the most important decisions. When authority is **decentralized**, it is delegated to divisions, functions, managers and workers at lower levels in the organization. *Decentralization has 3 main **advantages***:

(1) By delegating day-to-day operational decision-making authority to middle managers, strategic managers *reduce information overload*, which enables them to spend more time on strategic decision making, which = more effective decisions.

(2) When middle managers become responsible for adapting the organizational structure to local conditions, their motivation and accountability increase, which also promotes organizational flexibility necessary for anticipation of changes in the external competitive environment.

(3) When lower-level employees are given more authority, fewer managers are needed = lower costs.

Notwithstanding, *centralization has its **advantages*** too. *Firstly*, it makes coordination of the organizational activities needed to pursue the company's strategy, less chaotic than when the strategic planning is decentralized to include everybody's opinion. *Secondly*, centralization also means that decisions fit the broad organization objectives without any division pursuing its own objectives.

9.3 Horizontal Differentiation

As the company grows, even decentralization becomes less effective (e.g. Walmart with 2.2 million employees). The company will firstly have to resort to horizontal differentiation, and secondly to integration mechanisms and control systems (discussed in the next parts – **9.4 & 9.5**).

The challenge facing the company is choosing the *appropriate form of horizontal differentiation* – that is deciding how best to group organizational tasks and activities to meet the objectives of the company's strategies. The different grouping/structures are discussed below.

(1) **Functional structures** group people on the basis of their common expertise or because they use the same resources (e.g. engineers are grouped into R&D function of the firm's value chain).

Functional structures have several **advantages**. *Firstly,* if people who perform similar tasks are grouped together, they can learn from each other, and become more specialized and productive. *Secondly*, due to similar expertise, they can monitor each other to make sure that everybody is performing their tasks effectively and no one is free riding. *Thirdly*, it gives corporate managers greater control of organizational activities, because each function of the firm's value chain will have *its own manager overseeing the hierarchy within a firm's function* (i.e. managing the business is much easier, when different groups specialize in different organizational tasks, and are managed separately).

However, when the company becomes geographically diverse or starts producing a wide range of products, several coordination **problems** arise that undermine the company's ability to coordinate its activities and reduce costs:

Communication problems. As separate functional hierarchies evolve, functions grow more remote from one another, making it increasingly difficult to communicate across function to coordinate activities, because distinct functions develop different orientations toward the problems (and hence strategies) facing the organization (e.g. R&D vs. manufacturing perspective on strategy).

Measurement problems. As the number of its products grows, the company may find it difficult to measure the contribution of one or a few products to its overall profitability. Consequently, the company may turn out some unprofitable products without realizing it (e.g. Dell's explosive growth in the 1990s made it lose control of its inventory management systems).

Location problems. If the company makes and sells products in many different regions, then the centralized system of control provided by the functional structure no longer suits it, because managers in the various regions must have the flexibility to respond to the needs of their customers.

Strategic problems. Sometimes the combined effect of all these problems is that long-term strategic considerations are frequently ignored, because management is preoccupied with solving communication and coordination problems. As a result the company may lose direction and fail to take advantage of new opportunities, while costs escalate.

(2) In the **product structure**, activities are grouped by product line. The manufacturing function is broken down into different product lines based on the similarities and differences among the products. Seeing as, there might exist three different product grouping, the degree of horizontal differentiation in the product structure is higher than that in the functional structure. Moreover, the specialized support functions (e.g. accounting, sales and R&D) are centralized at the top of the organization, but each support function is divided in such a way that personnel tends to specialize in one of the (three) different product categories to *avoid communication problems*; thus there may be three groups of accountants, one for each of three product categories. Furthermore, the use of the product structure re*duces the problems of control and coordination associated with the functional structure*: it pushes aside barriers among functions/divisions, because the product line (rather than

each individual function/division), becomes the focus of attention. In addition, the profit contribution of each product line can be clearly identified, and hence resources can be allocated more efficiently. Ultimately, the product structure has one more level in the hierarchy than the functional structure due to the addition of product line managers. This increase in vertical differentiation allows managers at the production level to focus on day-to-day operations, which *gives top strategic managers more time to develop the long-term strategy* for the company's competitive advantage. Although the operating costs are higher than in the functional structure, this expense is warranted by the extra coordination that the structure provides. Below is the product structure typical of an imaging firm.

(3) In the **product-team structure**, as in the product structure, task activities are divided along product lines to reduce costs and increase management's ability to monitor and control the manufacturing process. The difference is that specialists are taken from the various support function and combined into cross-functional teams to serve the needs of the product/project. When all functions have direct input from the beginning, design costs and subsequent manufacturing costs can be kept low. In addition, the use of cross-functional teams can speed innovation and responsiveness to customers, because when authority is decentralized to the team, decisions can be made more quickly.

(4) When the company is geographically spread, geographic regions become the basis for the grouping of organizational activities, i.e. **geographic structure**. For example, the company may divide up its manufacturing operations and establish manufacturing plants in different regions of the country. This allows it to be responsive to the needs of its regional customers and reduces transportation costs. Similar to the product structure, the geographic structure provides more control than the functional structure, because there are several

regional hierarchies carrying out the work previously performed by a single centralized hierarchy (e.g. FedEx & Walmart). Moreover, because the purchasing function remains centralized, this gives the company a greater bargaining power over suppliers.

(4) The **multidivisional structure** has two main advantages over the functional structure: innovations that let the company grow, yet overcome problems that stem from loss of control. The main characteristics of a multidivisional structure are as follows.

Firstly, each distinct product line or business is placed in its own *self-contained unit/division*, with all the necessary support functions. *Secondly,* the office of corporate headquarters staff is created to monitor divisional activities and exercise financial control over each division. Seeing as this constitutes an additional level in the organizational hierarchy, the multidivisional structure has a higher level of vertical differentiation than the functional structure. *Thirdly,* there is flexibility in that each division is able to adopt the structure that best suits its needs (e.g. functional structure, product-team structure, **matrix structure** – a structure in which functional managers work with project managers in temporary teams to develop new products). *Ultimately,* in the multidivisional structure, the day-to-day operations of a division are the responsibility of divisional managers, i.e. divisional management has **operating responsibility**. Corporate managers are responsible for overseeing long-term strategic plans and providing guidance for interdivisional projects, i.e. they have **strategic responsibility**. Such a combination of self-contained divisions with the centralized corporate management represents a higher level of both vertical and horizontal differentiation, which provides the extra control necessary to coordinate growth and diversification. Although, this structure has the highest operating costs, it can help the company organize its value-creation activities to achieve even greater performance.

The multidivisional structure offers several **advantages**, and enable the company to operate more complex kinds of corporate-level strategies.

Enhanced corporate financial control. Seeing as, the profitability of different divisions is clearly visible and each division is its own profit centre, financial controls can be applied to each business (e.g. on the basis of profit criteria) to monitor performance. The corporate managers can then use this information to identify the divisions that are worth investing in for long-term profits. Essentially the corporate managers act as *internal investors*.

Enhanced strategic control. The multidivisional structure frees corporate managers from operating responsibilities, which gives them more time for contemplating wider long-term strategies in response to environmental changes. In addition, the structure provides corporate managers with the required information for strategic planning.

Growth. By reducing information overload at the corporate level, corporate managers can handle a greater number of businesses, i.e. they can consider more opportunities for further growth and diversification. Additionally, communication problems are reduced, because the same set of standardized accounting and financial control techniques can be used to evaluate all divisions.

Stronger pursuit of internal efficiency. Unlike the functional structure with its *measurement problem*, in a multidivisional structure the individual efficiency of each autonomous division can be directly observed and measured in terms of profitability. Autonomy makes divisional managers accountable; therefore they have no excuses for poor performance.

However, the multidivisional structure has its **disadvantages** too.

Establishing the appropriate divisional-corporate authority relationship. The corporate managers have to decide how much authority and control to assign to the operating divisions, and how much authority to retain at the corporate headquarters (i.e. how much authority to centralize and how much to decentralize). If too much authority is retained, the managers of the operating divisions lack the

sufficient autonomy to develop the business-level strategy that might best meet the needs of the division. On the other hand, when too much authority is delegated, manager may start to pursue strategies that benefit their own divisional objectives, but add little value to the corporation as a whole.

Distortion of information. If corporate management puts too much emphasis on divisional ROI, divisional managers may choose to distort the information they supply to the TMT to paint a rosier picture of their division (at the expense of long-term profitability). That is, divisions may start to pursue strategies that increase short-run profitability but reduce future long-run profitability.

Competition for resources. Given a fixed amount of resources for allocation, divisions may destructively compete for them, which prevents synergy gains or economies of scope from emerging.

Transfer pricing. Divisional competition may also lead to battles over transfer pricing. One of the main challenges that vertical integration and related diversification imposes is the need to set fair prices, at which products are transferred between divisions. This will be problematic, when each supplying division tries to set the highest price for its outputs to maximize its own profitability.

Focus on short-term R&D. Again, if extremely high profitability targets are set by corporate headquarters, the danger arises that divisions will cut back on R&D to improve the short-term financial performance of their divisions at the expense of long-term profitability.

High operating costs. Seeing as, in the multidivisional structure, each division has its own support functions, the operating costs are very high, because of the duplication of functions. Though the duplication is not a problem, if the gains from having separate support functions outweigh the costs.

9.4 Integration and Organizational Control

As was pointed out above, choosing the type of differentiation is only the first step in organizational design. The second decision concerns the level and type of *integration* and *control* necessary to make the organizational structure work effectively.

The company's level of integration is the extent to which it seeks to coordinate its value creation activities and make them interdependent. *The higher the company's level of differentiation, the higher the level of integration needed to make organizational structure work effectively*. There is a series of integrating mechanisms the company can use to increase its level of integration, as its level of differentiation increases.

Direct contact. The aim behind establishing direct contact among managers it to set up a context within which managers from different division/functions can work together. Though more often than not, managers tend to compete rather than cooperate, which wastes the top corporate managers' time, as they working on resolving these issues.

Interdepartmental liaison roles. Another way of improving interdepartmental coordination is giving one manager in each division/function the responsibility for coordinating with the other division/function. The responsibility for coordination is part of the manager's full time job, which helps form a more permanent relationship between the divisions/functions.

Temporary task forces. When more than two divisions/functions share a common problem, the solution is to adopt a temporary task force. One member of each division/function is assigned to the task force created to solve that specific problem. Essentially, task forces are *ad hoc committees*, and members are responsible for reporting back to their departments on the issues addressed and the solutions recommended. Task force members also have to perform their normal duties, while serving on the task force.

Permanent teams. When issues addressed by the task force often reoccur, it is sensible to form a permanent team for problems that have a great deal of integration between functions. Essentially, permanent teams are the organization's *standing committees* (not ad hoc), and much of the strategic direction of the organization is formulated in their meetings. In the product-team differentiation structure, the cross-functional teams are essentially the standing committees (i.e. permanent teams).

Integrating roles. The only function of the integrating role is to prompt integration among division/departments, which is a full-time job requiring an independent expert who, is normally a senior manager with a great deal of experience in the joint needs of the two departments.

Note that just as too much differentiation and not enough integration lead to the failure of implementation, the converse is also true. The combination of low differentiation and high integration leads to an over-controlled, bureaucratized organizations, in which flexibility and speed of response are reduced by the level of integration. Besides, differentiation and integration are both very costly; therefore the management goal is to decide on the optimum amount of integration (and differentiation), i.e. the simplest structure consistent with implementing its strategy effectively.

9.5 The Nature of Organizational Control

In practice, integrating mechanisms are only the first means through which the company seeks to increase its ability to coordinate its activities. *Control systems* are the second. **Organizational control** is the process by which managers monitor the ongoing activities of an organization and its members, to evaluate whether activities are being performed efficiently and effectively, and to take corrective action to improve performance if necessary. Organizational control *does not just mean reacting to events after* they have occurred; it also means keeping an organization on track, anticipating events that might occur, and responding swiftly to new opportunities that present themselves.

Strategic control systems are the formal target-setting, measurement, and feedback systems that allow strategic managers to evaluate whether the company is achieving superior efficiency, quality, innovation and customer responsiveness, and is implementing its strategy successfully. An effective control system should have three characteristics: *(1) it should be flexible enough to allow managers to respond quickly to unexpected events; (2) it should provide accurate information, giving true picture of organizational performance; (3) it should supply managers with the information in a timely manner, because making decisions on the basis of outdated information is a recipe for failure*.

As shown below, designing an effective strategic control system requires 4 steps.

The table below shows the various types of strategic control systems that manager can use to monitor and coordinate organizational activities (the unobvious ones will be discussed below).

In **output control**, strategic managers estimate/forecast appropriate performance goals for each division, department, and individual employees, and then measure actual performance vis-à-vis these set-out goals.

Behaviour control is control through establishment of a comprehensive system of rules and procedures, to direct the actions/behaviour of divisions, functions and individuals.

An **operating budget** is a blueprint that states how managers intend to use organizational resources to achieve organizational goals most efficiently. Oftentimes, managers at one level allocate to managers at a lower level a specific amount of resources for production of goods/services.

Standardization is the degree to which the company specifies how decisions are to be made so that employees' behaviour becomes predictable (e.g. JIT inventory systems help standardize the flow of inputs).

One important kind of behavioural control is the **organizational culture**, which is the specific collection of *values* and *norms* that are shared by people and groups in the organization, and that controls the way people interact with each other and with stakeholders outside the organization. **Organizational values** are beliefs and ideas about what kinds of goals, members of the organization should pursue, and what kinds or standards of behaviour employees should use to achieve these goals. From organizational values develop **organizational norms**, the guidelines or expectations that prescribe appropriate kinds of behaviour by employees in particular situations, and control the behaviour of organizational members toward one another. Ultimately, let's not forget that organizational culture is the product of *strategic leadership* provided by the organization's founder and TMT; the organization's founder is particular important in shaping the culture (e.g. Walmart or Nucor Steel Corporation).