Summary Contemporary Strategy Analysis 1-16

Strategisch Management (Universiteit van Amsterdam)

H1 Introduction

Role of strategy in success (fig 1.1) **9**

1. Goals that are consistent and long term
2. Profound understanding of the competitive environment
3. Objective appraisal of resources
4. Effective implementation

Basis framework for Strategy Analysis **11**

Strategy is a link between the firm and its external environment, fundamental is the notion of strategic fit. This refers to the consistency of a firm's strategy with the internal and external environment.

The concept of strategic fit is one component of a set of ideas known as contingency theory. This theory postulates that there is no single best way of organizing or managing, it depends upon circumstances.

Strategy today: What is Strategy? **15**

Strategy is the means by which individuals or organizations achieve their objectives.
Why do we need strategy?

- Strategy as decision support
- Strategy as a coordinating device
- Strategy as target

Corporate and Business Strategy **18**

Two major area's of a firm's strategy:

- Where to compete? Corporate Strategy
- How to compete? Business Strategy

Corporate Strategy: defines the scope of the firm in terms of the industries and markets in which it competes. Corporate strategy decisions include choice over diversification, vertical integration, new ventures and the allocation of resources between different businesses of the firm. Responsibility of the top management team and the corporate strategy staff.
Business Strategy: concerned with how the firm competes within a particular industry of market. If the firm is to prosper within the market, it must establish a competitive advantage over its rivals. This area of strategy is also referred to as competitive strategy.

Design versus Emergence **22**

Mintzberg (critic of rational approaches) distinguishes intended, realized and emergent strategies.
Intended strategy: as conceived of by the top management team. More an outcome of negotiation and compromise among the many groups involved in the making process.

Realized strategy: the actual strategy that is implemented, is only partly related to that which was intended. Only 10-30% of intended strategy is realized. The primary determinant of realized strategy is
Emergent strategy: the decisions that emerge from the complex processes in which individual managers interpret the intended strategy and adapt to changing circumstances.

Strategic Management of Not-for-Profit Organizations **25**
Ook voor nonprofit organisaties is strategie belangrijk.
Zie fig. 1.2 op blz 26!

Summary
- Strategy is a key ingredient of success. Successful strategies embody four elements: clear, long-term goals, profound understanding of external environment, appraisal of internal resources and capabilities and effective implementation.
- Strategy is no longer concerned with detailed planning based upon forecasts; it is increasingly about direction, identity and exploiting the sources of superior profitability.
- Developing a strategy for an organization requires a combination of purpose-led planning (rational design) and a flexible response to changing circumstances (emergence).
- The principles and tools of strategic management have been developed primarily for business enterprises; however they are also applicable to guiding the development of non-profit organizations, especially those that inhabit competitive environments.

H2 Goals, Values and Performance

Strategy as a quest for value

Value can be created in two ways: by production and by commerce. Production creates value by physically transforming products that are less valued by consumers into products that are more valued: clay into coffeemugs. Commerce creates value by repositioning them in space and time. Trade involves transferring products from individuals and locations where they are less valued to individuals and locations where they are more valued.

The difference between the value of a firm's output and the cost of its material inputs is its value added. Value added is equal to the sum of all the income paid to the suppliers of factors of production. Thus:

Value Added = Sales revenue from output – cost of material inputs
= Wages/Salaries + Interest + Rent + Taxes + Profit etc.

Value for whom? Shareholders vs. Stakeholders **36**

The value added created by frims is distributed to employees, landlord (rent), owners (profit), government (taxes). =**Stakeholder approach to the firm:** the idea that the corporation should balance the interests of multiple stakeholders has a long tradition. By contrast, most countries have endorsed **shareholder capitalism**, where companies' overriding duty is to produce profits for owners.

Clearly, companies have legal and ethical responsibilities to employees, customers, nature and society. However, companies that adopt a stakeholder approach and seek to pursue the combined interests of multiple stakeholders face major problems in formulating and implementing their strategies.

What is profit? **37**

Profit is the surplus of revenues over the costs available for distribution to the owners of the firm.

Accounting Profit and Economic Profit **38**

A major problem of accounting profit is that is combines two types of returns: the normal return to capital, which rewards investors for the use of their capital, and economic profit ('rent'), which is the surplus available after all inputs (incl capital) have been paid for. A widely used measure for economic profit is **economic value added (EVA)**:

EVA = Net operating profit after tax (NOPAT) – Cost of capital
Cost of capital = capital employed X Weighted average cost of capital (WACC)

Economic profit has 2 main advantages over accounting profit as a performance measure: first, it sets a more demanding performance discipline for managers.

Second, it improves the allocation of capital between the different businesses of the firm by taking account of the real costs of more capital-intensive businesses (2.1 , blz 38)

H3 Industry Analysis: The Fundamentals

Corporate Strategy: concerned with deciding which industries the firm should be engaged in and how it should allocate its resources among them.
Business Strategy: concerned with establishing competitive advantage. By analysing customer needs and preferences and the ways in which firms compete to serve customers, we identify the general sources of competitive advantage in an industry, what we call key success factors.

PEST analysis: Framework for organizing information. Environmental influences can be classified by source, for example: political, economic, social and technological factors.
The core of the firm's business environment is formed by its relationships with three sets of players, customers, suppliers and competitors: this s its industry environment. Zie fig 3.1 op blz 61.
For a firm to make profit it must create value for the customer, value is created when the price the customer is willing to pay for a product exceeds the costs incurred by the firm. But customer value does not translate directly into profit. The surplus of value over cost is distributed between customers and producers by the forces of competition.
Consumer surplus= the difference between the price they actually pay and the maximum price they would have been willing to pay. Vb: als er buiten een station 1 man paraplu's verkoopt, kan hij de hoofdprijs vragen. Als er meerdere verkopers komen, daalt de prijs bij iedereen.

The profits earned by the firms in an industry are determined by three factors:
- the value of the product to customers
- the intensity of competition
- the bargaining power of industry members relative to their suppliers and buyers

Industry analysis brings all three factors into a single analytic framework.

64: **Porter's Five Forces of Competition Framework:** this framework views the profitability of an industry as determined by five sources of competitive pressure. Three sources of 'horizontal' competition: competition from substitutes, competition from entrants and competition form established rivals; and two sources of 'vertical' competition: the power of suppliers and the power of buyers. The strength of each of these competitive forces is determined by a number of key structural variables, **fig 3.3 op blz 66.**

Competition from substitutes **65**
The price that a customer is willing to pay depends in part on the availability of substitute products. The existence of close substitutes means that customers will switch to them in response to price increases for the product (demand is elastic with

respect to price). The absence of close substitutes for a product means that consumers are comparatively insensitive to price (demand is non-elastic with respect to price).

Threat of entry **66**

- Capital Requirements
- Economics of Scale
- Absolute Cost advantages
- Product Differentiation
- Access to channels of distribution
- Governmental and legal barriers
- Retaliation
- The effectiveness of barriers to entry

Rivalry between established competitors **69**

The intensity of competition between established firms is the result of interactions between six factors:

- Concentration: seller concentration refers tot the number and size distribution of firms competing within a market, measured by concentration ratio.
- Diversity of competitors
- Product differentiation
- Excess capacity and exit barriers: barriers to exit are costs associated with capacity leaving an industry
- Cost conditions: scale economies and the ratio of fixed to variable costs

Bargaining Power of Buyers **71**

The firms in an industry compete in two types of markets: in the markets for inputs (these firms purchase raw materials, components and financial and labor services) and markets for output (firms sell their goods and services to customers).

Output markets: the strength of buying power that firms face from their customers depends on two sets of factors:

- Buyers' price sensitivity
  - The greater the importance of an item as a proportion of total cost, the more sensitive buyers will be about the price they pay
  - The less differentiated the products of the supplying industry, the more willing the buyer is to switch suppliers on the basis of price.
  - The more intense the competition among buyers, the greater their eagerness for price reductions from their sellers.
  - The more critical an industry's product to the quality of the buyer's product of service, the less sensitive are buyers to the prices they are charged.
- Relative bargaining power
  - Size and concentration of buyers relative to suppliers
  - Buyers' information
  - Ability to integrate vertically

Summary

- the centrepiece of our approach is Porter's five forces of competition framework, which links the structure of an industry to the competitive intensity within it and to the profitability that is realizes
- The primary application for the Porter FFCF is in predicting how changes in an industry's structure are likely to affect it's profitability.

H4 Further topics in industry and competitive analysis

In dit hoofdstuk een diepere strategic analysis van industrie en competitie dan Porters framework.

Complements: a missing force in the Porter model? 89

While the presence of *substitutes* reduces the value of a product, *complements* increase its value: without ink cartridges my printer has very little value to me. Or: a car and gasoline, insurance, repair services etc. Simplest way is to add a sixth force to Porter's framework (fig 4.1, blz 90).

Dynamic Competition: hypercompetition, game theory and competitor analysis 91

Hypercompetition: a general feature of industries today = intensive and rapid competitive moves, in which competitors must move quickly to build advantages and erode the advantages of their rivals.

Game Theory 92

Game theory allows us to model this competitive interaction, it offers 2 especially valuable contributions to strategic management:
- it permits the framing of strategic decisions
- it can predict the outcome of competitive situations and identify optimal strategic choices (like prisoner's dilemma).

Game theory points to five aspects of strategic behavior through which a firm can improve its competitive outcomes: *cooperation, deterrence, commitment, changing the structure of the game being played and signaling.*

Competitive Intelligence 97

Involves the systematic collection and analysis of information about rivals for informing decision making. It has three main purposes:
- to forecast competitors' future strategies and decisions
- to predict competitors' likely reactions to a firm's strategic initiatives
- to determine how competitors' behavior can be influenced to make it more favorable

Dunne grens tussen legal en illegal informatie zoeken!

A framework for predicting competitor behavior 98

Comp intell is not simply about collecting information. The problem is likely to be too much rather than too little information. The key is a systematic approach that makes it clear what info is required and for what purposes it will be used. 'get inside the head of your opponent.' Porter: four part framework for predicting competitor behavior (4.3, blz 98).

- Competitor's *current strategy*
- *Competitor's objectives*
- *Competitor's assumptions about the industry*
- *Competitor's resources and capabilities*

Segmentation and strategic groups **99**

Initially, it may be convenient to define industries broadly, but for a more detailed analysis of competition we need to focus on markets that are drawn more narrowly in terms of both products and geography. This process of disaggregating industries into specific markets we call **segmentation**.

Analysis proceeds in 5 stages:

1. identify key segmentation variables
2. construct a segmentation matrix
3. analyze segment attractiveness
4. identify the segment's key success factors (KSF's)
5. select segment scope

Strategic groups **104**

= 'the group of firms in an industry following the same or a similar strategy along the strategic dimensions'.

Whereas segmentation analysis concentrates on the characteristics of markets as the basis for disaggregating industries, strategic group analysis segments an industry on the basis of the strategies of the member firms.

Summary

In terms of industry and competitive analysis, we have extended our strategy toolkit in several directions:

- we have recognized the potential for complementary products to add value and noted the importance of strategies that can exploit this source of value.
- we have noted the importance of competitive interactions between close rivals and learned a structured approach to analysing competitors and predicting their behavior. At a more sophisticated theoretical level, we have recognized how game theory offers insights into competition, bargaining, and the design of winning strategies.
- We examined the microstructure of industries and markets and the value of segmentation analysis and strategic group analysis in understanding industries at a more detailed level and in selecting an advantageous strategic position within an industry.

H5 Analysing Resources and Capabilities

The role of resources and capabilities in Strategy formulation
Strategy → is concerned with matching a firm's resources and capabilities to the opportunities that arise in the external environment.
Internal environment → resources and capabilities (R&C)

Emphasis on the role of R&C is the basis for strategy is the result of two factors:
- When industry environment is unstable, so R&C more secure basis.
- Competitive advantage rather than industry attractiveness is the primary source of profitability. → resource-based view of the firm

Figure 5.1 Analysing resources and capabilities

Identifying resources
Resources → the productive assets owned by the firm.
Capabilities → what the firm can do.
Key success factors (KSF) → the sources of competitive advantage within an industry. And is a starting point for identifying key R&C

Figure 5.3 Links between resources, capabilities and competitive advantage

We can identify three main types of resources:
- Tangible resources → the financial resources and physical assets that are valued in a firm's balance sheet.
  The goal of resource analysis is understand a firm's potential for creating competitive advantage. → Balance sheet + information on the composition and characteristics of the resources
    - Are there opportunities for economizing?
    - Can existing assets be deployed more profitably?

  Intangible resources →
  Exploiting the profit potential of intangible resources typically involve extending the range of products over which they are exploited.
    - Brand names
    - Reputational asset
    - Technology
    - Intellectual property
    - Organizational culture
- Human resources → comprise the skills and productive effort offered by an organization's employees.
    - Competence modelling → identifying the set of skills, content of knowledge, attitudes, and values associated with superior

performers within a particular job category, then assessing each employee against that profile

Identifying organizational capabilities

Capabilities = competence

Distinctive capabilities → those capabilities that can provide a basis for competitive advantage = primary interest

Core competences → those capabilities that are fundamental to a firm's strategy and performance in that:

- They make a disproportionate contribution to ultimate customer value or to the efficiency with which that value is delivered.
- They provide a basis for entering new markets.

For identifying a firm's organizational capabilities two approaches are commonly used for classifying and disaggregating the firm's activities.

- Functional analysis → identifies organizational capabilities within each of the firm's functional areas.
- Value chain analysis → identifies a sequential chain of the main activities that the firm undertakes

  Porter's value chain distinguishes between:
  - Primary activities → involved with the transformation of inputs and interface with the customer.
  - Supported activities

Figure 5.3 Functional classifications of organizational capabilities
Figure 5.4 Porter's Value Chain

Routinization → regular and predictable behavioural patterns comprising repetitive patterns of activity = an essential step in creating organizational capabilities.

- Trade-off between efficiency and flexibility

Hierarchy of capabilities → Higher-level capabilities require the broadest integration of know-how, typically across different functional departments = greatest management challenge.

Appraising resources and capabilities

Once identified the principle C&R, we need to look at how we appraise their potential for value creation. Two fundamental issues:

- What is the strategic importance of different resources and capabilities?
- What are the strengths of the firm, relative to its competitors' strengths, in relation to these R&C

For a resource or capability to establishing competitive advantage, two conditions must be present:

- Scarcity → if a resource or capability is widely available within the industry, it may be necessary in order to compete, but it will not be a sufficient basis for competitive advantage.
- Relevance → a resource or capability must be relevant to the Key Success Factors (KSF's) in the market.

Three characteristics determine the sustainability of competitive advantage.

- Durability → the more durable a resource, the greater its ability to support a competitive advantage over the long term.
- Transferability → competitive advantage is undermined by competitive imitation. If resources and capabilities are transferable, the can be bought and sold, then any competitive advantage that is based upon them will erode.
- Replicability → if a firm cannot buy a resource or capability, it must build it. Capabilities based on complex organizational routines are less easy to copy.

Appropriating the returns to competitive advantage

- Property rights → in human intensive firms, there is an ongoing struggle between employees and shareholders as to the division of the rents arising from superior capabilities.
- Relative bargaining power → the less clear are property rights in resources and capabilities, the greater the importance of relative bargaining power in determining the division of returns between the firm and its members.
- Embeddedness → the more deeply embedded are individual skills and knowledge within the organizational routines, the weaker the employee is relative to the firm

Figure 5.7 Appraising the strategic importance of resources and capabilities

A next step is assessing how a firm measures up relative to its competitors.
Benchmarking → the process of identifying, understanding and adapting outstanding practices from organizations anywhere in the world to help your organization improve its performance.

Developing strategy implications

The main question is how do we exploit our key strengths most effectively?

- Exploit your key strengths.
- Can the capabilities you own, be used as a basis for establishing new businesses?
- If a company has few key strengths, this may suggest adopting a niche strategy.

Managing key weaknesses?

- Converting weakness into strength is likely to be a long-term task for most companies.
- The most decisive, and often most successful, solution to weaknesses in key functions is outsource.

What about superfluous strengths?

- It's possible to develop innovative strategies that turn apparently inconsequential strengths into key strategy differentiators.

Figure 5.8 Framework for appraising resources and capabilities

In general it is best to define industry context relatively broadly.

H6: Organization Structure and Management Systems: The Fundamentals of Strategy Implementation.

From strategy to Execution

Strategy management process:

1. Formulation
2. Implementation
   These are interdependent.

(chapter 1 Mintzberg): The *intended strategy* is reformulated and redirected by the *emergent strategy.*

- The intented strategy is incomplete. It is during its implementation stage that the gaps are filled in, because circumstances change and unforeseen issues arise > strategy changes.

The annual strategic planning cycle: regular strategic planning process that results in a doc that is endorsed at the highest level of the company.

1. CEO initiates procces with clear strategy priorities.
2. organizational units create strategic plans, presented at review meetings.
3. Comentary of CEO, CFO and head of strategy and the business plans get revised.
4. Presented to board of approval.

Contents of strategic plan:

- Corporate priorities: strategic and financial.
- Priority of business strategies in terms of primary basis for competitive advantage.
- Strategic milestones: target dates for intitiating or completing targets or goals.
- Resource commitments.
- Performance targets and financial projections.

But the most important aspect of strategic planning is: the strategy process: dialog through which knowledge is shared and ideas are communicated, and the consensus that is established.

- Also need for flexibility and adaption became more important.
- Less focus on medium and longterm economic and market forecasts of the future.
- More focus on general issues of strategic direction (vision, mission, strategic intent) and alternative views of the future (*scenario analysis)*.

Overall the strategic planning has shifted from a control perspective (where senior management were controlling decisions etc) to a coordination perspective (dialogue, knowledge sharing, consensus building). The strategic planning process has become increasingly informal!

Strategy process is nothing unless strategy is *implemented.*

- Action: through operating plans
- Motivation and accountability: through performance management.
- Resource allocation: through capital budgeting.

Operating plans

Breaking down medium-term planning into series of short-term plans. A set of performance targets that are derived from the series of annual plans. These are both financial and operational.

*Management by objectives (*by Peter Drucker): An approach based on implementing strategy through establishing performance targets

Allocating resources: Capital expenditure budgeting.

- When organizational units plan their major projects the involve the capital expenditure.
- The top management aggregates the business plans into a corporate plan. It then establishes capital expenditure budgets both for the company as a whole and for individual business units.
- It is then up to individual units to submit capital expenditure requests for specific projects.
- Approval is based on forecast of cash flows, which are then discounted at company's cost of capital. Also extent of project's returns are sensitive to key enviromental uncertainty is estimated.

Organizational Design: the Fundamental of Organizing.

How a firm is organized determines its capacity for action.

Emergence of modern corporation: (strategy capsule 6.1 in book)

- Legal development: the introduction of limited liability, which protected shareholder from corporate debts permitted large-scale equity financing.
- Organizational innovation: derived military and organizational developments in the US:
    - Line and Staff structure: Transport and communication became available. Line employees were engaged in operational tasks within units. Staff comprised adminstrators and functoinal specialists located at head office.
    - The holding company: a financial structure created by a parent company acquiring controlling equity stakes in a nr of subsidary companies.

- Multidivisional corporation: replaced both centralized, functional structures. Decentralization and divided decision making for large corporations.

To design a firm we must first recognize what it is supposed to do. Henry Mintzberg: "The structure of the org can be defined simply as the ways in which labor is divided into distinct tasks and coordination is achieved among these tasks".

Specializtion and division of labor:
The fundamental source of efficiency is *specialization* through the *division of labor* into seperate tasks. BUT the more production processes are divided between different specialists, the more complex is the challenge of integrating their separate efforts. (Harder when external environment is unstable).

The coorperation problem:
- coorperation problem: aligning of the interests of individueals who have divergent goals
- coordination problem: even in absence of goal conflicht, how do individuals harmonize their different activities?

Agency problem: problem of ensuring that managers operate companies to maximize shareholder wealth is at the center of the corporate governance debate.
- Agency problem throughout the hierarchy: Organization structure itself may be the problem. Each department tends to create its own subgoals that conflict with those of other departments.

Several mechanisms are available for management for achieving goal alignment within organizations:
- Control mechanisms: hierachical supervision. Positive: oppurtunity of promotion up the hierarchy. Negative: dismissal and demotion.
- Performance incentives: links output to rewards. Pay for performance. Work hard, get paid.
- Shared values: Shared core values can act as a control mechanism 'clan control'. Reach commonality between members. Create culture.

The coordination problem:
Without coordination your skills or cooperation means nothing.
- Rules and directives.
- Routines (regular and predictable sequences of coordinated actions by individuals are the foundation of organizational capability).
- Mutual adjustment.

Hierarchy in organizational design:
Hierarchy is the primary means by which companies achieve specialization, cooperation and coordination. How should the hierarchy structured and how should the various parts be linked?
- *Hierarchy as control. Bureaucracy:* Top down control. Every layer has its superior.(Think of Weber bureaucracy with systematic division of labour,

formalization, standardized rules and operating procedures. Bureaucratic organizations have been referred to as mechanistic.)

- *Hierarchy as coordination. Modularity:* viewing organizations as natural hierarchies.

    - Economizing on coordination. Make different teams so interactions are structurized and clear. Different moduls.
    - Adaptability: The moduls should have a sense of independence. Work without the need of all other teams, but all the models must fit together.

Contingency approaches to organization design:

- (1970s) There is no one best way to organize. It depends upon the strategy being pursued, the techonology employed and the surrounding environment.
- Earlier existed the mechanistic form (specialized, rules, vertical, centralized, stable environment) and organic form (flexible, mutual adjustment, common culture, uncertain environment).

Organizational Design: Choosing the Right Structure

So: in order to undertake complex tasks, people need to be grouped into organizational units, and cooperation and coordination need to be established among the units.

On what basis should individuals be grouped into organizational units?

Employees can be grouped on the basis of: common tasks, products, location, process.

- *intensity of coordination needs:* individuals who need to interact most closely should be located within the same organization unit. Developed by James Thompson, 3 levels:
    - Pooled interdependence (loosest): individuals operate independently byt depend upon another's performance.
    - Sequential interdependence: output of one individual is the input of the other.
    - Reciprocal interdependence (most intense): individuals are mutually dependent.

Alternative structural forms: functional, multidivisional, matrix.

Three basic organizational forms:

Functional structure:

- Single business firms tend to be organized along functional lines. Grouping together funcationally similar tasks is conducive to exploiting scale economies, promoting learning and capability building and deploying standardized control systems.
- Since cross functional integration occurs at the top of the org, functional structures are conducive to high degree of centralized control.

- However also functional structures are subject to problems of cooperation and coordination. Especially if the firm increases.

Multidivisional structure:

- Loose-coupled, modular organization, where business-level strategies and operating decisions can be made at the divisional level, while the corporate headquarters concentrates on corporate planning, budgeting, and providing common services.

Matrix structure:

- Organizational structures thay formalize coordination and control across multiple dimensions.
- Benefits are often outweighed by excessive complexity, larger head-office staffs, slower decision making and diffused authority. They led to conflict and confusion.

Trends in organizational design

Two decades ago scholars of organization identified a "new organizational revolution" with flatter hierarchies, decentralized decisionmaking etc etc. We cannot speak of a revolution, a better word is evolution. Hierarchy remains the basic structural form of almost all companies, and the familiar structural configurations - functional, divisional, matrix - are still evident. But change has occured:

- *Delayering:* Hierarchies flatter. Less supervision and greater decentralization of initiative. Faster decisionmaking.
- *Adhocracy and team-based organizations:* org with shared values, high levels of participation, flexible communication, spontaneous coordination. Hierarchy, authority and control mechanisms are largely absent. In org where problem solving and non-routine activities dominate. (research, engineering, entertainment business).
- *Project-based org:* related to team-based. Work assignments are for a finite duration and the structure is dynamically flexible. Every project is different, so involves sequence of phases. (construction, consulting, oil exploration, engineering business).
- *Network structures:* Sees transnational org as multinational corporation organized as an integrated global network. This emphasis on patterns of communication and interaction (rather than the formal relationships) put emphasis on the informal mechanisms through which coordination occurs and work gets done.
- *Permeable organizational boundaries:* Narrow down corporate scope through outsourcing and refocusing upon core business activities, while relying on close relationships with partner firms to accces a wider range of expertise. Strategic alliances and localized networks.

All these changes share several common characteristics:

- Focus on coordination rather than on control. (Culture)
- Reliance on informal coordination where mutual adjustment replaces rules and directives.
- Individuals in multiple organizational roles. (Flexibility and responsiveness).

H7: The sources and dimensions of competitive advantage

Competitive advantage & sustainability

How did competitive advantage emerge?

The changes that generate competitive advantage can be either internal or external.

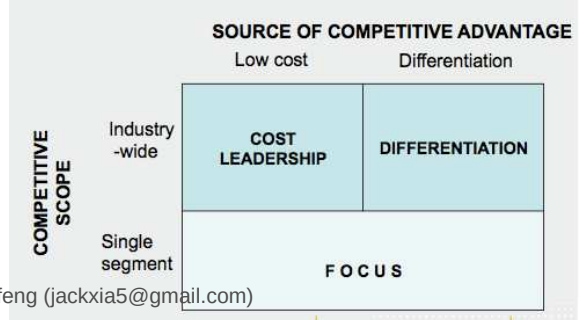
- External
  - The ability to anticipate to changes in the environment
  - Speed: quick response capability (due to advanced IT?) and Time-based competition
- Internal
  - Strategic innovation = new approaches to doing business including new business models.
    "creative destruction". Strategic innovation tend to involve pioneering along 3 dimensions:
    - New industries - blue ocean strategy = the creation of uncontested market space).
    - New customer segments
    - New sources of competitive advantage – new game strategy = reconfiguring the industry value chain in order to change the rules of the game.

Sustainability

For competitive advantage to sustain barriers of imitation should exist = **isolating mechanisms.** The more effective the mechanism, the longer the competitive advantage can be sustained. Types of isolating mechanisms:

- Identification → obscuring superior performance
- Incentives for imitation → deterrence = signal aggressive intentions to imitators
  → pre-emption – occupying an existing niche to reduce the range of opportunities to challenger. Different forms eg. large investments & patents.
- Diagnosis → **causal ambiguity**: when a firm's competitive advantage is multidimensional and is based on complex bundles of resources and capabilities, it is difficult for rivals to diagnose the success of the leading firm. The outcome is uncertain imitability: if causes of the firms success can't be known
- Resource acquisition → the imitation barriers here are limits to the transferability and replicability of resources and capabilities.

A firm can achieve a high rate of profit by supplying an identical product at the lowest price (= cost leadership) or a product that is differentiated in such a way that the customer is willing to pay price premium that exceeds the



additional cost of the differentiation (differentiation leadership). By combining these two with the firms choice of scope – broad market vs. narrow market, Michael Porter has defined 3 generic strategies →

- **Cost analysis**

There are 7 determinants of a firms unit cost → cost drivers.

Cost drivers

The importance of these cost drivers varies across industries, firms and across different firm activities.

1. Economies of scale
   Exist wherever increases in the amount of inputs employed in a production process result in lower unit costs. The point at which most scale economies are exploited is the minimum efficient plant size MEPS, relation between unit cost and plant capacity. They arise from 3 principal sources:
   - Technical input-output relations
   - Indivisibilities: spread the costs of resources and activities over larger volume of output.
   - Specialization

   Scale economies are key determinations of an industry's level of concentration. Small firms offset the disadvantages of small scale by superior flexibility, outsourcing activities and by avoiding motivational and coordination problems.
2. Economies of learning
   Learning occurs at the individual level (through improvements in dexterity and problem solving) and at the group level (through development and refinement of organizational routines).
3. Process technology and process design
   Try to process innovation.
   Business process re-engineering (BPR) is an approach to redesign operational processes that gained massive popularity during 1990s. For the characteristics see p. 184. BPR has let to major gains in efficiency, quality and speed. Wile BPR has lost much of the popularity; firms continue to engage in business process management where the emphasis has shifted from workflow management to information technology to redesign organizational processes.
4. Product design
   Design- for –manufacture = designing products of the ease of production rather than functionality and ethics. This can offer cost savings. Standardization of design and components is too.
5. Capacity utilization
   Ratio of fixed to variable costs
   Fast and flexible capacity adjustments
6. Input costs
   The firms in an industry do not necessarily pay the same price for identical products. Sources of lower input costs:
   - Location differences
   - Ownership of low costs sources of supply
   - Non-union labour

- Bargaining power: the ability to negotiate preferential prices and ad discounts can be a major source of cost advantage for industry leaders, especially in retailing.

7. Residual efficiency
   This relates to the extend to which the firm approaches its efficiency frontier of optimal organization, which depends on the firms ability to eliminate Organizational slack or X-inefficiency.
   Motivation and organization culture & managerial effectiveness.

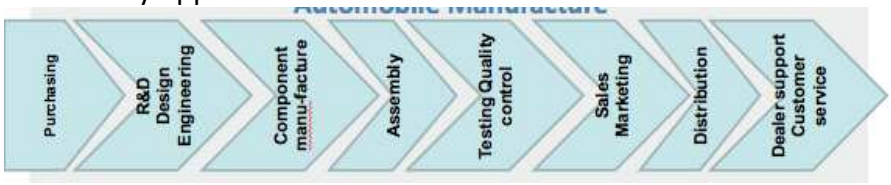
Using the value chain to analyse costs

A value chain analysis of a firm's costs seek to identify:

1. The relative importance of each activity with respect to total costs
2. The cost drivers for each activity & comparative efficiency with which the firm performs each activity.
3. How costs in one activity influence costs in another
4. Which activities should be undertaken within the firm and which should be outsourced.

A value chain analysis of a firms costs position includes the following stages:

1. Identify the main value chain activities
2. Allocate total costs between value chain activities
3. Identify the cost drivers at each stage of the value chain
4. Identify linkage between activities
5. Identify opportunities for cost reduction



- **Differentiation analysis**

A firm differentiates itself from its competitors " when it provides something unique that is valuable to buyers beyond simply offering a lower price". Every firm has opportunities for differentiation, but the range of differentiation opportunities depends on the characteristics of the product. Products that lack differentiation are called commodities (eg. Cement, memory chips). Even commodities can be differentiated to create customer value.

Differentiation is about identifying and understanding every possible interaction between the firm and its' customers and asking how these interactions can be enhanced or changed in order to deliver additional value to the customer. This requires looking at the firm → supply side and customers → demand side.
→ understanding customers and how a firm can best meet their needs.
→ offer uniqueness for customers
Establishing differentiation advantage requires creativity, it can not be achieved simply through applying standardized frameworks and techniques.

The nature and significance of differentiation

Differentiation includes every aspect of the way in which a company relates to its customers. Differentiation activities infuse all aspects of the relationship between an organization and it's customers, including the identity and culture of a company.

Differentiation includes tangible (observable product characteristics) and intangible (social, emotional considerations that links to status, exclusivity etc.) dimensions.

Differentiation = not segmentation

Segmentation is a feature of market structure, differentiation is a strategic choice made by a firm

Sustainability of differentiation advantage

Differentiation offers a more secure basis for competitive advantage than low cost dos. Cost advantages can be overturned by e.g. innovation/new entrants. Differentiation can be persued through quality, branding and innovation.

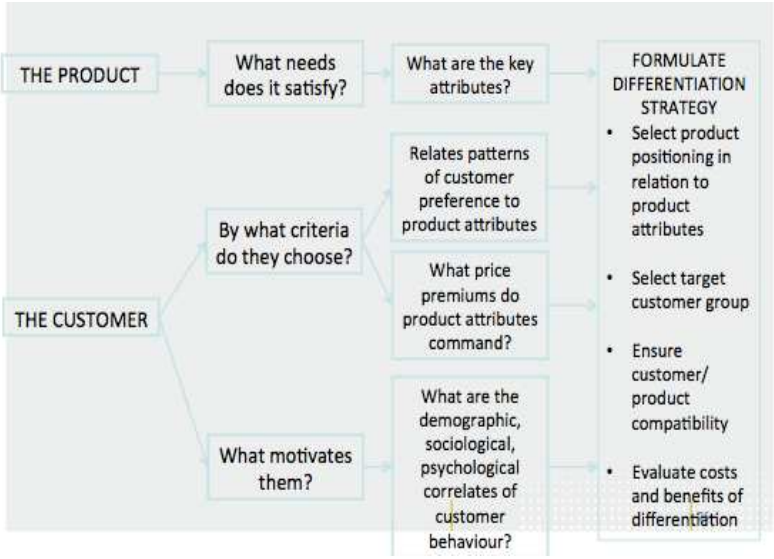
Analysing differentiation: the demand side

The key to successful differentiation is to understand customers. Understanding customer needs requires the analysis of multiple attributes. Market research developed several techniques:

- Multidimensional scaling (MDS) – represents customers perceptions of competing products graphically
- Conjoint analysis – measures the strength of customer preferences for different product attributes
  Used to predict market share of forthcoming firms/products.
- Hedonic price analysis – views products as bundles of underlying attributes.
  Used to make decisions as to what levels of attribute & price to include in new products.
- Value curve analysis – maps the performance characteristics of competing products.

Social and psychological factors

Few goods or services only satisfy physical needs as most buying is influenced by social and psychological motivations (e.g. the desire to find community with others and reinforce owns' identity). So to identify profitable differentiation opportunities, we must analyse not only the product and it's characteristics but also customers, their lifestyle and aspirations and the



relationship of product to those lifestyles and aspirations.
→ see figure 7.10

Analysing differentiation: the supply side

Drivers of uniqueness

A firms opportunity for creating uniqueness are not within a particular function or activity, but can arise in virtually everything it does. Differentiation can occur through:

- Bundling: offering a combination of complementary products and services
- Unbundling: products become commoditized while complementary services become provided by special suppliers.
- Rebundling: combining products and services into new systems

Product integrity

Product integrity refers to the consistency of a firm's differentiation: its extend to which a product achieves a total balance of product characteristics.

- Internal dimension: consistency between function and structure of the product
- External dimension: consistency between how well a product fit the customer's objective.

Achieving internal and external integrity is complex: it requires a combination of cross functional collaboration and intimate customer relationship.

Signaling and reputation

Search goods: qualities and characteristics can be determined by inspection
Experience goods: qualities and characteristics are recognized after consumption.
Producers need to find credible means of signalling quality to the consumer. The more difficult it is to ascertain performance prior to purchase, the more important signalling is.

Brands

A brand provides a guarantee by the producer to the consumer of quality. It identifies the producer, ensures its' legally accountable and represent an investment → credible signal of quality (very important with e-commerce to reduce consumers perceived risk). Consumer goods companies are seeking new approaches to brand development that focus less on product characteristics and more no brand experience, identity , emotional value and shared value. Traditional mass-market advertising is less effective for promoting brand identity as worth=of-mote promotion deploying web-based social networks what ahs been referred to as viral marketing or stealth marketing.

Cost of differentiation

One way of reconciling differentiation with cost efficiency is to postpone differentiation to later stages of the firms value chain.

The value chain in differentiation analysis

The key to successful differentiation is matching the firms capacity for creating differentiation to the attributes that customers value most. Using the value chain to identify opportunities for differentiation advantage involves three stages:

1. construct a value chain
2. identify drivers of uniqueness
3. locate linkages between value than of the firm and that of the buyer.

Consumer goods – consumers engage in a chain of activities that involve search, acquisition and the use of the product.

Implementing cost and differentiation strategies

Generic Strategy	Key Strategy Elements	Resource and Organizational Requirements
Cost Leadership	• Scale-efficient plants • Design for manufacture • Control of overheads and R&D • Process innovation • Outsourcing/offshoring • Avoiding marginal customers	• Access to capital • Process engineering skills • Frequent reports • Tight cost control • Specialization of jobs and functions • Incentives linked to quantitative targets accounts
Differentiation	• Emphasis on branding advertising, design, service, quality, and new product development	• Marketing abilities • Product engineering skills • Cross-functional coordination • Creativity • Research capability • Incentives linked to qualitative performance targets

Two primary sources of competitive advantage define two different approaches to business strategy. A firm that attempts to pursue both is stuck in the middle and almost guaranteed low profitability. Market leadership is held by firm that maximizes customer appeal by reconciling effective differentiation with low costs. The cost leader is not the market leader but a smaller competitor. Reconciling cost efficiency with differentiation has been facilitated by management technique: Total Quality Management has refuted the perceived trade off between quality and cost: flexible manufacturing systems have reconciled scale economies with variety.

Chapter 8: Industry Evolution and Strategic Change

The Industry Life Cycle (4 stages) → Figure 8.1

Demand Growth

- *Introduction stage:*
  Sales are small and the rate of market penetration is low because the industry's products are little known and customers are few. The novelty of the technology, small scale of production, and lack of experience mean high costs and low quality. Customers for new products tend to be affluent, innovation-oriented, and risk-tolerant.
- *Growth stage:*
  Accelerating market penetration as technical improvements and increased efficiency open up the mass market.
- *Maturity stage:*
  Market saturation
- *Decline stage*
  Industry becomes challenged by new industries that produce technologically superior substitute products.

Creation and Diffusion of Knowledge

- *Introduction stage*
  Product technology advances rapidly. Rivalry between different technologies leads to a *dominant design* and a *technical standard*, which become accepted by the industry as a whole. Technical standards emerge where there are *network effects*: the need for users to connect with one another.

- *From Product to Process Innovation (Growth stage).*
  Once a dominant design (& technical standard) has emerged, there's a shift from radical to incremental product innovation. This transition may be necessary to inaugurate the industry's *growth stage*: greater standardization reduces risks to customers and encourages firms to invest in production capacity. The transition typically involves increased attention to process innovation as firms seek to reduce costs and increase product reliability through large-scale production methods.

- *Knowledge on the customer side*
  Over the course of the life cycle, customers become increasingly informed. As they become more knowledgeable about the performance attributes of rival manufacturers' products, so they are better able to judge value for money and become more price sensitive

How General Is the Life-Cycle Pattern?

- Life cycles *vary from industry to industry*

- *Patterns of evolution differ* (some industries may never enter a decline stage, others may experience a rejuvenation of their life cycle).
- Industries are likely to be *at different stages of its life cycle in different countries*.
- *Boundaries of industries shift*: Some industries converge, others tend to fragment.

Implications of the Life Cycle for Competition and Strategy → Table 8.1

- *Product Differentiation:* Convergence around a dominant design is often followed by *commoditization* during the maturity stage unless producers develop new dimensions for differentiation.
- *Organizational Demographics and Industry Structure*: The number of firms in an industry changes over the life cycle. Some main findings of the field of *organizational ecology* are:
  - The number of firms in an industry increases rapidly during the early stages of an industry's life.
  - With the onset of maturity, the number of firms begins to fall. Very often, industries go through one or more *shakeout* phases during which the rate of firm failure increases sharply.
  - As industries become increasingly concentrated and the leading firms focus on the mass market, so a new phase of entry may take place as new firms create niche positions in the market (*resource partitioning).*

However, in different industries structural change follows very different evolutionary paths.

Location and International Trade

Industries move internationally during their life cycles as a result of shifts in demand decreasing dependence on advanced knowledge. New industries begin in the advanced industrial countries (because of the availability of technology and the presence of affluent consumers). With maturity, commoditization, and deskilling of production processes, production eventually shifts to developing countries where labor costs are lowest.

The Nature and Intensity of Competition

These changes in industry structure over the life cycle have implications for competition: first, a shift from non-price competition to price competition; second, margins shrink as the intensity of competition grows.

- *introduction stage*: battle for technological leadership → heavy investments in innovation and market development, barely any price competition
- *growth stage:* more conducive to profitability, especially if there are barriers to entry.
- *maturity stage*: increased product standardization and excess capacity stimulate price competition, especially during *shakeout*.
- *decline stage*: strong price competition (often degenerating into destructive price wars)

Key Success Factors and Industry Evolution

All of these changes also have important implications for the sources of competitive advantage at each stage of industry evolution. Key challenges for firms during each stage:

- *introduction stage:* Product innovation, investment requirements, financial recources, manufacturing, marketing, and distribution.
- *growth stage*: Scaling up → adapt product design and manufacturing capabilities to large-scale production. Access to distribution, new capabilities, and more complex structures.
- *maturity stage:* Efficiency → cost efficiency, low wages, and low overheads.
- *decline stage:* Cost cutting and stability

Managing Organizational Adaptation and Strategic Change

Why is Change so Difficult? The Sources of Organizational Inertia.

Different theories of organizational and industrial change emphasize different barriers to change:

- *Organizational routines*: Capabilities are based on organizational routines and it is difficult to develop new routines → *Competency traps,*where "core capabilities become core rigidities".
- *Social and political structures:* Social system → patterns of interaction that make organizational change stressful and disruptive. Political system → stable distribution of power, change represents a threat to the power of those in positions of authority.
- *Conformity:* Firms tend to imitate one another. The process of *institutional isomorphism* locks organizations into common structures and strategies that make it difficult for them to adapt to change.
- *Limited search*: Organizations often prefer *exploitation* of existing knowledge over *exploration* for new opportunities. This is enforced by *bounded rationality:* human beings have limited information processing capacity, which constrains the set of choices they can consider, and *satisficing*: individuals (and organizations) tend to stop searching for better solutions when they reach a satisfying level of performance.
- *Complementarities between strategy, structure, and systems:* Organizations struggle to establish complex, idiosyncratic combinations of multiple characteristics. However, once established, this becomes a barrier to change. To respond to a change in its external environment, the firm will need to find a new configuration that involves a comprehensive set of changes. This process may require the appointment of a CEO from outside, who is not wedded to the previous configuration.

Organizational Adaptation and Industry Evolution

- *Organizational ecology:* a broader theory of economic change based on the assumption of organizational inertia. The competitive process is a *selection mechanism*, in which organizations whose characteristics match the requirements of their environment can attract resources; those that do not are eliminated.

- *Evolutionary economics:* focuses upon individual organizations as the primary agents of change. The process of variation, selection, and retention takes place at the level of the *organizational routine*.

Coping with Technological Change

In most industries we find a mixture of start-up companies (*de novo* entrants) and established companies that have diversified from other sectors (*de alio* entrants). This is not just a feature of the early stages of an industry's life cycle: it is ongoing. Any form of change in the external environment of an industry offers opportunities for newcomers to challenge incumbents. The major stumbling block for established firms is technological change, but why is this such a problem for established firms?

Competence enhancing and competence destroying technological change

Tushman and Anderson argue that some technological changes are "competence destroying" –they render obsolete the resources and capabilities of established firms. Other changes are "competence enhancing" –they preserve, even strengthen the resources add capabilities of incumbent firms.

Architecture and Component Innovation

A key factor determining the success of established firms in adapting to technological change is whether the technological innovation occurs at the *component* or the *architectural* level. Henderson and Clark argue that innovations which change the overall architecture of a product create great difficulties for established firms because an architectural innovation requires a major reconfiguration of a company's strategy and organizational structure.

Disruptive Technologies

Clay Christiansen distinguishes between new technology that is *sustaining* –it augments existing performance attributes- and new technology that is *disruptive* –it incorporates different performance attributes than the existing technology.

Managing Strategic Changes

Dual Strategies and Organizational Ambidexterity

In chapter 1 we learned that strategy has two major dimensions: *positioning* and *adapting.* Derek Abell argues that dual strategies require dual planning systems: short-term planning that focuses on strategic fit and performance over a one- or two-year period; and longer-term planning to develop vision, reshape the corporate portfolio, redefine and reposition individual businesses, develop new capabilities, and redesign organizational structures over periods of five years or more. Given the observation that companies are biased toward *exploitation* instead of *exploration*, most firms will emphasize short-term over long-term planning. An *Ambidextrous organization* is capable of simultaneously *exploiting* and *exploring*. Two types have been identified:

- *Structural ambidexterity*: exploration and exploitation are undertaken in separate organizational units. It is usually easier to foster change initiatives in new organizational units rather than within the existing organization.

- *Contextual ambidexterity* involves the same organizational units and the same organizational members pursuing both exploratory and exploitative activities.

Tools of Strategic Change Management

- *Creating Perceptions of Crisis:* A crisis sets up the conditions for strategic change by loosening the organization's attachment to the status quo. However, when an organization is engulfed in crisis, it is already too late, hence the merits of the CEO creating the perception of impending crisis within the company so that necessary changes can be implemented well before the real crisis emerges.
- *Establishing Stretch Targets:* performance targets that are achievable but only with an extension of employee effort can motivate creativity and initiative while attacking complacency.

- *Creating Organizational Initiatives*: an organization-wide initiative endorsed and communicated by the chief executive that are effective for disseminating strategic changes, best practices, and management innovations.
- *Reorganization and New Blood*: reorganizing the company structure top management can create an opportunity for redistributing power, reshuffling top management, and introducing new blood.

Dynamic Capabilities

- *David Teece*: a firm's ability to integrate, build, and reconfigure internal and external competences to address rapidly changing environments.
- *Eisenhardt & Martin*: any capabilities that allow an organization to reconfigure its resources in order to adapt and change.
- *Winter & Zollo*: a "higher level" process through which the firm modifies its operating routines.

- *Using Scenarios to Prepare for the Future*: *Scenario analysis* is a systematic way of thinking about how the future might unfold that builds on what we know about current trends and signals. However, the value of scenario analysis is not in the results but in the process.
- *Shaping the Future*: The key to organizational change is not to adapt to external change, but to create the future. Hamel & Prahalad's *new strategy paradigm* emphasizes the role of strategy as a systematic and concerted approach to redefining both the company and its industry environment in the future. *Revolution must be met by revolution* → TABLE 8.3. However, where some companies have achieved radical change, other companies' efforts at radical change have resulted in disaster.

Developing New Capabilities

Early Experiences and Path Dependency

Organizational capability is subject to *path dependency* –a company's capabilities today are the result of its history.

Integrating Resources to Create Capability

Organizational capabilities results from the combination of different resources, most importantly the skills of different organizational members. The effectiveness of this integration depends upon:

- *Processes (organizational routines):* Processes ensure that task performance is efficient, repeatable, and reliable
- *Structure*: The people and processes that contribute to an organizational capability need to be located within the same organizational unit.
- *Motivation*: Without motivation, not only will individuals give less than their best, but also they will not set aside their personal preferences and prejudices to integrate as a team
- *Organizational alignment (fit)*: Excellent capabilities require the components of capabilities to fit with one another and with the broader organizational context.

Since developing new capabilities requires a systematic and long-term process of development, that demands a lot upon management, an organization must limit the number and scope of the capabilities it is attempting to create at any point in time. Capabilities need to be developed *sequentially* rather than all at once. Developing capabilities is also complicated by the fact that we have limited knowledge about how to manage capability development.

The Contribution of Knowledge Management and the Knowledge-Based View

Knowledge Management comprises a range of organizational processes and practices whose common feature is their concern with generating value from knowledge.

Explicit and Tacit Knowledge:

- *Knowledge-Based-View:* a conception of the firm as an assemblage of knowledge assets where value is created by deploying this knowledge.
- *Explicit Knowledge (Knowing about):* comprises facts, theories and sets of instructions. Once created, it can be replicated among innumerable users at low costs and is only secure from rivals when it is protected, either by intellectual property rights or by secrecy.
- *Tacit Knowledge (Know-how)*: involves skills that are expressed through their performance. Its transfer between people is slow, costly, and uncertain.

Knowledge Management Activities that Contribute to Capability Development → TABLE 8.5

H9: Technology-based Industries and the Management of Innovation

Competitive Advantage in Technology-intensive Industries

The Innovation Process

- Invention is the creation of new products and processes through the development of new knowledge or from new combination of existing knowledge. Most inventions are the result of novel applications of existing knowledge.
- Innovation is the initial commercialization of invention by producing and marketing a new good or service or by using a new method of production. Once introduced, innovation diffuses: on the demand side, through customers purchasing the good or service; on the supply side, through imitation by competitors. An innovation may be the result of a single invention or it may combine many inventions. Many innovations may involve little or no new technology.

Figure 9.1 The development of technology: From knowledge creation to diffusion

The Profitability of Innovation

- The profitability of an innovation to the innovator depends on the value create by the innovation and the share of that value that the innovator is able to appropriate. The value created by an innovation is distributed among a number of different parties (innovators, suppliers, followers and customers).
- The term regime of appropriability is used to describe the conditions that influence the distribution of returns to innovation. In a strong regime of appropriability, the innovator is able to capture a substantial share of the value created. In a weak regime of appropriability, other parties derive most of the value. The regime of appropriability comprises four key components which determine the innovator's ability to profit from innovation:
    - Property Rights in Innovation
      Appropriating the returns on innovation depends, to a great extent, on the ability to establish property rights in the innovation (patents, copyrights, trademarks and trade secrets). The effectiveness of intellectual property depends on the type of innovation being protected.
    - Tacitness and Complexity of the Technology
      In the absence of effective legal protection the extent to which an innovation can be imitated by a competitor depends on the ease with which the technology can be comprehended and replicated. This depends on:

        - The extent to which the technical knowledge is codifiable. Codifiable knowledge, by definition, is that which can be written down. Hence, if it is not effectively protected by patents or copyright, diffusion is likely to be rapid and the competitive advantage not sustainable.
        - Complexity.

    - Lead Time
      The innovator's lead time is the time it will take followers to catch up. The challenge for the innovator is to use initial lead-time advantages to build capabilities and market position to entrench industry leadership.
      Lead time allows a firm to move down its learning curve ahead of followers.
    - Complementary Resources
      Bringing new products and processes to market requires not just invention; it also requires the diverse resources and capabilities needed to finance, produce, and market innovation.
      Complementary resources may be accessed through alliances with other firms. When an innovation and the complementary resources that support it are supplied by different firm, the division of value between them depends on their relative value. A key determinant of this is whether the complementary resources are specialized or unspecialized. Where complementary resources are generic, the innovator is in a much stronger position to capture value.

Figure 9.3 Complementary resources

Which Mechanisms Are Effective at Protecting Innovation?

- Patent protection is of limited effectiveness as compared with lead time, secrecy, and complementary manufacturing and sales/service resources. Patenting actively appears to be strategic; it is directed toward blocking the innovation efforts of other companies and establishing property rights in technologies that can then be used in bargaining with other companies for access to their proprietary technologies.

Strategies to Exploit Innovation: How and When to Enter

<u>Alternative Strategies to Exploit Innovation</u>

- Figure 9.4 Alternative strategies for exploiting innovation. This table orders them according to the size of the commitment of resources and capabilities that each requires.
- Which mode of innovation is chosen by the firm depends on two sets of factors:
    - Characteristics of the Innovation
      The extent to which a firm can establish clear property rights in an innovation is a critical determinant of its innovation strategy.

Licensing is only viable where ownership is the innovation is protected by patent or copyrights.
The advantages of licensing are:

- It relieves the company of the need to develop the full range of commentary resources and capabilities needed for commercialization;
- It can allow the innovation to be commercialized quickly.

If the lead time offered by the innovation protection is short, multiple licensing can allow for a fast global rollout. The problem, however, is that the success of the innovation in the market is totally dependent n the commitment and effectiveness of the licensees.

- Resources and Capabilities of the Firm
  As Figure 9.4 shows, different strategies require very different resources and capabilities. Hence, the choice of how to exploit an innovation depends critically upon the resources and capabilities that the innovator brings to the party.
  - Start-up firms possess few of the complementary resources and capabilities needed to commercialize their innovations. Inevitably, they will be attracted to licensing or to accessing the resources of larger firms through outsourcing, alliances, or joint ventures.
  - Established corporations with a wealth of resources and capabilities are better placed than start-ups for internal commercialization. However, even these companies have been forced into more technological collaborations with other companies.

<u>Timing Innovation: To Lead or to Follow</u>

- The advantage of being an early mover depends on the following factors:
  - The extent to which innovation can be protected by property rights or lead time advantages: if an innovation is appropriable through a patent, copyright, or lead-time advantage, there is advantage in being an early mover.
  - The importance of complementary resources: the more important complementary resources are in exploiting an innovation, the greater the costs and risks of pioneering.
  - The potential to establish a standard: the greater the importance of technological standards, the greater the advantages of being an early mover to influence those standards and gain the market momentum needed to establish leadership. Once a standard has been set, displacing it becomes exceptionally difficult.
- Optimal timing depends also on the resources and capabilities that the individual firm has at its disposal. Different companies have different strategic windows – periods in time when their resources and capabilities are aligned with the opportunities available in the market.

- The most effective follower strategies are those that initiate a new product's transition from niche market to mass market.

Managing Risk

- Emerging industries are risky. There are two main sources of uncertainty:
    - Technological uncertainty arises from the unpredictability of technological evolution and the complex dynamics through which technical standards and dominant designs are selected.
    - Market uncertainty relates to the size and growth rates of the market for new products. Forecasting demand for new products is hazardous – most forecasting techniques are based on past data. Demand forecasts for new products tend to rely either on analogies or expert opinion.
- If managers are unable to forecast technology and demand, then to manage risk they must be alert to emerging trends while limiting their exposure to risk through avoiding large-scale commitments. Useful strategies for limiting risk include:
    - Cooperating with lead users
      During the early phases of industry development, careful monitoring of and response to market trends and customers requirements is essential to avoid major errors in technology and design.
    - Limiting risk exposure
      The financial risks of emerging industries can be mitigated by financial and operational practices that minimize a firm's exposure to adversity. By avoiding debt and keeping fixed costs low, a firm can lower its financial and operational gearing. Outsourcing and strategic alliance can also hold down capital investment and fixed costs.
    - Flexibility
      Uncertainty necessitates rapid responses to unpredicted events. Achieving such flexibility means keeping options open and delaying commitment to a specific technology until its potential becomes clear. Large, well-sourced companies have the luxury of pursuing multiple strategic options.

Competing for Standards

With the emergence of the digital, networked economy, more and more markets are affected by standards. For companies, the ability to influence or even own a standard is critical to establishing a competitive advantage.

Types of Standard

- A standard is a format, an interface, or a system that allows interoperability. Standards can be:
    - Public or open standards are those that are available to all either free or for a nominal charge. Typically, they do not involve any privately owned intellectual property, or the intellectual-property owners

make access free. Public standards are set by public bodies and industry associations.
    - Private or proprietary standards are those where the technologies and designs are owned by companies or individuals.

- Standards can also be classified according to who sets them:
    - Mandatory standards are set by government and have the force of law behind them.
    - De facto standards emerge through voluntary adoption by producers and users. A problem with de facto standards is that they may take a long time to emerge, resulting in a duplication of investments and delaying the development of the market.

Why Standards Appear: Network Externalities

- Standards emerge I markets that are subject to network externalities. A network externality exists whenever the value of the product to an individual costumer depends on the number of other users of that product.
- Network externalities do not require everyone to use the same product or even the same technology, but rather that the different products are compatible with one another through some form of common interface.
- Network externalities arise from several sources:
    - Products where users are linked to a network
    - Availability of complementary products and services
      Where products are consumed as systems, the availability of complementary products and services depend on the number of customers for that system.
    - Economizing on switching costs
      By purchasing the product or system that is most widely used, there is less chance that I shall have to bear the costs of switching.
- The implication of network externalities is that they create positive feedback. Once a technology or system gains market leadership, it attracts a growing portion of new buyers. Conversely, once market leadership is lost, a downward spiral is likely. This process is called tipping: once a certain threshold is reached, cumulative forces become unstoppable. The result is a tendency toward a winner-takes-all market. Those markets subject to significant network externalities tend to be dominated by a single supplier.
- Once established, technical and design standards tend to be highly resilient. Standards are difficult to displace due to learning effects and collective lock-in. Learning effects cause the dominant technology and design to be continually improved and refined. Even where the existing standard is inherently inferior, switching to a superior technology may not occur because of collective lock in.

Wining Standards Wars

- In markets subject to network externalities, control over standards is the primary basis for competitive advantage.

- Important issues about designing a winning strategy in markets subject to network externalities:
    - Determining whether we are competing in a market that will converge around a single technical standard.
    - Recognizing the role of positive feedback: the technology that can establish early leadership will rapidly gain momentum. Building a "bigger bandwagon" requires:
        - Before you go to war, assemble allies
          You'll need the support of consumers, suppliers of complements, even competitors. Not even the strongest companies can afford to go it alone in a standards war.
        - Preempt the market
          Enter early, achieve fast-cycle product development, make early deals with key customers, and adopt penetration pricing
        - Manage expectations
          The key to managing positive feedback is to convince customers, suppliers, and the producers of complementary goods that you will emerge as the victor. These expectations become a self-fulfilling prophecy.
- The lesson that has emerged from the classic standards battles of the past is that in order to create initial leadership and maximize positive feedback effects a company must share the value created by the technology with other parties (customers, competitors, complementors, and suppliers). If a company attempts to appropriate too great a share of the value created, it may well fail to build a big enough band wagon to gain market leadership. Thus, recent standards battles involve broad alliances, where the owner enlists the support of complementors and would-be competitors.
- Achieving compatibility with existing products is a critical issue in standards battles. Advantage typically goes to the competitor that adopts an evolutionary strategy rather than one that adopts a revolutionary strategy.
- The key resources needed to win a standards war:
    - Control over an installed base of customers;
    - Owning intellectual property rights in the new technology;
    - The ability to innovate in order to extend and adapt the initial technological advance;
    - First-mover advantage;
    - Strength in complements;
    - Reputation and brand name.
- As companies become more familiar with the dynamics of standards competition, they are launching their strategic initiatives earlier, long before product release dates. As result the standards ware are increasingly about the management of expectations. Companies are also more alert to the emergence of tipping points. As a result, standards wars are being resolved quicker.

Implementing Technology Strategies: Creating the Conditions for Innovation

Managing Creativity

- The Conditions for Creativity
  Invention is an act of creativity requiring knowledge and imagination. The creativity that drives invention is typically an individual act that establishes a meaningful relationship between concepts or objects that had not previously been related.
  Individual creativity also depends on the organizational environment in which they work. Few great works of art or outstanding inventions are the products of solitary geniuses. Creativity is stimulated by human interaction.
- Organizing for Creativity
  Creativity requires management systems that are quite different from those that are appropriate for efficiency. In particular, creatively oriented people tend to be responsive to distinctive types of incentive. They desire to work in an egalitarian culture with enough space and resources to provide the opportunity to be spontaneous, experience freedom, and have fun in the performance of the firm. Praise, recognition, and opportunities for education and professional growth are also more important than assuming managerial responsibilities. Nurturing the drive to create may require a degree of freedom and flexibility that conflicts with conventional HR practices.
  Organizational environments conducive to creativity tend to be both nurturing and competitive. Creativity requires a work context that is secure but not cozy.

From Innovation to Innovation: The Challenge of Integration

- Balancing Creativity and Commercial Direction
  For creativity to create value, both for the company and for society, it must be directed and harnessed. Balancing creative freedom with discipline and integration is a key issue to companies, which position themselves on the leading edge of innovation.
  Creative flair can lead to commercial success if it is focused upon market need. Few important inventions have been the result of spontaneous creation by technologists; almost all have resulted from grappling with practical problems.
- Organizational Approaches to the Management of Innovation
  Reconciling creativity with commercial effectiveness is a major challenge for organizational design. The organizational solution comes from reconciling differentiation and integration. The creative and operational functions of the organization need different structures and systems. Yet, the key to successful innovation is in integrating creativity and technological expertise with capabilities in production, marketing, finance, distribution and customer support.
  As innovation has become an increasing priority for established corporations, so chief executives have sought to emulate the flexibility, creativity, and entrepreneurial spirit of technology-based start-ups. Organizational initiatives aimed at stimulating new products development and the exploitation of new technologies include the following:
    - Cross-functional product development teams

These have proven highly effective mechanisms for integrating creativity with functional effectiveness. Conventional approaches to new product development involved a sequential process that began in the corporate research lab then went "over the wall" to engineering, manufacturing, finance, and so on.

- Product champions
  These provides a means, first, for incorporating individual creativity within organizational processes and, second for linking invention to subsequent commercialization.
- Buying innovation
  Recognition that small, technology-intensive start-ups have advantages in the early stages of the innovation process, while large corporations have superior capabilities, has encouraged large companies to enhance their technological performance by acquiring innovation from other firms.
- Open innovation
  The shift from vertically integrated systems of innovation, where companies develop their own technologies in-house and then exploit them internally, to more also licensing out their own technologies, has given way to ideas of open innovation. As innovation increasingly requires the integration of multiple technologies often from traditionally separate scientific areas, so firms have been forced to look more widely in their sourcing technology and in sharing know-how.
- Corporate incubators
  These are business developments established to fund and nurture new business based upon technologies that have been developed internally but have limited applications within a company's established business.

Summery

In emerging and technology-based industries, nurturing and exploiting innovation is the foundation mental source of competitive advantage and the focus of strategy formulation. Yet the basic tools of strategy analysis are the same as those that we have already encountered in this book. The fundamental strategic issues we are concerned with include the drivers of competition in these markets, the resources and capabilities through which a firm can establish competitive advantage, and the design of structures and systems to implement strategy.

Yet, the unpredictability and instability of these industries mean that strategic decisions in technology-driven industries have a very special character. The remarkable dynamics of these industries mean that difference between massive value creation and ignominious failure may be the result of small errors of timing or technological choices.

In technology-based industries, traditional approaches to strategy based upon forecasting and detailed planning are inadequate. The combination of speed and unpredictability of change means that effective strategies are those which combine clarity of vision with flexibility and responsiveness. The companies that have

succeeded in emerging and technology-based industries are those that recognized most clearly the strategic characteristics of their industries and adapted most effectively to them. In industries that have been turned upside-down by technological change – whether telecommunications equipment, medical imaging, information storage, or sports equipment – it is companies that have understood the resources of competitive advantage and assembled the resources and capabilities needed to exploit them that have emerged as winners.

Our learning about how to complete in emerging and technology-based industries had included:

- understand the innovation process, in particular the progression from knowledge creation to invention to innovation to diffusion, and some of the characteristics of these different stages;
- the determinants of the profitability of innovation, in particular the role of intellectual-property rights, the complexity and tacitness of the innovation, lead time, and complementary resources;
- the design of innovation strategies, including the choice between being an early mover or a follower; the relative merits of licensing, alliances, joint ventures, and internal development exploiting and innovation; and the management of risk;
- competing for standards requires recognizing the presence of network externalities and exploiting positive feedback mechanisms to gain market leadership; and the management of identifying the factors that determine the comparative advantages of begin a leader or a follower in innovation.

Finally, we addressed strategy implementation in emerging and technology-based industries – creating the structure, management systems, and organizational climate conductive to innovation. Here we recognized some of the challenges of reconciling the conditions for creativity with those required for operational efficiency and commercial effectiveness.

Such dilemmas are central in challenges for the managers of technology-intensive firms. A fundamental dilemma is that innovation is an unpredictable process requiring flexibility and market responsiveness, while strategy is about irreversible resource-allocation decisions involving long-term commitments. How can a company create the conditions for nurturing innovation while planning the course of its development? John Scully, a former CEO of Apple, observed: “Management and creativity might even be considered antithetical states. While management demands consensus, control, certainty, and the status quo, creativity thrives on the opposite: instinct, uncertainty, freedom, and iconoclasm.”

Fortunately, the experiences of companies such as Cisco Systems, 3M, Amgen, and IBM point to solutions to these dilemmas. The role of cross-functional development teams, product champions, and open innovation are examples of organizational initiatives that have assisted large, established firms in maintaining impressive records of innovation.

Chapter 10: Competitive Advantage in Mature Industries

1. Competitive Advantage in Mature Industries

Introduction

Maturity has two principal implications for competitive advantage:

- It tends to reduce the number of opportunities for establishing competitive advantage, this stems from:
  - less scope for differentiation advantage from better informed buyers, product standardization, and lack of technological change
  - diffusion of process technology
  - a lower barrier for new entrants due to a highly developed industry infrastructure and the presence of powerful distributors
- It shifts these opportunities from differentiation-based factors to cost-based factors

A trend towards declining industry attractiveness is a constant threat in mature industries.

Cost Advantage

Primary sources of low cost:

- Economies of scale: the significance of scale economies in mature industries is indicated by the fact that the association between return on investment and market share is stronger in mature industries than in emerging industries (where there's more insecurity as to return on investment)
- Low-cost inputs: acquiring low-cost materials / cutting labor costs (e.g. in business operated by family members who are willing to work long hours without the usual benefits and overtime pay).
- Low overheads

Answer to cost inefficiencies in mature enterprises: corporate restructuring, involving cost reduction. Three successful approaches are:

- Asset (*activa)* and cost surgery: e.g. cutbacks in marketing expenditures / inventories
- Selective product and market pruning: refocusing on segments that were most profitable or where the firm possessed distinctive strength
- Piecemeal productivity moves

Segment and Customer Selection

Creating new market segments (finding a niche) in an (unattractive) industry can be a solution when profitability is depressed. Mostly this is caused by slow demand growth, lack of product differentiation and international competition. Segment focussing implies further disaggregation of markets, down to the level of the individual customer.

New approaches to customer relationship management (CRM) make it possible to analyze on that level (which are (un)attractive customers, what do customers want, by which marketing strategy can customers be reached?). The next stage is to actively target attractive customers and transform less valuable customers into valuable customers.

The Quest for Differentiation
The trend towards commoditization narrows the scope for differentiation and reduces customer willingness to pay a premium for differentiation.

In consumer goods, maturity often means a shift from physical differentiation to image differentiation.

Innovation
Measured by patenting activity, there is evidence that some mature industries are as innovative as emerging industries. Despite an increased pace of technological change in many mature industries, though, the most opportunities for establishing competitive advantage are likely to arise from strategic innovation, including new game strategies and blue-ocean strategies (see CH 7). In addition to the value chain reconfiguration approach (see CH 7), firms can seek strategic innovation by redefining markets and market segments. This may involve:

- Embracing new customer groups
- Augmenting, bundling, and theming the product offering → customer gets involved in an entire experience (goes beyond the products being sold)
- Customer solutions: an integrated bundle of products and support services that are offered as a customized package.
- Liberation from the maturity mindset: managers need to free themselves from conventional thinking about strategy. This means cultivating an entrepreneurial organization where middle managers are encouraged to experiment and learn.

Strategic innovation in mature industries is often associated with firms that are either outsiders or peripheral players.

<u>2. Strategy Implementation in Mature Industries: Structure, Systems, and Style</u>

Efficiency through Bureaucracy
Machine bureaucracy (Mintzberg): formalized type of organization dedicated to the pursuit of efficiency. This is a caricature of actual organizations. However, in most mature industries, the features of mechanistic organizations are evident in highly routinized operations controlled by detailed rules and procedures.

(Look at Table 10.1 (p. 286)

Trends in Strategy Implementation among Mature Businesses

The efficiency leaders in mature industries are not necessarily the biggest firms that are able to exploit scale benefits to the maximum: they are more likely to be companies that have dedicated themselves to efficiency through implementing performance-oriented management systems. Unifying an organization around the pursuit of efficiency requires management systems that allow disaggregation of company-wide goals into specific performance targets for departments and individuals – the balanced scorecard is often used for achieving this (see CH 2). Most important, however, is embedding performance goals within the company's organizational culture.

The conventional model for reconciling efficiency with innovation in mature companies is internal differentiation: innovation and entrepreneurship are the responsibility of specialists within the company.

3. Strategies for Declining Industries

Among the key features of declining industries are:

- excess capacity
- lack of technological change
- a declining number of competitors
- high average age of both physical and human resources
- aggressive price competition

Two factors that determine whether or not a declining industry becomes a competitive bloodbath:

- the balance between capacity and output
- the nature of the demand for the product

Adjusting Capacity to Declining Demand

The ease with which capacity adjusts to declining demand depends on the following factors:

- The predictability of decline
- Barriers to exit, the major ones are:
    - Durable and specialized assets (when they cannot easily be used in another industry)
    - Costs incurred in plant closure (e.g. redundancy payments to employees, compensation costs)
    - Managerial commitment (e.g. emotional and moral reasons)
- The strategies of the surviving firms: the willingness of the industry players to close plants and divest assets.

Strategy Alternatives for Declining Industries

The conventional strategy recommendations for declining industries (either divest or harvest) assume that the industries are inherently unprofitable. If profit potential exists, one or more of these strategies (Harrigan & Porter) may be attractive:

- Leadership (acquiring competitors or making it attractive for competitors to exit the industry)
- Niche: identify a segment that is likely to maintain a stable demand and that other firms are unlikely to invade (and then pursue a leadership strategy) The most attractive niches are those that offer the greatest prospects of stability and where demand is most inelastic).
- Harvest: maximizing its cash flow from existing assets, while avoiding further investment. Raising prices and cutting costs.
- Divest: in the early stages of decline, before a consensus has developed as to the inevitability of decline.

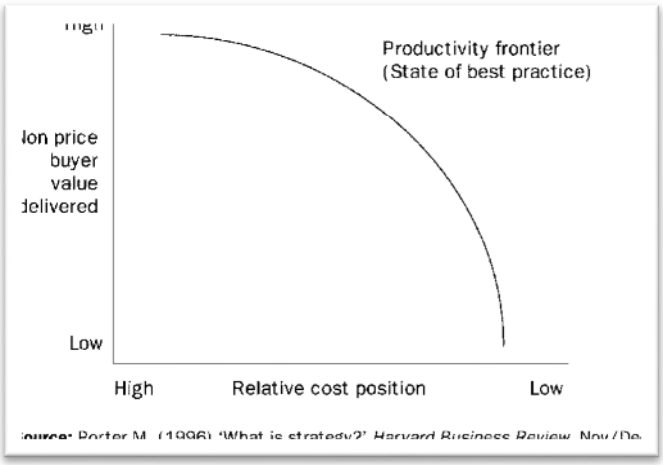
Selecting an appropriate strategy: Figure 10.1 (p. 290).

Porter, 1996: What is strategy?

The article examines the difference between Operational effectiveness (OE) and strategy. Porter feels the distinction between the two has been lost. While both are important for achieving superior performance, in his view strategy will result in long-term advantages while operational effectiveness while give unsustainable advantages of shorter duration. The differences between both and his arguments for the above view will be detailed below.

What is operational effectiveness?

Operational effectiveness (I'll use OE for the remaining of this summary) is about how well the activities of the firm are performed. Getting the job done better. As an example of OE he highlights the rise of Japanese firms in the '70s and '80s. Because of their focus on efficiency they were able to outperform the (western) competitors. They produced more value with less input.



Examples of tools for OE are: TQM (total quality management), benchmarking, outsourcing and reengineering. All these tools can be combined to make the whole process of creating, producing and selling of ones produce more efficient. Porter goes on to imagine a *Productivity frontier*, the mix of all the most efficient practices to arrive at an output. On this frontier you deliver maximum value for the lowest relative cost. Firms try to achieve this by employing OE, this will bring them closer to producing at the frontier. The frontier will expand (forever) outward by technological development.

Porter makes the case that the advantages that a firm enjoy from using OE, while being profitable in the short term, is unsustainable in the longer run. This is because all other firms will quickly try to mimic the employed tools and as an result will also produce closer to the frontier. This becomes an arms race, a war of attrition where the benefits in the long term are for the consumer (in the form of lower prices for higher quality) and not for the producer and the supplier of equipment (in a continuing demand for better and better equipment.)

Strategy rests on unique activities

According to Porter strategy is the process of deliberately choosing a particular set of activities to provide a unique mix of value. F.i. a low-cost airliner is optimized to provide a low-cost way of flying from A to B. This means that they often fly on

secondary airports, they operate a more uniform fleet, they provide no meals onboard, no first class and generally just for short to medium hauls. By operating this way they are able to provide their costumer with the product they require. A no-frills, cheap and fast way of getting from A to B. The next example he gives is Ikea. At Ikea everything is optimized for delivering cheap, stylish furniture. The way they positioned themselves to provide this is just as with the airliners all encompassing. From the way the store is layed out, the fact that Ikea displays the items in a setting similar to a room, that you can navigate the store yourself and of course they warehouse wwhere you get your own stuff.

They tailored approach to providing their customers with a particular value is what Porter calls strategy or positioning. He lists 3 sources of positioning:
- **variety-based positioning**. Based on a product instead of a costumer segment. When a company can provide a particular subset of products better than the competition. Car glass for windshield repair but Kwikfit for general maintenance. Because of the narrow focus only in a small part of costumer need.
-- **Needs based positioning**. More costumer segment orientated. See Ikea.
- **Access-based positioning**. Least common, happens for example when costumers are geographically dispersed. For example a chain that only serve small towns.

Positioning is always a function of activities. Supply side choices to best fit your costumers need.
A sustainable strategic position requires trade-offs
A valuable position will attract attention from competitors. They will try and copy your approach in 1 of 2 ways. First of all, they can try and reposition themselves. F.i. when a cheap cloth store tries to become more up-market. The second method is called straddling and this is when they try to mimic a valuable position without giving up there current model. Example; an “expensive” airline that also tries to offer cheap flights like Easyjet.

In straddling trade-offs occur.
- The mix of activities that make one a good fit to deliver a certain service are not the same as for another position. It would be hard for MacD to start offering gourmet diners. And for a top-of-the-bill restaurant delivering fastfood an a giant scale provides challenges for which they are not equipped.
- Reputation doesn’t fit. See prev. example.
- Organisational it also hard to try and combine all kinds of activities in one company. To at the same time try and provide the highest service while also trying to be a cheap, low service alternative will confuse staff. Lacks clear framework.
The choices you make to arrive at a certain position limit or determine what your options later on will be. Making these choices is what is strategy.

Fit drives both competitive advantage and sustainability
Positioning not only determines which activities a company employs but also how they relate. OE is about doing every activity as good as possible, strategy is about combining activities.
To return to the previously mentioned airline, there advantages lies not in there low-

cost, quick turnaround at thegate or there standardised fleet. All these things work together and reinforce oneanother. Strategic fit creates competitive advantage and superior profitability.

Three kinds of fit:
- First-order or simple consistencies. F.i. when company has low-cost strategy all the processes that are geared toward lowering cost. (Shelving system in the Lidl)
- Second order or reinforcing. F.i. Selling your expensive soap in a expensive hotel.
- Third order or optimisation of effort. The it capabilities of Wal-Mart and there distribution are a good example.

Strategic fit is fundamental to achieve a competitive advantage but also to make that sustainable. It is much harder to imitate a chain of interlocking systems/procedures/resources then it is to copy 1 thing. So there is a barrier to imitate. The more there is 2nd and 3rd order fit, the harder it is to copy. Also a high level of fit creates incentives to OE. Poor performance in A drags down B. So now you have more of a reason to work on A.

Strategy is creating fit among a company's activities

Rediscovering strategy

A lot of companies fail to have a sound strategy. Problem could be external (uncertainty in future tech, competitors) but are more often internal. Most often the desire to grow. When in a broad targeted company starts aggressively go for low prices they risk alienate costumers who appreciate more service. Targeted companies lose customers who are more price-sensitive. Managers have a constant incentive to broaden the scope of the company. To expand past the strategy. Compromises and inconsistencies in the quest for growth risk hurting the competitive advantage.

Profitable growth

The way to make growth a success is generaly to deepen a strategic position instead of diluting it. If you have a competive advantage in one area/product, work from there. If you are the best sportscar maker you're not necessarily the best lawnmower builder. Deeping a position means making your position more distinctive, strengthening fit and communicating the strategy better to costumers. Globalization is ooften a way of growing that reinforces a company's strategy. Opening larger markets for a focused growth.
When deciding to grow by broadening perhaps using different brandnames for it is the way to go. No risk to your brand name.

The role of leadership

The main role for top management according to Porter is setting out te strategy. They should have a clear idea about which way to go, the industry opportunities and pitfalls. After figuring out your strategic position have the courage to see it through. Separate OE and strategy, both important but not the same.

A companies choice of a new position must bedriven by the ability to find new trade-

offs and leverage a new system of complementary activities into a sustainable advantage.

Porter, Kramer, 2011: Creating shared value

Inleinding

In recent years business embraced Corporate Responsibility, which lead to the fact the they were being blamed for society's failures. A big part of the problem lies with companies themselves, which remain trapped in an outdated approach to value creation that has emerged over the past few decades.

The solution lies in the principle of shared value, which involves creating economic value in a way that also creates value for society by addressing its needs and challenges.

The purpose of the corporation must be redefined as creating shared value, not just profit per se. This will drive the next wave of innovation and productivity growth in the global economy. It will also reshape capitalism and its relationship to society.

Moving beyond trade off's

Two theories about how companies/business and society works

- In neoclassical thinking, a requirement for social improvement such as safety or hiring the disabled imposes a constraint on the corporation. Adding a constraint to a firm that is already maximizing profits, says the theory, will inevitably raise costs and reduce those profits.

- A related concept, with the same conclusion, is the notion of externalities. Externalities arise when firms create social costs that they do not have to bear, such as pollution. Thus, society must impose taxes, regulations, and penalties so that firms "internalize" these externalities a belief influencing many government policy decisions.

The concept of shared value, in contrast, recognizes that societal needs, not just conventional economic needs, define markets. It also recognizes that social harms or weaknesses frequently create *internal* costs for firms such as wasted energy or raw materials, costly accidents, and the need for remedial training to compensate for inadequacies in education.

The roots of shared value

At a very basic level, the competitiveness of a com- pany and the health of the communities around it are closely intertwined. A business needs a successful community, not only to create demand for its products but also to provide critical public assets and a supportive environment. A community needs successful businesses to provide jobs and wealth creation opportunities for its citizens. This interdependence means that public policies that undermine the productivity and competitiveness of businesses are self-defeating, especially in a global economy where facilities and jobs can easily move elsewhere.

How Shared value is created

Companies can create economic value by creating societal value. There are three distinct ways to do this: by *reconceiving products and markets*, *redefining productivity in the value chain*, and *building supportive industry clusters at the company's locations*. Each of these is part of the virtuous circle of shared value; improving value in one area gives rise to opportunities in the others.

The ability to create shared value applies equally to advanced economies and developing countries, though the specific opportunities will differ. The opportunities will also differ markedly across industries and companies but every company has them.

Reconceiving products and markets

For a company, the starting point for creating shared value is to identify all the societal needs, benefits, and harms that are or could be embodied in the firm's products. The opportunities are not static; they change constantly as technology evolves, economies develop, and societal priorities shift. An ongoing exploration of societal needs will lead companies to discover new opportunities for differentiation and repositioning in traditional markets, and to recognize the potential of new markets they previously overlooked.

Redefining productivity in the value chain

Areas in the value chain where shared value can be applied

- Energy use and logistics
- Resource use
- Procurement
- Distribution
- Employee productivity
- Location

as stated in the article,"reimagining value chains from the perspective of shared value will offer significant new ways to innovate and unlock new economic value that most businesses have missed."

Enabling local cluster development

Companies do not operate in isolation from their surroundings. To compete and thrive, for example, they need reliable local suppliers, a functioning infrastructure of roads and telecommunications, access to talent, and an effective and predictable legal system.

Clusters are prominent in all successful and growing regional economies and play a crucial role in driving productivity, innovation, and competitiveness. Capable local suppliers foster greater logistical efficiency and ease of collaboration, as we have discussed. Stronger local capabilities in such areas as training, transportation services, and related industries also boost productivity. Without a supporting cluster, conversely, productivity suffers.

Creating shared value in practice

Shared value is defining a whole new set of best practices that all companies must embrace. It will also become an integral part of strategy. The essence of strategy is choosing a unique positioning and a distinctive value chain to deliver on it. Shared value opens up many new needs to meet, new products to offer, new customers to serve, and new ways to configure the value chain. And the competitive advantages that arise from creating shared value will often be more sustainable than conventional cost and quality improvements. The cycle of imitation and zero-sum competition can be broken.

The next evolution in Capitalism

Shared value holds the key to unlocking the next wave of business innovation and growth. It will also reconnect company success and community success in ways that have been lost in an age of narrow management approaches, short-term thinking, and deepening divides among society's institutions.

H11 Vertical integration and the scope of the firm

In this chapter overall scope and vertical integration are discussed.
We discuss firm boundaries and the role of transaction costs. Opportunities for outsourcing, alliances and electronic commerce make companies rethink which of their activities should remain within organizational boundaries.

Firms markets and transaction costs

The capitalist economy is referred to as a market economy but actually exists of two forms of economic organization.

- One is the *market mechanism* where individuals and firms, guided by market prices make independent decisions to buy and sell goods and services. (Classified by Adam Smith as the "Invisible hand", because its coordinating role does not require conscious planning).
- The other is the *administrative mechanism* of firms, where decisions concerning production and resource allocation are made by managers and imposed through hierarchies. (Alfred Chandler referred to this mechanism as the "Visible Hand" because coordination involves active planning)

Both firms and markets may be viewed as alternative institutions for organizing production. Firms are distinguished bythe fact that they comprise a number of individuals bound by employment contacts with a central contracting agency. Firms are not essential for organizing production.
What determines which activities are undertaken by a market or a firm? Richard Coases' answer is *relative cost*. Markets are not costless: Making a purchase involves search, negotiating, monitoring and legal costs. All these costs are *Transaction costs*. If these costs are greater than the administrative costs of organizing within the firm, we can expect the coordination of the productive activity will be internalized within firms.

The shifting boundary between firms and markets

During the 19th and most of the 20th century, companies grew in size and scope, absorbing transactions that had previously taken place across markets. This can be attributed to the fall in administrative costs relative to the transaction costs of markets. Two factors have greatly increased the efficiency of firms in organizing economic activity:

- Technology: the developments in computer and telephone have played an important role in facilitating communications within firms and expanding the decision-making capacity of managers.
- Management techniques: Development in the principles and techniques of management has greatly expanded the organizational and decision-making effectiveness of managers.

For the past three decades companies reverted to downsizing and refocusing on their core business despite the fact that they were expanding internationally. Refocusing was both in product scope and vertical scope through outsourcing. The contraction of corporate boundaries points to markets increasing their efficiency relative to firms administrative processes. This was mostly because in times of economic turbulence, large vertical companies had a large overhead and tended to lack flexibility.
When it comes to vertical integration, a company needs to choose between vertically integrated or vertically specialized. In short: To make or to buy.

The benefits and costs of vertical integration

Vertical integration refers to a firms ownership of vertically related activities. The extent of a firms vertical integration is indicated by the ratio of value added / its sales revenue.
Vertical integration can either be *backward* (or upstream) into its suppliers activities or *forward* (downstream) into its customers activities. It can also be full or partial (e.g. Part of produce of farmer is sold directly to end user, part is bought by distributor)

A great advantage of vertical integration can be the cost savings through physical integration of processes it offers. Having two parts of the value chain in one building might save costs but it does not stipulate that the processes are also run by the same company(*Common ownership*).
A cost of vertical integration can be the loss of free trade. You are bound to a single supplier/customer and this mutual dependency drives the price. Efficiencies of competitive markets are lost. Also, the two can *hold up* the other.
Among automakers, specialized parts are more likely to be manufactured in-house than commodity items like spark plugs or tires.
Vertical integration avoids the cost of using the market but internalizing the process imposes administrative cost. The size of the cost depends on a number of factors:

- *Scale*: Small breweries buy their bottles from factories, due to sheer volume Heineken is cheaper off producing its own.
- Distinctive capabilities: A key advantage of a company that is specialized in a few activities is its ability to develop distinctive capabilities in those activities. (IT department can be outsourced because IBM can do it better for less.) Where one capability is closely integrated capabilities with adjacent activities you might gain more from vertical integration. (Wal-Mart needs real-time information on supplies and thus manages its own IT.)
- *Strategic difference*: Few manufacturing companies retail their own products. Manufacturing and retailing require different organizational capabilities and different approaches to strategic planning, control, HR management and top management styles and skills. Marriott Hotels are split up in a company owning hotels and one running hotels.
- *Incentive problems*: Where a market interface exists, profit incentives ensure that the buyer is motivated to secure the best deal and the seller strives for high efficiency and service to attract the buyer. These are high-powered incentives. With vertical integration, internal supplier-customer relationships are subject to low-powered

incentives. One approach to creating stronger performance incentives in vertically integrated companies is to open internal divisions to external competition.
- *Competitive effects*: vertical integration can be used to extend a monopoly position of an industry's value chain to adjacent stages. Such cases are rare. Usually there is no extra profit to be extracted and a company risks damaging its competitive position in its original business because it must now compete with its customers or suppliers. The Disney Channel led to less Disney productions aired through other channels.
- Flexibility: There are two types of flexibility: Where the required flexibility is rapid responsiveness to uncertain demand there are advantages in market transactions. Where system-wide flexibility is required, Vertical integration may allow for speed and coordination in achieving simultaneous adjustment throughout the vertical chain.
- *Compounding Risk*. Problems at one stage of a vertically integrated chain threaten production and profitability of all other stages.

We have seen that vertical integration is neither good nor bad, it is case specific. So far the book has only compared vertical integration with arms-length market contracts. In practise buyers and sellers can coordinate their interests trough a variety of relationships. These relationships may be classified through two characteristics:

- The extent to which buyers and sellers commit resources to the relationship. Spot contacts involve no extra commitment of resources where Vertical integration involves a substantial amount.
- The formality of the relationship. Long-term contracts and franchises are formalized by the complex written agreements they entail.

Different vertical relationships:

- *Long-term contracts*
- *Vendor partnerships*
- *Franchising*
- *Joint ventures*
- *Spot sales*

Important factors in choosing between different forms:

- *Resources, capabilities and strengths*: within the same industry different companies will choose different vertical arrangements according to their reactive resource and capability strengths and the strategies they pursue
- *Allocation of risk*. Anything other than a spot contract means you need to cope with the uncertainties of the contract. In the contract, risks are divided between buyer and seller.
- *Incentive structures*: Incentives are central to the design of vertical relationships. Incentives for opportunistic behaviour are the bugbear of market contract while weak low-powered incentives for performance are the central problem of vertical integration. Intermediate models tend to offer the best solutions to the design of incentives.

Extreme levels of outsourcing have led to the concept of *virtual corporations*. It's a firm that has the role of coordinating the activities of downstream partners. The main role here is that of the systems integrator. A big risk is that the virtual corporation may become a hollow corporation that loses the capability to adapt to change.

H12: Global Strategy and the Multinational Corporation

Internationalization occurs firstly through product and service **trading (TR)** with other countries, and secondly through **direct investment (DI)** in other countries(building assets). On the basis of those we can identify different patterns:

Patterns of Internationalization
- Sheltered Industries: Low DI and low TR (Fresh foods, big products)
-Trading industries: Low DI, high TR opportunities(diamond mining, aerospace)
- Multidomestic Industries: High DI, low TR (Hotels, Consulting)
- Global Industries: High DI and low TR (Oil, Automobiles)
Depending on degree of either International trade or direct investment you can categorize an industry in one of the 4 types. (see also figure 12.1, page 317)

Implications for competition
Using porters five forces model we can identify 3 implications for competition:
- Competition from potential entrants
- Rivalry among existing firms
- Increasing the bargaining power of buyers

National Influences on Competitiveness: Comparative Advantage
When companies go international, a new factor must be taken in account for: the national environment, which includes recource availability, government policies and market conditions.
When a product or service uses intensively use of a resource that is abundant within that country, there is a **comparative advantage.** A comparative advantage can turn into a competitive advantage if the exchange rates are well behaved.

Porters National Diamond
According to Porter there are 4 forces that form the basis of understanding of national competitive advantage:

- Factor conditions (Home-grown resources)
- Related and supporting industries
- Demand conditions
- Strategy, structure and rivalry

These forces are all interconnected and influence each other.
Determinants of Geographical Locatio: Where to manufacture?

- National Resouces availibility
- Firm-specific competitive advantages
- Tradability

Location and the value chain

A key feature of recent internationalization had been the international fragmentation of value chains as firms seek to locate countries whose resource availability and cast best match each stage of the value chain.To determine the optimal location the following framework can be used: (see also figure 12.5, page 326)

Where to locate an activity?

1 Independent activity
- 1.1 Optimal location in terms of cost and resource?
- 1.2 What are governmental rules
- 1.3 What are capabilities of firm on location?

2 Activity depends on other firms' activities
- 2.1 What is the firms strategy? (cost or differentiation)
- 2.2 What are the benefits for co-locating activities?

Foreign entry strategies

To take in consideration before entering:
- Is the firms competitive advantage based on firm-specific or country-specific resources?
- Is the product tradable and what are barriers to trade?
- Does the firm possess the ful range of recources and capabilities for establishing a competitive advantage in the overseas market?
- Can the firm directly appropriate the returns to its resources?
- What transaction costs are involved?

Multinationals tend to predominate in industries where:
- Firm-specific intangible resources are important
- Exporting is subject to transaction costs
- Customer demand is similar between countries

Global Integration vs National differentiation

Benefits of Global Strategy:
- Cost benefits of scale and replication
- Serving global customers
- Exploit differential national resources
- Learning benefits
- Competing Strategically

Need for national differentiation

For all the advantages of global strategy, national market differences persist. The more an industry to the final consumer, the more important cultural factors are likely to be.

Reconciling Global Integration with National Differentiation
Reconciling benefits of global integration and national differentiation involves disaggregating the company by product and function. Figure 12.7 on page 333 gives you an idea which products and services benefit primarily from global organization, which from national differentiation and which can benefit from both.

The evolution of Multinational Strategies and Structures
3 different stages:
- Early 20th century: European multinationals, Decentralized federations
- After second WW: American multinationals, Coordinated federations
- 70s and 80s: Japanese multinationals, centralized hubs

Reconfiguring the MNC: The transnational Corporation

- Changing organizational structure
- Reconciling global Integration and national differentiation: **The transnational organization** is an organization that simultaneously acts responsive to both national markets and global coordination. With the distinguishing characteristic that it is an integrated network of interdependent resources and capabilities. Therefore it needs:
  - Each national unit to be a source of ideas and capabilities that can be used by the total organization.
  - National units to have access to global scale economies of the total organization.
  - The center to have a new, highly complex managing role that coordinates the relationships between national units in a flexible way. (see figure 12.9)

  The transnational organization concept is rather a new way of thinking about organizing then a organizational archetype. It is about trying to integrate the current corporation organizational types.
- Organizing R & D and New Product Development

H13 Diversification strategy

Trends in diversification over time

- Urge to diversify (’50 – ‘80). Emergence of the conglomerate corporate form. ‘Senior managers don’t need industry-specific experience’.
- Refocusing (’80 – ‘09) because of:
  - Emphasis on shareholder value (profitability over growth).
  - Higher transaction costs in turbulence (slower decision making), goes only for the mature industrialized countries.
  - Trends on management thinking (competitive advantage requires focus on key strengths in R&C)

Motives for diversification

- Growth, to not be trapped in one (declining) industry.
- Risk reduction, by reducing the variance between cash flows of different businesses from different industries. According to the capital asset pricing model (CAPM) security that matters, systematic risk, isn’t reduced if separate businesses are bought under common ownership.
- These factors are only attractive to managers, shareholders can do the same by diversifying their portfolio.

- To determine if the diversification is profitable/useful to maximize the interest of shareholders, according to Porter, we have to operate 3 tests:
  - Attractiveness (of chosen industries) test.
  - Cost-of-entry test; cost of entry must not capitalize all future profits.
  - Better-off test; new unit must gain competitive advantage from its link with the corporation of vice versa. This test matters most, because normally *cost of entry cancels out advantages of industry attractiveness* and *companies can enter unattractive industries and still be better off*.

Value creation through diversification (exploiting linkages)

- Economies of scope, when using a resource across multiple activities uses less of that resource than when the activities are carried out independent.
  - Tangible resources: creating single shared facilities in *shared service organizations*.
  - Intangible resources: *brand extension*.
  - Organisational capabilities: combining businesses’ *general management capabilities*.
- Economies from internalizing transactions, licensing or selling a resource or capability to another company.
- Which of those two is better is determined by *relative efficiency* (transaction costs of market contracts vs. administrative costs of

diversifying) and the *better off* principle.

- Parenting value added (Goold, Campbell and Alexander)
  - Deploying resources and general management skills possessed by the parenting company
  - Focussed on *capability* rather than Porters' *better off* test, that focuses more on resources. 'Could we add more value than any other parent can?'.
- Diversified firm as an internal market; lower costs of managing transactions internally can result in *better off* efficiencies, even without economies of scope.
  - Internal Capital markets, avoidance of external capital market and better access to financial prospects information. Only successful in combination with *strict financial discipline*, *rigorous analysis and evaluation*, a *refusal to overpay for acquisitions* and a *willingness to close or sell existing businesses*.
    A *private equity firm* also reduces transaction costs of external capital markets, but is less susceptible to managers playing politics and money being misspent.
  - Internal labour markets, ability to transfer employees (mostly managers an technical specialists) across their divisions. This saves on hiring and firing. Broader set of career opportunities will attract a higher class of employee. Detailed information about an employees' competencies and characteristics.

Diversification and performance

- Diversified firms are more profitable than specialized firms to a certain point, because of the organizational complexity that diversification creates (McKinsey & Company).
  - Whether this is an association or causation is yet to be distinguished.
- More consistent evidence implies that when diversified companies concentrate more on their core businesses, profitability and stock-market valuation increase; changing relationship between diversification and profitability (higher management costs in turbulent times).
- Related diversification generally outperforms unrelated diversification. Relatedness is created at an operational or at a management level.
  - *Dominant logic* (Prahalad & Bettis) is what the linkage between businesses ultimately depends on, managers' cognition of the rationale that unifies different parts of the company.

H14 Implementing Corporate Strategy: Managing the Multibusiness Firm

The Role of Corporate Management

Multibusiness corporations include a variety of different businesses. Inclusion of a business within the portfolio is only profitable when: 1) profit exceeds the costs of headquarters management, and 2) **parenting advantage**: net profit should be bigger than that which any other potential corporate parent can offer.

Four activities of corporate management

1) Managing corporate portfolio
2) Managing each individual business
3) Managing linkages among businesses
4) Managing change

Managing Corporate Portfolio

Core questions of corporate management

1) What business should we be in?
2) How should we manage those businesses in order to generate as much value as possible?

To answer the first question one must create a clear overview of all the positive and negative aspects of being in a business. The 'GE/McKinsey portfolio planning matrix (p. 368) and the 'BCG growth-share matrix' (p. 369) are analytic tools with which the variables 'market attractiveness' and 'competitive advantage' are used in order to decide whether a business is profitable or not. Its simplicity is also its downside; defining what market a business is in is impossible and corporate influence is not measured.

The 'Ashridge portfolio display' (p. 370) is based on parenting advantage and uses key issues of synergy that are ignored by the other portfolio-planning matrices. The focus is on the fit between the business and its parent company measured by two variables:

- **Value adding**: Corporate management can create positive outcomes: Improving synergy and developing capabilities, provide central services and resources, monitoring and control.
- **Value destroying**: Corporate management can create negative outcomes: Extra management costs, extra bureaucratic complexity and obscuring the financial performance.

Managing Individual Businesses

Corporate headquarters can control their businesses in two ways:

1) **Input control**: The company controls input into strategy (certain decisions, mostly involving resources) by referring them upwards for corporate approval.
2) **Output control**: The company controls the output from strategy by setting and monitoring performance targets backed by penalties.

The challenge for corporate management is to create a strategy-making process where the corporate headquarter controls and monitors, shares knowledge and is responsible for shareholder interest while there is room for business level management to make decentralized decisions to foster flexibility, responsiveness and a sense of ownership at the business level.

Multidivisional companies have a dual planning process:

1) **Strategic planning** → In order to achieve medium and long term goals
2) **Financial control** → In order to achieve short-term goals

- Companies that are more focused on strategic planning emphasize longer-term development of their businesses and have corporate HQ that is heavily involved in business-level planning.
- Companies that are more focused on financial control embrace short-term budgetary control and corporate HQ monitors through performance targets but has little involvement in business strategy formulation.

Performance targets are set in order to achieve these goals and are supported by management incentives and sanctions. These targets include strategic goals (market share, quality, new product introduction) as well as operational performance (output, productivity).

Managing Linkages across Businesses

Opportunities for creating value in multibusiness companies arise from sharing resources and transferring capabilities among the different business units. This sharing occurs both through centralization of common services at the corporate level and through direct linkages between the businesses.

Common corporate services

Centralized provision can avoid costs of duplication. But there tend to be little incentive among the corporate staff and the specialized corporate units to meet the business-level customers. Often these staffs grow under their own momentum. Therefore they separate the corporate HQ into two groups:

1) **Corporate management unit** responsible for supporting activities such as strategic planning, finance and legal.
2) **Shared service organization** for supplying common services such as research, engineering and training.

Business linkages & corporate strategy types

Exploiting economies of scope doesn't always mean centralizing resources at the corporate level. Resources and capabilities can also be shared between the businesses.

Four corporate strategy types

- **Portfolio management**: The parent company simply acquires a portfolio of well managed companies, which allows them to operate autonomously and links them through internal capital market.
- **Restructuring**: Creating value by acquiring poorly managed companies, restructure it by appointing new management, cut costs, dispose underperforming businesses and restructure balance sheets.
- **Transferring skills**: Transferring organizational capabilities between business units. Value is only created when the capabilities are applicable to different business units.
- **Sharing activities**: Exploiting economies of scope in common resources and activities. Corporate management formulates business unit strategy and intervenes in operational matters so that opportunities for sharing resources and activities are fully exploited.

The closer the linkages among businesses → the more value can be created from sharing resources and transferring capabilities → the greater need for corporate HQ to coordinate across businesses. The size of corporate HQ's is determined by the corporate involvement in interdivisional affairs. Its success depends on the linkage between businesses and the understanding of commonalities among the different businesses.

Managing Change in the Multibusiness Corporation

Nowadays managing a company's own portfolio is not enough. One must also be increasingly responsive to external change and accelerating the pace of organizational evolution.

The McKinsey restructuring pentagon (p. 380): Framework that offers a systematic approach to analyze the potential for increasing the market value of multibusiness companies through corporate restructuring.

For restructuring a corporate HQ must identify and implement means which create value. The term 'parenting' for these activities shows the growing emphasis for corporate development.

Three ways of dealing with change within a corporate organization

1) **Adaptive tension**: Decentralized decision making to business level. Improving responsiveness to external change and striving for constant performance improvement.
2) **Institutionalizing strategic change**: Redesigning planning systems for sensing external changes and responding to the opportunities these changes offer.
3) **Top-down, large scale development initiatives**: Corporate development by linking strategic intent to specific projects and programs.

Managing change requires certainty and security for the people to follow you into the unknown.

Governance of Multibusiness Corporations

For whom is value created?

Corporate governance: The system by which companies are directed and controlled. When ownership is dispersed (shareholders), what prevents the management of a company from running it in its own interest?

The critical problem is that the ability of shareholders to exercise effective control over management is limited by their large number. This creates coordination and motivation problems. Therefore the board of direction monitors the management. One of the biggest criticism of board oversight wes the financial compensation for the management. With bonuses for short-term performances and the lack of punishment for shareholder value destruction.

H15 External Growth Strategies: Mergers, Acquisitions, and Alliances

Mergers, acquisitions and alliances are not strategies themselves, but the means by which a firm pursues a particular strategic aim.

Mergers and Acquisitions

An acquisition is where one company purchases another. A friendly acquisition is supported by the board of the target company, an unfriendly acquisition (hostile takeover) is opposed by the board of the target company.

A merger is where two companies amalgamate to form a new company. Shareholders of both companies have to agree and exchange their shares for shares in the new company.

Reasons form mergers and acquisitions can be:

- Acquiring strategically important resources and capabilities;
- Seeking cost economies and market power;
- Expanding into new geographical markets;
- Diversifying into new industries.

The most valuable resources and capabilities are those that are not transferable and not easily replicated. Acquisitions are a way to obtain these resources and capabilities, but they carry a risk because they are expensive and have to be successfully integrated into the company.

If a company acquires another company in the same industry, they can eliminate duplicate functions, create cost economies because they can exploit scale economies, and increase market power.

Acquisitions in foreign markets are a popular means of entry, because it allows a firm to quickly gain critical mass in that market and overcome lack of local knowledge, local connections and barriers to distributions (liabilities of foreignness).

Acquisition is the predominant mode of diversification for firms, because it is allows firms to quickly establish a major presence in a different sector.

Research shows that acquisitions are mostly profitable for the shareholders of the acquired company, because the acquiring company has to pay a large premium. Shareholders of the acquiring company should be skeptical of acquisitions, because in some cases the CEO only wants to acquire a company to grow and gain more power, not to increase profitability. It should be made clear what the intended strategy is, how the proposed acquisition will contribute to that strategy and a detailed and realistic assessment of what the outcome of the acquisition will be.

Successful management of post-merger integration is very important. Many mergers ended up as disasters because they failed to integrate the companies successfully.

Strategic Alliances

A strategic alliance is a collaborative arrangement between two or more firms to pursue agreed common goals. Alliances are created to fulfill specific purposes. A strategic alliance can involve equity participation, but there are also agreements without any ownership stakes. A joint venture is a particular form of equity alliance where the partners form a new company that they jointly own. Alliances may be purely bilateral arrangements or they may be a part of a network of interfirm relationships, for example a supplier network or a localized industry cluster.

Alliances are motivated primarily by opportunities for exploiting complementarities between the resources and capabilities owned by a different company. Alliances can be formed to access the partner's resources and capabilities, but also to acquire them through learning from their partner. In most instances alliances are about accessing rather than acquiring capabilities: for most firms the basic rationale of alliances is that they allow the firm to specialize in a limited range of capabilities while enabling the exploitation of specific opportunities that require a wider range of capabilities. A key advantage of such alliances is flexibility. Alliances also permit risk sharing between companies on certain projects. Managing alliance relationships requires relational capability.

Alliances can be an attractive mode of foreign entry into international markets when a firm lacks local knowledge, political connections and access to distribution channels and when acquisitions are too expensive or impossible because of local regulations. For the local partner, an alliance with a foreign firm can also be an attractive means of accessing resources and capabilities, especially for emerging-market countries. However, international alliances are difficult to manage because of differences in language, culture and geographical distance.

Franko 2004 – The death of diversification? The focusing of the world's industrial firms, 1980–2000

The 1990s saw the world's industrial companies turn away in droves from the strategy of product diversification. The causes for such change include a recognition of the poor performance of highly diversified firms, a trend toward decision frameworks based on market allocation of resources among disparate activities, and the rise of institutional shareholders that demand performance and clarity.

A move begun during the 1980s away from conglomeration was followed during the 1990s by a broad reduction in diversification, even of "related" diversification, by the majority of the world's large manufacturing companies. The top 12 US, European, Japanese, and other companies in the major sectors of world industry dropped by half between 1980 and 2000. In contrary motion, the number of focused firms rose sharply to constitute more than two-thirds of the world's top 201 firms by the beginning of this century. Conglomerates have all but disappeared from the population of the world's leading corporations, accounting for only 5 percent of the total.

The move to focus

American firms led the way
The decline in the population of diversified firms began to drop first in the United States during the 1980s. This drop was primarily due to the acquisition and/or carve-up of diversified firms. The number of focused US firms increased from less than half to more than two-thirds of all US firms among the world's leaders between 1980 and 1990

The 1990s: Focus dominates and comes to Europe
During the '90s, focused companies came even more to dominate the population of US firms among the industry leaders. What was most striking, however, was the sharp change among European firms, most of which happened during the lat- ter half of the decade. Focused European firms reached two-thirds.

A Japanese exception?
Japanese firms are a more complicated case. In spite of the moribund Japanese economy of the 1990s, Japan's global company leaders in electronics and automobiles all *gained* world market share at the expense of their Western competitors during the decade. Japanese firms based in such sunset industries as iron & steel and textiles & apparel, however, were and are exceptions to the general

worldwide trend—the numbers and proportions of diversified firms in these sectors *increased* over time.

Focus and performance

The most tangible factor driving the turn away from diversification was its underperformance as a strategy. With rare exceptions, highly diversified firms have performed more poorly than focused ones. During the 1980s, evidence accumulated indicating that diversification strategies, especially those of the conglomerate variety, were less successful than strategies based on focus. Narrowly diversified firms, presumably built around more specialized assets, earn higher levels of profit than do widely diversified firms.

Other studies found that not only did focused firms generate higher accounting profit and other measures of economic return than high diversifiers, but much of the diversification did not even succeed in terms of a key rationale: that of reducing risk. As a consequence of underperformance, diversifiers' share prices often dropped to sell at a "conglomerate discount." The superiority of focused strategies continued to be manifest during the 1990s, as evidenced by companies' gains and losses in world market shares.

Diversification and the growth of the firm

Product diversification was long considered the normal, almost inevitable consequence of the growth and development of large, successful companies.

The conglomeration wave of the '60s and early '70s was rationalized first as a way to spread the presumably scarce resource of "professional management" across industries, then as a means to reduce corporate risk by building a portfolio of counter-cyclical businesses. Later, in the '70s and '80s, "growth-share" strategy analysis proposed diversification as a necessary means to corporate renewal.

The rise of incentive-based compensation, and especially the use of stock options, made in-company portfolio management yet more unattractive. Combining a high degree of both product diversification and geographical dispersion proved a particularly daunting circle to square. The temptation was therefore great to try to be both diversified *and* multinational. Some firms succeeded in becoming diversified by both product and geography only to enter into a brave new world of organizational complexity. Few of these attempts at internal "extra-market" solutions to complexity have survived the 1990s, such as General Electric, Corning, Swedish-Swiss ABB and Philips. Confronted with mounting evidence of the failure of complex diversification and diversification-cum-multinational strategies, strategic management thinkers came to exhort firms to "stick to their knitting" and focus on their "core competencies."

Change in the external environment

Still, much as management and finance researchers might like to think that their influence was the primary cause of the great refocusing of the 1990s, other forces were probably much stronger. **(1)**, the breakdown of the "negotiable environment" of trade protection and the rise of free-trade areas like the EU and NAFTA, culminating in monetary union in Europe. **(2)**, the development of global and institutionally dominated capital markets, or the rise of "fiduciary capi- talism."

(1) The opening of world markets
The story of the international business environment from 1970 to 2000 has been a fairly continuous one of the opening of cross-border trade, the creation of regional and world markets, and the arrival of more and more globally oriented competitors.

(2) Financial market pressures: The rise of "fiduciary capitalism"
The straw that broke the camel's back was the change in financial and capital markets. Junk-bond financing of corporate raiders led to a boom in the development of the market for corporate control and in the rise of the hostile takeover. The raiders, take-over artists, and leveraged buy-out (LBO) firms were unsentimental about keeping underperforming activities inside firms just because they had always been there, or waiting for internal corporate reorganizations to produce results.

Much of the cause of this continuing pressure on management to become ever more efficiency-oriented was, ironically, due to the interests of people rarely identified with those of management as a class: teachers, public employees, and oftunionized workers.

The last quarter of the twentieth century has seen the rise of fiduciary capitalism in the United States and a return to concentrated share ownership after a half-century interval of separation of management and shareholders. A boom in individual company listings on US stock exchanges and in American Depositary Receipt (ADR) programs has further exposed non-US companies to American shareholder and institutional investor pressures.

Corporate managements contemplating corporate product diversification strategies are now operating between two scissor blades of globalization. On one side are increasingly competitive international goods markets; on the other are ever more interlinked, ever more institutionalized financial markets.

Is diversification really dead?
It is possible, perhaps eminently desirable, to diversify quite a bit without venturing into dangerous territory. It is also not obvious that because some focus is good, more focus is necessarily better.

Cyriac, Koller & Thomsen, 2012 – Testing the limits of diversification

This strategy can create value, but only if a company is the best possible owner of businesses outside its core industry.

To boost growth when a company reaches a certain size and maturity, executives will be tempted to diversify. Although a few talented people have proved capable of managing diverse business portfolios, most executives and boards today realize how difficult it is to add value to businesses that aren't connected to each other in some way. As a result, unlikely pairings have largely disappeared.

Still many executives believe that diversifying into unrelated industries reduces risks for investors or that diversified businesses can better allocate capital across businesses than the market does – without regard to the skills needed to achieve these goals. Because few have such skills, diversification instead often caps the upside potential for shareholders but doens't limit the downside risk. In practice, the best-performing conglomerates do well not because they're diversified but because they're best owners, even of businesses outside their core industries.

Limited upside, unlimited downside
Reducing volatility by diversification doesn't benefit the shareholder. The shareholder can do this by for example an mutual fund. At an aggregrate level, conglomerates have underperformed more focused companies both in the real economy (growth and returns on capital) and in the stock market.

But the median doens't tell the entire story:
Some conglomerates did outperform many focused companies. The distribution's shape of the conglomerates is chopped off on the upside, but not on the downside. Upside gains are limited because it's unlikely that all of a diverse conglomerate's businesses will outperform at the same time. Conglomerates are also usually made up of relatively mature businesses. This means they would not be likely to generate unexpected returns. But the downside isn't limited, because the performance of the more mature businesses found in most conglomerates can fall a lot further than it can rise.

Prerequisites for creating value

What matters in a diversification strategy is whether managers have the skills to add value to businesses in unrelated industries – by allocating capital to competing investments, managing their portfolios, or cutting costs. High performance conglomerates shared three characteristics:

- *Disciplined (and sometimes contrarian) investors*
  High performing conglomerates continually rebalance their portfolios by purchasing companies they believe are undervalued by the market and whose performance they can improve.
- *Agressive capital managers*
  High performing conglomerates agressively manage capital allocation across units at the corporate level. All cash that exceeds what's needed for operating requirements is transferred to the parent company, which decides how to allocate it across current and new business or investment opportunities, based on their potential for growth and returns on invested capital.
- *Rigorous 'lean' corporate centers*
  High-performing conglomerates operate much as better private-equity firms do: with a lean corporate center that restricts its involvement in the management of business units to selecting leaders, allocating capital, vetting strategy, setting performance targets and monitoring performance. These firms do not create extensive corporate-wide processes or large shared-service centers.

Conglomerates in emerging markets

In emerging markets, large conglomerates have economic benefits that don't exist in the developed world. These countries still need to build up their infrastructure – such projects typically require large amounts of capital that smaller companies can't raise. Large conglomerates typically have the resources and relationships needed to navigate the maze of government regulations and to ensure relatively smooth operations. Finally, large conglomerates are more attractive to potential managers because they offer greater career development opportunities. In contrast, companies – including export-oriented ones such as those in IT services and pharmaceuticals – that rely less on access to capital land connections tend to be focused on, rather than part of, large conglomerates.

Although the time could be decades away, conglomerates large size and diversification will eventually become impediments rather then advantages.

In short

Value-destroying failures litter the history of diversifcation strategies. Executives considering one should ask themselves, first and foremost, whether they have the skills to be the best owners of businesses outside their core industries.

Kotter 2012 – Accelerate!

how to most innovative companies capitalize on today's rapid-fire strategic challenges and still make their numbers. By John P. Kotter

we can't keep up with the pace of change, let alone get ahead of it. At the same time, the stakes financial, social, environmental, political are rising. The hierarchical structures and organizational processes we have used for decades to run and improve our enterprises are no longer up to the task of winning in this faster moving world.

What do we do then

We cannot ignore the daily demands of running a company, which traditional hierarchies and mana- gerial processes can still do very well. What they do not do well is identify the most important hazards and opportunities early enough, formulate creative strategic initiatives nimbly enough, and implement them fast enough

The new operating system con- tinually assesses the business, the industry, and the organization, and reacts with greater agility, speed, and creativity than the existing one. It complements rather than overburdens the traditional hierarchy, thus freeing the latter to do what it's optimized to do.

There are three main differences between those eight steps and the eight "accelerators" on which the strategy system runs: (1) The steps are often used in rigid, finite, and sequential ways, in effecting or re- sponding to episodic change, whereas the accelera- tors are concurrent and always at work. (2) The steps are usually driven by a small, powerful core group, whereas the accelerators pull in as many people as possible from throughout the organization to form a "volunteer army." (3) The steps are designed to function within a traditional hierarchy, whereas the accelerators require the flexibility and agility of a network.

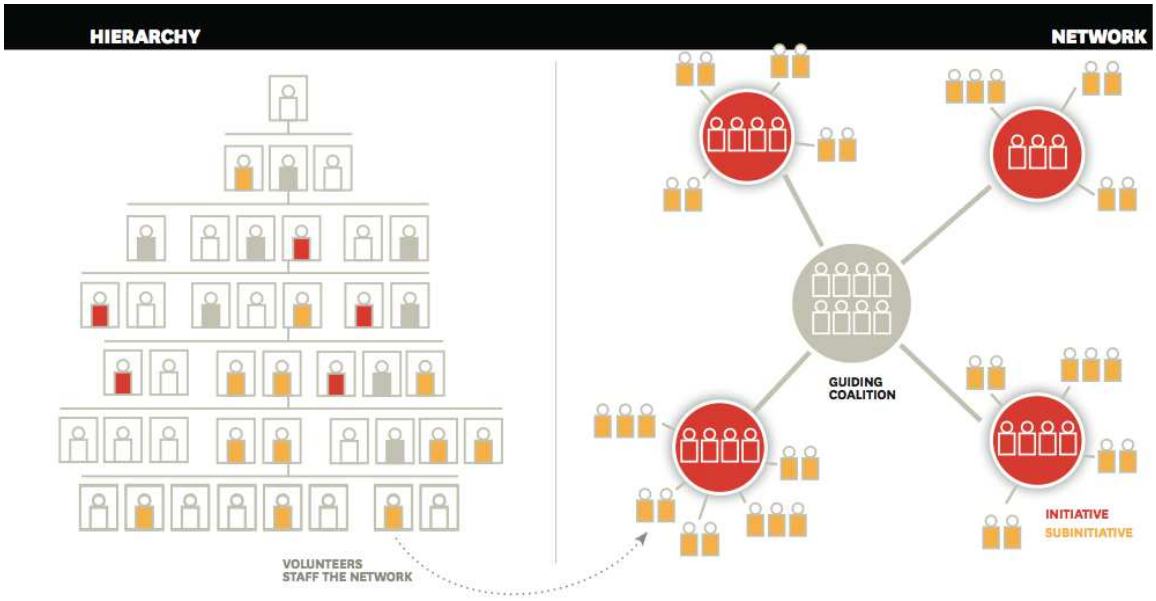
strategy should be viewed as a dynamic force that constantly seeks opportunities, identifies initiatives that will capital- ize on them, and completes those initiatives swiftly and efficiently.

The limits of hierarchy and conventional change management
Hierarchies are useful. They let us sort work into de- partments, product divisions, regions, and the like with expertise, time-tested procedures, and clear reporting relationships and accountability so that we can do what we know how to do with efficiency, predictability, and effectiveness. Hierarchies are di- rected by familiar managerial processes for planning, budgeting, defining jobs, hiring and firing, and measuring results.
Moreover, strategy implementation methodologies, hung on the hierarchical spine, are not up to the challenge of managing speedy transformation. Change management typically relies on tools such as diagnostic assessments and analyses, communi- cations techniques, and training modules that can be invaluable in helping with episodic problems for which there are relatively straightforward solutions, such as implementing a well-tested financial reporting system.

They can be made stronger or faster by add- ing more resources, more-sophisticated versions of the same old methods, or smarter people to drive the process but again, only up to a point. After that point, using this approach to launch strategic initia- tives that ask an organization to absorb more change faster can create confusion, resistance, fatigue, and higher costs.

Complementary systems

- Many change agents, not just the usual few appointees
- A want-to and a get-to not just a have-to mind-set
- Head and heart, not just head.
- Much more leadership, not just more management.
- Two systems, one organization.



The eight accelerators

- Create a sense of urgency around a single big opportunity.
- Build and maintain a guiding coalition.
- Formulate a strategic vision and develop change initiatives designed to capitalize on the big opportunity.
- Communicate the vision and the strategy to create buy-in and attract a growing volunteer army
- Accelerate movement toward the vision and the opportunity by ensuring that the network removes barriers.
- Celebrate visible, significant short-term wins
- Never let up. Keep learning from experience. Don’t declare victory too soon.
- nstitutionalize strategic changes in the culture.

The Eight Accelerators

The processes that enable the strategy network to function

The members of the volunteer army also help make the daily business of the organization hum; they're not a separate group of consultants, new hires, or task force appointees. They have organizational knowledge, relationships, credibility, and influence. They understand the need for change they are often the first to see threats or opportunities and have the zeal to implement it.

People who have never seen this sort of dual operating system work often worry, quite logically, that a bunch of enthusiastic volunteers might create more problems than they solve by, for example, running off and making not very thoughtful decisions and disrupting daily operations. Here is where the very specific details built into the network and the accelerators come into play. This second system not only creates the army but guides the volunteers with a structure and processes that create a powerful, smart, and increasingly needed strategic force.

Building momentum

A dual operating system doesn't start fully formed and doesn't require a sweeping overhaul of the organization. It grows over time, accelerates action over time, and takes on a life of its own that seems to dif- fer from company to company in the details. It can start with small steps.

Summary and prediction

The inevitable failures of single operating systems hurt us now. They are going to kill us in the future. The 21st century will force us all to evolve toward a fundamentally new form of organization.

Nevertheless, the companies that get there first, because they act *now,* will see immediate and long-term success for shareholders, customers, employees, and themselves. Those that lag will suffer greatly, if they survive at all