CHAPTER 6

Strengthening a Company's Competitive Position

Strategic Moves, Timing, and Scope of Operations

Competing in the marketplace is like war. You have injuries and casualties, and the best strategy wins.

John Collins – *NHL executive*

In the virtual economy, collaboration is a new competitive imperative.

Michael Dell – *CEO of Dell Inc.*

Our success has really been based on partnerships from the very beginning.

Bill Gates – *Founder and CEO of Microsoft*

Don't form an alliance to correct a weakness . . . The only result from a marriage of weaknesses is the creation of even more weaknesses.

Michel Robert – *Author and consultant*

Learning Objectives

LO 1 Learn whether and when to pursue offensive or defensive strategic moves to improve a company's market position.

LO 2 Recognize when being a first mover or a fast follower or a late mover is most advantageous.

LO 3 Become aware of the strategic benefits and risks of expanding a company's horizontal scope through mergers and acquisitions.

LO 4 Learn the advantages and disadvantages of extending the company's scope of operations via vertical integration.

LO 5 Become aware of the conditions that favor farming out certain value chain activities to outside parties.

LO 6 Understand when and how strategic alliances can substitute for horizontal mergers and acquisitions or vertical integration and how they can facilitate outsourcing.

Once a company has settled on which of the five generic competitive strategies to employ, attention turns to what *other strategic actions* it can take to complement its competitive approach and maximize the power of its overall strategy. The first set of decisions concerns whether to undertake offensive or defensive competitive moves, and the timing of such moves.

The second set concerns the breadth of a company's activities (or its *scope* of operations along an industry's entire value chain). All in all, the following measures to strengthen a company's competitive position must be considered:

- Whether to go on the offensive and initiate aggressive strategic moves to improve the company's market position.
- Whether to employ defensive strategies to protect the company's market position.
- When to undertake strategic moves—whether advantage or disadvantage lies in being a first mover, a fast follower, or a late mover.
- Whether to bolster the company's market position by merging with or acquiring another company in the same industry.
- Whether to integrate backward or forward into more stages of the industry value chain system.
- Which value chain activities, if any, should be outsourced.
- Whether to enter into strategic alliances or partnership arrangements with other enterprises.

This chapter presents the pros and cons of each of these measures.

GOING ON THE OFFENSIVE—STRATEGIC OPTIONS TO IMPROVE A COMPANY'S MARKET POSITION

LO 1

Learn whether and when to pursue offensive or defensive strategic moves to improve a company's market position.

No matter which of the five generic competitive strategies a firm employs, there are times when it makes sense for the company to *go on the offensive* to improve its market position and business performance. Strategic offensives are called for when a company spots opportunities to gain profitable market share at the expense of rivals or when a company has no choice but to try to whittle away at a strong rival's competitive advantage. Companies like Exxon Mobil, Amazon, Walmart, and Microsoft play hardball, aggressively pursuing competitive advantage and trying to reap the benefits a competitive edge offers—a leading market share, excellent profit margins, and rapid growth.[1] The best offensives tend to incorporate several principles: (1) focusing relentlessly on building competitive advantage and then striving to convert it into a sustainable advantage, (2) applying resources where rivals are least able to defend themselves, (3) employing the element of surprise as opposed to doing what rivals expect and are prepared for, and (4) displaying a strong bias for swift, decisive, and overwhelming actions to overpower rivals.[2]

Sometimes a company's best strategic option is to seize the initiative, go on the attack, and launch a strategic offensive to improve its market position.

Choosing the Basis for Competitive Attack

Challenging rivals on competitive grounds where they are strong is an uphill struggle.[3] Offensive initiatives that exploit competitor weaknesses stand a better chance of succeeding than do those that challenge competitor strengths, especially if the weaknesses represent important vulnerabilities and weak rivals can be caught by surprise with no ready defense.

The best offensives use a company's most powerful resources and capabilities to attack rivals in the areas where they are weakest.

Strategic offensives should, as a general rule, be based on a company's strongest competitive assets—its most valuable resources and capabilities such as a better-known brand name, a more efficient production or distribution system, greater technological capability, or a superior reputation for quality. But a consideration of the company's strengths should not be made without also considering the rival's strengths and weaknesses. A strategic offensive should be based on those areas of strength where the company has its greatest competitive advantage over the targeted rivals. If a company has especially good customer service capabilities, it can make special sales pitches to the customers of those rivals that provide subpar customer service. Likewise, it may be attractive to pay special attention to buyer segments that a rival is neglecting or is weakly equipped to serve.

Ignoring the need to tie a strategic offensive to a company's competitive strengths and what it does best is like going to war with a popgun—the prospects for success are dim. For instance, it is foolish for a company with relatively high costs to employ a price-cutting offensive. Price-cutting offensives are best left to financially strong companies whose costs are relatively low in comparison to those of the companies being attacked.

The principal offensive strategy options include the following:

1. *Offering an equally good or better product at a lower price.* Lower prices can produce market share gains if competitors don't respond with price cuts of their own and if the challenger convinces buyers that its product is just as good or better. However, such a strategy increases total profits only if the gains in additional unit sales are enough to offset the impact of lower prices and thinner margins per unit sold. Price-cutting offensives are best initiated by companies that have *first achieved a cost advantage.*[4] Irish airline Ryanair used this strategy successfully against rivals such as British Air and Aer Lingus, by first cutting costs to the bone and then targeting leisure passengers who care more about low price than in-flight amenities and service.[5]
2. *Leapfrogging competitors by being first to market with next-generation products.* In technology-based industries, the opportune time to overtake an entrenched competitor is when there is a shift to the next generation of the technology. Microsoft got its next-generation Xbox 360 to market a full 12 months ahead of Sony's PlayStation 3 and Nintendo's Wii, helping it build a sizeable market share and develop a reputation for cutting-edge innovation in the video game industry.
3. *Pursuing continuous product innovation to draw sales and market share away from less innovative rivals.* Ongoing introductions of new and improved products can put rivals under tremendous competitive pressure, especially when rivals' new product development capabilities are weak. But such offensives can be sustained only if a company can keep its pipeline full and maintain buyer enthusiasm for its new and better product offerings.
4. *Adopting and improving on the good ideas of other companies (rivals or otherwise).* The idea of warehouse-type home improvement centers did not originate with Home Depot cofounders Arthur Blank and Bernie Marcus; they got the "big-box" concept from their former employer Handy Dan Home Improvement. But they were quick to improve on Handy Dan's business model and take Home Depot to the next plateau in terms of product line breadth and customer service. Offense-minded companies are often quick to adopt any good idea (not nailed down by a patent or other legal protection) and build upon it to create competitive advantage for themselves.
5. *Using hit-and-run or guerrilla warfare tactics to grab market share from complacent or distracted rivals.* Options for "guerrilla offensives" include occasional lowballing on price (to win a big order or steal a key account from a rival), surprising rivals with sporadic but intense bursts of promotional activity (offering a special trial offer to draw customers away from rival brands), or undertaking special campaigns to attract the customers of rivals plagued with a strike or problems in meeting buyer

demand.[6] Guerrilla offensives are particularly well suited to small challengers that have neither the resources nor the market visibility to mount a full-fledged attack on industry leaders.

6. *Launching a preemptive strike to secure an advantageous position that rivals are prevented or discouraged from duplicating.*[7] What makes a move preemptive is its one-of-a-kind nature—whoever strikes first stands to acquire competitive assets that rivals can't readily match. Examples of preemptive moves include (1) securing the best distributors in a particular geographic region or country, (2) moving to obtain the most favorable site at a new interchange or intersection, in a new shopping mall, and so on, (3) tying up the most reliable, high-quality suppliers via exclusive partnerships, long-term contracts, or acquisition, and (4) moving swiftly to acquire the assets of distressed rivals at bargain prices. To be successful, a preemptive move doesn't have to totally block rivals from following; it merely needs to give a firm a prime position that is not easily circumvented.

How long it takes for an offensive to yield good results varies with the competitive circumstances.[8] It can be short if buyers respond immediately (as can occur with a dramatic cost-based price cut, an imaginative ad campaign, or an especially appealing new product). Securing a competitive edge can take much longer if winning consumer acceptance of an innovative product will take some time or if the firm may need several years to debug a new technology or put a new production capacity in place. But how long it takes for an offensive move to improve a company's market standing (and whether it can do so) also depends on whether market rivals recognize the threat and begin a counterresponse. And whether rivals will respond depends on whether they are capable of making an effective response and if they believe that a counterattack is worth the expense and the distraction.[9]

Choosing Which Rivals to Attack

Offensive-minded firms need to analyze which of their rivals to challenge as well as how to mount the challenge. The following are the best targets for offensive attacks:[10]

- *Market leaders that are vulnerable.* Offensive attacks make good sense when a company that leads in terms of market share is not a true leader in terms of serving the market well. Signs of leader vulnerability include unhappy buyers, an inferior product line, a weak competitive strategy with regard to low-cost leadership or differentiation, aging technology or outdated plants and equipment, a preoccupation with diversification into other industries, and financial problems. Toyota's massive product recalls in 2009 and 2010 due to safety concerns presented other car companies with a prime opportunity to attack a vulnerable and distracted market leader. GM and Ford used incentives and low-financing offers aimed at winning over Toyota buyers to increase their market share during this period.
- *Runner-up firms with weaknesses in areas where the challenger is strong.* Runner-up firms are an especially attractive target when a challenger's resources and capabilities are well suited to exploiting their weaknesses.
- *Struggling enterprises that are on the verge of going under.* Challenging a hard-pressed rival in ways that further sap its financial strength and competitive position can weaken its resolve and hasten its exit from the market. In this type of situation, it makes sense to attack the rival in the market segments where it makes the most profits, since this will threaten its survival the most.
- *Small local and regional firms with limited capabilities.* Because small firms typically have limited expertise and resources, a challenger with broader and/or deeper capabilities is well positioned to raid their biggest and best customers—particularly those that are growing rapidly, have increasingly sophisticated requirements, and may already be thinking about switching to a supplier with a more full-service capability.

Blue-Ocean Strategy—A Special Kind of Offensive

A **blue-ocean strategy** seeks to gain a dramatic and durable competitive advantage by abandoning efforts to beat out competitors in existing markets and, instead, *inventing a new industry or distinctive market segment that renders existing competitors largely irrelevant and allows a company to create and capture altogether new demand.*[11] This strategy views the business universe as consisting of two distinct types of market space. One is where industry boundaries are defined and accepted, the competitive rules of the game are well understood by all industry members, and companies try to outperform rivals by capturing a bigger share of existing demand. In such markets, lively competition constrains a company's prospects for rapid growth and superior profitability since rivals move quickly to either imitate or counter the successes of competitors. The second type of market space is a "blue ocean," where the industry does not really exist yet, is untainted by competition, and offers wide-open opportunity for profitable and rapid growth if a company can create new demand with a new type of product offering.

> **CORE CONCEPT**
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> A **blue-ocean strategy** offers growth in revenues and profits by discovering or inventing new industry segments that create altogether new demand.

A terrific example of such wide-open or blue-ocean market space is the online auction industry that eBay created and now dominates. Other examples of companies that have achieved competitive advantages by creating blue-ocean market spaces include Starbucks in the coffee shop industry, The Weather Channel in cable TV, FedEx in overnight package delivery, and Cirque du Soleil in live entertainment. Cirque du Soleil "reinvented the circus" by pulling in a whole new group of customers—adults and corporate clients—who not only were noncustomers of traditional circuses (like Ringling Brothers), but were also willing to pay several times more than the price of a conventional circus ticket to have a "sophisticated entertainment experience" featuring stunning visuals and star-quality acrobatic acts. Zipcar Inc. is presently using a blue-ocean strategy to compete against entrenched rivals in the rental-car industry. It rents cars by the hour or day (rather than by the week) to members who pay a yearly fee for access to cars parked in designated spaces located conveniently throughout large cities. By allowing drivers under 25 years of age to rent cars and by targeting city dwellers who need to supplement their use of public transportation with short-term car rentals, Zipcar entered uncharted waters in the rental-car industry, growing rapidly in the process.

Blue-ocean strategies provide a company with a great opportunity in the short run. But they don't guarantee a company's long-term success, which depends more on whether a company can protect the market position they opened up and sustain their early advantage. See Illustration Capsule 6.1 for an example of a company that opened up new competitive space in online luxury retailing only to see their blue ocean waters ultimately turn red.

> Good defensive strategies can help protect a competitive advantage but rarely are the basis for creating one.

DEFENSIVE STRATEGIES—PROTECTING MARKET POSITION AND COMPETITIVE ADVANTAGE

In a competitive market, all firms are subject to offensive challenges from rivals. The purposes of defensive strategies are to lower the risk of being attacked, weaken the impact of any attack that occurs, and influence challengers to aim their efforts at other rivals. While defensive strategies usually don't enhance a firm's competitive advantage, they can definitely help fortify the firm's competitive position, protect its most valuable resources and capabilities from imitation, and defend whatever competitive advantage it might

ILLUSTRATION CAPSULE 6.1

Gilt Groupe's Blue-Ocean Strategy in the U.S. Flash Sale Industry

Luxury fashion flash sales exploded onto the U.S. e-commerce scene when Gilt Groupe launched its business in 2007. Flash sales offer limited quantities of high-end designer brands at steep discounts to site members over a very narrow timeframe: the opportunity to snap up an incredible bargain is over in a "flash." The concept of online time-limited, designer-brand sale events, available to members only, had been invented six years earlier by the French company, Vente Privée. But since Vente Privée operated in Europe and the UK, the U.S. market represented a wide-open, blue ocean of uncontested opportunity. Gilt Groupe's only rival was Ideeli, another U.S. startup that had launched in the same year.

Gilt Groupe thrived and grew rapidly in the calm waters of the early days of the U.S. industry. Its tremendous growth stemmed from its recognition of an underserved segment of the population—the web-savvy, value-conscious fashionista—and also from fortuitous timing. The Great Recession hit the U.S. in December 2007, causing a sharp decline in consumer buying and leaving designers with unforeseen quantities of luxury items they could not sell. The fledgling flash sale industry was the perfect channel to offload some of the excess inventory since it still maintained the cachet of exclusivity, with members-only sales and limited-time availability.

Gilt's revenue grew exponentially from $25 million in 2008 to upwards of $600 million by 2011. But their success prompted an influx of fast followers into the luxury flash sale industry, including Hautelook and RueLaLa, who were able to enter the market in December 2007 and April 2008, respectively. The new rivals not only competed for online customers, who could switch costlessly from site to site (since memberships were free), but they also competed for unsold designer inventory. As the U.S. economy came out of the recession, much less of this type of inventory was available. Larger players had also begun to enter the flash sales market in the U.S., with Nordstrom's acquisition of Hautelook, eBay's purchase of RueLaLa, and Amazon's 2011 acquisition of **MyHabit.com**. In late 2011, Vente Privée announced the launch of their U.S. online site, via a joint venture with American Express.

As the competitive waters have begun to roil and turn increasingly red, Gilt Groupe has been looking for new ways to compete, expanding into a variety of online luxury product and services niches and venturing overseas. They have been successful in getting new rounds of venture capital, but as of early 2012 had not yet become profitable. Can they survive and prosper in a more crowded competitive space? Only time will tell.

Developed with Judith H. Lin.

Sources: Matthew Carroll, "The Rise of Gilt Groupe," ***Forbes.com***, January 2012; Mark Brohan, "The Top 500 Guide," *Internet Retailer,* June 2011; Colleen Debaise, "Launching Gilt Groupe, A Fashionable Enterprise," *The Wall Street Journal,* October 2010 (all accessed at **www.wsj.com** on February 26, 2012); and **http://about.americanexpress.com/news/pr/2011/vente_usa.aspx**, accessed March 3, 2012.

have. Defensive strategies can take either of two forms: actions to block challengers and actions to signal the likelihood of strong retaliation.

Blocking the Avenues Open to Challengers

The most frequently employed approach to defending a company's present position involves actions that restrict a challenger's options for initiating a competitive attack. There are any number of obstacles that can be put in the path of would-be challengers. A defender can introduce new features, add new models, or broaden its product line to close off gaps and vacant niches to opportunity-seeking challengers. It can thwart the efforts of rivals to attack with a lower price by maintaining economy-priced options of its own. It can try to discourage buyers from trying competitors' brands by lengthening warranties, offering free training and support services, and providing coupons and sample giveaways to buyers most prone to experiment. It can make early announcements about impending new products or price changes to induce potential buyers to postpone switching. It can challenge the quality or safety of rivals' products. Finally, a defender can grant volume discounts or better financing terms to dealers and distributors to discourage them from experimenting with other suppliers, or it can convince them to handle its product line *exclusively* and force competitors to use other distribution outlets.

There are many ways to throw obstacles in the path of would-be challengers.

Signaling Challengers that Retaliation Is Likely

The goal of signaling challengers that strong retaliation is likely in the event of an attack is either to dissuade challengers from attacking at all or to divert them to less threatening options. Either goal can be achieved by letting challengers know the battle will cost more than it is worth. Signals to would-be challengers can be given by:

- Publicly announcing management's commitment to maintain the firm's present market share.
- Publicly committing the company to a policy of matching competitors' terms or prices.
- Maintaining a war chest of cash and marketable securities.
- Making an occasional strong counterresponse to the moves of weak competitors to enhance the firm's image as a tough defender.

Signaling is most likely to be an effective defensive strategy if the signal is accompanied by a credible commitment to follow through.

TIMING A COMPANY'S OFFENSIVE AND DEFENSIVE STRATEGIC MOVES

When to make a strategic move is often as crucial as *what* move to make. Timing is especially important when **first-mover advantages** or **disadvantages** exist. Under certain conditions, being first to initiate a strategic move can have a high payoff in the form of a competitive advantage that later movers can't dislodge. Moving first is no guarantee of success, however, since first movers also face some significant disadvantages. Indeed, there are circumstances in which it is more advantageous to be a fast follower or even a late mover. Because the timing of strategic moves can be consequential, it is important for company strategists to be aware of the nature of first-mover advantages and disadvantages and the conditions favoring each type.[12]

CORE CONCEPT

Because of **first-mover advantages** and **disadvantages**, competitive advantage can spring from *when* a move is made as well as from *what* move is made.

LO 2

Recognize when being a first mover or a fast follower or a late mover is most advantageous.

The Potential for First-Mover Advantages

Market pioneers and other types of first movers typically bear greater risks and greater development costs than firms that move later. If the market responds well to its initial move, the pioneer will benefit from a monopoly position (by virtue of being first to market) that enables it to recover its investment costs and make an attractive profit. If the firm's pioneering move gives it a competitive advantage that can be sustained even after other firms enter the market space, its first-mover advantage will be greater still. The extent of this type of advantage, however, will depend on whether and how fast follower firms can piggyback on the pioneer's success and either imitate or improve on its move.

The conditions that favor first-mover advantages, then, are those that slow the moves of follower firms or prevent them from imitating the success of the first mover. There are six such conditions in which first-mover advantages are most likely to arise:

1. *When pioneering helps build a firm's reputation and creates strong brand loyalty.* Customer loyalty to an early mover's brand can create a tie that binds, limiting the success of later entrants' attempts to poach from the early mover's customer base and steal market share.
2. *When a first-mover's customers will thereafter face significant switching costs.* Switching costs can protect first movers when consumers make large investments in learning how to use a specific company's product or in complementary products that are also brand-specific. Switching costs can also arise from loyalty programs or long-term contracts that give customers incentives to remain with an initial provider.
3. *When property rights protections thwart rapid imitation of the initial move.* In certain types of industries, property rights protections in the form of patents, copyrights, and trademarks prevent the ready imitation of an early mover's initial moves. First-mover advantages in pharmaceuticals, for example, are heavily dependent on patent protections, and patent races in this industry are common. In other industries, however, patents provide limited protection and can frequently be circumvented. Property rights protections also vary among nations, since they are dependent on a country's legal institutions and enforcement mechanisms.
4. *When an early lead enables the first mover to move down the learning curve ahead of rivals.* When there is a steep learning curve and when learning can be kept proprietary, a first mover can benefit from volume-based cost advantages that grow ever larger as its experience accumulates and its scale of operations increases. This type of first-mover advantage is self-reinforcing and, as such, can preserve a first-mover's competitive advantage over long periods of time. Honda's advantage in small multiuse motorcycles has been attributed to such an effect.
5. *When a first mover can set the technical standard for the industry.* In many technology-based industries, the market will converge around a single technical standard. By establishing the industry standard, a first mover can gain a powerful advantage that, like experienced-based advantages, builds over time. The lure of such an advantage, however, can result in standard wars among early movers, as each strives to set the industry standard. The key to winning such wars is to enter early on the basis of strong fast-cycle product development capabilities, gain the support of key customers and suppliers, employ penetration pricing, and make allies of the producers of complementary products.

Illustration Capsule 6.2 describes how **Amazon.com** achieved a first-mover advantage in online retailing.

The Potential for Late-Mover Advantages or First-Mover Disadvantages

There are instances when there are advantages *to being an adept follower* rather than a first mover. Late-mover advantages (or *first-mover disadvantages*) arise in four instances:

- When pioneering is more costly than imitative following, and only negligible learning-curve benefits accrue to the leader—a condition that allows a follower to end up with lower costs than the first-mover.

ILLUSTRATION CAPSULE 6.2

Amazon.com's First-Mover Advantage in Online Retailing

Amazon.com's path to becoming the world's largest online retailer began in 1994 when Jeff Bezos, a Manhattan hedge fund analyst at the time, noticed that the number of Internet users was increasing by 2,300 percent annually. Bezos saw the tremendous growth as an opportunity to sell products online that would be demanded by a large number of Internet users and could be easily shipped. Bezos launched the online bookseller **Amazon.com** in 1995. The startup's revenues soared to $148 million in 1997, $610 million in 1998, and $1.6 billion in 1999. Bezos's business plan—hatched while on a cross-country trip with his wife in 1994—made him *Time* magazine's Person of the Year in 1999.

The volume-based and reputational benefits of **Amazon.com**'s early entry into online retailing had delivered a first-mover advantage, but between 2000 and 2011 Bezos undertook a series of additional strategic initiatives to solidify the company's number-one ranking in the industry. Bezos undertook a massive building program in the late-1990s that added five new warehouses and fulfillment centers totaling $300 million. The additional warehouse capacity was added years before it was needed, but Bezos wanted to move preemptively against potential rivals and ensure that, as demand continued to grow, the company could continue to offer its customers the best selection, the lowest prices, and the cheapest and most convenient delivery. The company also expanded its product line to include sporting goods, tools, toys, grocery items, electronics, and digital music downloads, giving it another means of maintaining its experience and scale-based advantages. **Amazon.com**'s 2010 revenues of $34.2 billion made it the world's largest Internet retailer and Jeff Bezos's shares in **Amazon.com** made him the 12th wealthiest person in the United States with an estimated net worth of $12.6 billion.

Moving down the learning curve in Internet retailing was not an entirely straightforward process for **Amazon.com**. Bezos commented in a *Fortune* article profiling the company, "We were investors in every bankrupt, 1999-vintage e-commerce startup. **Pets.com**, **living.com**, **kozmo.com**. We invested in a lot of high-profile flameouts." He went on to specify that although the ventures were a "waste of money," they "didn't take us off our own mission." Bezos also suggested that gaining advantage as a first mover is "taking a million tiny steps—and learning quickly from your missteps."

Sources: Mark Brohan, "The Top 500 Guide," *Internet Retailer,* June 2009 (accessed at **www.internetretailer.com** on June 17, 2009); Josh Quittner, "How Jeff Bezos Rules the Retail Space," *Fortune,* May 5, 2008, pp. 126–34; company website.

- When the products of an innovator are somewhat primitive and do not live up to buyer expectations, thus allowing a follower with better-performing products to win disenchanted buyers away from the leader.
- When rapid market evolution (due to fast-paced changes in either technology or buyer needs) gives second-movers the opening to leapfrog a first-mover's products with more attractive next-version products.
- When market uncertainties make it difficult to ascertain what will eventually succeed, allowing late movers to wait until these needs are clarified.

To Be a First Mover or Not

In weighing the pros and cons of being a first mover versus a fast follower versus a late mover, it matters whether the race to market leadership in a particular industry is a marathon or a sprint. In marathons, a slow mover is not unduly penalized—first-mover advantages can be fleeting, and there's ample time for fast followers and sometimes even late movers to catch up.[13] Thus the speed at which the pioneering innovation is likely to catch on matters considerably as companies struggle with whether to pursue an emerging market opportunity aggressively (as a first mover or fast follower) or cautiously (as a late mover). For instance, it took 5.5 years for worldwide mobile phone use to grow from 10 million to 100 million worldwide and close to 10 years for the number of at-home broadband subscribers to grow to 100 million worldwide. The lesson here is that there is a market penetration curve for every emerging opportunity. Typically, the curve has an inflection point at which all the pieces of the business model fall into place, buyer demand explodes, and the market takes off. The inflection point can come early on a fast-rising curve (like the use of e-mail) or farther on up a slow-rising curve (like the use of broadband). Any company that seeks competitive advantage by being a first mover thus needs to ask some hard questions:

- Does market takeoff depend on the development of complementary products or services that currently are not available?
- Is new infrastructure required before buyer demand can surge?
- Will buyers need to learn new skills or adopt new behaviors?
- Will buyers encounter high switching costs in moving to the newly introduced product or service?
- Are there influential competitors in a position to delay or derail the efforts of a first mover?

When the answers to any of these questions are yes, then a company must be careful not to pour too many resources into getting ahead of the market opportunity—the race is likely going to be more of a 10-year marathon than a 2-year sprint.[14] On the other hand, if the market is a winner-take-all type of market, where powerful first-mover advantages insulate early entrants from competition and prevent later movers from making any headway, then it may be best to move quickly despite the risks.

STRENGTHENING A COMPANY'S MARKET POSITION VIA ITS SCOPE OF OPERATIONS

> **CORE CONCEPT**
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> The **scope of the firm** refers to the range of activities which the firm performs internally, the breadth of its product and service offerings, the extent of its geographic market presence, and its mix of businesses.

Apart from considerations of competitive moves and their timing, there is another set of managerial decisions that can affect the strength of a company's market position. These decisions concern the scope of a company's operations—the breadth of its activities and the extent of its market reach. Decisions regarding the **scope of the firm** focus on which activities a firm will perform internally and which it will not. For example, should Panera Bread Company produce the fresh dough that its company-owned and franchised bakery-cafés use in making baguettes, pastries, bagels, and other types of bread, or should it obtain its dough from outside suppliers? Scope decisions also concern which segments of the market to serve—decisions that can include geographic market segments as well as product and service segments. Should Panera expand its menu to include light dinner entrees? Should it offer delivery or drive-through service? Should it expand into all 50 states or concentrate on strengthening its market presence regionally?

Decisions such as these, in essence, determine where the boundaries of a firm lie and the degree to which the operations within those boundaries cohere. They also have much to do with the direction and extent of a business's growth. In this chapter, we introduce the topic of company scope and discuss different types of scope decisions in relation to a company's business-level strategy. In the next two chapters, we develop two additional dimensions of a firm's scope. Chapter 7 focuses on international expansion—a matter of extending the company's geographic scope into foreign markets. Chapter 8 takes up the topic of corporate strategy, which concerns diversifying into a mix of different businesses. Scope issues are at the very heart of corporate-level strategy.

Several dimensions of firm scope have relevance for business-level strategy in terms of their capacity to strengthen a company's position in a given market. These include the firm's **horizontal scope,** which is the range of product and service segments that the firm serves within its product or service market. Mergers and acquisitions involving other market participants provide a means for a company to expand its horizontal scope. Expanding the firm's vertical scope by means of vertical integration can also affect the success of its market strategy. **Vertical scope** is the extent to which the firm engages in the various activities that make up the industry's entire value chain system, from initial activities such as raw-material production all the way to retailing and after-sales service activities. Outsourcing decisions concern another dimension of scope since they involve narrowing the firm's boundaries with respect to its participation in value chain activities. We discuss the pros and cons of each of these options in the sections that follow. Since strategic alliances and partnerships provide an alternative to vertical integration and acquisition strategies and are sometimes used to facilitate outsourcing, we conclude this chapter with a discussion of the benefits and challenges associated with cooperative arrangements of this nature.

CORE CONCEPT

Horizontal scope is the range of product and service segments that a firm serves within its focal market.

CORE CONCEPT

Vertical scope is the extent to which a firm's internal activities encompass one, some, many, or all of the activities that make up an industry's entire value chain system, ranging from raw-material production to final sales and service activities.

HORIZONTAL MERGER AND ACQUISITION STRATEGIES

LO 3

Become aware of the strategic benefits and risks of expanding a company's horizontal scope through mergers and acquisitions.

Mergers and acquisitions are much-used strategic options to strengthen a company's market position. A *merger* is the combining of two or more companies into a single corporate entity, with the newly created company often taking on a new name. An *acquisition* is a combination in which one company, the acquirer, purchases and absorbs the operations of another, the acquired. The difference between a merger and an acquisition relates more to the details of ownership, management control, and financial arrangements than to strategy and competitive advantage. The resources and competitive capabilities of the newly created enterprise end up much the same whether the combination is the result of an acquisition or merger.

Horizontal mergers and acquisitions, which involve combining the operations of firms within the same product or service market, provide an effective means for firms to rapidly increase the scale and horizontal scope of their core business. For example, Microsoft has used an aggressive acquisition strategy to extend its software business into new segments and strengthen its technological capabilities in this domain. Mergers between airlines, such as the recent United–Continental merger, have increased their scale of operations and extended their reach geographically.

Merger and acquisition strategies typically set sights on achieving any of five objectives:[15]

1. *Creating a more cost-efficient operation out of the combined companies.* Many mergers and acquisitions are undertaken with the objective of transforming two or more high-cost companies into one lean competitor with significantly lower costs. When a company acquires another company in the same industry, there's usually enough overlap in operations that less efficient plants can be closed or distribution

and sales activities partly combined and downsized. Likewise, it is usually feasible to squeeze out cost savings in administrative activities, again by combining and downsizing such administrative activities as finance and accounting, information technology, human resources, and so on. The combined companies may also be able to reduce supply chain costs because of greater bargaining power over common suppliers and closer collaboration with supply chain partners. By helping to consolidate the industry and remove excess capacity, such combinations can also reduce industry rivalry and improve industry profitability.

2. *Expanding a company's geographic coverage.* One of the best and quickest ways to expand a company's geographic coverage is to acquire rivals with operations in the desired locations. Since a company's size increases with its geographic scope, another benefit is increased bargaining power with the company's suppliers or buyers. Greater geographic coverage can also contribute to product differentiation by enhancing a company's name recognition and brand awareness. Banks like Wells Fargo and Bank of America have used acquisition strategies to establish a market presence and gain name recognition in an ever-growing number of states and localities.
3. *Extending the company's business into new product categories.* Many times a company has gaps in its product line that need to be filled in order to offer customers a more effective product bundle or the benefits of one-stop-shopping. For example, customers might prefer to acquire a suite of software applications from a single vendor that can offer more integrated solutions to the company's problems. Acquisition can be a quicker and more potent way to broaden a company's product line than going through the exercise of introducing a company's own new product to fill the gap. Coca-Cola has increased the effectiveness of the product bundle it provides to retailers by acquiring beverage makers Minute Maid, Odwalla, Hi-C, and Glaceau.
4. *Gaining quick access to new technologies or complementary resources and capabilities.* Making acquisitions to bolster a company's technological know-how or to expand its skills and capabilities allows a company to bypass a time-consuming and expensive internal effort to build desirable new resources and capabilities. From 2000 through April 2011, Cisco Systems purchased 97 companies to give it more technological reach and product breadth, thereby enhancing its standing as the world's largest provider of hardware, software, and services for building and operating Internet networks.
5. *Leading the convergence of industries whose boundaries are being blurred by changing technologies and new market opportunities.* In fast-cycle industries or industries whose boundaries are changing, companies can use acquisition strategies to hedge their bets about the direction that an industry will take, to increase their capacity to meet changing demands, and to respond flexibly to changing buyer needs and technological demands. News Corporation has prepared for the convergence of media services with the purchase of satellite TV companies to complement its media holdings in TV broadcasting (the Fox network and TV stations in various countries), cable TV (Fox News, Fox Sports, and FX), filmed entertainment (Twentieth Century Fox and Fox studios), newspapers, magazines, and book publishing.

Numerous companies have employed a horizontal acquisition strategy to catapult themselves from the ranks of the unknown into positions of market leadership. Wells Fargo began as a small regional bank and grew via acquisition, transforming itself into a nationwide bank with global presence. By 2011, it still lagged behind the largest banks in terms of assets, but far outclassed them in terms of efficiency, profitability, and market value.[16] Moreover, it was also listed by *Fortune* magazine in 2011 as among the world's "Most Admired Companies."

Illustration Capsule 6.3 describes how Bristol-Myers Squibb developed its "string-of-pearls" horizontal acquisition strategy to fill in its pharmaceutical product development gaps.

ILLUSTRATION CAPSULE 6.3

Bristol-Myers Squibb's "String-of-Pearls" Horizontal Acquisition Strategy

Back in 2007, the pharmaceutical company Bristol-Myers Squibb had a problem: its top-selling drugs, Plavix and Abilify, would go off patent by 2012 and its drug pipeline was nearly empty. Together these drugs (the first for heart attacks, the second for depression) accounted for nearly half of the company's sales. Not surprisingly, the company's stock price had stagnated and was underperforming that of its peers.

Developing new drugs is difficult: new drugs must be identified, tested in increasingly sophisticated trials and approved by the Food and Drug Administration. On average, this process takes 13 years and costs $2B. The success rate is low: only one drug in eight manages to pass through clinical testing. In 2007, Bristol-Myers Squibb had only six new drugs at the clinical testing stage.

At the time, many drug companies were diversifying into new markets like over-the-counter drugs to better manage drug development risk. Bristol-Myers Squibb's management pursued a different strategy: product diversification through horizontal acquisitions. Bristol-Myers Squibb targeted small companies in new treatment areas, with the objective of reducing new product development risk by betting on pre-identified drugs. The small companies it targeted, with one or two drugs in development, needed cash; Bristol-Myers Squibb needed new drugs. The firm's management called this its "string-of-pearls" strategy.

To implement its approach and obtain the cash it needed, Bristol-Myers Squibb sold its stake in Mead Johnson, a nutritional supplement manufacturer. Then, it went on a shopping spree. Starting in 2007, the company spent over $8B on 18 transactions, including 12 horizontal acquisitions. In the process, the company acquired many promising new drug candidates for common diseases such as cancer, cardiovascular disease, rheumatoid arthritis, and Hepatitis C.

By early 2012, the company's string-of-pearls acquisitions were estimated to have added over $4B of new revenue to the company's coffers. Analysts reported that Bristol-Myers Squibb had one of the best pipelines among drug makers. Investors agreed: between 2007 and 2012, the company's stock price climbed 20 percent, substantially outperforming that of its peers.

Developed with Dennis L. Huggins.

Sources: D. Armstrong and M. Tirrell, "Bristol's Buy of Inhibitex for Hepatitis Drug Won't Be Last," *Bloomberg Businessweek,* January 2012 (accessed at **www.bloomberg.com** on January 30, 2012); S. M. Paul, et al., "How to Improve R&D Productivity: the Pharmaceutical Industry's Grand Challenge," *Nature Reviews,* March 2010, pp. 203–214; Bristol-Myers Squibb 2007 and 2011 Annual Reports.

Why Mergers and Acquisitions Sometimes Fail to Produce Anticipated Results

Despite many successes, mergers and acquisitions do not always produce the hoped-for outcomes.[17] Cost savings may prove smaller than expected. Gains in competitive capabilities may take substantially longer to realize or, worse, may never materialize at all. Efforts to mesh the corporate cultures can stall due to formidable resistance from organization members. Key employees at the acquired company can quickly become disenchanted and leave; the morale of company personnel who remain can drop to disturbingly low levels because they disagree with newly instituted changes. Differences in management styles and operating procedures can prove hard to resolve. In addition, the managers appointed to oversee the integration of a newly acquired company can make mistakes in deciding which activities to leave alone and which activities to meld into their own operations and systems.

A number of mergers/acquisitions have been notably unsuccessful. eBay's $2.6 billion acquisition of Skype in 2005 proved to be a mistake—eBay wrote off $900 million of its Skype investment in 2007 and sold 70 percent of its ownership in Skype in September 2009 to a group of investors. While the company finally found a white knight in Microsoft in 2011, the jury is out as to whether or not Microsoft can make this acquisition work. A number of recent mergers and acquisitions have yet to live up to expectations—prominent examples include Oracle's acquisition of Sun Microsystems, the Fiat–Chrysler deal, and Bank of America's acquisition of Countrywide Financial.

VERTICAL INTEGRATION STRATEGIES

LO 4

Learn the advantages and disadvantages of extending the company's scope of operations via vertical integration.

Expanding the firm's vertical scope by means of a vertical integration strategy provides another way to strengthen the company's position in its core market. A **vertically integrated firm** is one that participates in multiple segments or stages of an industry's value chain system. A good example of a vertically integrated firm is Maple Leaf Foods, a major Canadian producer of fresh and processed meats whose best-selling brands include Maple Leaf and Schneiders. Maple Leaf Foods participates in hog and poultry production, with company-owned hog and poultry farms; it has its own meat-processing and rendering facilities; it packages its products and distributes them from company-owned distribution centers; and it conducts marketing, sales, and customer service activities for its wholesale and retail buyers but does not otherwise participate in the final stage of the meat processing vertical chain—the retailing stage.

CORE CONCEPT

A **vertically integrated firm** is one that performs value chain activities along more than one stage of an industry's value chain system.

A vertical integration strategy can expand the firm's range of activities *backward* into sources of supply and/or *forward* toward end users. When Tiffany & Co, a manufacturer and retailer of fine jewelry, began sourcing, cutting, and polishing its own diamonds, it integrated backward along the diamond supply chain. Mining giant De Beers Group and Canadian miner Aber Diamond integrated forward when they entered the diamond retailing business.

A firm can pursue vertical integration by starting its own operations in other stages of the vertical activity chain or by acquiring a company already performing the activities it wants to bring in-house. Vertical integration strategies can aim at *full integration* (participating in all stages of the vertical chain) or *partial integration* (building positions in selected stages of the vertical chain). Firms can also engage in *tapered integration* strategies, which involve a mix of in-house and outsourced activity in any given stage of the vertical chain. Oil companies, for instance, supply their refineries with oil from their own wells as well as with oil that they purchase from other producers—they engage in tapered backward integration. Boston Beer Company, the maker of Samuel Adams, engages in tapered forward integration, since it operates brew-pubs, but sells the majority of its products through third-party distributors.

The Advantages of a Vertical Integration Strategy

Under the right conditions, a vertical integration strategy can add materially to a company's technological capabilities, strengthen the firm's competitive position, and boost its profitability.[18] But it is important to keep in mind that vertical integration has no real payoff strategywise or profitwise unless the extra investment can be justified by compensating improvements in company costs, differentiation, or competitive strength.

Integrating Backward to Achieve Greater Competitiveness It is harder than one might think to generate cost savings or improve profitability by integrating backward into activities such as parts and components manufacture (which could otherwise be purchased from suppliers with specialized expertise in making these parts and components). For **backward integration** to be a cost-saving and profitable strategy, a company must be able to (1) achieve the same scale economies as outside suppliers and (2) match or beat suppliers' production efficiency with no drop-off in quality. Neither outcome is a slam dunk. To begin with, a company's in-house requirements are often too small to reach the optimum size for low-cost operation. Furthermore, matching the production efficiency of suppliers is fraught with problems when suppliers have considerable production experience of their own, when the technology they employ has elements that are hard to master, and/or when substantial R&D expertise is required to develop next-version components or keep pace with advancing technology in components production.

CORE CONCEPT

Backward integration involves entry into activities previously performed by suppliers or other enterprises positioned along earlier stages of the industry value chain system; **forward integration** involves entry into value chain system activities closer to the end user.

That said, occasions still arise when a company can improve its cost position and competitiveness by performing a broader range of industry value chain activities in-house rather than having such activities performed by outside suppliers. When suppliers have outsized profit margins or when there is a sole supplier, vertical integration can lower costs by limiting supplier power. Vertical integration can also lower costs by facilitating the coordination of production flows and avoiding bottleneck problems. Furthermore, when a company has proprietary know-how that it wants to keep from rivals, then in-house performance of value-adding activities related to this know-how is beneficial even if such activities could be performed by outsiders. Apple recently decided to integrate backward into producing its own chips for iPhones, chiefly because chips are a major cost component, they have big profit margins, and in-house production would help coordinate design tasks and protect Apple's proprietary iPhone technology. International Paper Company backward integrates into pulp mills that it sets up near its paper mills (outside suppliers are generally unwilling to make a site-specific investment for a buyer) and reaps the benefits of coordinated production flows, energy savings, and transportation economies.

Backward vertical integration can produce a differentiation-based competitive advantage when performing activities internally contributes to a better quality product/service offering, improves the caliber of customer service, or in other ways enhances the performance of the final product. On occasion, integrating into more stages along the industry value chain system can add to a company's differentiation capabilities by allowing it to build or strengthen its core competencies, better master key skills or strategy-critical technologies, or add features that deliver greater customer value. Spanish clothing maker Inditex has backward integrated into fabric making, as well as garment design and manufacture, for its successful Zara brand. By tightly controlling the process and postponing dyeing until later stages, Zara can respond quickly to changes in fashion trends and supply its customers with the hottest items. NewsCorp backward integrated into film studios (Twentieth Century Fox) and TV program production to ensure access to high-quality content for its TV stations (and to limit supplier power).

Integrating Forward to Enhance Competitiveness Like backward integration, **forward integration** can lower costs by increasing efficiency and bargaining power. In addition, it can allow manufacturers to gain better access to end users, improve market visibility, and include the end user's purchasing experience as a differentiating feature. For example, Ducati and Harley motorcycles both have company-owned retail stores that are essentially little museums, filled with iconography, that provide an environment conducive to selling not only motorcycles and gear but also memorabilia, clothing, and other items featuring the brand. Insurance companies and brokerages have the ability to make consumers' interactions with local agents and office personnel a differentiating feature by focusing on building relationships.

In many industries, independent sales agents, wholesalers, and retailers handle competing brands of the same product and have no allegiance to any one company's brand—they tend to push whatever offers the biggest profits. An independent insurance agency, for example, represents a number of different insurance companies. Under this arrangement, there's plenty of opportunity for independent agents to promote the policies of favored insurers over others. An insurance company may conclude, therefore, that it is better off integrating forward and setting up its own local offices, as State Farm and Allstate have done. Likewise, it can be advantageous for a manufacturer to integrate forward into wholesaling or retailing rather than depend on the sales efforts of independent distributors/retailers that stock multiple brands and steer customers to the brands on which they earn the highest profit margins. To avoid dependence on distributors/dealers with divided loyalties, Goodyear has integrated forward into company-owned and franchised retail tire stores. Consumer-goods companies like Bath & Body Works, Tommy Hilfiger, Chico's, and Polo Ralph Lauren have integrated forward into retailing and operate their own branded stores in factory outlet malls, enabling them to move overstocked items, slow-selling items, and seconds.

Some producers have opted to integrate forward by selling directly to customers at the company's website. Bypassing regular wholesale/retail channels in favor of direct sales and Internet retailing can have appeal if it reinforces the brand and enhances consumer satisfaction or if it lowers distribution costs, produces a relative cost advantage over certain rivals, and results in lower selling prices to end users. In addition, sellers are compelled to include the Internet as a retail channel when a sufficiently large number of buyers in an industry prefer to make purchases online. However, a company that is vigorously pursuing online sales to consumers at the same time that it is also heavily promoting sales to consumers through its network of wholesalers and retailers is *competing directly against its distribution allies.* Such actions constitute *channel conflict* and create a tricky route to negotiate. A company that is actively trying to expand online sales to consumers is signaling a weak strategic commitment to its dealers *and* a willingness to cannibalize dealers' sales and growth potential. The likely result is angry dealers and loss of dealer goodwill. Quite possibly, a company may stand to lose more sales by offending its dealers than it gains from its own online sales effort. Consequently, in industries where the strong support and goodwill of dealer networks is essential, companies may conclude that it is important to avoid channel conflict and that *their websites should be designed to partner with dealers rather than compete against them.*

The Disadvantages of a Vertical Integration Strategy

Vertical integration has some substantial drawbacks beyond the potential for channel conflict.[19] The most serious drawbacks to vertical integration include the following concerns:

- Vertical integration raises a firm's capital investment in the industry, thereby *increasing business risk.*
- Vertically integrated companies are often *slow to embrace technological advances* or more efficient production methods when they are saddled with older technology or facilities. A company that obtains parts and components from outside suppliers can always shop the market for the newest, best, and cheapest parts, whereas a vertically integrated firm saddled with older technology or facilities may choose to continue making suboptimal parts rather than face the high costs of premature abandonment.
- Vertical integration can result in *less flexibility in accommodating shifting buyer preferences* when a new product design doesn't include parts and components that the company makes in-house. It is one thing to design out a component made by a supplier and another to design out a component being made in-house (which can mean laying off employees and writing off the associated investment in equipment

and facilities). Integrating forward or backward locks a firm into relying on its own in-house activities and sources of supply.

- Vertical integration *may not enable a company to realize economies of scale* if its production levels are below the minimum efficient scale. Small companies in particular are likely to suffer a cost disadvantage by producing in-house when suppliers that serve many small companies can realize scale economies that a small company cannot attain on its own.
- Vertical integration poses all kinds of *capacity matching problems.* In motor vehicle manufacturing, for example, the most efficient scale of operation for making axles is different from the most economic volume for radiators, and different yet again for both engines and transmissions. Consequently, integrating across several production stages in ways that achieve the lowest feasible costs can be a monumental challenge.
- Integration forward or backward often *calls for developing different types of resources and capabilities.* Parts and components manufacturing, assembly operations, wholesale distribution and retailing, and direct sales via the Internet represent different kinds of businesses, operating in different types of industries, with different key success factors. Many manufacturers learn the hard way that company-owned wholesale/retail networks present many headaches, fit poorly with what they do best, and don't always add the kind of value to their core business they thought they would.

In today's world of close working relationships with suppliers and efficient supply chain management systems, *very few businesses can make a case for integrating backward into the business of suppliers* to ensure a reliable supply of materials and components or to reduce production costs. The best materials and components suppliers stay abreast of advancing technology and are adept in improving their efficiency and keeping their costs and prices as low as possible. A company that pursues a vertical integration strategy and tries to produce many parts and components in-house is likely to find itself very hard-pressed to keep up with technological advances and cutting-edge production practices for each part and component used in making its product.

Weighing the Pros and Cons of Vertical Integration

All in all, therefore, a strategy of vertical integration can have both important strengths and weaknesses. The tip of the scales depends on (1) whether vertical integration can enhance the performance of strategy-critical activities in ways that lower cost, build expertise, protect proprietary know-how, or increase differentiation, (2) the impact of vertical integration on investment costs, flexibility, and response times, (3) the administrative costs of coordinating operations across more vertical chain activities, and (4) how difficult it will be for the company to acquire the set of skills and capabilities needed to operate in another stage of the vertical chain. *Vertical integration strategies have merit according to which capabilities and value-adding activities truly need to be performed in-house and which can be performed better or cheaper by outsiders.* Without solid benefits, integrating forward or backward is not likely to be an attractive strategy option.

American Apparel, the largest U.S. clothing manufacturer, has made vertical integration a central part of its strategy, as described in Illustration Capsule 6.4.

OUTSOURCING STRATEGIES: NARROWING THE SCOPE OF OPERATIONS

In contrast to vertical integration strategies, outsourcing strategies narrow the scope of a business's operations (and the firm's boundaries, in terms of what activities are performed internally). **Outsourcing** involves

ILLUSTRATION CAPSULE 6.4

American Apparel's Vertical Integration Strategy

American Apparel, known for its hip line of basic garments and its provocative advertisements, is no stranger to the concept of "doing it all." The Los Angeles–based casual wear company has made both forward and backward vertical integration a central part of its strategy, making American Apparel a rarity in the U.S. fashion industry. Not only does it do all its own fabric cutting and sewing, but it also owns several knitting and dyeing facilities in southern California, as well as a distribution warehouse, a wholesale operation, and over 270 retail stores in 20 countries. American Apparel even does its own clothing design, marketing, and advertising, often using its employees as photographers and clothing models.

Founder and CEO Dov Charney claims that the company's vertical integration strategy lets American Apparel respond more quickly to rapid market changes, allowing the company to bring an item from design to its stores worldwide in the span of a week. End-to-end coordination also improves inventory control, helping prevent common problems in the fashion business such as stockouts and steep markdowns. The company capitalizes on its California-based vertically integrated operations by using taglines such as "Sweatshop Free. Made in the USA" to bolster its "authentic" image.

However, this strategy is not without risks and costs. In an industry where 97 percent of goods are imported, American Apparel pays its workers wages and benefits above the relatively high mandated American minimum. Furthermore, operating in so many key vertical chain activities makes it impossible to be expert in all of them and creates optimal scale and capacity mismatches—problems with which the firm has partly dealt by tapering its backward integration into knitting and dyeing. Lastly, while the company can respond quickly to new fashion trends, its vertical integration strategy may make it more difficult for the company to scale back in an economic downturn or respond to radical change in the industry environment. Ultimately, only time will tell whether American Apparel will dilute or capitalize on its vertical integration strategy in its pursuit of profitable growth.

Developed with John R. Moran.

Sources: American Apparel website, **www.americanapparel.net** (accessed June 16, 2010); American Apparel investor presentation, June 2009, **http://files.shareholder.com/downloads/APP/938846703x0x300331/3dd0b7ca-e458-45b8-8516-e25ca272016d/NYC%20JUNE%202009.pdf**; Dov Charney, "American Apparel—Dov Charney Interview," *YouTube,* 2007, **http://youtube.com/watch?v=hYqR8UIl8A4**; Christopher Palmeri, "Living on the Edge at American Apparel," *BusinessWeek,* June 27, 2005.

a conscious decision to abandon attempts to perform certain value chain activities internally and instead to farm them out to outside specialists.[20] Many PC makers, for example, have shifted from assembling units in-house to outsourcing the entire assembly process to manufacturing specialists, which can operate more efficiently due to their greater scale, experience, and bargaining power over components makers. Nike has outsourced most of its manufacturing-related value chain activities so it can concentrate on marketing and managing its brand.

CORE CONCEPT

Outsourcing involves contracting out certain value chain activities to outside vendors.

Outsourcing certain value chain activities makes strategic sense whenever:

LO 5

Become aware of the conditions that favor farming out certain value chain activities to outside parties.

- *An activity can be performed better or more cheaply by outside specialists.* A company should generally *not* perform any value chain activity internally that can be performed more efficiently or effectively by outsiders—the chief exception occurs when a particular activity is strategically crucial and internal control over that activity is deemed essential.

- *The activity is not crucial to the firm's ability to achieve sustainable competitive advantage.* Outsourcing of support activities such as maintenance services, data processing, data storage, fringe-benefit management, and website operations has become commonplace. Colgate-Palmolive, for instance, has been able to reduce its information technology operational costs by more than 10 percent per year through an outsourcing agreement with IBM.
- *It improves organizational flexibility and speeds time to market.* Outsourcing gives a company the flexibility to switch suppliers in the event that its present supplier falls behind competing suppliers. Moreover, seeking out new suppliers with the needed capabilities already in place is frequently quicker, easier, less risky, and cheaper than hurriedly retooling internal operations to replace obsolete capabilities or trying to install and master new technologies.
- *It reduces the company's risk exposure to changing technology or buyer preferences.* When a company outsources certain parts, components, and services, its suppliers must bear the burden of incorporating state-of-the-art technologies and/or undertaking redesigns and upgrades to accommodate a company's plans to introduce next-generation products. If what a supplier provides falls out of favor with buyers, or is rendered unnecessary by technological change, it is the supplier's business that suffers rather than the company's.
- *It allows a company to assemble diverse kinds of expertise speedily and efficiently.* A company can nearly always gain quicker access to first-rate capabilities and expertise by employing suppliers who already have them in place than by trying to build them from scratch internally.
- *It allows a company to concentrate on its core business, leverage its key resources, and do even better what it already does best.* A company is better able to enhance its own competitively valuable capabilities when it concentrates its full resources and energies on performing only those activities. Coach, for example, devotes its energies to designing new styles of ladies handbags and leather accessories, opting to outsource handbag production to 40 contract manufacturers in 15 countries. Hewlett-Packard, IBM, and others have sold their manufacturing plants to outsiders and contracted to repurchase the output from the new owners.

The Big Risk of Outsourcing Value Chain Activities

> A company must guard against outsourcing activities that hollow out the resources and capabilities that it needs to be a master of its own destiny.

The biggest danger of outsourcing is that a company will farm out too many or the wrong types of activities and thereby hollow out its own capabilities.[21] In such cases, a company loses touch with the very activities and expertise that over the long run determine its success. But most companies are alert to this danger and take actions to protect against being held hostage by outside suppliers. Cisco Systems guards against loss of control and protects its manufacturing expertise by designing the production methods that its contract manufacturers must use. Cisco keeps the source code for its designs proprietary, thereby controlling the initiation of all improvements and safeguarding its innovations from imitation. Further, Cisco uses the Internet to monitor the factory operations of contract manufacturers around the clock, and can therefore know immediately when problems arise and decide whether to get involved.

Another risk of outsourcing comes from the lack of direct control. It may be difficult to monitor, control, and coordinate the activities of outside parties via contracts and arm's-length transactions alone. Unanticipated problems may arise that cause delays or cost overruns and become hard to resolve amicably. Moreover, contract-based outsourcing can be problematic because outside parties lack incentives to make investments specific to the needs of the outsourcing company's internal value chain.

STRATEGIC ALLIANCES AND PARTNERSHIPS

LO 6

Understand when and how strategic alliances can substitute for horizontal mergers and acquisitions or vertical integration and how they can facilitate outsourcing.

Strategic alliances and cooperative partnerships provide one way to gain some of the benefits offered by vertical integration, outsourcing, and horizontal mergers and acquisitions while minimizing the associated problems. Companies frequently engage in cooperative strategies as an alternative to vertical integration or horizontal mergers and acquisitions. Increasingly, companies are also employing strategic alliances and partnerships to extend their scope of operations via international expansion and diversification strategies, as we describe in Chapters 7 and 8. Strategic alliances and cooperative arrangements are now a common means of narrowing a company's scope of operations as well, serving as a useful way to manage outsourcing (in lieu of traditional, purely price-oriented contracts).

For example, oil and gas companies engage in considerable vertical integration—but Shell Oil Company and Pemex (Mexico's state-owned petroleum company) have found that joint ownership of their Deer Park Refinery in Texas lowers their investment costs and risks in comparison to going it alone. The colossal failure of the Daimler-Chrysler merger formed an expensive lesson for Daimler AG about what can go wrong with horizontal mergers and acquisitions; its 2010 strategic alliance with Renault-Nissan may allow the two companies to achieve jointly the global scale required for cost competitiveness in cars and trucks while avoiding the type of problems that so plagued Daimler-Chrysler. Many companies employ strategic alliances to manage the problems that might otherwise occur with outsourcing—Cisco's system of alliances guards against loss of control, protects its proprietary manufacturing expertise, and enables the company to monitor closely the assembly operations of its partners while devoting its energy to designing new generations of the switches, routers, and other Internet-related equipment for which it is known.

CORE CONCEPT

A **strategic alliance** is a formal agreement between two or more separate companies in which they agree to work cooperatively toward some common objective.

Companies in all types of industries have elected to form strategic alliances and partnerships to complement their own strategic initiatives and strengthen their competitiveness—the very same goals that motivate vertical integration, horizontal mergers and acquisitions, and outsourcing initiatives. A **strategic alliance** is a formal agreement between two or more separate companies in which they agree to work collaboratively toward some strategically relevant objective. Typically, they involve shared financial responsibility, joint contribution of resources and capabilities, shared risk, shared control, and mutual dependence. They may be characterized by cooperative marketing, sales or distribution, joint production, design collaboration, or projects to jointly develop new technologies or products. They can vary in terms of their duration and the extent of the collaboration; some are intended as long-term arrangements, involving an extensive set of cooperative activities, while others are designed to accomplish more limited, short-term objectives.

CORE CONCEPT

A **joint venture** is a partnership involving the establishment of an independent corporate entity that the partners own and control jointly, sharing in its revenues and expenses.

Collaborative arrangements may entail a contractual agreement, but they commonly stop short of formal ownership ties between the partners (although sometimes an alliance member will secure minority ownership of another member). A special type of strategic alliance involving ownership ties is the **joint venture**. A joint venture entails forming a new corporate entity that is jointly owned by two or more companies that agree to share in the revenues, expenses, and control of the newly formed entity. Since joint ventures involve setting up a mutually owned business, they tend to be more durable but also riskier than other arrangements. In other types of strategic alliances, the collaboration between the partners involves a much less rigid structure in which the partners retain their independence from one another. If a strategic alliance is not working out, a partner can choose to simply walk away or reduce its commitment to collaborating at any time.

An alliance becomes "strategic," as opposed to just a convenient business arrangement, when it serves any of the following purposes:[22]

1. It facilitates achievement of an important business objective (like lowering costs or delivering more value to customers in the form of better quality, added features, and greater durability).
2. It helps build, sustain, or enhance a core competence or competitive advantage.
3. It helps block a competitive threat.
4. It helps remedy an important resource deficiency or competitive weakness.
5. It increases the bargaining power of alliance members over suppliers or buyers.
6. It helps open up important new market opportunities.
7. It mitigates a significant risk to a company's business.

Strategic cooperation is a much-favored approach in industries where new technological developments are occurring at a furious pace along many different paths and where advances in one technology spill over to affect others (often blurring industry boundaries). Whenever industries are experiencing high-velocity technological advances in many areas simultaneously, firms find it virtually essential to have cooperative relationships with other enterprises to stay on the leading edge of technology, even in their own area of specialization.

It took a $3.2 billion joint venture involving the likes of Sprint-Nextel, Clearwire, Intel, Time Warner Cable, Google, Comcast, and Bright House Networks to roll out next-generation 4G wireless services based on Sprint's and Clearwire's WiMax mobile networks. WiMax was an advanced Wi-Fi technology that allowed people to browse the Internet at speeds as great as 10 times faster than other cellular Wi-Fi technologies. The venture was a necessity for Sprint-Nextel and Clearwire since they lacked the financial resources to handle the rollout on their own. The appeal of the partnership for Time Warner, Comcast, and Bright House was the ability to bundle the sale of wireless services to their cable customers, while Intel had the chip sets for WiMax and hoped that WiMax would become the dominant wireless Internet format. Google's interest in the alliance was to strengthen its lead in desktop search on wireless devices.

Clear Channel Communications has entered into a series of partnerships to provide a multiplatform launchpad for artists like Taylor Swift, Phoenix, and Sara Bareilles. In 2010, they partnered with MySpace, Hulu, and the artist management company 19 Entertainment for *If I Can Dream,* an original reality series where unsigned musicians and actors share a "real world"–style house in Los Angeles and document their attempts at stardom. Clear Channel has helped promote the show by conducting exclusive radio interviews and performances with the talent, which in turn has helped the show become a top-30 weekly program on Hulu.[23]

Because of the varied benefits of strategic alliances, many large corporations have become involved in 30 to 50 alliances, and a number have formed hundreds of alliances. Genentech, a leader in biotechnology and human genetics, has formed R&D alliances with over 30 companies to boost its prospects for developing new cures for various diseases and ailments. Most automakers have forged a variety of long-term strategic partnerships with suppliers of automotive parts and components, both to achieve lower costs and to improve the quality and reliability of their vehicles. Daimler AG has been entering a number of alliances to lower its risks and improve its prospects in electric cars, where it lacks key capabilities. Its equity-based strategic partnership with Tesla Motors, for example, will allow Daimler to use proven technology to bring its electric vehicles to market quickly, while helping Tesla learn how to mass produce its electric

Companies that have formed a host of alliances need to manage their alliances like a portfolio.

cars. Daimler's 2010 joint venture with Chinese car maker BYD is intended to help Daimler make and sell electric cars for the Chinese market. Companies that have formed a host of alliances need to manage their alliances like a portfolio—terminating those that no longer serve a useful purpose or that have produced meager results, forming promising new alliances, and restructuring existing alliances to correct performance problems and/or redirect the collaborative effort.

Why and How Strategic Alliances Are Advantageous

The best alliances are highly selective, focusing on particular value chain activities and on obtaining a specific competitive benefit. They enable a firm to build on its strengths and to learn.

The most common reasons companies enter into strategic alliances are to expedite the development of promising new technologies or products, to overcome deficits in their own expertise and capabilities, to improve supply chain efficiency, to share the risks of high-stake, risky ventures, to gain economies of scale in production and/or marketing, and to obtain market access through joint marketing agreements.[24] When a company needs to correct particular resource gaps or deficiencies, it may be faster and cheaper to partner with other enterprises that have the missing know-how and capabilities. Manufacturers frequently pursue alliances with parts and components suppliers to gain the efficiencies of better supply chain management and to speed new products to market. Allies can learn much from one another in performing joint research, sharing technological know-how, and collaborating on complementary new technologies and products—sometimes enough to enable them to pursue other new opportunities on their own.[25] In industries where technology is advancing rapidly, alliances are all about fast cycles of learning, staying abreast of the latest developments, gaining quick access to the latest round of technological know-how, and developing dynamic capabilities. In bringing together firms with different skills and knowledge bases, alliances open up learning opportunities that help partner firms better leverage their own resources and capabilities.[26]

There are several other instances in which companies find strategic alliances particularly valuable. A company that is racing to *stake out a strong position in an industry of the future* needs alliances to:

- *Establish a stronger beachhead* for participating in the target industry.
- *Master new technologies and build new expertise and competencies* faster than would be possible through internal efforts.
- *Open up broader opportunities* in the target industry by melding the firm's own capabilities with the expertise and resources of partners.

Capturing the Benefits of Strategic Alliances

The extent to which companies benefit from entering into alliances and partnerships seems to be a function of six factors:[27]

1. *Picking a good partner.* A good partner must bring complementary strengths to the relationship. To the extent that alliance members have nonoverlapping strengths, there is greater potential for synergy and less potential for coordination problems and conflict. In addition, a good partner needs to share the company's vision about the overall purpose of the alliance and to have specific goals that either match or complement those of the company. Strong partnerships also depend on good chemistry among key personnel and compatible views about how the alliance should be structured and managed.
2. *Being sensitive to cultural differences.* Cultural differences among companies can make it difficult for their personnel to work together effectively. Cultural differences can be problematic among companies

from the same country, but when the partners have different national origins, the problems are often magnified. Unless there is respect among all the parties for company cultural differences, including those stemming from different local cultures and local business practices, productive working relationships are unlikely to emerge.

3. *Recognizing that the alliance must benefit both sides.* Information must be shared as well as gained, and the relationship must remain forthright and trustful. If either partner plays games with information or tries to take advantage of the other, the resulting friction can quickly erode the value of further collaboration. Open, trustworthy behavior on both sides is essential for fruitful collaboration.
4. *Ensuring that both parties live up to their commitments.* Both parties have to deliver on their commitments for the alliance to produce the intended benefits. The division of work has to be perceived as fairly apportioned, and the caliber of the benefits received on both sides has to be perceived as adequate.
5. *Structuring the decision-making process so that actions can be taken swiftly when needed.* In many instances, the fast pace of technological and competitive changes dictates an equally fast decision-making process. If the parties get bogged down in discussions or in gaining internal approval from higher-ups, the alliance can turn into an anchor of delay and inaction.
6. *Managing the learning process and then adjusting the alliance agreement over time to fit new circumstances.* One of the keys to long-lasting success is adapting the nature and structure of the alliance to be responsive to shifting market conditions, emerging technologies, and changing customer requirements. Wise allies are quick to recognize the merit of an evolving collaborative arrangement, where adjustments are made to accommodate changing market conditions and to overcome whatever problems arise in establishing an effective working relationship.

Most alliances that aim at sharing technology or providing market access turn out to be temporary, lasting only a few years. This is not necessarily an indicator of failure, however. Strategic alliances can be terminated after a few years simply because they have fulfilled their purpose; indeed, many alliances are intended to be of limited duration, set up to accomplish specific short-term objectives. Longer-lasting collaborative arrangements, however, may provide even greater strategic benefits. Alliances are more likely to be long-lasting when (1) they involve collaboration with partners that do not compete directly, (2) a trusting relationship has been established, and (3) both parties conclude that continued collaboration is in their mutual interest, perhaps because new opportunities for learning are emerging.

The Drawbacks of Strategic Alliances and Partnerships

While strategic alliances provide a way of obtaining the benefits of vertical integration, mergers and acquisitions, and outsourcing, they also suffer from some of the same drawbacks. Anticipated gains may fail to materialize due to an overly optimistic view of the synergies or a poor fit in terms of the combination of resources and capabilities. When outsourcing is conducted via alliances, there is no less risk of becoming dependent on other companies for essential expertise and capabilities—indeed, this may be the Achilles' heel of such alliances. Moreover, there are additional pitfalls to collaborative arrangements. The greatest danger is that a partner will gain access to a company's proprietary knowledge base, technologies, or trade secrets, enabling the partner to match the company's core strengths and costing the company its hard-won competitive advantage. This risk is greatest when the alliance is among industry rivals or when the alliance is for the purpose of collaborative R&D, since this type of partnership requires an extensive exchange of closely held information.

The question for managers is when to engage in a strategic alliance and when to choose an alternative means of meeting their objectives. The answer to this question depends on the relative advantages of each method and the circumstances under which each type of organizational arrangement is favored.

The principle advantages of strategic alliances over vertical integration or horizontal mergers/acquisitons are threefold:

1. They lower investment costs and risks for each partner by facilitating resource pooling and risk sharing. This can be particularly important when investment needs and uncertainty are high, such as when a dominant technology standard has not yet emerged.
2. They are more flexible organizational forms and allow for a more adaptive response to changing conditions. Flexibility is essential when environmental conditions or technologies are changing rapidly. Moreover, strategic alliances under such circumstances may enable the development of each partner's dynamic capabilities.
3. They are more rapidly deployed—a critical factor when speed is of the essence. Speed is of the essence when there is a winner-take-all type of competitive situation, such as the race for a dominant technological design or a race down a steep experience curve, where there is a large first-mover advantage.

The key advantages of using strategic alliances rather than arm's-length transactions to manage outsourcing are (1) the increased ability to exercise control over the partners' activities and (2) a greater willingness for the partners to make relationship-specific investments. Arm's-length transactions discourage such investments since they imply less commitment and do not build trust.

On the other hand, there are circumstances when other organizational mechanisms are preferable to alliances and partnering. Mergers and acquisitions are especially suited for situations in which strategic alliances or partnerships do not go far enough in providing a company with access to needed resources and capabilities. Ownership ties are more permanent than partnership ties, allowing the operations of the merger/acquisition participants to be tightly integrated and creating more in-house control and autonomy. Other organizational mechanisms are also preferable to alliances when there is limited property rights protection for valuable know-how and when companies fear being taken advantage of by opportunistic partners.

While it is important for managers to understand when strategic alliances and partnerships are most likely (and least likely) to prove useful, it is also important to know how to manage them.

How to Make Strategic Alliances Work

A surprisingly large number of alliances never live up to expectations. Even though the number of strategic alliances increases by about 25 percent annually, about 60 to 70 percent of alliances continue to fail each year. The success of an alliance depends on how well the partners work together, their capacity to respond and adapt to changing internal and external conditions, and their willingness to renegotiate the bargain if circumstances so warrant. A successful alliance requires real in-the-trenches collaboration, not merely an arm's-length exchange of ideas. Unless partners place a high value on the skills, resources, and contributions each brings to the alliance and the cooperative arrangement results in valuable win–win outcomes, it is doomed to fail.

While the track record for strategic alliances is poor on average, many companies have learned how to manage strategic alliances successfully and routinely defy these averages. Samsung Group, which includes Samsung Electronics, successfully manages an ecosystem of over 1,300 partnerships that enable productive activities from global procurement to local marketing to collaborative R&D. Companies that have greater success in managing their strategic alliances and partnerships often credit the following factors:

- *They create a system for managing their alliances.* Companies need to manage their alliances in a systematic fashion, just as they manage other functions. This means setting up a process for managing the different aspects of alliance management from partner selection to alliance termination procedures. To ensure that the system is followed on a routine basis by all company managers, many companies create a set of explicit procedures, process templates, manuals, or the like.

- *They build relationships with their partners and establish trust.* Establishing strong interpersonal relationships is a critical factor in making strategic alliances work since they facilitate opening up channels of communication, coordinating activity, aligning interests, and building trust.
- *They protect themselves from the threat of opportunism by setting up safeguards.* There are a number of means for preventing a company from being taken advantage of by an untrustworthy partner or unwittingly losing control over key assets. Cisco Systems, for example, does not divulge the source code for its designs to its alliance partners, thereby controlling the initiation of all improvements and safeguarding its innovations from imitation. Contractual safeguards, including noncompete clauses, can provide other forms of protection.
- *They make commitments to their partners and see that their partners do the same.* When partners make credible commitments to a joint enterprise, they have stronger incentives for making it work and are less likely to "free-ride" on the efforts of other partners. Because of this, equity-based alliances tend to be more successful than nonequity alliances.[28]
- *They make learning a routine part of the management process.* There are always opportunities for learning from a partner, but organizational learning does not take place automatically. Whatever learning occurs cannot add to a company's knowledge base unless the learning is incorporated systematically into the company's routines and practices.

Finally, managers should realize that alliance management is an organizational capability, much like any other. It develops over time, out of effort, experience, and learning. For this reason, it is wise to begin slowly, with simple alliances, designed to meet limited, short-term objectives. Short-term partnerships that are successful often become the basis for much more extensive collaborative arrangements. Even when strategic alliances are set up with the hope that they will become long-term engagements, they have a better chance of succeeding if they are phased in, so that the partners can learn how they can work together most fruitfully.

Strategic Thinking Capsule

Strategic Positioning of Indian Firms

Tata Motors, Mahindra and Mahindra, Hindalco, and Tata Steel have made big ticket overseas acquisitions. Even smaller firms like Renuka Sugars, Astral Coke, Jubilant Organosys, Videocon Industries, Godrej Consumer Products, and the UB group have made acquisitions of more than US$100 million. Our research shows that it is not that just large cap firms that can think of global ambitions, but firms in lower left quadrant are also global candidates provided they can decide on their distinctive competencies and remain focused.

The Tata Steel—Corus deal in 2006 is a significant milestone reflecting maturity of Indian enterprises. It is an effort to improve competitiveness of Tata Steel in European markets through low-cost intermediate products from India and converting them into high-value, sophisticated finished products. Aspirations to be a global player, superior complementary combinations, and greater hold over a geographic market are

> During 2005-08, Godrej Consumer Products bought three firms, one in the UK and two in South Africa. In 2010, it bought four, not including the buyout of Sara Lee Corp.'s stake in Godrej Sara Lee Ltd.

motivations which reflect a sense of supreme confidence to be globally competitive; a premise that is most essential to eventually become a multinational firm.[48]

Strategic Choices for Indian Firms[49]

In terms of strategic implications, more efficient but smaller Indian firms are most vulnerable as acquisition targets by global champions. These 'local' champions will provide cheaper and readymade access to huge Indian markets and also be an excellent base for outsourcing and global manufacturing for the acquiring companies. Earlier, we had the classic case of Thums Up being sold out by the Chauhans to Coca Cola and Godrej's soap-making assets bought out by alliance partner P&G. More recently, we had two cases where well-performing Indian companies were taken over by foreigners. The buyout of Delhi-based Indo Asian Fusegear by Legrand of France and Shanta Biotech by Sanofi are such examples, whereby the foreign entrant gets ready access to the Indian market in the electric switchgear and pharma businesses. In a nutshell, they are liable to be acquired at a premium by foreign and domestic companies, or can simply wither away in the face of competition.

Focus, Focus and Focus[50]

Unless firms focus on scale, scope, or competences, they will remain vulnerable.

Blend Technology with Innovation[51]

Here we must mention our penchant for jugaads. India abounds in local-level *jugaads.* These are functionally useful problem-solutions but usually physically dangerous and environmentally disastrous, and never patentable. For instance, we had a repaid job on our suitcase that made it almost new when all vendors said that this beyond repair. It cost us a fraction of a price that a new one would have. But over-emphasis of this approach on adaptations can drift a company from a path of patentable innovations. Equally, catchy management jargons such as 'bottom-of-pyramid' can severely handicap a firm from properly slicing (segmenting) the market and designing products to the customer profile.

The real test of competitiveness is a firm's export competitiveness. A hi-technology innovation should lead to greater exports and reduced customer negotiation power. This is an area where we have failed collectively! For last 60 years we have not been able to produce any 'global' product or service that enhances our image as a technology or knowledge-based economy. In several emerging and sunrise industries such as biotech, nuclear, renewable energy, aeronautics, consumer electronics, and pharmaceuticals, our firms have not yet started on the innovation curve (barring exceptions). Where are our own hi-technology small and medium enterprises which form the backbone of German export competitiveness? South Korea and Taiwan are leading-edge countries in consumer electronics, while China has moved rapidly ahead in renewable energy, automobiles, and electronics hardware and software.

A good indicator of our global competitiveness is the number of patents filed and rejected within the country. We are far behind on this parameter compared to developed nations and even some other Asian countries. Digging deeper, we have no figures for number of patents granted for the money (dollars) invested in R&D which indices the efficiency of our investments. The other useful statistic could be the Return on Investment on Technology (ROIT). This important statistic can help develop a better commercial understanding of various research projects.

The main reasons for our collective inability to develop new hi-tech innovations can be summarized as:

1. Too much differentiation between process and product innovations. In real commercial world these do not matter!
2. Low priority to engineering skills compared to managerial ones (in terms of monetary rewards and societal prestige)—leading to de-emphasis on systems-based problem-solving skills.

3. Poor or absent knowledge management in companies. The knowledge is individual-based and once the person retires or leaves the firm is stranded. An off-shoot of this mindset is the paucity of information in research journals and textbooks about innovations by Indian companies. Even today we depend on western world produced literature and case studies for our curriculum.
4. Poor or absent safeguarding structures and systems for the innovators. Often the research-minds are burdened with administrative duties, or worse, evaluated on normal bureaucratic parameters even in centers of excellence.

Poor overall results in hi-technology innovations are surprising and troubling at the same time. Pick up any issue of a major science or research-based journal, and one can find many Indians writing and contributing major pieces. In an issue of *Nature*, we counted at least 9 Indians (single largest community) who were reporting state-of-the-art research commentary in major papers on subjects as diverse as physics, astronomy, chemistry, biology, and pharma-genetics. It also showed that our much-maligned universities are, after-all, not so bad for producing top talent.

Implications for Corporate Strategy

The issue before the Indian business leadership is not (lack of) strategies, or level-playing field industry structure, or even government policy. It is purely a question of hunger and fire in the belly. Firms must define and articulate their aspirations in clear and simple terms. Our research points out that the aspirational and vision deficit in our firms is remarkable. We tend to get satisfied rather too quickly and by very few real achievements despite talent and potential. Sania Mirza is a classic example. Should our companies remain satisfied with World No. 32 (her career high ranking)? Or should they have Vishwanathan Anand and Saina Nehwal as role models?

This is a challenge for the strategic managers of 21st Century—how do we create structures and strategies that will take their firms into the next orbit.

Structure remains one of the most underrated and under-explored concepts in Indian corporate world. Organization theorists in the early 1900s gave great emphasis to the design of organizations. They understood that structure would determine the manner in which information flowed, and therefore define the power equations of employees. Somehow, in the latter half of the century, consultants took over and this important concept got subsumed in the sexy world of 'strategic thinking', 'global competition' and 'leadership'. While much has been written about various strategy- and finance-related causes of corporate sickness, we are yet to see a major research study on the impact of organizational structures on declining business performance.

Structure is not just some lines on a piece of paper (organogram) but governs individual space and roles. The physical man-made structure like a wall imposes boundaries and discipline on the incumbents, so that energies remain focused and in alignment with the organizational objectives.

A right design results in motivated, responsible employees that ultimately determines successful strategy execution. In the Internet age, information is available on real-time basis and knowledge and networks and this could be the only competitive advantage for an organization. Organizational design thus becomes much more complex compared to the simple hierarchical, functional, divisional, or even geographic structures.

Major innovations and newer technologies are developing now at the boundaries of new disciplines. The new emerging structures mean working in interdisciplinary *ad hoc* teams, global communities, and virtual networks. It goes beyond flat structures since control and supervision become major issues. We can see around us new research institutions that are bringing fresh structural and strategic re-alignments to harness and apply new scientific ideas. Two relevant examples are:

(a) The newly established Yale-NUS College (YNC) in Singapore is a collaboration between the National University of Singapore (NUS) and Yale University. It has been formed to develop high quality interdisciplinary talent at undergraduate levels. Students would be required to choose common curriculum courses in all areas of the natural sciences (including science, mathematics or computer science), social sciences (including psychology, economics), humanities and arts. Startup funds and continuing research funds would be made available. The College will not have disciplinary departments. Faculty is expected to work on research ideas cutting across disciplines.

(b) The Ph.D. Program in Systems Biology at Harvard Medical School is a cross-Harvard interdisciplinary program that attracts extraordinary graduate students. The department provides supportive environment for 'creative thinkers who take risks in defining and addressing important scientific problems in interdisciplinary sciences at the intersection of biology and medicine'.

In India too, something similar is shaping up at ISB-Mohali. The School will initially house four 'independent' Centers based on the 'cloud' concept, which potentially would allow synergistic confluence of ideas and knowledge through cross-fertilization. This in turn can lead to non-linear growth for each of the four Schools through co-existence, collaboration, and co-creation. The Schools can therefore create not only domain-based programmes, but also other short and long term programmes at across-specialization intersections.

India has high potential to become the Bay Area-Silicon Valley of Asia, but this requires that our organizations break free from the tyranny of existing mental and physical structures that chain our minds and bodies.

Questions:

1. Given that innovation for companies is important to be able to bring out differentiated products and services, how can Indian companies increase their innovation capability?
2. Is going global and innovation at structures the solution to above question? Justify.

Key Points

1. Once a company has settled on which of the five generic competitive strategies to employ, attention turns to how strategic choices regarding (1) competitive actions, (2) timing of those actions, and (3) scope of operations can complement its competitive approach and maximize the power of its overall strategy.
2. Strategic offensives should, as a general rule, be grounded in a company's strategic assets and employ a company's strengths to attack rivals in the competitive areas where they are weakest.
3. Companies have a number of offensive strategy options for improving their market positions: using a cost-based advantage to attack competitors on the basis of price or value, leapfrogging competitors with next-generation technologies, pursuing continuous product innovation, adopting and improving the best ideas of others, using hit-and-run tactics to steal sales away from unsuspecting rivals, and launching preemptive strikes. A blue-ocean type of offensive strategy seeks to gain a dramatic new competitive advantage by abandoning efforts to beat out competitors in existing markets and, instead, inventing a new industry or distinctive market segment that renders existing competitors largely irrelevant and allows a company to create and capture altogether new demand.
4. The purposes of defensive strategies are to lower the risk of being attacked, weaken the impact of any attack that occurs, and influence challengers to aim their efforts at other rivals. Defensive strategies to protect a company's position usually take one of two forms: (1) actions to block challengers and (2) actions to signal the likelihood of strong retaliation.
5. The timing of strategic moves also has relevance in the quest for competitive advantage. Company managers are obligated to carefully consider the advantages or disadvantages that attach to being a first mover versus a fast follower versus a wait-and-see late mover.

6. Decisions concerning the scope of a company's operations—which activities a firm will perform internally and which it will not—can also affect the strength of a company's market position. The *scope of the firm* refers to the range of its activities, the breadth of its product and service offerings, the extent of its geographic market presence, and its mix of businesses. Companies can expand their scope horizontally (more broadly within their focal market) or vertically (up or down the industry value chain system that starts with raw-materials production and ends with sales and service to the end consumer). Horizontal mergers and acquisitions (combinations of market rivals) provide a means for a company to expand its horizontal scope. Vertical integration expands a firm's vertical scope.
7. Horizontal mergers and acquisitions can strengthen a firm's competitiveness in five ways: (1) by improving the efficiency of its operations, (2) by heightening its product differentiation, (3) by reducing market rivalry, (3) by increasing the company's bargaining power over suppliers and buyers, and (5) by enhancing its flexibility and dynamic capabilities.
8. Vertical integration, forward or backward, makes strategic sense only if it strengthens a company's position via either cost reduction or creation of a differentiation-based advantage. Otherwise, the drawbacks of vertical integration (increased investment, greater business risk, increased vulnerability to technological changes, less flexibility in making product changes, and the potential for channel conflict) are likely to outweigh any advantages.
9. Outsourcing involves contracting out pieces of the value chain formerly performed in-house to outside vendors, thereby narrowing the scope of the firm. Outsourcing can enhance a company's competitiveness whenever (1) an activity can be performed better or more cheaply by outside specialists; (2) having the activity performed by others won't hollow out the outsourcing company's core competencies; (3) it streamlines company operations in ways that improve organizational flexibility, speed decision making, and cut cycle time; (4) it reduces the company's risk exposure; (5) it allows a company to access capabilities more quickly and improves its ability to innovate; and (6) it permits a company to concentrate on its core business and focus on what it does best.
10. Strategic alliances and cooperative partnerships provide one way to gain some of the benefits offered by vertical integration, outsourcing, and horizontal mergers and acquisitions while minimizing the associated problems. They serve as an alternative to vertical integration and mergers and acquisitions; they serve as a supplement to outsourcing, allowing more control relative to outsourcing via arm's-length transactions.
11. Companies that manage their alliances well generally (1) create a system for managing their alliances, (2) build relationships with their partners and establish trust, (3) protect themselves from the threat of opportunism by setting up safeguards, (4) make commitments to their partners and see that their partners do the same, and (5) make learning a routine part of the management process.

Assurance of Learning Exercises

1. Does it appear that Nintendo relies more heavily on offensive or defensive strategies as it competes in the video game industry? Has Nintendo's timing of strategic moves made it an early mover or a fast follower? Could Nintendo's introduction of the Wii be characterized as a blue-ocean strategy? You may rely on your knowledge of the video game industry and information provided at Nintendo's Investor Relations website (**www.nintendo.co.jp**) to provide justification for your answers to these questions. **LO 1, LO 2**
2. Using your university library's subscription to Lexis-Nexis, EBSCO, or a similar database, identify at least two companies in different industries that are using **LO 3**

mergers and acquisitions to strengthen their market positions. How have these mergers and acquisitions enhanced the acquiring companies' resources and competitive capabilities?

3. American Apparel, known for its hip line of basic garments and its provocative advertisements, is no stranger to the concept of "doing it all." Illustration Capsule 6.4 describes how American Apparel has made vertical integration a central part of its strategy. What value chain segments has American Apparel chosen to enter and perform internally? How has vertical integration aided the company in building competitive advantage? Has vertical integration strengthened its market position? Explain why or why not. **LO 4**
4. Perform an Internet search to identify at least two companies in different industries that have entered into outsourcing agreements with firms with specialized services. In addition, describe what value chain activities the companies have chosen to outsource. Do any of these outsourcing agreements seem likely to threaten any of the companies' competitive capabilities? **LO 5**
5. Using your university library's subscription to Lexis-Nexis, EBSCO, or a similar database, find two examples of how companies have relied on strategic alliances or joint ventures to substitute for horizontal or vertical integration. **LO 6**

Exercise for Simulation Participants

1. Has your company relied more on offensive or defensive strategies to achieve your rank in the industry? What options for being a first mover does your company have? Do any of these first-mover options hold competitive advantage potential? **LO 1, LO 2**
2. Does your company have the option to merge with or acquire other companies? If so, which rival companies would you like to acquire or merge with? **LO 3**
3. Is your company vertically integrated? Explain. **LO 4**
4. Is your company able to engage in outsourcing? If so, what do you see as the pros and cons of outsourcing? Are strategic alliances involved? Explain. **LO 5, LO 6**

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