**PAST EXAM PAPER MODEL ANSWERS**

**PART A**

**Not relevant for this year exam**

**PART B**

1. **Strategy is a firm’s theory about how to gain competitive advantage. Define competitive advantage. In your definition, distinguish between: temporary and sustainable competitive advantage, competitive parity and competitive disadvantage. Can competitive advantage be measured?**

**If so, how? Critically discuss this question.**

**Competitive advantage** means that there is something about a firm’s offering to the market that allows the firm to realize greater economic value than competitors (Harley-Davidson Motorcycles). Economic value is simply the difference between the perceived benefits gained by a customer that purchases a firm's products or services and the full economic cost of these products and services. This difference in economic value could come about in several different ways:

• it could be that the product offered or the way it is offered causes people to **prefer** it to the point that they are willing to pay a higher price for the product (Nordstrom)

• it could be that the firm has figured out a way to produce and distribute the product at a **lower cost** than competitors (Wal-Mart)

• a firm’s strategic choices and its implementation of those choices determine whether or not these differences will exist (K-Mart’s apparently failed attempts to move upscale)

• thus, competitive advantage stems from **preferences** and/or **cost advantages**

A **temporary competitive advantag**e is a competitive advantage that lasts a very short period of time while a **sustained competitive advantage** lasts much longer.

**Competitive parity** means that a firm and/or its output are viewed as being about the same as other firms, or in other words, about average in the marketplace. Firms facing a flat demand curve are at competitive parity. They are not viewed as being any better or worse than the average firm. Customers have no preference or aversion to the market offering of the firm.

A **competitive disadvantage** can occur for many reasons:

* potential customers may have an aversion (preference not to buy) to a firm’s market offering
* an unfavourable cost structure due to outdated and inefficient equipment and/or technology
* a bad reputation

If the firm or the firm’s output is viewed as being inferior to most other firms, almost anything could potentially become a source of competitive disadvantage.

The basic logic of measuring competitive advantage is that if a firm has one or more competitive advantages we should find evidence of that advantage in the performance of the firm.

It is sometimes difficult to directly link the performance of a firm to the firm’s competitive advantage. It is often easy to see that a firm is achieving superior performance, but it may be difficult to trace that superior performance to a specific competitive advantage. Even if we can trace superior performance to a specific competitive advantage it remains nearly impossible to measure and quantify the competitive advantage itself. Rather we are left to use the firm’s performance as a proxy measure of the firm’s competitive advantage. If there are several potential sources of competitive advantage within a firm, then the measurement issue becomes even more inexact.

**3. Under which conditions would it be more appropriate for a firm to enter into a strategic alliance rather than pursue a corporate strategy of either ‘going it alone’ or acquisitions? Which tools could a firm use to pre-empt or prevent the misappropriation of value within an alliance?**

Appropriateness of strategic alliances over other corporate strategies

Firms “go it alone” when they attempt to develop all the resources and capabilities they need to exploit market opportunities and neutralize market threats by themselves. Sometimes “going it alone” can create the same - or even more - value than using alliances to exploit opportunities and neutralize threats. In these settings, “going it alone” is a substitute for a strategic alliance. However, in other settings, using an alliance can create substantially more value than “going it alone.” In these settings, “going it alone” is not a substitute for a strategic alliance. In general alliances will be preferred to going it alone when

1. The level of transaction-specific investment required to complex an exchange is moderate.
2. When an exchange partner possesses valuable, rare, and costly-to-imitate resources and capabilities.
3. When there is great uncertainty about the future value of an exchange.

The acquisition of other firms can be a substitute for alliances. In this case, rather than developing a strategic alliance or attempting to develop and exploit the relevant resources by “going it alone,” a firm seeking to exploit opportunities may simply acquire another firm that already possesses the relevant resources and capabilities. The four conditions under which alliances will be preferred to acquisitions include:

1. There are legal constraints on acquisitions.
2. Acquisitions limit a firm's flexibility under conditions of high uncertainty.
3. There is substantial unwanted organizational "baggage" in an acquired firm.
4. The value of a firm's resources and capabilities depends on its interdependence.

**Tools firms to pre-empt or prevent the misappropriation of value within an alliance**

This requires an initial brief outline of the types of misappropriating behaviour that can occur in the context of an alliance:

**Adverse Selection** (contributions to the alliance) **-**

Potential partners misrepresent the value of the skills & abilities they propose to bring to the alliance (esp. intangibles)

**Moral Hazard** (performance within the alliance) **-**

* + Partners provide to the alliance skills and abilities of lower quality than they promised

**Holdup** (allocating the value created in the alliance)

-When a firm that has not made significant investment in the alliance demands returns from the alliance that are higher than what was initially agreed between the partners

**Contracts.** One way to avoid cheating in strategic alliances is for parties to an alliance to anticipate the ways in which cheating may occur (including adverse selection, moral hazard, and holdup) and to write explicit contracts that define legal liability if cheating does occur. Writing these contracts, together with the close monitoring of contractual compliance and the threat of legal sanctions, can reduce the probability of cheating.

**Equity investments.** The effectiveness of contracts can be enhanced by having partners in an alliance make equity investments in each other so that if one of the partners to an alliance cheats, they will negatively impacted through their equity investment in their partner.

**Firm reputations.** Information about an alliance partner that has cheated is likely to become widely known. A firm with a reputation as a cheater is not likely to be able to develop strategic alliances with other partners in the future, despite any special resources or capabilities that it might be able to bring to an alliance. In this way, cheating in a current alliance may foreclose opportunities for developing valuable alliances. For this reason, firms may decide not to cheat in their current alliances.

**Joint ventures.** Creating a separate legal entity, in which alliance partners invest and from whose profits they earn returns on their investments, reduces some of the risks of cheating in strategic alliances. When a joint venture is created, the ability of partners to earn returns on their investments depends on the economic success of the joint venture. Partners in joint ventures have limited interests in behaving in ways that hurt the performance of the joint venture, because such behaviors end up hurting themselves. Moreover, unlike reputational consequences of cheating, cheating in a joint venture does not just foreclose future alliance opportunities; it can hurt the cheating firm in the current period as well.

**Trust.** Trust, in combination with contracts, can help reduce the threat of cheating. More important, trust may enable partners to explore exchange opportunities that they could not explore if only legal and economic organizing mechanisms were in place.

**4. Discuss how cost leadership as a business-level strategy may help to neutralize each of the major threats in an industry.**

**Cost leadership helps neutralize each of the major threats in an industry viz.**

* **Threat of Entry.** A cost-leadership competitive strategy helps reduce the threat of new entrants by creating cost‑based barriers to entry such as economies of scale and cost advantages independent of scale.
* **Threat of Rivalry**. Firms with a low-cost position also reduce the threat of rivalry. The threat of rivalry is reduced through pricing strategies that low-cost firms can engage in and through their relative impact on the performance of a low-cost firm and its higher-cost rivals. First, these firms can set their prices equal to the prices of higher-cost competitors. Second, low-cost firms can price their goods or services slightly below the prices of their high-cost rivals.
* **Threat of Substitutes.** Substitutes become a threat to a firm when their cost and performance, relative to a firm's current products or services, become more attractive to customers. Cost leaders have the ability to keep their products and services attractive relative to substitutes.
* **Threat of Suppliers.** Suppliers can become a threat to a firm by charging higher prices for the goods or services they supply or by reducing the quality of those goods or services. However, when a supplier sells to a cost leader, that firm has greater flexibility in absorbing higher-cost supplies than does a high-cost firm.
* **Threat of Buyers.** Powerful buyers are a threat to firms when they insist on low prices or higher quality and service from their suppliers. Lower prices threaten firm revenues; higher quality can increase a firm's costs. Cost leaders can have their revenues reduced by buyer threats and still earn normal or above-normal performance. These firms can also absorb the greater costs of increased quality or service and may still have a cost advantage over their competition. Cost leaders can also reduce the threat of buyers by deterring backward vertical integration, and through large volumes of production.

A single source of cost advantage may be valuable for multiple reasons (i.e., it neutralizes more than one threat). It is important to signal a cost advantage as the ability of a cost advantage to neutralize threats often depends on other firms knowing about the cost advantage. Firms have strong incentives to compete vigorously on cost because of the many sources of value associated with a cost leadership position.

1. **Discuss the differences between mergers and acquisitions and differentiate between friendly and unfriendly acquisitions. Why might a bidding firm still engage in acquisitions even if, on average, the acquisitions do not create value for the bidding firm's stockholders? Critically discuss this question.**

A firm engages in an **acquisition** when it purchases a second firm. An acquiring firm can use cash it has generated from its ongoing businesses to purchase a target firm, it can go into debt to purchase a target firm, it can use its own equity to purchase a target firm, or it can use a mix of these mechanisms to purchase a target firm. Also, an acquiring firm can purchase all of a target firm’s assets, it can purchase a majority of those assets (greater than 51%), or it can purchase a controlling share of those assets (i.e., enough assets so that the acquiring firm is able to make all the management and strategic decisions in the target firm). Acquisitions can be **friendly** (when the management of the target firm wants to be acquired) or **unfriendly** (when the management of the target firm does not want to be acquired). Some unfriendly acquisitions are also known as hostile takeovers. When the assets of two similar sized firms are combined, this transaction is called a **merger**.

Possible motivations to engage in mergers and acquisitions even though they do not generate profits for bidding firms include:

**To ensure survival.** Even if mergers and acquisitions, on average, generate only zero economic profits for bidding firms, it may be necessary for bidding firms to engage in these activities, to ensure their survival. In particular, if all of a bidding firm’s competitors have been able to improve their efficiency and effectiveness through a particular type of acquisition, then failing to make such an acquisition may put a firm at a competitive disadvantage. Here, the purpose of a merger or acquisition is not to gain competitive advantages but rather to gain competitive parity.

**To invest free cash flow.** Free cash flow is simply the amount of cash a firm has to invest after all positive net present-value investments in a firm’s ongoing businesses have been funded. Free cash flow is created when a firm’s ongoing business operations are very profitable but offer few opportunities for additional investment. In this context, merger and acquisition strategies are a viable option, for bidding firms, on average, can expect to generate at least competitive parity. Put differently, while mergers and acquisitions may not be a source of superior profits, there are worse things you could do with your free cash flow.

**Agency problems.** Another reason why firms might continue to engage in mergers and acquisitions, despite earning only competitive parity from doing so, is that mergers and acquisitions benefit managers directly, independent of any value they may or may not create for a bidding firm’s stockholders. Merger and acquisition strategies can benefit managers - even if they do not directly benefit a bidding firm’s equity holders - in at least two ways. First, managers can use mergers and acquisitions to help diversify their human capital investments in their firm. Second, managers can use mergers and acquisitions to quickly increase firm size, measured in either sales or assets. If management compensation is closely linked to firm size, managers who increase firm size are able to increase their compensation.

**Managerial hubris.** Managers can fall victim to managerial hubris or the unrealistic belief, held by managers in bidding firms, that they can manage the assets of a target firm more efficiently than can the target firm’s current management. This notion can lead bidding firms to engage in acquisition strategies even though there may not be positive economic profits from doing so.

**The potential for above-normal profits**. A final reason why managers might continue to pursue merger and acquisition strategies is the potential that these strategies offer for generating profits for at least some bidding firms. The empirical research on returns to bidding firms in mergers and acquisitions is very strong. On average, bidding firms do not gain profits from their merger and acquisition strategies. However, just because bidding firms, *on average,* do not earn profits on these strategies does not mean that all bidding firms will always fail to earn profits. In some situations bidding firms may be able to gain competitive advantages from merger and acquisition activities.

The first four reasons have a somewhat negative connotation in that each suggests that managers lack a truly value creating strategy that will benefit shareholders. The final reason seems to be the one that makes the most strategic sense from the point of view of shareholders.