PART 1
Strategy Analysis

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CHAPTER 1

What Is Strategy and Why Is It Important?

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

LO 1-1 Define competitive advantage, sustainable competitive advantage, competitive disadvantage, and competitive parity.

LO 1-2 Define strategy and explain its role in a firm's quest for competitive advantage.

LO 1-3 Explain the role of firm effects and industry effects in determining firm performance.

LO 1-4 Describe the role of corporate, business, and functional managers in strategy formulation and implementation.

LO 1-5 Outline how business models put strategy into action.

LO 1-6 Describe and assess the opportunities and challenges managers face in the 21st century.

LO 1-7 Critically evaluate the role that different stakeholders play in the firm's quest for competitive advantage.

CHAPTERCASE 1

The Premature Death of a Google Forerunner at Microsoft

IN 1998, 24-year-old Sergey Brin and 25-year-old Larry Page founded Google. They met as graduate students in computer science at Stanford University, where they began working together on a web crawler, with the goal of improving online searches. What they developed was the PageRank algorithm, which returns the most relevant web pages more or less instantaneously and ranks them by how often they are referenced on other important web pages. A clear improvement over early search engines such as AltaVista, Overture, and Yahoo, all of which indexed by keywords, the PageRank algorithm is able to consider 500 million variables and 3 billion terms. What started as a homework assignment launched the two into an entrepreneurial venture when they set up shop in a garage in Menlo Park, California.

Today, Google is the world's leading online search and advertising company, with some 70 percent market share of an industry estimated to be worth more than $25 billion a year, and that is growing quickly. Though Yahoo is a distant second with less than 20 percent share, in 2008 Microsoft's CEO Steve Ballmer offered to buy the runner-up for close to $50 billion to help his company gain a foothold in the paid-search business where Google rules. Yahoo turned down the offer.

What haunts Ballmer is that Microsoft actually had its own working prototype of a Google forerunner, called Keywords, more than a decade earlier. Scott Banister, then a student at the University of Illinois, had come up with the idea of adding paid advertisements to Internet searches. He quit college and drove his Geo hatchback to the San Francisco Bay Area to start Keywords, later joining an online ad company called LinkExchange. In 1998, Microsoft bought LinkExchange for some $265 million (about one–two-hundredth the price it would later offer for Yahoo). LinkExchange's managers urged Microsoft to invest in Keywords. Instead, Microsoft executives shut down LinkExchange in 2000 because they did not see a viable business model in it. One LinkExchange manager actually approached Ballmer himself and explained that he thought Microsoft was making a mistake. But Ballmer said he wanted to manage through delegation and would not reverse a decision made by managers three levels below him. Thus ended Microsoft's first online advertising venture.

In 2003, Microsoft got a second chance to enter the online advertising business when some of its mid-level managers proposed buying Overture Services, an innovator in combining Internet searches with advertisements. This time, Ballmer, joined by Microsoft's co-founder Bill Gates, decided not to pursue the idea because they thought Overture was overpriced. Shortly thereafter, Yahoo bought Overture for $1.6 billion.

Having missed two huge opportunities to pursue promising strategic initiatives that emerged from lower levels within the firm, Microsoft has been playing catch-up in the paid-search business ever since. In the summer of 2009, it launched its own search engine, Bing. Microsoft's new search engine will also power Yahoo searches, after the two announced a strategic alliance. These two strategic moves helped Microsoft increase its share in the lucrative online search business to roughly

25 percent, up from just over 8 percent. It remains an open question whether this is sufficient, however, to challenge Google's dominance. In particular, Bing's increase in market share of online searches is obtained at the expense of Yahoo's, and not Google's, market share.[1]

After reading the chapter, you will find more about this case, with related questions, on page 21.

▲ **HOW DID A STARTUP** by two college students outperform Microsoft, one of the world's leading technology companies, in online search and advertising? Why is Google successful in the online search business while Yahoo is struggling? For that matter, why is any company successful? What enables some firms to gain and then sustain their competitive advantage over time? Why do once-great firms fail? How can a firm's managers influence performance?

Answering these questions requires integrating the knowledge you've obtained in your studies of different business disciplines (such as accounting, finance, economics, marketing, operations, IT management, organizational behavior, and human resource management) to understand what leads to superior performance. **Strategic management,** the topic of this course and this book, is the integrative management field that combines analysis, formulation, and implementation in the quest for competitive advantage. The AFI strategy framework shown on the part-opening page (page 1) embodies this view of strategic management. In this chapter, we lay the groundwork for the study of strategic management by introducing some foundational ideas about strategy and competitive advantage, and by looking at the components of the AFI framework.

WHAT STRATEGY IS: GAINING AND SUSTAINING COMPETITIVE ADVANTAGE

>> **LO 1-1**
Define competitive advantage, sustainable competitive advantage, competitive disadvantage, and competitive parity.

The desire to perform better than our competitors applies to nearly every area of our lives. Universities compete for the best students and professors. Startup firms compete for financial and human capital. Existing companies compete for future growth, and employees compete for raises and promotions. University professors compete for research grants, and college students for jobs and graduate school admission. Political candidates compete for votes, and charities for contributions.

In every competitive situation, the winners are generally those with the better strategy. In general terms, *strategy* is the planned and realized set of actions a firm takes to achieve its goals. For instance, the general manager of the Oakland A's, Billy Beane, applied a sophisticated analysis to formulate and implement a new strategy.[2] Beane began by devising new metrics to assess a player's potential and performance more accurately. These metrics, in turn, allowed the Oakland A's to field a low-cost team that could compete against much richer rivals in Major League Baseball. Taken together, strategy governs the ubiquitous quest for superior performance.

What Is Competitive Advantage?

A firm that formulates and implements a strategy that leads to superior performance relative to other competitors in the same industry or the industry average has a **competitive advantage.** Google has a competitive advantage over Microsoft, Yahoo, and others competing in the online search and advertising business. A firm that is able to outperform its competitors or the industry average over a prolonged period of time has a

sustainable competitive advantage.[3] It appears that Google has a sustainable competitive advantage, because it has outperformed its rivals consistently over time. Yet, past performance is no guarantee of future performance. Microsoft, Yahoo, and others are working hard to neutralize Google's competitive advantage.

In both business and sports, strategy is about outperforming one's rivals. Identifying the winner in a sporting event, however, is relatively easy. In 2011, the University of Connecticut Huskies won the NCAA basketball championship, beating the Butler University Bulldogs 54-41 in the title game. We could say that the UConn Huskies gained a temporary competitive advantage. To answer the question of who has a *sustainable* competitive advantage, however, is a bit trickier. Here, we need to look at the recent history of tournaments. If we say, for example, that 10 years is an appropriate time period over which to assess the sustainability of competitive advantage (2002–2011), then we find that seven teams were victorious: the University of Connecticut, the University of Florida (Gators), and the University of North Carolina at Chapel Hill (Tar Heels) each two times; and Duke University, the University of Kansas, Syracuse University, and the University of Maryland each one time. We could argue that over this 10-year period the Huskies, the Gators, and the Tar Heels enjoyed a sustainable competitive advantage over other NCAA teams. Since competitive advantage needs to be assessed relative to other competitors, we can only say that the Huskies, Gators, and Tar Heels, although outperforming the other contenders, performed at a similarly high level. This example shows that assessing competitive advantage, let alone sustainable competitive advantage, is not an easy task.

In business, we have no *absolute* measure of performance for competitive advantage as we do for height or weight or NCAA tournament victories. Rather, we compare performance to a benchmark, either the performance of other firms in the same industry or an industry average. If a firm underperforms its rivals or the industry average, for instance, it has a **competitive disadvantage.** A 15 percent return on invested capital (RoIC) may sound like superior firm performance, but in the energy industry where the average RoIC has been above 20 percent the last few years, it is actually a competitive disadvantage. In contrast, if a firm's RoIC is 5 percent in a commodity industry like steel, where the industry average is 1–2 percent, then the firm has a competitive advantage. Should two or more firms perform at the same level, they have **competitive parity.**

If other companies can easily imitate a firm's source of competitive advantage, then any edge the firm gains is short-lived. But if the advantage is difficult to understand or imitate, the firm can sustain it over time. Patents, for example,

strategic management An integrative management field that combines analysis, formulation, and implementation in the quest for competitive advantage.

competitive advantage Superior performance relative to other competitors in the same industry or the industry average.

sustainable competitive advantage Outperforming competitors or the industry average over a prolonged period of time.

competitive disadvantage Underperformance relative to other competitors in the same industry or the industry average.

competitive parity Performance of two or more firms at the same level.

often protect certain products from direct imitation for a period. Pfizer's Lipitor, a patent-protected cholesterol-lowering drug, is the best-selling prescription drug ever, grossing some $14 billion dollars in revenues each year between 2006 and 2009.[4] This highly successful product contributed to a competitive advantage for Pfizer, accounting for roughly one-third of its total annual revenues.[5] The patent on Lipitor expired in 2010, however, allowing generic drug makers to copy the drug and offer it at much lower prices, eroding Pfizer's competitive advantage.

What Is Strategy?

>> **LO 1-2**
Define strategy and explain its role in a firm's quest for competitive advantage.

Strategy describes the goal-directed actions a firm intends to take in its quest to gain and sustain competitive advantage.[6] The firm that possesses competitive advantage provides superior value to customers at a competitive price or acceptable value at a lower price. Profitability and market share are the consequences of superior value creation. Henry Ford was driven by his ambition to mass-produce a reliable car at a low cost. Larry Page and Sergey Brin were motivated to create a better search engine. For Ford, Page, and Brin, and numerous other businesspeople, making money was the *consequence* of providing a product or service consumers wanted. The important point here is that strategy is about creating superior value, while containing the cost to create it. The greater the difference between value creation and cost, the greater the economic contribution the firm makes, and thus the greater the likelihood for competitive advantage.

Strategy is not, however, a zero-sum game—it's not always the case that one party wins while all others lose. Many strategic successes are accomplished when firms or individuals cooperate with one another.[7] Even direct competitors cooperate occasionally, to create win–win scenarios. When competitors cooperate with one another to achieve strategic objectives, we call this **co-opetition.**[8] The new Cell microprocessor, which powers the PlayStation 3 game console, was the result of a collaborative effort among IBM, Toshiba, and Sony—companies that directly compete with one another in other markets.

We've noted that to gain a competitive advantage, a firm needs to provide either goods or services consumers value more highly than those of its competitors, or goods or services similar to the competitors' but at a lower price. The essence of strategy, therefore, is being different from rivals and thus unique. Managers accomplish this difference through *strategic positioning,* staking out a unique position in an industry that allows the firm to provide value to customers, while controlling costs.

Strategic positioning requires trade-offs, however. As a low-cost retailer, JCPenney has a clear strategic profile and serves a specific market segment. Upscale retailer Neiman Marcus also has built a clear strategic profile by providing superior customer service to a specific (luxury) market segment. While the companies are in the same industry, their respective customer segments overlap very little, if at all, and thus they are not direct competitors. To keep it that way, their managers must make conscious trade-offs that enable both to strive for competitive advantage in the same industry.

strategy The goal-directed actions a firm intends to take in its quest to gain and sustain competitive advantage.

co-opetition Cooperation by competitors to achieve a strategic objective.

As emphasized by Michael Porter of Harvard Business School, strategy is as much about deciding what *not* to do, as it is about deciding what to do. Because the supply of resources is not unlimited, managers must carefully consider their business strategy choices in their quest for competitive advantage. Trying to be everything to everybody would be a recipe for inferior performance. For example, to ward off successful low-cost entrants like Southwest Airlines (SWA), Continental and Delta added low-cost Continental

Lite and Delta's Song to their core hub-and-spoke businesses. Their managers fell prey to the illusion that they could straddle a low-cost leadership position (already well-executed by SWA) and their existing differentiation strategy of serving a large number of destinations. Both new ventures failed because they left Continental and Delta *stuck in the middle*, leading to inferior performance in both markets. (We'll consider different business strategies in more depth in Chapter 6.)

Strategy as a Theory of How to Compete

A firm's strategy can be seen as its managers' theory about how to gain and sustain competitive advantage. A *theory* answers the questions, what causes what and why?[9] It's a contingent statement based on assumptions about how the world works. Based on the law of gravity, for example, we can predict what will happen if you drop something out the window—without your having to do it to find out. As the old adage goes, nothing is more practical than a good theory. Based on their assumptions about competitive conditions—that is, the relative value of their firm's resources and capabilities as compared to those of their collaborators and competitors, predictions about the actions that competitors may initiate, and the development of trends in the external environment—managers express their theory of how to gain and sustain competitive advantage in the strategy they set for the firm.[10] As we will see in Chapters 3 and 4, a firm can gain competitive advantage by leveraging its internal resources, capabilities, and relationships to exploit opportunities in its external environment.

Strategy as a *theory of how to compete* provides managers with a roadmap to navigate the competitive territory. The more accurate the map, the better strategic decisions managers can make. In the competitive world, managers test their theories in the marketplace. Positive feedback validates managers' strategic assumptions: "iPhone sales vastly exceeded expectations, so it must have been the right product at the right time." Negative feedback allows managers to adjust their assumptions: "The Apple Newton flopped [in 1993], so its price—over $1,000 in today's dollars—and bulkiness weren't right for the PDA market at that time." The Newton's failure, however, laid the foundation for later successes such as Apple's iPhone and the iPad. Competitors also learned from the Newton debacle: They subsequently introduced improved products, including Palm's Pilot, Handspring's Visor, and RIM's BlackBerry, at a lower price. A firm's relative performance in the competitive marketplace provides managers with the necessary feedback to assess how well their strategy works in their quest for competitive advantage. *The strategic management process, therefore, is a never-ending cycle of analysis, formulation, implementation, and feedback.*

Walmart became the world's largest retailer in part due to founder Sam Walton's accurate assumptions about the connection between low retail prices in underserved rural and suburban areas and high volume, thus generating the ability to be the low-price leader in mass-merchandising.[11] His insight of how to do things differently in the retail industry created a competitive advantage for his firm. Later, Walmart reinforced its competitive advantage with a revolutionary IT system that tracks sales in real time and allows just-in-time deliveries. For the year 2008, one of the worst stock performance years on record, the Dow Jones Industrial Average fell 34 percent, yet Walmart's shares actually rose 18 percent, outperforming the average of the 30 blue-chip firms by 52 percentage points. The reason? When managers align their assumptions closely with competitive realities, they can draft and implement a successful strategy that yields superior firm performance. Walmart's cost leadership strategy became even more valuable in a time of economic hardship.

In contrast, when managers' theories of how to gain and sustain competitive advantage do not reflect reality, their firm's strategy will destroy rather than create value and will lead to inferior performance. The U.S. auto manufacturers Chrysler, Ford, and GM have fallen on hard times partly because their managers built their strategies around the flawed assumptions that gasoline prices would remain low and U.S. drivers would continue to want big trucks and sport utility vehicles. These were also the only vehicles that U.S. car manufacturers, given their inflated cost structure, could sell at a profit. The Ford F-150 pickup truck is the most-sold vehicle of all time in the United States, and the Hummer (about 8 miles per gallon) was once one of GM's most profitable vehicles. When gas prices rose above $4 per gallon in the summer of 2008 (up from less than $2.50 a gallon just a year earlier), consumer preferences for more fuel-efficient and "green" cars increased.

Meanwhile, in Japan where gas prices have always been high, Toyota's managers had begun to think as early as the 1990s about how fuel efficiency and possible regulation would influence consumer behavior. So while Toyota provided large SUVs and pickup trucks to meet U.S. market demand, it also developed hybrid vehicles to compete in an environment of increased regulation, higher gas prices, and heightened consumer concerns about the ecological impact of gas-guzzling cars. In 1997, Toyota launched the Prius (60 miles per gallon), which has since sold more than 2 million units. Because the strategies of U.S. car manufacturers were based on flawed assumptions and each manufacturer had long-term resource commitments that were not easily reversible, U.S. car manufacturers did not have a competitive fuel-efficient (or hybrid) vehicle.[12] The poor financial performance that followed was the logical consequence of a strategy that no longer fit the competitive realities. In 2009, both GM and Chrysler filed for bankruptcy. Engineering a shrewd strategic turnaround, Ford (which, by the way, did not receive a government bailout) is experiencing a resurgence.[13]

firm effects The results of managers' actions to influence firm performance.

industry effects The results attributed to the choice of industry in which to compete.

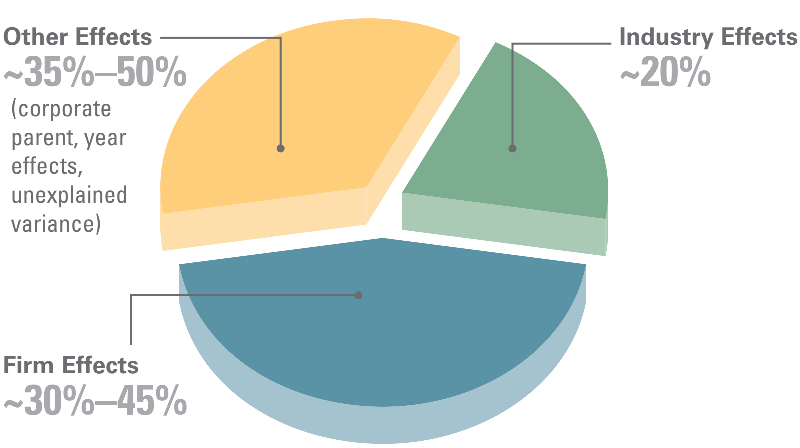
Industry vs. Firm Effects in Determining Performance

Managers' actions tend to be more important in determining firm performance than the forces exerted upon the firm by its external environment. Thus, **firm effects**—the results of managers' actions to influence firm performance—tend to have more impact than **industry effects**—the results attributed to the choice of industry in which to compete.[14] Based on a number of empirical studies, academic researchers found that the industry a firm is in determines about 20 percent of a firm's profitability, while the firm's strategy within a given industry explains between 30–45 percent of its performance.[15] These findings are depicted in Exhibit 1.1. Although a firm's industry environment is not quite as important as the firm's strategy within its industry, they jointly determine the firm's overall performance.

Astute managers create superior performance through strategy.

EXHIBIT 1.1

Industry, Firm, and Other Effects Explaining Superior Firm Performance



They leverage a company's strengths while mitigating its weaknesses. They turn external threats into opportunities. Strategy generally requires making important trade-offs (think low-cost Kia versus luxury Ferrari in the car industry). Indeed, some of the biggest advances in competitive positioning have been accomplished when managers resolved apparent trade-offs. Toyota introduced lean manufacturing to resolve the trade-off between quality and cost. This process innovation allowed Toyota to produce higher-quality cars at a lower unit cost, and to perfect the mass customization of cars. Lean manufacturing, over time, has become a necessary but not sufficient condition for competitive advantage in the auto industry. Today, if a carmaker can't produce high-quality, mass-customized cars at low cost, it is not even in the game. More recently, Toyota stumbled as questions arose whether the company could maintain its stellar quality record while growing so fast. Korea's Hyundai stepped into this void, offering cars that surpass Toyota in quality while attempting to provide luxury similar to Lexus vehicles.[16] Hyundai's managers carved out a strong strategic position for the company by focusing on resolving the trade-offs between luxury, quality, and cost. The ups and downs in the car industry clearly show that competitive advantage is transitory. It is a difficult quest to gain competitive advantage; it is even more difficult to sustain it. The tools of strategic management aid managers in this important challenge.

>> **LO 1-3**
Explain the role of firm effects and industry effects in determining firm performance.

What Strategy Is *Not*

To gain a deeper understanding of what strategy is, it is helpful to know what strategy is *not*.[17] You will hear many people today refer to a host of different plans and activities as pricing strategy, Internet strategy, alliance strategy, operations strategy, IT strategy, brand strategy, marketing strategy, HR strategy, and so on. While all these elements may be *part* of a firm's functional strategy to support its business model (see the next section), we will reserve the term *strategy* for describing the firm's overall efforts to *gain and sustain competitive advantage.*

Nor is competitive benchmarking "strategy." Best-in-class practices such as just-in-time inventory, enterprise resource planning (ERP) systems, and Six Sigma quality initiatives all fall under the umbrella of *tools* for operational effectiveness. Being best-in-class is a sufficient but not a necessary condition for competitive advantage. Take this idea to its extreme in a quick thought experiment: If all firms in the same industry pursued Six Sigma in the same fashion, all would have identical cost structures and none could gain a competitive advantage. Indeed, competition would be cut-throat because all firms would be more or less the same, but very efficient. Everyone would be running faster, but nothing would have changed in relative strategic positions.

Rather than focusing on copying a competitor, the key to successful strategy is to combine a set of activities to stake out a unique position in an industry. Competitive advantage has to come from performing activities differently than rivals do. Operational effectiveness, marketing skills and other functional expertise, along with best practice contribute to a unique strategic position, but by themselves they are not a substitute for strategy. Exhibit 1.2 summarizes the concept of strategy.

EXHIBIT 1.2

What Is Strategy?

Definition: *Strategy is the quest to gain and sustain competitive advantage.*

- It is the managers' theories about how to gain and sustain competitive advantage.
- It is about being different from your rivals.
- It is about creating value while containing cost.
- It is about deciding what to do, and what *not* to do.
- It combines a set of activities to stake out a unique position.
- It requires long-term commitments that are often not easily reversible.

FORMULATING STRATEGY ACROSS LEVELS: CORPORATE, BUSINESS, AND FUNCTIONAL MANAGERS

>> **LO 1-4**
Describe the role of corporate, business, and functional managers in strategy formulation and implementation.

Strategy formulation concerns the choice of strategy in terms of *where* and *how* to compete. To understand the interdependencies across different levels, it is helpful to break down strategy formulation into three distinct levels: corporate, business, and functional.

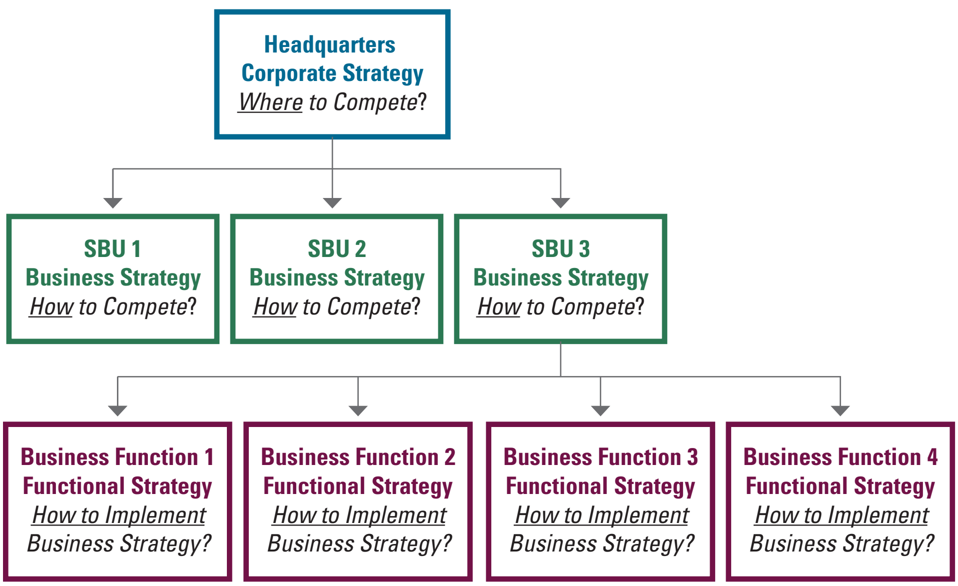
Corporate strategy involves decisions made at the highest level of the firm about *where* to compete. *Corporate executives* need to decide in which industries, markets, and geographies their company should compete, as well as how they can create synergies across business units that may be quite different. They are responsible for setting overarching strategic goals and allocating scarce resources, among the different business divisions, monitoring performance, and making adjustments to the overall portfolio of businesses when needed. Corporate executives determine the scope of the business, deciding whether to enter certain industries and markets and whether to sell certain divisions. The objective of corporate-level strategy is to increase overall corporate value. Over the last 20 years, due to a new corporate-level strategy, IBM's CEO Sam Palmisano and his predecessors have transformed IBM from a hardware company to a global IT services firm. It even sold its PC unit to Lenovo, a Chinese high-tech company as part of the transformation process.

Exhibit 1.3 shows that corporate strategy is formulated at headquarters, and that *business strategy* occurs within **strategic business units,** the standalone divisions of a larger conglomerate, each with its own profit-and-loss responsibility. *General managers* in strategic business units (SBUs) must answer the strategic question of *how* to compete in order to achieve superior performance within the business unit. Currently, for example, IBM has four strategic business units or divisions: hardware, software, technology services, and financing. General managers are responsible for formulating a strategic position for their business unit. The technology services SBU at IBM is led by a senior vice president, who has profit-and-loss responsibility for IBM's technology services worldwide. The same goes for the heads of the other three SBUs at IBM.

strategic business unit (SBU) A standalone division of a larger conglomerate, with its own profit-and-loss responsibility.

EXHIBIT 1.3

Strategy Formulation and Implementation Across Levels: Corporate, Business, and Functional Strategy



Within each SBU are various business *functions* such as accounting, finance, human resources, information technology, product development, operations, marketing, and customer service. Each *functional manager* is responsible for decisions and actions within a single functional area that aid in the implementation of the business-level strategy. A manager in IBM's product-development function, for example, may be responsible for encouraging new product offerings. The set of functional strategies enables the general managers of the SBUs to pursue their respective business-level strategy, which in turn needs to be in line with the overall corporate-level strategy.

Functional managers, who are closer to the final products, services, and customers than managers at higher levels, may sometimes be able to come up with strategic initiatives that may influence the direction of the company. One functional manager at IBM, for instance, suggested entry into the life sciences field.[18] In 2000, she saw a business opportunity for IBM, in which application of high-performance computing and information technology could solve thorny problems that accompanied data-intensive work such as decoding human genomes and furthering personalized medicine. IBM's general and corporate managers supported this strategic initiative, dubbed "information-based medicine."[19] This new business opportunity generated more than $5 billion in revenue by 2006.

BUSINESS MODELS: PUTTING STRATEGY INTO ACTION

>> **LO 1-5**
Outline how business models put strategy into action.

We've said that strategy denotes the managers' theories of how to compete, but theory alone is useless if it is not put into action. The translation of strategy into action takes place in the firm's **business model,** which details the firm's competitive tactics and initiatives. Simply put, the firm's business model explains how the firm intends to make money. If it fails to translate a strategy into a profitable business model, the firm will cease to exist. To come up with a business model, the firm first transforms its theory of how to compete into a blueprint of actions and initiatives that support the overarching strategy. In a second step, the organization implements this blueprint through structures, processes, culture, and procedures.

The so-called *razor–razor-blade business model* is a famous example. The idea is to give away or sell for a small fee the product and make money on the replacement part needed. As the name indicates, it was invented by Gillette, which gave away its razors and sold the replacement cartridges for relatively high prices. The razor–razor-blade model is found in many business applications today. For example, HP charges very little for its laser printers but imposes high prices for its replacement cartridges.

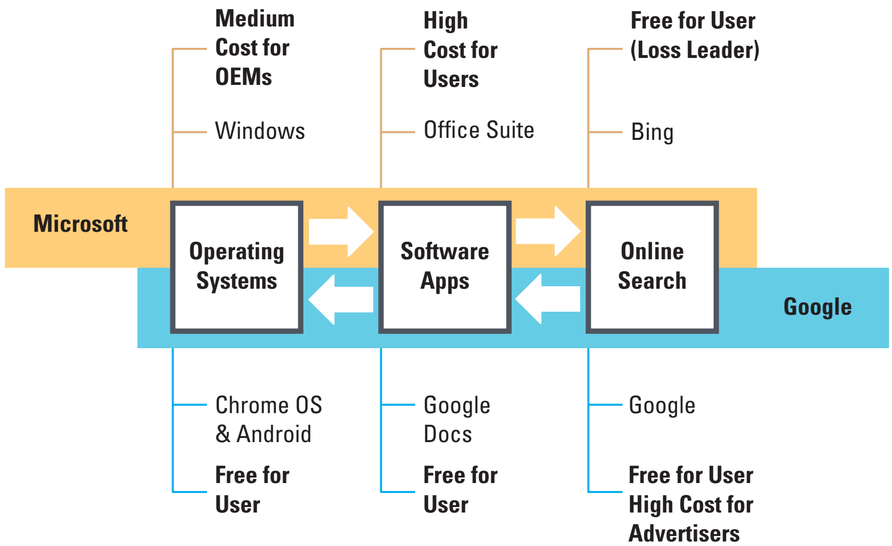
Similarly, telecommunications companies provide a basic cell phone at no charge or significantly subsidize high-end smart phones when you sign up for a two-year wireless service plan. They combine the razor–razor-blade model with the *subscription-based business model,* which was first introduced by magazines and newspapers. They recoup the subsidy provided for the smart phone by requiring customers to sign up for lengthy service plans. The leading provider of audio books, Audible, a subsidiary of Amazon, also uses a subscription-based business model.

The opening case foreshadows the up-and-coming battle between Google and Microsoft as each moves progressively on to the other's turf. Although Google started out as an online search and advertising company, it now offers software applications (Google Docs, word processing, spreadsheet, e-mail, interactive calendar, and presentation software) and operating systems (Chrome OS for the web and Android for mobile applications), among many other online products and services. In contrast, Microsoft began its life by offering an operating system (since 1985, called Windows), then moved into software applications with its

business model
Organizational plan that details the firm's competitive tactics and initiatives; in short, how the firm intends to make money.

EXHIBIT 1.4

Competing Business Models: Google vs. Microsoft



Office Suite, and now into online search and advertising with Bing. Thus, the stage is set for a clash of the technology titans.

In fighting this battle, Google and Microsoft pursue very different business models, as shown in Exhibit 1.4.[20] Google offers its applications software Google Docs for free to induce and retain as many users as possible for its search engine. Although Google's flagship search engine is free for the end user, Google makes money from sponsored links by advertisers. The advertisers pay for the placement of their ad on the results pages and every time a user clicks through an ad (which Google calls a "sponsored link"). Thus, many billion mini-transactions add up to a substantial business. As indicated in Exhibit 1.4, Google uses part of the profits earned from its lucrative online advertising business to subsidize Google Docs. Giving away products and services to induce widespread use allows Google to benefit from *network effects*—the increase in the value of a product or service as more people use it. Thus, Google can charge advertisers for highly targeted and effective ads, allowing it to subsidize other product offerings that compete directly with Microsoft.

Microsoft's business model is almost the reverse of Google's. Initially, Microsoft focused on creating a large installed base of users for its PC operating system (Windows). It now holds some 90 percent market share in operating system software worldwide. Once the users are locked into a Microsoft operating system (which generally comes preloaded with the computer they purchased), they then want to buy applications that run seamlessly with the operating system. The obvious choice for most users is Microsoft's Office Suite (containing Word, Excel, PowerPoint, Outlook, and Access), but they need to pay several hundred dollars for the latest version. As shown in Exhibit 1.4, Microsoft uses the profits from its application software business to subsidize its search engine Bing, which is—just like Google's—a free product offering for the end user. Given Bing's relatively small market share, however, and the tremendous cost in developing the search engine, Microsoft, unlike Google, does not make any money from its online search offering; rather, it is a big money loser. The logic behind Bing is to provide a countervailing power to Google's dominant position in online search. The logic behind Google Docs is to create a threat to Microsoft's dominant position in application software. These strategies create *multi-point competition* between the two technology firms.[21] Taken together, Google and Microsoft compete with one another for market share in several different product categories through quite different business models.

STRATEGY IN THE 21ST CENTURY

As the adage goes, change is the only constant—and the rate of change appears to be increasing.[22] Changing technologies spawn new industries, while others die out. Managers today face an increasingly competitive world and a truly global marketplace. These trends, rapid technological change and increasing globalization, dramatically affect how to formulate and implement an effective strategy in the 21st century. Here we expand on the impact of key trends (accelerating technological change, a truly global world, and future industries) that will affect strategy making in the 21st century.

>> **LO 1-6**
Describe and assess the opportunities and challenges managers face in the 21st century.

Accelerating Technological Change

The rate of technological change has accelerated drastically over the last hundred years. Exhibit 1.5 shows how many years it took for different technological innovations to reach 50 percent of the U.S. population (either through ownership or usage). As an example, it took 84 years for half of the U.S. population to own a car, but only 28 years for half the population to own a TV. The pace of the adoption rate of recent innovations continues to accelerate. It took 19 years for the PC to reach 50 percent ownership, but only 6 years for MP3 players to accomplish the same diffusion rate.

What factors explain rapid technological diffusion and adoption? One factor is that initial innovations like the car, airplane, telephone, and use of electricity provided the necessary infrastructure for newer innovations to diffuse more rapidly. Another reason is the emergence of new business models that make innovations more accessible. For example, Dell's direct-to-consumer distribution system improved access to low-cost PCs, and Walmart's low-price, high-volume model utilized its sophisticated IT logistics system to fuel explosive growth. In addition, satellite and cable distribution systems facilitated the ability of mass media such as radio and TV to deliver advertising and information to a wider audience. The speed of technology diffusion has accelerated further with the emergence of the Internet, social networking sites, and viral messaging.

The life experience of the Gen-Y population reflects the accelerated pace of technology diffusion. New technologies are a natural part of their lives, like eating and breathing. The

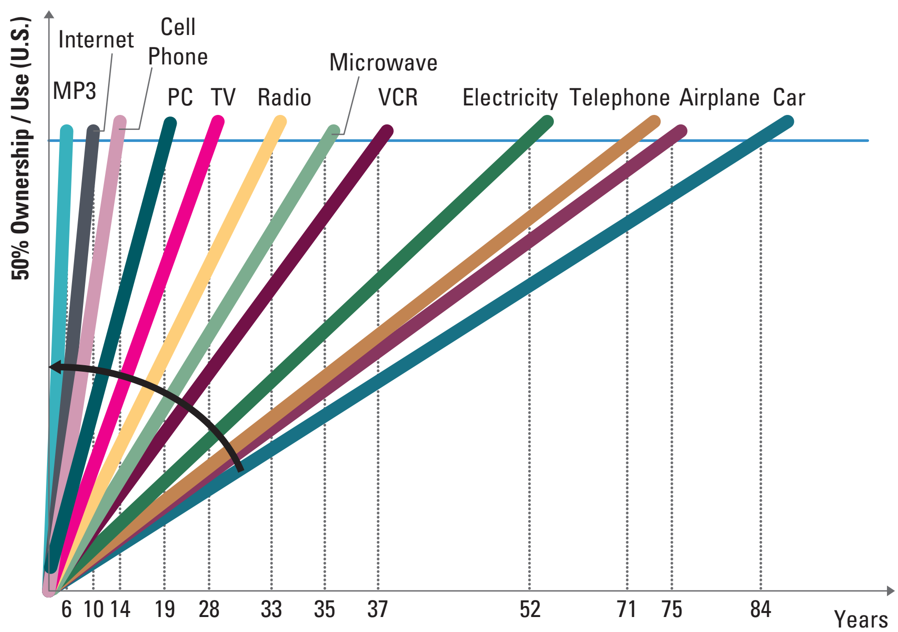


EXHIBIT 1.5

Accelerating Speed of Technological Change

Source: Data from U.S. Census Bureau; Consumer Electronics Association; *Forbes;* and National Cable and Telecommunications Association.

Gen-Y cohort came of age during the boom of the Internet; its members are accustomed to constant connectivity and to rapid technological change. By the time they graduate from college, the average Gen-Y student has spent over 10,000 hours playing video games and over 20,000 hours watching TV.[23] The Gen-Y cohort is sometimes called *digital natives*—people who grew up with the Internet and other advanced technologies and who need no help to adapt to new technologies.[24] Those who did not grow up with the Internet and other advanced technologies, and so have taken longer to adapt to them, are called *digital immigrants*. We discuss the strategic implications of innovation and technological change in Chapter 7.

A Truly Global World

The New York Times columnist and author Thomas Friedman used his book title, *The World Is Flat,*[25] to describe a truly global marketplace in which goods, services, capital, knowledge, ideas, and people move freely across geographic boundaries in search of greater opportunities. Advances in information technology and transportation have led to the "death of distance."[26]

Due to falling trade and investment barriers, companies are now part of a global economy made up of several key markets. Combining 27 member states and more than 500 million people, the European Union (EU) is the world's largest economy.[27] Sixteen EU countries are almost a fully integrated bloc with unified economic and monetary policies, using the euro as a common currency.[28] China, with more than 1.4 billion people, is the most populous country in the world, and India, with 1.2 billion people, is the world's largest democracy. Together with Brazil and Russia, they make up the *BRIC countries,* which have more than 40 percent of the world's population and occupy more than a quarter of the world's landmass. This group of fast-growing, emerging economies could one day eclipse the richest countries in the world.

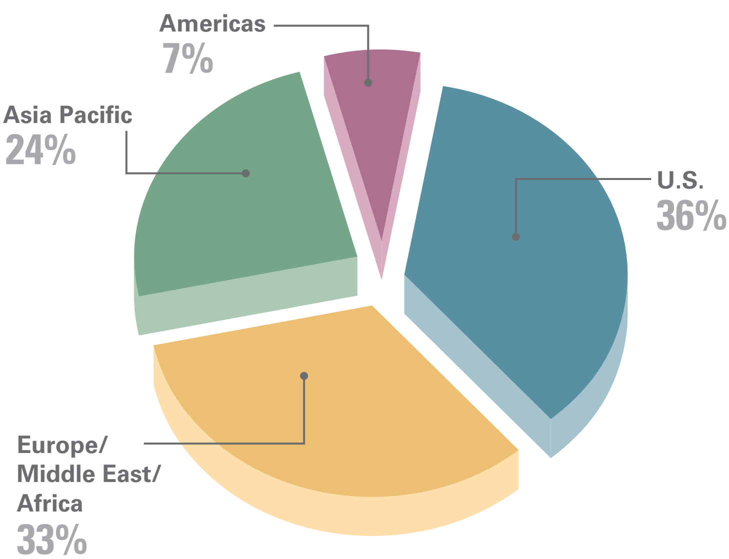
Many U.S. companies have become global players. The technology giant IBM employs 425,000 people and has revenues of roughly $100 billion. Although IBM's headquarter is in Armonk, NY, the vast majority of its employees (more than 70 percent) actually work outside the United States. IBM, like many other U.S.-based multinationals, now earns the majority of its revenues (roughly two-thirds) outside the United States (as shown in Exhibit 1.6).[29] IBM's revenues in the BRIC countries have been growing at between 20 and 40 percent per year, while they have grown by only about 1 to 3 percent in developed markets such as the United States. IBM's goal is to obtain 35 percent of its total revenue from fast-growing emerging economies such as the BRIC countries by 2015. To capture these opportunities, IBM (along with many other multinational companies) has been reducing the U.S. headcount while increasing employment in emerging economies such as India.[30]

While many multinational companies like Coca-Cola, Procter & Gamble, and

EXHIBIT 1.6

Geographic Sources of IBM Revenues, 2010

Source: 2010 IBM Annual Report.



Sony tend to focus on more affluent customers, some 4 billion people on the planet live on less than $2,000 a year (or $5.50 a day).[31] Recently, scholars have shown that this so-called **bottom of the pyramid** of the global economy—the largest but poorest socioeconomic group of the world's population—can yield significant business opportunities, which—if satisfied—could improve the living standard of the world's poorest.[32] Muhammad Yunus, winner of the 2006 Nobel Peace Prize, founded Grameen Bank in Bangladesh to provide small loans (so-called *microcredit*) to impoverished villagers. Loans provided funding for their entrepreneurial ventures so that villagers could help themselves climb out of poverty. As a follow-up business, Grameen Telecom now offers a microloan combined with a cell phone for local entrepreneurs. Other businesses have also found profitable business opportunities at the bottom of the pyramid. In India, Arvind Mills offers jeans in a ready-to-make kit that costs only a fraction of the high-end Levi's. The Tata Group, a widely diversified multinational conglomerate headquartered in Mumbai, India, in 2009 introduced its Nano car, the lowest-priced car in the world.[33] Although the Nano sells for less than $2,500 ("one lakh" rupees), if sold in the hundreds of millions, it can add up to a substantial business. Given its importance, we take up global strategy in Chapter 10.

Future Industries

Tomorrow's winners are the ones that focus today on making investments to build a position in up-and-coming industries. Given current trends, several industries promise significant potential for value creation (and thus career opportunities), among them health care, the green economy, and Web 2.0.[34]

HEALTH CARE. In 2010, U.S. health care spending reached $2.5 trillion, or 16 percent of total economic activity, making it the largest industry in the country.[35] With aging baby boomers making up the largest age demographic in the United States, the growth of the health care industry, estimated at 7 percent annually, will far outstrip the growth rate of the overall economy. As a consequence, by 2019 the health care sector is estimated to be 20 percent of total U.S. economic activity.

Not only are baby boomers a large part of the U.S. population, most of the wealth is also concentrated in this group. As baby boomers age, they will demand more professional health care, wellness and enhancement services such as Botox treatments, liposuction, and laser eye surgery. Important medical breakthroughs in biotechnology, nanotechnology, and genomics will allow health care providers to offer individualized medicine to support longer and healthier living. For example, 23andMe, an entrepreneurial venture founded by Anne Wojcicki and Linda Avey, leverages the convergence of IT, genomics, and biotechnology to allow customers to understand their own unique genetic makeup in terms of health, traits, and ancestry. After having one's personal DNA tested, 23andMe will provide an individualized profile of how that genetic makeup is related to the probability of developing any of over 100 different diseases and conditions.

Given the opportunities in the health care industry, GE announced its *healthymagination* initiative, in which it will invest $6 billion to attempt to solve strategic trade-offs in health care by increasing access, improving quality, and lowering costs.[36] Patterned after its successful *ecomagination* program, this initiative allows GE to draw on the expertise of its various business units. It is intended to refocus GE on its industrial strength, but in a way that looks to emerging opportunities.

Although the health care sector of the economy seems to provide significant business opportunities in the future due to favorable demographics in the U.S. and most developed economies, managers must also consider impending threats such as more government regulation. While more Americans will be required to have health insurance, the

bottom of the pyramid The largest but poorest socioeconomic group of the world's population.

reimbursements for specific procedures are likely to go down. This will decrease the incentives for firms to make investments in this industry and for students to become nurses or medical doctors. Health care providers, moreover, face the challenge of squaring a circle when required by law to provide more access, equal- or higher-quality care, and lower cost. One possible way to resolve this trade-off is innovation in products and processes, a topic that we will take up in Chapter 7.

GREEN ECONOMY. The vast majority of today's economic activity around the globe is powered by carbon-based sources of energy such as oil, coal, and natural gas. Yet, these carbon-based energy sources are finite, and they come with a cost that businesses and consumers do not bear. Such a cost, which economists call **externalities,** represents the side-effects of production and consumption that are not reflected in the price of the product. The externalities of carbon-based energy are CO_2 emissions, which some researchers suggest are linked to air pollution and global warming,[37] and ecological disasters such as the BP oil spill in the Gulf of Mexico.[38]

Moreover, fossil fuels are a finite, non-renewable resource. Oil prices spiked to almost $150 a barrel in the summer of 2008, pushing up gas prices in the U.S. to over $4 a gallon from $1.25 (inflation-adjusted) in the late 1990s. The increase in oil prices over time occurred in a roller coaster fashion as shown in Exhibit 1.7. The global trend line of oil prices, however, is pointing upwards as supplies dwindle and energy demand increases, especially in the rapidly developing countries. Higher oil prices and increasing public awareness of the externalities produced by the burning of fossil fuels have led to a search for renewable energy sources that are more ecologically friendly.

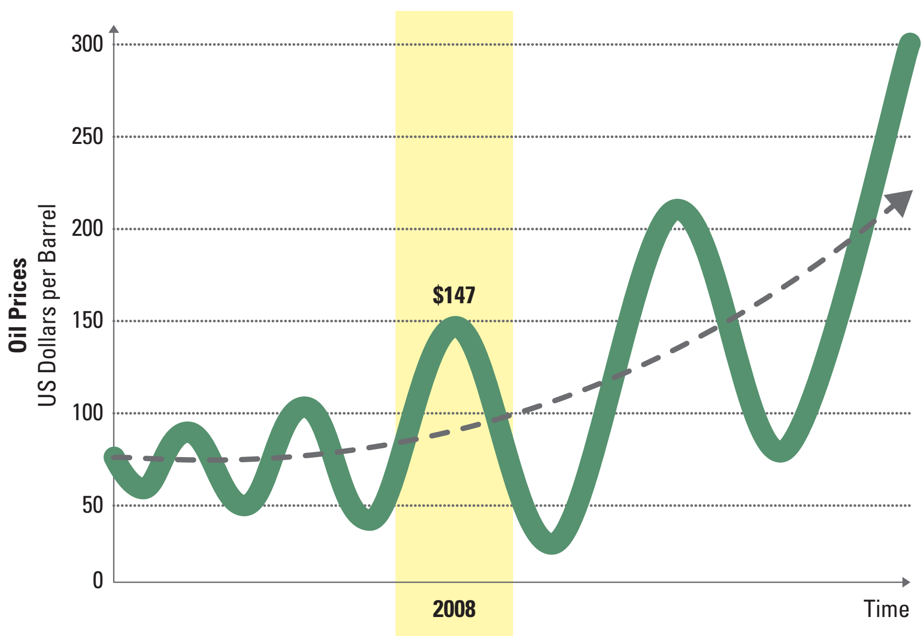
externalities Side-effects of production and consumption that are not reflected in the price of a product.

The *green and clean-tech economy* describes future business opportunities in renewable energy, energy conservation, efficient energy use, and energy technology.[39] The goal is to develop a sustainable global economy that the earth can support indefinitely.[40] Several governments across the world such as Germany, Denmark, Israel, and Spain provide incentives to induce businesses to invest in the green economy, and thus create sustainable jobs. The U.S.

EXHIBIT 1.7

Conceptual Depiction of Oil Prices and Predicted Trend

Source: Adapted from Shai Agassi's presentation at TED, February 2009, www.ted.com/talks/lang/eng/shai_agassi_on_electric_cars.html.



plans to invest $150 billion over the next decade to help jump-start a green economy. It hopes to create five million new jobs that pay well, can't be outsourced, and reduce America's dependence on middle-eastern oil.[41] In the meantime, China is fast becoming the world's leading producer of solar panels, having driven the prices for such panels down by almost 50 percent within just a year.[42] If the size of the current energy industry is any indication, the green and clean-tech economy is likely to be a multi-trillion dollar business. This of course creates opportunities for existing companies such as ABB, GE Energy, Philips, and Siemens, as well as entrepreneurs, in their quest to make an ecosystem of energy innovation become a reality.[43]

Again, a note of caution is in order: Although the green economy receives significant media attention, most green energy sources are not yet cost-competitive with old-line coal and oil. This is partly due to the fact that market prices do not include externalities. Some studies also indicate that world oil reserves will be sufficient for another 100 years or more.[44] Moreover, the U.S. has the largest proven coal reserves worldwide (roughly 30 percent), and is most likely to use those to provide the base load for its energy consumption. Famed investor Warren Buffett shares this perspective: his Berkshire Hathaway company acquired Burlington Northern railroads for over $26 billion.[45] Railroads are the most cost-effective way of transporting commodities such as coal, steel, wheat, lumber, and consumer goods over long distances. Burlington Northern moves coal from where it is mined to population-rich states that receive much of their power from coal-fired plants. As in any business situation, managers must carefully consider both opportunities and threats when making strategic decisions.

STRATEGY HIGHLIGHT 1.1

Threadless: Leveraging Crowdsourcing to Design Cool T-Shirts

Threadless, a community-centered online apparel store (www.threadless.com), was founded in 2000 by Jake Nickell, then a student at the Illinois Institute of Art, and Jacob DeHart, then a student at Purdue University, with $1,000 as startup capital. After Jake had won an online T-shirt design contest, the two entrepreneurs came up with a business model to leverage user-generated content. The idea is to let consumers "work for you" and thus turn consumers into *prosumers,* a hybrid between producers and consumers.

Members of the Threadless "community" do most of the work, which they consider fun: They submit T-shirt designs online, and community members vote on which designs they like best. The designs receiving the most votes are put in production, printed, and sold online. Threadless leverages crowdsourcing, a process in which a group of people voluntarily perform tasks that were traditionally being completed by a firm's employees. Rather than outsourcing its work to other companies, Threadless outsources its T-shirt design to its website community. The Web 2.0 concept of leveraging a firm's own customers to help produce better products is explicitly included in Threadless's business model.

WEB 2.0. In the early days of the Internet, websites more or less passively displayed information. Examples of the "old" WWW (World Wide Web) are initial versions of companies' websites that merely displayed information such as their logo, hours, phone numbers, address, and a brief overview of the company. The term *Web 2.0* was coined to denote interactivity, with the goal of harnessing the collective intelligence of web users.[46] The idea was that the more people participate, the better the resulting websites and in turn the better the resulting products and services. Web 2.0, therefore, relies on network effects.[47] As an example, the more people use Google's search engine, the better the search engine gets as it continuously fine-tunes its PageRank algorithm. Many companies are devising ways to utilize social networking to strengthen customer relationships and thus the basis for competitive advantage. Amazon, Netflix, YouTube, Facebook, Flickr, and Threadless are but a few examples of Web 2.0 applications that benefit from network effects. Strategy Highlight 1.1 shows how the online startup Threadless uses Web 2.0 technology to craft an innovative business model.

crowdsourcing A process in which a group of people voluntarily performs tasks that were traditionally completed by a firm's employees.

Threadless's business model translates real-time market research and design contests into quick sales. Threadless produces only T-shirts that were approved by its community. Moreover, it has a very good understanding of market demand because it knows the number of people who participated in each design contest. In addition, when scoring each T-shirt design in a contest, Threadless users have the option to check "I'd buy it." These features give the Threadless community a voice in T-shirt design and also coax community members into making a pre-purchasing commitment. Threadless does not make any significant investments until the design and market size are determined, thus basically minimizing its downside. Not surprisingly, Threadless has sold every T-shirt that it has printed. Moreover, it has a cult-like following and is outperforming established companies such as Old Navy and Urban Outfitters with their more formulaic T-shirt designs.[48]

GAINING & SUSTAINING COMPETITIVE ADVANTAGE

STAKEHOLDERS

>> **LO 1-7**
Critically evaluate the role that different stakeholders play in the firm's quest for competitive advantage.

Each chapter contains a section entitled *Gaining & Sustaining Competitive Advantage,* in which we put one specific theory or concept under the magnifying glass to critically evaluate if and how it is linked to competitive advantage, the overarching goal in strategic management. To accomplish this, we combine strategic management research with real-world observations. We conclude this chapter by looking at stakeholders and their relationship to competitive advantage.

Successful business strategies generate value for society. When firms or individuals compete in their own self-interest while obeying the law and acting ethically, they ultimately create value. In so doing, they make society better.[49] Value creation lays the foundation for all the important benefits successful economies can provide: education, public safety, and health care, among others. Superior performance allows a firm to reinvest some of its profits to accrue more resources and thus to grow. This in turn provides more opportunities for employment and fulfilling careers. In the chapter opener, we saw that Google created tremendous value, and with it career opportunities. In contrast, strategic mistakes can be expensive. Conservative estimates of the ill-fated AOL TimeWarner merger suggest it destroyed about $100 billion of shareholder value and with it many employment and career opportunities.

Competitive advantage, therefore, not only is of interest to the CEO or shareholders, but also directly affects every person who has an interest in a company. These persons are **stakeholders**—individuals or groups who can affect or are affected by the actions of a firm.[50] They have a claim or interest in the performance and continued survival of the firm. As shown in Exhibit 1.8, *internal stakeholders* include stockholders, employees (including executives, managers, and workers), and board members. *External stakeholders* include customers, suppliers, alliance partners, creditors, unions, communities, and governments at various levels (local, state, federal, and supranational in the case of the European Union). As Exhibit 1.8 indicates, all stakeholders make specific contributions to the firm, which in turn provides different types of inducements to different stakeholders. The firm, therefore, has a multifaceted exchange relationship with a number of diverse internal and external stakeholders. (Given the importance of stakeholders to firm performance, we take up this topic again in Chapter 12 when studying strategy implementation.)

Some stakeholders can exert a powerful influence on firms. In some instances, firms are able to *create* a competitive advantage but fail to *capture* it because of actions of their stakeholders.[51] This sounds like a contradiction, doesn't it? It is not. Consider this: Once a firm has created a competitive advantage, a battle can ensue over how the spoils of that competitive advantage are split among the firm's different stakeholders.[52] In the U.S. car industry, the United Auto Worker (UAW) had such a stronghold on GM, Chrysler, and Ford that some argue they were a major factor in creating a competitive disadvantage

stakeholders
Individuals or groups who can affect or are affected by the actions of a firm.

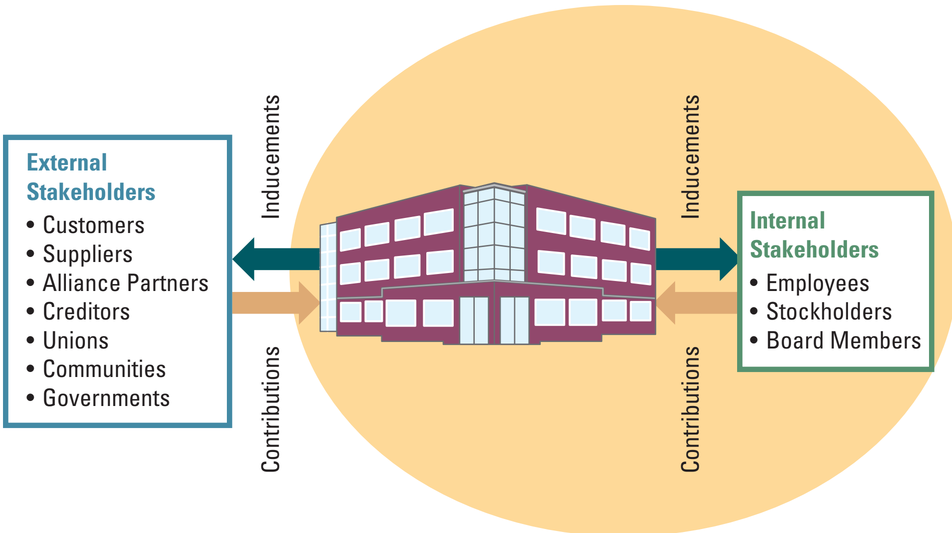


EXHIBIT 1.8

Internal and External Stakeholders in an Exchange Relationship with the Firm

(although management signed the labor contracts with the unions).[53] In the investment banking industry, employees are powerful stakeholders. Skilled human capital is one of the most important resources in investment banking (as in other professional services such as management consulting and law firms). As a consequence of their strong position, the combined annual bonuses of investment banks' employees frequently exceed the bank's net income. In 2007, the year before the financial meltdown, the net income of the big-five U.S. investment banks combined (Bear Sterns, Goldman Sachs, Lehman Brothers, Merrill Lynch, and Morgan Stanley) was a little over $10 billion, and the total of the bonuses paid to the employees was close to $40 billion.[54] During 2008, the worst year in terms of stock performance since the Great Depression, the big-five investment banks lost $25 billion, but still paid bonuses that exceeded $25 billion.[55] These data show that although investment banks clearly have valuable resources (namely, employees) that can create competitive advantage, those same resources are powerful stakeholders that can capture the value they create. By capturing that value, the employee stakeholders left less value for other stakeholders, such as stockholders or customers. These examples show that although some stakeholders have a strong influence in helping a firm gain and sustain competitive advantage, they also capture much of the value created because these key employees realize how critical they are in creating the value in the first place. Not all stakeholder groups are created equal, and their differential power influences how the economic value created is distributed among different stakeholder groups. If some stakeholders are able to extract significant value, the firm's competitive advantage may not be realized when comparing overall firm performance to that of competitors.

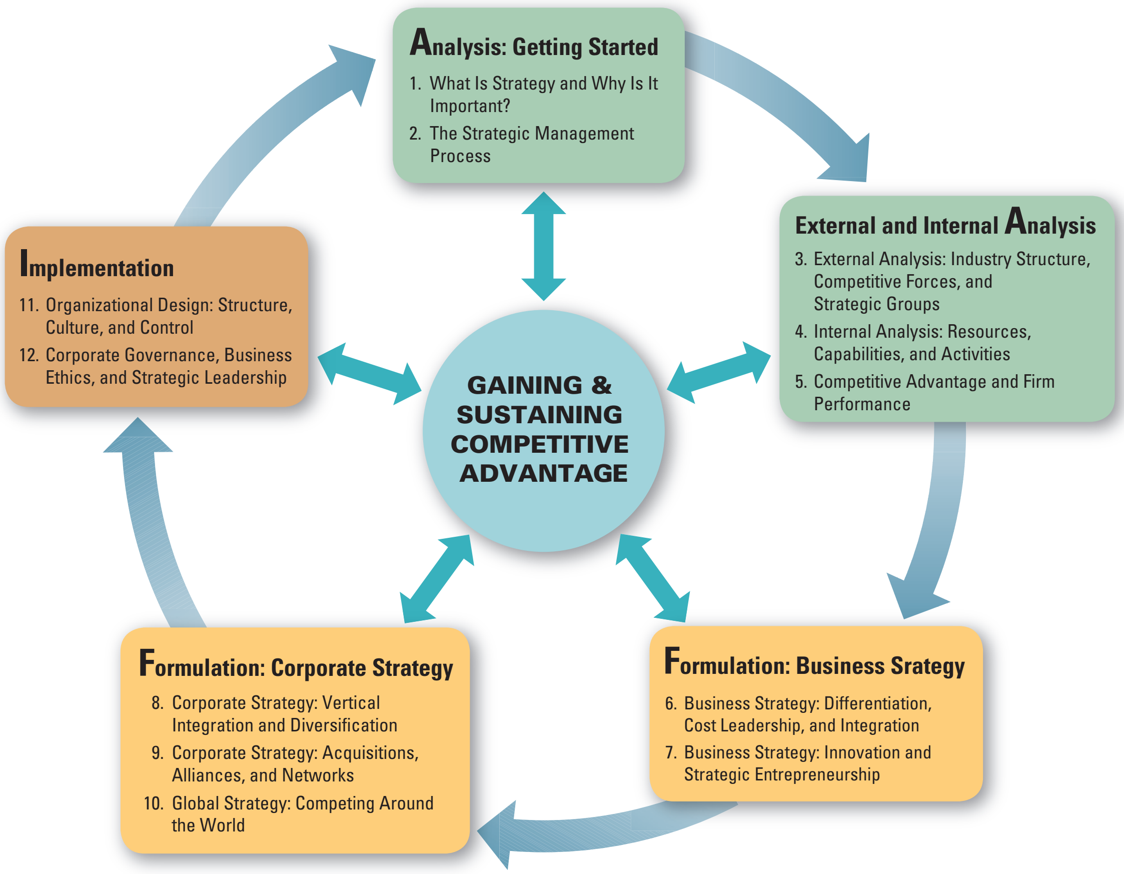
THE AFI STRATEGY FRAMEWORK

A successful strategy details a set of goal-directed actions that managers intend to take to improve or maintain overall firm performance. Building strategy is the result of three broad management tasks:

1. Analyze (A)
2. Formulate (F)
3. Implement (I)

EXHIBIT 1.9

The AFI Strategy Framework and Text Outline



These are the pillars of research and knowledge about strategic management. Although we will study each task one at a time, they are highly interdependent and frequently happen simultaneously. A firm cannot really formulate a strategy without thinking about how to implement it, for instance, and while implementing a strategy, managers are constantly analyzing the need to adjust to changing circumstances. We've captured those relationships in the **AFI strategy framework,** shown in Exhibit 1.9. This model links the three interdependent management tasks—analyze, formulate, and implement. What we want our model to do is explain and predict differences in firm performance. This information will allow managers to conceive of and implement a strategy that can improve its performance and result in competitive advantage.

AFI strategy framework A model that links three interdependent strategic management tasks—analyze, formulate, and implement—that, together, help firms conceive of and implement a strategy that can improve performance and result in competitive advantage.

In each of the three broad management tasks, managers focus on specific *questions,* listed next. (We address those questions in specific chapters, as indicated.)

Strategy analysis (*A*):

- The strategic management process: *What are our vision, mission, and values? What is our process for "making" strategy (how does strategy come about?)* (Chapter 2)
- External analysis: *What effects do forces in the external environment have on strategy and competitive advantage?* (Chapter 3)

- Internal analysis: *What effects do our internal resources and capabilities have on strategy and competitive advantage?* (Chapter 4)
- Firm performance: *How can we measure competitive advantage?* (Chapter 5)

Strategy formulation (*F*):

- Business strategy: *How should we compete?* (Chapters 6 and 7)
- Corporate strategy: *Where should we compete?* (Chapters 8 and 9)
- Global strategy: *Where and how should we compete around the world?* (Chapter 10)

Strategy implementation (*I*):

- Organizational design: *How should we organize to put the formulated strategy into practice?* (Chapter 11)
- Corporate governance, business ethics, and strategic leadership: *What type of strategic leadership and corporate governance do we need? How do we anchor our decision in business ethics?* (Chapter 12)

The AFI strategy framework shown in Exhibit 1.9 will be repeated at the beginning of each of the book's parts, to help show where we are in our study of the firm's quest to gain and sustain competitive advantage.

CHAPTERCASE 1 | *Consider This...*

ON THE OPENING page of the chapter, ChapterCase 1 provides background information about a quest for competitive advantage taking place in the Internet-search market. Microsoft's Bing picked up a new partner—Facebook—in its continuing journey to unseat Google from the top of the search engine business. In terms usually reserved for a hot new Silicon Valley startup, Facebook's CEO, Mark Zuckerberg, announced the company's surprising decision to partner with the "really scrappy . . . underdog" Bing, rather than the incumbent Google. Zuckerberg stated, "When you're an incumbent in an area . . . there is a tension between innovating and trying new things versus what you already have."[56] Perhaps the announcement shouldn't have been such a surprise. After all, in 2007 Microsoft did invest $240 million, for an ownership share of less than 2 percent, of privately held Facebook.[57]

Microsoft and Facebook are rolling out a variety of features to make "search more social." If, say, you are looking for a new restaurant in your area, Bing searches can include data on what your Facebook friends have "liked." A view of Microsoft's attempt to unseat Google can be found from Bing director Lisa Gurry who notes, "We think both companies [Google and Microsoft] are focused on improving performance; our approach . . . is about the speed of getting things done—not the speed of getting a high volume of results."[58]

Thinking about this chapter's opening case, answer the following questions.

1. Google was not the first search engine on the Internet, but it has been the most successful for a decade. What is Google's competitive advantage?
2. LinkExchange was created in 1996 by Sanjay Madan and Tony Hsieh (more recently with Zappos) and as noted in the case, was purchased by Microsoft in 1998. Why was Microsoft not interested in keeping the Keywords project in 2000?
3. What strategy and business model is Microsoft using today with Bing to try to succeed in the Internet-search business?

Take-Away Concepts

This chapter defined strategy and competitive advantage and set the stage for further study of strategic management, as summarized by the following learning objectives and related take-away concepts.

LO 1-1 Define competitive advantage, sustainable competitive advantage, competitive disadvantage, and competitive parity.

- >> Competitive advantage is always judged relative to other competitors or the industry average.
- >> To obtain a competitive advantage, a firm must either create more value for customers while keeping its cost comparable to competitors, or it must provide value equivalent to competitors but at lower cost.
- >> A firm able to dominate competitors for prolonged periods of time has a sustained competitive advantage.
- >> A firm that continuously underperforms its rivals or the industry average has a competitive disadvantage.
- >> Two or more firms that perform at the same level have competitive parity.

LO 1-2 Define strategy and explain its role in a firm's quest for competitive advantage.

- >> Strategy is the set of goal-directed actions a firm intends to take in its quest to gain and sustain competitive advantage.
- >> An effective strategy requires that strategic trade-offs be recognized and addressed—e.g., between value creation and the costs to create the value.
- >> Managers' strategic assumptions are an outflow of their theory of how to compete. Successful strategy requires three integrative management tasks—analysis, formulation, and implementation.
- >> When managers align their assumptions closely with competitive realities, they can create and implement successful strategies, resulting in value creation and superior firm performance.
- >> When managers' theories about how to gain and sustain competitive advantage do not reflect reality, their firm's strategy will destroy rather than create value, leading to inferior firm performance.

LO 1-3 Explain the role of firm effects and industry effects in determining firm performance.

- >> A firm's performance is more closely related to its managers' actions (firm effects) than to the external circumstances surrounding it (industry effects).
- >> Firm and industry effects, however, *are interdependent and thus both are relevant in determining firm performance.*

LO 1-4 Describe the role of corporate, business, and functional managers in strategy formulation and implementation.

- >> Corporate executives must provide answers to the question of *where* to compete (in industries, markets, and geographies), and *how to create synergies* among different business units.
- >> General (or business) managers must answer the strategic question of *how to compete* in order to achieve superior performance. They must manage and align all value-chain activities for competitive advantage.
- >> Functional managers are responsible for *implementing business strategy* within a single functional area.

LO 1-5 Outline how business models put strategy into action.

- >> To put a firm's strategy into action, a business model must: (1) translate the firm's strategy into competitive tactics and initiatives, and (2) implement the strategy through effective structures, processes, culture, and procedures.

LO 1-6 Describe and assess the opportunities and challenges managers face in the 21st century.

- >> The competitive landscape of the 21st century is characterized by ever-faster technological change in a truly global marketplace.
- >> Examples of industries that seem likely to provide good future opportunities are health care, the green economy, and Web 2.0.

LO 1-7 Critically evaluate the role that different stakeholders play in the firm's quest for competitive advantage.

- Stakeholders are individuals or groups that have a claim or interest in the performance and continued survival of the firm; they make specific contributions for which they expect rewards in return.
- Internal stakeholders include stockholders, employees (including executives, managers, and workers), and board members.
- External stakeholders include customers, suppliers, alliance partners, creditors, unions, communities, and governments at various levels.
- Some stakeholders are more powerful than others, and may extract significant rewards from a firm, so much that any firm-level competitive advantage may be negated.

Key Terms

AFI strategy framework *(p. 20)*
Bottom of the pyramid *(p. 15)*
Business model *(p. 11)*
Competitive advantage *(p. 4)*
Competitive disadvantage *(p. 5)*
Competitive parity *(p. 6)*
Co-opetition *(p. 6)*
Crowdsourcing *(p. 17)*
Externalities *(p. 16)*
Firm effects *(p. 8)*
Industry effects *(p. 8)*
Stakeholders *(p. 18)*
Strategic business unit (SBU) *(p. 10)*
Strategic management *(p. 4)*
Strategy *(p. 6)*
Sustainable competitive advantage *(p. 5)*

Discussion Questions

1. How is a strategy different from a business model? How is it similar?
2. Threadless (in Strategy Highlight 1.1) is an example of a firm building on its customer base to use new products and also to participate in the design and vetting of popular designs. In the summer of 2010, Dell Computer announced a partnership with Threadless for designs on its laptop computers. For a small additional fee (and an extra day's delay in shipping), you can get a Threadless design etched on your new Dell laptop.[59] Why do you think Dell is keen on offering this service? What other firms use this crowdsourcing technique? Where else might this type of business model show up in the future?
3. As noted in the chapter, research found that firm effects are more important than industry effects. What does this mean? Can you think of situations where this might not be true?
4. This chapter introduces three different levels appropriate for strategic considerations (see Exhibit 1.3). In what situations would some of these levels be more important than others? How should the organization ensure the proper attention to each level of strategy as needed?

Ethical/Social Issues

1. Given that traditional U.S. firms such as IBM have over 70 percent of their employees and almost two-thirds of revenues come from outside the United States, what is an appropriate definition of a "U.S. firm"? Is there any special consideration a firm should have for its "home country"?
2. Corporate leaders are responsible for guiding the firm's strategies. Their goal is to help the firm gain and sustain a competitive advantage and thus

a profit for the shareholders. What responsibility do company managers have for other consequences of their strategies? For example, should Walmart try to mitigate the negative impact its arrival in communities can have on small locally owned stores? Why or why not? Explain.

Small Group Exercises

SMALL GROUP EXERCISE 1

The chapter argues that Microsoft and Google have quite different business models. In 2009, Microsoft revenues were $58.4 billion, an amount that was down 3 percent from 2008 levels (the first annual decline in Microsoft's history). Google had sales of $23.6 billion—an increase of 9 percent over its 2008 levels.[60]

Form a group of three or four students and spend 5 to 10 minutes discussing one of the following questions. (Your instructor may assign the question.)

1. Is this revenue downturn a sign that Microsoft is in trouble or just a result of the recession over the period? Should Microsoft change any of its strategies based on this information?
2. While Google increased sales, 97 percent of its revenues came from advertising. Is this a problem going forward? Should it change any of its strategies?
3. Apple and IBM are two firms in the competitive landscape. Should Microsoft (Google) be more proactive in addressing these competitors?

SMALL GROUP EXERCISE 2

Corporations are starting to become more aware of blogging on the Internet. Blogging can be a factor that can increase buyers' ability to have either positive or negative effects on a firm.

In one well-publicized case, journalist/blogger Jeff Jarvis of www.buzzmachine.com blogged about problems with a Dell computer he purchased. His site was inundated with others who also had poor experiences with Dell. The "Dell hell" uproar resulted in Dell not only calling Mr. Jarvis and resolving his problem but opening its own blog www.dell.com/blogs. Additionally, some time later Mr. Jarvis visited Dell's headquarters and wrote an article for *BusinessWeek* entitled "Dell Learns to Listen."[61]

1. Use a search engine to find large companies that include a blog on their official website. (Keywords "fortune 500 blogs" will steer you to many lists of such companies.)
2. What seems to be the primary purpose of most of the blogs you found?
3. Does the blog seem to be updated regularly?
4. Does the blog allow users to post comments or questions to the firm? If so, do any of the questions get answered by the company?

Strategy Term Project

PROJECT OVERVIEW

The goal of the strategy term project is to give you practical experience with the elements of strategic management. Each end-of-chapter assignment requires data collection and analysis relating the material discussed in the chapter to the firm you select here for study throughout the course. At the end of each chapter, we make additional stages of a strategic analysis available. The goal of this term-long project is to give you a tangible application of many of the concepts discussed in the text. By the end of the project, you will not only have practice in using key strategic management components and processes to increase your understanding of the material, but you also will be able to conduct a complete strategic management analysis of any company.

MODULE 1: INITIAL FIRM SELECTION AND REVIEW

In this first module, you will identify a firm to study for this project. We suggest you select one company and use it for each module in this term project. Choose a firm which you find interesting or one that is part of an industry you would like to know more about. Throughout the modules, you will be required to obtain and analyze a significant amount of data about the firm. Therefore, a key criterion is also to choose a firm that has data available for you to gather.

The primary approach to this project is to select a publicly held firm. Many large firms such as Apple, Coca-Cola, and GE have been widely reported on in the business and popular press, and a wealth of information is available on them. Other medium-sized public firms such as GameStop, Netflix, and Under Armour can be used as example firms for this project. One cautionary note: For firms that are less than three years public or in industries that are not well-defined, it will take some additional reflection to properly identify such items as competitors and suppliers. But if it is a firm you are truly motivated to study, the effort can be quite rewarding.

Relevant data on all public firms can be freely obtained using web services such as Edgar (www.sec.gov/edgar.shtml). Annual reports for firms also are a treasure-trove of information. These reports and other quarterly update materials are often available from the firm's own website (look for "about us" or "investor relations" tabs, often located at the bottom of the company's website). Additionally, most university and public libraries have access to large databases of articles from many trade publications. (Factiva and ABI/Proquest are two examples.) Company profiles of a variety of publicly listed firms are available at reliable websites such as Hoovers.com and finance.yahoo.com. Also, many industries have quite active trade associations that will have websites and publications that can also be useful in this process. Your local librarian can likely provide you some additional resources that may be licensed for library use or otherwise not available online. Examples of these are Value Line Ratings & Reports and Datamonitor.

A second approach to this project is to select a smaller firm in your area. These firms may have coverage in the local press. However, if the firm is not public, you will need to ensure you have access to a wide variety of data from the firm. If this is a firm for which you have worked or where you know people, please check ahead of time to be sure the firm is willing to share its information with you. This approach can work well, especially if the firm is interested in a detailed analysis of its strategic position. But to be successful with this project, be sure you will have access to a broad range of data and information (perhaps including interviews of key managers at the firm).

If you are in doubt on how to select a firm, check with your instructor before proceeding. In some instances, your instructor will assign firms to the study groups.

For this module, answer the following questions:

1. Provide a brief history of the company.
2. List the top management of the firm and note what experience and leadership skills they bring to the firm. If a larger conglomerate, list both corporate and business managers.
3. What is the principal business model of the firm? (How does the firm make most of its profits?)

*my*Strategy

HOW TO POSITION YOURSELF FOR CAREER ADVANTAGE

As the chapter discussed, firm-level decisions have a significant impact on the success or failure of organizations. Industry-level effects, however, can also play a role. Many considerations go into deciding what career choices you make during your working life. The chapter notes that some sectors (such as health care, the green economy, and Web 2.0) are expected to grow faster than others.

At the top of the next page is a sample of revenue growth rates in various industries for a recent five-year period.

Sample Five-Year Growth Rates (2005–2009)[62]

Industry Name	Change in Sales
Power	54.51%
Petroleum (production)	44.64%
Pharmacy services	43.68%
Insurance (property/casualty)	37.60%
Advertising	35.99%
Biotechnology	35.06%
Pharmaceuticals	24.88%
Natural gas (diversified)	24.54%
E-commerce	20.32%
Securities brokerage	16.20%
Telecommunication services	16.05%
Entertainment technology	15.99%
Computer software/services	15.26%
Internet	13.71%
Chemical (diversified)	13.52%
Medical supplies	12.87%
Total market average	**12.79%**
Apparel	0.50%
Retail stores	0.49%
Banking	0.00%
Semiconductor equipment	–16.66%
Homebuilding	–30.52%
Public/private equity	–32.41%
Insurance (life)	–71.81%

1. If you are about to embark on a new career, what effect should the likelihood of industry growth play in your decision?
2. Why could growth rates be an important consideration? Why not?

Endnotes

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16. See recent J.D. Power's quality reports, for example, as presented in "Ford touts its small-car resurgence," *The Wall Street Journal,* January 11, 2010.

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