Interestingly, some cost leaders (e.g., SWA) score much higher than some differentiators (e.g., Delta) in terms of reliability and convenience, offering frequent point-to-point connections to conveniently located airports, often in or near city centers. This key divergence between the two strategies explains why generic cost leaders have frequently outperformed generic differentiators in the U.S. airline industry. Overall, both value curves show a consistent pattern representative of a more or less clear strategic profile as either differentiation or low-cost leader.

Now look at JetBlue's value curve. Rather than being consistent such as the differentation or low-cost value curves, the JetBlue value curve follows a zigzag pattern. JetBlue attempts to achieve parity or even out-compete differentiators in the U.S. airline industry along the competitive factors such as different seating classes (e.g., the high-end Mint offering discussed in the ChapterCase), higher level of in-flight amenities, higher-quality beverages and meals, plush airport lounges, and a large number of international routes (mainly with global partner airlines). JetBlue, however, looks more like a low-cost leader in terms of the ability to provide only a few connections via hubs domestically, and it recently has had a poor record of customer service, mainly because of some high-profile missteps as documented in the ChapterCase. JetBlue's reliability is somewhat mediocre, but it does provide a larger number of convenient point-to-point flights than a differentiator such as Delta, but fewer than a low-cost leader such as SWA.

A value curve that zigzags across the strategy canvas indicates a lack of effectiveness in its strategic profile. The curve visually represents how JetBlue is *stuck in the middle* and as a consequence experienced inferior performance and thus a sustained competitive disadvantage vis-à-vis airlines with a stronger strategy profile such as SWA and Delta, among others.

6.6 Implications for Strategic Leaders

Strategy is never easy, even when, as in achieving competitive advantage, only a handful of strategic options are available (i.e., low cost or differentiation, broad or narrow, or blue ocean). The best managers work hard to make sure they understand their firm and industry effects, and the opportunities they reveal. They work even harder to fine-tune strategy formulation and execution. When well-formulated and implemented, a firm's business strategy enhances a firm's chances of obtaining superior performance. Strategic positioning requires making important trade-offs (think Walmart versus J. Crew in clothing).

In rare instances, a few exceptional firms might be able to change the competitive landscape by opening previously unknown areas of competition. To do so requires the firm reconcile the significant trade-offs between increasing value and lowering costs by pursuing both business strategies (differentiation and low cost) simultaneously. Such a blue ocean strategy tends to be successful only if a firm is able to rely on a value innovation that allows it to reconcile the trade-offs mentioned. Toyota, for example, initiated a new market space with its introduction of lean manufacturing, delivering cars of higher quality and value at lower cost. This value innovation allowed Toyota a competitive advantage for a decade or more, until this new process technology diffused widely. JCPenney, on the other hand, stumbled and found itself failing on most fronts, resulting in a sustained competitive disadvantage (see Strategy Highlight 6.2).

CHAPTER**CASE 6** / Consider This . . .

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Early in its history JetBlue Airways achieved a competitive advantage based on *value innovation*. In particular, JetBlue was able to drive up perceived customer value while lowering costs. This allowed it to carve out a strong strategic position and move to a non-contested market space. This implies that no other competitors in the U.S. domestic airline industry were able to provide such value innovation at that point in time. Rather than directly competing with other airlines, JetBlue created a blue ocean.

Although JetBlue was able to create an initial competitive advantage, the airline was unable to sustain it. Because JetBlue failed in reconciling the strategic trade-offs inherent in combining differentiation and cost leadership, it was unable to continue its blue ocean strategy, despite initial success. Between 2007 and 2015, JetBlue experienced a sustained competitive disadvantage, at one point lagging the Dow Jones U.S. Airlines Index by more than 180 percentage points in 2015.

A new leadership team CEO Robin Hayes put in place in early 2015 is attempting to reverse this trend. The new team made quick changes to improve the airline's flagging profitability. It is putting strategic initiatives in place to lower costs, while also trying to further increase its value offering. To lower operating costs, JetBlue decided to start charging $50 per checked bag instead of offering it as a free service. It also removed the additional legroom JetBlue was famous for in the industry. To drive up perceived customer value, JetBlue is adding to its fleet a new airplane (Airbus A-321), which scores significantly higher in customer satisfaction surveys than the older A-320. Although JetBlue already flies internationally by serving destinations in Central and South America as well as the Caribbean, Hayes is considering adding selected flights to Europe. Flying non-stop to cities in Europe such as London is now possible with the new Airbus A-321. Flying longer, non-stop routes drives down costs. International routes, moreover, tend to be much more profitable than domestic routes because of less competition, for the time being.

Questions

1. Despite its initial success, why was JetBlue unable to sustain a blue ocean strategy?
2. JetBlue's chief marketing officer, Marty St. George, was asked by *The Wall Street Journal*, "What is the biggest marketing challenge JetBlue faces?" His response: "We are flying in a space where our competitors are moving toward commoditization. We have taken a position that air travel is not a commodity but a services business. We want to stand out, but it's hard to break through to customers with that message."[45]
   a. Given St. George's statement, which strategic position is JetBlue trying to accomplish: differentiator, cost leader, or blue ocean strategy? Explain why.
   b. Which strategic moves has the new CEO put in place, and why? Explain whether they focus on value creation, operating costs, or both simultaneously. Do these moves correspond to St. George's understanding of JetBlue's strategic position? Why or why not? Explain.
3. Consider JetBlue's value curve in Exhibit 6.11. Why is JetBlue experiencing a competitive disadvantage? What recommendations would you offer to JetBlue to strengthen its strategic profile? Be specific.
4. JetBlue CEO Robin Hayes is contemplating adding international routes, connecting the U.S. East Coast to Europe. Would this additional international expansion put more pressure on JetBlue's current business strategy? Or would this international expansion require a shift in JetBlue's strategic profile? Why or why not? And if a strategic repositioning is needed, in which direction should JetBlue pivot? Explain.

TAKE-AWAY CONCEPTS

This chapter discussed two generic business-level strategies: *differentiation* and *cost leadership*. Companies can use various tactics to drive one or the other of those strategies, either narrowly or broadly. A *blue ocean strategy* attempts to find a competitive advantage by creating a new competitive area, which it does (when successful) by value innovation, reconciling the trade-offs between the two generic business strategies discussed.

These concepts are summarized by the following learning objectives and related take-away concepts.

LO 6-1 / Define business-level strategy and describe how it determines a firm's strategic position.

- Business-level strategy determines a firm's strategic position in its quest for competitive advantage when competing in a single industry or product market.
- Strategic positioning requires that managers address strategic trade-offs that arise between value and cost, because higher value tends to go along with higher cost.
- Differentiation and cost leadership are distinct strategic positions.
- Besides selecting an appropriate strategic position, managers must also define the scope of competition—whether to pursue a specific market niche or go after the broader market.

LO 6-2 / Examine the relationship between value drivers and differentiation strategy.

- The goal of a differentiation strategy is to increase the perceived value of goods and services so that customers will pay a higher price for additional features.
- In a differentiation strategy, the focus of competition is on value-enhancing attributes and features, while controlling costs.
- Some of the unique value drivers managers can manipulate are product features, customer service, customization, and complements.
- Value drivers contribute to competitive advantage only if their increase in value creation (ΔV) exceeds the increase in costs, that is: $(\Delta V) > (\Delta C)$.

LO 6-3 / Examine the relationship between cost drivers and cost-leadership strategy.

- The goal of a cost-leadership strategy is to reduce the firm's cost below that of its competitors.
- In a cost-leadership strategy, the focus of competition is achieving the lowest possible cost position, which allows the firm to offer a lower price than competitors while maintaining acceptable value.
- Some of the unique cost drivers that managers can manipulate are the cost of input factors, economies of scale, and learning- and experience-curve effects.
- No matter how low the price, if there is no acceptable value proposition, the product or service will not sell.

LO 6-4 / Assess the benefits and risks of differentiation and cost-leadership strategies vis-à-vis the five forces that shape competition.

- The five forces model helps managers use generic business strategies to protect themselves against the industry forces that drive down profitability.
- Differentiation and cost-leadership strategies allow firms to carve out strong strategic positions, not only to protect themselves against the five forces, but also to benefit from them in their quest for competitive advantage.
- Exhibit 6.8 details the benefits and risks of each business strategy.

LO 6-5 / Evaluate value and cost drivers that may allow a firm to pursue a blue ocean strategy.

- To address the trade-offs between differentiation and cost leadership at the business level, managers must employ value innovation, a process that will lead them to align the proposed business strategy with total perceived consumer benefits, price, and cost.
- Lowering a firm's costs is primarily achieved by eliminating and reducing the taken-for-granted factors on which the firm's industry rivals compete.
- Increasing perceived buyer value is primarily achieved by raising existing key success factors and by creating new elements that the industry has not yet offered.
- Strategic leaders track their opportunities and risks for lowering a firm's costs and increasing perceived value vis-à-vis their competitors by use of a strategy canvas, which plots industry factors among competitors (see Exhibit 6.11).

LO 6-6 / Assess the risks of a blue ocean strategy, and explain why it is difficult to succeed at value innovation.

- A successful blue ocean strategy requires that trade-offs between differentiation and low cost be reconciled.
- A blue ocean strategy often is difficult because the two distinct strategic positions require internal value chain activities that are fundamentally different from one another.
- When firms fail to resolve strategic trade-offs between differentiation and cost, they end up being "stuck in the middle." They then succeed at neither business strategy, leading to a competitive disadvantage.

KEY TERMS

Blue ocean strategy *(p. 204)*
Business-level strategy *(p. 185)*
Cost-leadership strategy *(p. 187)*
Differentiation strategy *(p. 186)*
Diseconomies of scale *(p. 196)*
Economies of scale *(p. 194)*
Economies of scope *(p. 190)*
Focused cost-leadership strategy *(p. 188)*
Focused differentiation strategy *(p. 188)*
Minimum efficient scale (MES) *(p. 195)*
Scope of competition *(p. 187)*
Strategic trade-offs *(p. 186)*
Strategy canvas *(p. 209)*
Value curve *(p. 209)*
Value innovation *(p. 205)*

DISCUSSION QUESTIONS

1. What are some drawbacks and risks to a broad generic business strategy? To a focused strategy?
2. In Chapter 4, we discussed the internal value chain activities a firm can perform (see Exhibit 4.7). The value chain priorities can be quite different for firms taking different business strategies. Create examples of value chains for three firms: one using cost leadership, another using differentiation, and a third using value innovation business-level strategy.
3. The chapter notes there are key differences between economies of scale and learning effects. Let us put that into practice with a brief example.

   A company such as Intel has a complex design and manufacturing process. For instance, one fabrication line for semiconductors typically costs more than $1.5 billion to build. Yet the industry also has high human costs for research and development (R&D) departments. Semiconductor firms spend an average of 17 percent of revenues on R&D. For comparison the automobile industry spends a mere 3 percent of sales on R&D.[46] Thus Intel's management must be concerned with both scale of production and learning curves. When do you think managers should be more concerned with large-scale production runs, and when do you think they should be most concerned with practices that would foster or hinder the hiring, training, and retention of key employees?

ETHICAL/SOCIAL ISSUES

1. Suppose Procter & Gamble (P&G) learns that the relatively new start-up company Method (www.methodhome.com) is gaining market share with a new laundry detergent in West Coast markets. In response, P&G lowers the price of its Tide detergent from $18 to $9 for a 150-ounce bottle only in markets where Method's product is for sale. The goal of this "loss leader" price drop is to encourage Method to leave the laundry detergent market. Is this an ethical business practice? Why or why not?
2. In the chapter discussion on value innovation, IKEA is noted as a firm that has successfully applied these techniques. What roles, if any, do sustainability and triple-bottom-line factors have in the success of IKEA as a leader in the furniture industry? (See Chapter 5.)

SMALL GROUP EXERCISES

//// SMALL GROUP EXERCISE 1

Ryanair based in Dublin, Ireland, has been renowned in Europe as a firm that can make a profit on a $20 ticket by imposing numerous fees and surcharges. The airline has sought to be the lowest of the low-cost providers in the EU with a "no frills get you from point A to B model." Ryanair is on record as saying it wants to be the "Amazon.com of travel in Europe" by bringing in competitors' price comparison, hotel discounts, and even concert tickets.[47] Check out the company website (www.ryanair.com) and consider the questions that follow.

1. If you were a competitor in the European market, such as British Airways or Lufthansa, how would you compete against Ryanair, knowing your cost structure would not allow price parity? If you were a low-cost leader like EasyJet, how would you compete against Ryanair?
2. What similarities and differences do you find about RyanAir compared to Jet Blue from ChapterCase 6?

//// SMALL GROUP EXERCISE 2

This chapter discusses several firms in the retailing environment. Strategy Highlight 6.2 for example covers the struggles JCPenney has had in recent years and the closing of 140 stores across the United States. JC Penney is far from alone in having performance challenges. By March 2017, 21 retailers (including Macy's, Sears, and The Limited) had announced the closure of over 3,500 stores affecting more than 50,000 jobs just in 2017. Several factors are impacting the retailing industry. For example, consumer behavior in developed countries is shifting from shopping trips to social experiences. In 2016 the amount of money spent in restaurants and bars for the first time surpassed that spent in grocery stores across the United States. Complicating matters for stores such as JCPenney, Macy's, and Nordstrom, which are largely based in malls, is a 2017 report that showed the United States had 1,200 malls and probably needs less than 900. On a per capita basis, the United States has 40 percent more shopping space than Canada and a remarkable 1,000 percent more than Germany.[48]

1. The retail department store is clearly a red ocean space right now. Your team has been asked to consult for Simon Property Group (SPG in NYSE), one of the largest U.S. operators of shopping malls. The company wants to know how its mall space could be repurposed. What blue ocean ideas can your team develop to present to the executives at Simon? Consider the positives and negatives of typical mall sizes and locations in your answer. Stretch beyond traditional retailing for ideas to consider.

*my*STRATEGY

Low-Cost and Differentiated Workplaces

We have studied the differences in business-level strategies closely in this chapter, but how might these differences relate directly to you? As you've learned, firms using a differentiation strategy will focus on drivers such as product features and customer service, while firms using a cost-leadership strategy will prioritize cost of inputs and economies of scale. These strategic decisions can have an impact on an employee's experience with the firm's work environment and culture.

Nordstrom, Whole Foods Market (before its 2017 acquisition by Amazon), and Wegmans Food Markets are companies that routinely end up on *Fortune's* list of "100 Best Places to Work." These companies use a differentiation business strategy. In contrast, Amazon and Walmart use the cost-leadership strategy; and as low-cost leaders, they do not rate nearly as well. According to inputs from the employee review site Glassdoor.com, only 50 percent of the employees working at Walmart would recommend the firm to a friend. Compare this to the 72 percent who would recommend both Nordstrom and Whole Foods, and the 80 percent who would recommend Wegmans Food Markets. As for Whole Foods, some industry watchers believe Amazon will enact the same tactics in dealing with workers at Whole Foods as it has applied to its own warehouse workers, leading to a low rating of employee satisfaction.

As you seek options for starting or growing your career, carefully consider the strategy the firm takes in the marketplace. By no means

should you avoid low-cost leaders in lieu of strong differentiators (nor should you deem all differentiators as great places to work). Fast-paced organizations that focus on driving tangible results for the organization offer much to learn. For example, Amazon has been a very successful company for the past decade, and many employees have had multiple opportunities to learn enormous amounts in a short period. The firm has also made HR and cultural changes after a scathing *New York Times* article about its "bruising workplace." Amazon has reportedly eliminated the practice of forcing employee rankings to follow a normal curve with only a small percentage getting top scores.

Amazon employees are encouraged to criticize each other's ideas openly in meetings; they work long days and on weekends; and they strive to meet "unreasonably high" standards. "When you're shooting for the moon, the nature of the work is really challenging. For some people it doesn't work," says Susan Harker, a top recruiter for Amazon. The high standards and relentless pace are a draw for many employees who are motivated to push themselves to learn, grow, and create—perhaps beyond their perceived limits. Many former employees say the nimble and productive environment is great for learning and the Amazon experience has really helped their careers expand. Now consider the following questions.

1. Employees and consultants say the Amazon workplace is the epitome of a "do more for less cost" environment. We recognize this is a hallmark goal of a cost-leadership business strategy. But ask yourself this key question, *Is it the type of high-pressure work environment in which YOU would thrive?*
2. Amazon has surpassed 350,000 employees, adding more than 100,000 employees in 2016 alone! The company will be offering bold new ideas and moving Amazon toward being the first trillion-dollar retailer under an intense pressure to deliver on its goals. The allure from this type of success is compelling and offers tremendous rewards to many employees, shareholders, and customers. What aspects of success are you seeking in your professional career?
3. Before you launch into a new project, job, or firm, or even before you make a change in industry in the effort to move forward in your career, always consider the trade-offs that you would and would not be willing to make.[49]

ENDNOTES

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2. This discussion is based on: Porter, M.E. (2008, Jan.), "The five competitive forces that shape strategy," *Harvard Business Review*; Porter, M.E. (1996), "What is strategy?" *Harvard Business Review*, November–December; Porter, M.E. (1985), *Competitive Advantage: Creating* and *Sustaining Superior Performance* (New York: Free Press); and Porter, M.E. (1980), *Competitive Strategy: Techniques for Analyzing Industries and Competitors* (New York: Free Press).

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5. Porter, M.E. (1996), "What is strategy?" *Harvard Business Review*, November–December.

6. To decide if and how to divide the market, you can apply the market segmentation techniques you have acquired in your marketing and microeconomics classes.

7. For sources on JetBlue, see: McCartney, S. (2017, Mar. 8), "Discount business class?

Thank JetBlue," *The Wall Street Journal*; Leahy, J. (2017, Apr. 17), "Azul float raises hopes for Brazil's stalled IPO market," *Financial Times*; Lovelace Jr., B. (2017, Apr. 11), "Brazilian airline Azul begins trading at the NYSE, shoots 8% higher," *CNBC*; Carey, S. (2016, Dec. 16), "JetBlue unveils cost-cutting plan worth up to $300 million by 2020," *The Wall Street Journal*; Carey, S. (2016, Jul. 26), "JetBlue considers foray into Europe," *The Wall Street Journal*; Carey, S. (2016, Apr. 12), "JetBlue to expand its high-end service, dubbed Mint, to more routes," *The Wall Street Journal*; Nicas, J. (2015, Mar. 27), "Pilot sues JetBlue for allegedly letting him fly while mentally unfit," *The Wall Street Journal*; Mayerowitz, S. (2015, Feb. 16), "JetBlue's CEO vies to please passengers, stocks," *The Associated Press*; Vranica, S. (2015, Feb. 22), "JetBlue's plan to repair its brand," *The Wall Street Journal*; Harris, R.L. (2015, Feb. 11), "On JetBlue, passengers can use ApplePay," *The New York Times*; Rosenbloom, S. (2015, Jan. 23), "Flying deluxe domestic coast-to-coast for around $1,000," *The New York Times*; Nicas, J. (2014, Nov. 19), "JetBlue to add bag fees, reduce legroom," *The Wall Street Journal*; Gardiner, S. (2010, Aug. 10), "Flight attendant grabs two beers, slides down the emergency chute," *The Wall Street Journal*; "Can JetBlue weather the storm?" *Time*, February 21, 2007; "Held hostage on the tarmac: Time for a passenger bill of rights?" *The New York Times*, February 16, 2007; Bryce, D.J., and J.H. Dyer (2007, May), "Strategies to crack well-guarded markets," *Harvard Business Review*; Friedman, T. (2005), *The World Is Flat: A Brief History of the Twenty-First Century* (New York: Farrar, Strauss and Giroux); and Neeleman, D. (2003, Apr. 30), "Entrepreneurial thought leaders lecture," *Stanford Technology Ventures Program*.

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10. The interested reader is referred to the strategy, marketing, and economics literatures. A good start in the strategy literature is the classic work of M.E. Porter: Porter, M.E. (1980), *Competitive Strategy: Techniques for Analyzing Industries and Competitors* (New York: Free Press); Porter, M.E. (1985), *Competitive Advantage: Creating* and *Sustaining Superior Performance* (New York: Free Press); and Porter, M.E. (2008, Jan.), "The five competitive forces that shape strategy," *Harvard Business Review*.

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17. "Boeing 787: Orders and Deliveries (updated monthly)," *The Boeing Co.*, March 2015, www.boeing.com.

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23. Levitt, B., and J.G. March (1988), "Organizational learning,"*Annual Review of Sociology* 14: 319–340.

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Y=1726.5* (X^–0.363)

Data underlying Exhibit 6.6:

Units	Per-Unit Cost ($)
100	$324,464
500	$180,901
1,000	$140,659
1,500	$121,407
2,000	$109,369
2,500	$100,859
3,000	$94,400
3,500	$89,263
4,000	$85,039
4,500	$81,480
5,000	$78,422
5,500	$75,756
6,000	$73,400
6,500	$71,298
7,000	$69,406
7,500	$67,689
8,000	$66,122
8,500	$64,683
9,000	$63,354
9,500	$62,123
10,000	$60,977
10,500	$59,907
11,000	$58,903
11,500	$57,961
12,000	$57,072

28. The exact data for learning curves depicted in Exhibit 6.7 are depicted below. A simplifying assumption is that the manufacturing of one aircraft costs $100 million, from there the two different learning curves set in. Noteworthy, that while making only one aircraft costs $100 million, when manufacturing over 4,000 aircraft the expected per-unit cost falls to only $28 million (assuming a 90 percent learning curve) and only $7 million (assuming an 80 percent learning curve).

Data underlying Exhibit 6.7

	Learning Curves	
	Per-Unit Cost*	
Units	90%	80%
1	$100	$100
2	90	80
4	81	64

8	73	51
16	66	41
32	59	33
64	53	26
128	48	21
256	43	17
512	39	13
1,024	35	11
2,048	31	9
4,096	28	7

* Rounded to full dollar value in millions.

29. This discussion is based on: Gulati, R., D. Lavie, and H. Singh (2009), "The nature of partnering experience and the gain from alliances," *Strategic Management Journal* 30: 1213–1233; Thompson, P. (2001), "How much did the liberty shipbuilders learn? New evidence from an old case study," *Journal of Political Economy* 109: 103–137; Edmondson, A.C., R.M. Bohmer, and G.P. Pisano (2001), "Disrupted routines: Team learning and new technology implementation in hospitals," *Administrative Science Quarterly* 46: 685–716; Pisano, G.P., R.M. Bohmer, and A.C. Edmondson (2001), "Organizational differences in rates of learning: Evidence from the adoption of minimally invasive cardiac surgery," *Management Science* 47: 752–768; Rothaermel, F.T., and D.L. Deeds (2006), "Alliance type, alliance experience, and alliance management capability in high-technology ventures," *Journal of Business Venturing* 21: 429–460; Hoang, H., and F.T. Rothaermel (2005), "The effect of general and partner-specific alliance experience on joint R&D project performance," *Academy of Management Journal* 48: 332–345; Zollo, M., J.J. Reuer, and H. Singh (2002), "Interorganizational routines and performance in strategic alliances," *Organization Science* 13: 701–713; King, A.W., and A.L. Ranft (2001), "Capturing knowledge and knowing through improvisation: What managers can learn from the thoracic surgery board certification process," *Journal of Management* 27: 255–277; and Darr, E.D., L. Argote, and D. Epple (1995), "The acquisition, transfer and depreciation of knowledge in service organizations: Productivity in franchises," *Management Science* 42: 1750–1762.

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CHAPTER 8

Corporate Strategy: Vertical Integration and Diversification

Chapter Outline

Learning Objectives

LO 8-1 Define corporate strategy and describe the three dimensions along which it is assessed.

LO 8-2 Explain why firms need to grow, and evaluate different growth motives.

LO 8-3 Describe and evaluate different options firms have to organize economic activity.

LO 8-4 Describe the two types of vertical integration along the industry value chain: backward and forward vertical integration.

LO 8-5 Identify and evaluate benefits and risks of vertical integration.

LO 8-6 Describe and examine alternatives to vertical integration.

LO 8-7 Describe and evaluate different types of corporate diversification.

LO 8-8 Apply the core competence–market matrix to derive different diversification strategies.

LO 8-9 Explain when a diversification strategy does create a competitive advantage and when it does not.

CHAPTER CASE 8

Amazon.com: To Infinity and Beyond

WHEN JEFF BEZOS started Amazon.com out of a garage in a Seattle suburb to sell books online, he furnished his makeshift office with discarded wood doors for desks. In less than 25 years, Amazon morphed from a fledgling startup into one of the world's most valuable companies, active in far-flung businesses from ecommerce and cloud computing to media entertainment and groceries. Yet, wood doors turning into desks remain a staple at Amazon, where strict cost control is paramount to this day. At the same time, in pursuing its mission of being the "earth's most customer-centric company," Amazon excels at customer service. Indeed, a recent survey ranked Amazon as the most well-regarded company in the United States.

Jeff Bezos is founder and CEO of Amazon.com, one of the world's most valuable companies.
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Amazon.com's website went live in 1995 and was an instant success with booklovers everywhere. The online startup set itself apart from other internet merchants by pioneering one-click shopping, customer reviews, and order verification via e-mail. Next, Amazon executed a series of strategic alliances and acquisitions to rapidly expand its product and service offerings. In 2000, Amazon started to offer Marketplace, which is a platform on which independent third-party sellers can access Amazon customers globally. In 2005, Amazon launched its Prime membership service. Subscribers pay $99 a year and receive free two-day shipping, as well as access to Amazon's video and music streaming services. Besides offering every imaginable product online, it sells its own line of consumer electronics such as tablets, e-readers, and voice-enabled wireless devices such as Echo. Among them, the Kindle e-reader (launched in 2007) has transformed the publishing industry. Amazon holds two-thirds market share in e-books and now sells more e-books than print books. Launched in 2014, Echo is powered by Amazon's Alexa, an intelligent digital assistant that marks Amazon's foray into augmented reality. It plays any song you request, reads aloud your audiobooks, shares the latest news and weather forecast, controls your home's thermostat and lights, and even turns on the home alarm or the yard's sprinkler system. Exhibit 8.1 depicts Amazon's key strategic initiatives and stock market valuation over the years.

Carrying the moniker "the everything store," Amazon has become the largest online retailer in the United States, with an estimated 400 million items available, some 50 times the number sold by Walmart, the world's largest traditional retailer. Globally, only Alibaba, China's leading ecommerce conglomerate, is larger than Amazon. Besides offering a wide variety of products and services, Amazon also diversified geographically pretty much from the outset. In 1998, it added country-specific sites in the United Kingdom (amazon.co.uk) and Germany (amazon.de) to accommodate its growing popularity in Europe. French (amazon.fr) and Japanese (amazon.co.jp) Amazon sites debuted in 2000. Today, Amazon operates country-specific sites in more than a dozen countries, including in China (amazon.cn), and is making a major push into India (amazon.in), where the domestic Flipkart—started by former Amazon employees—took an early lead.

In addition to diversification in products and services as well as geography, Amazon also integrated vertically. Created in 2006, Amazon Web Services (AWS) is a cloud-based computing service, including software applications, data storage, content delivery, payment and billing systems, and other business applications. Today, AWS is the world's largest cloud-computing provider. It is also Amazon's most profitable business endeavor. In 2016, AWS gross revenues were $12 billion, with $1 billion in profits. That is, AWS' contribution to Amazon's total revenues of

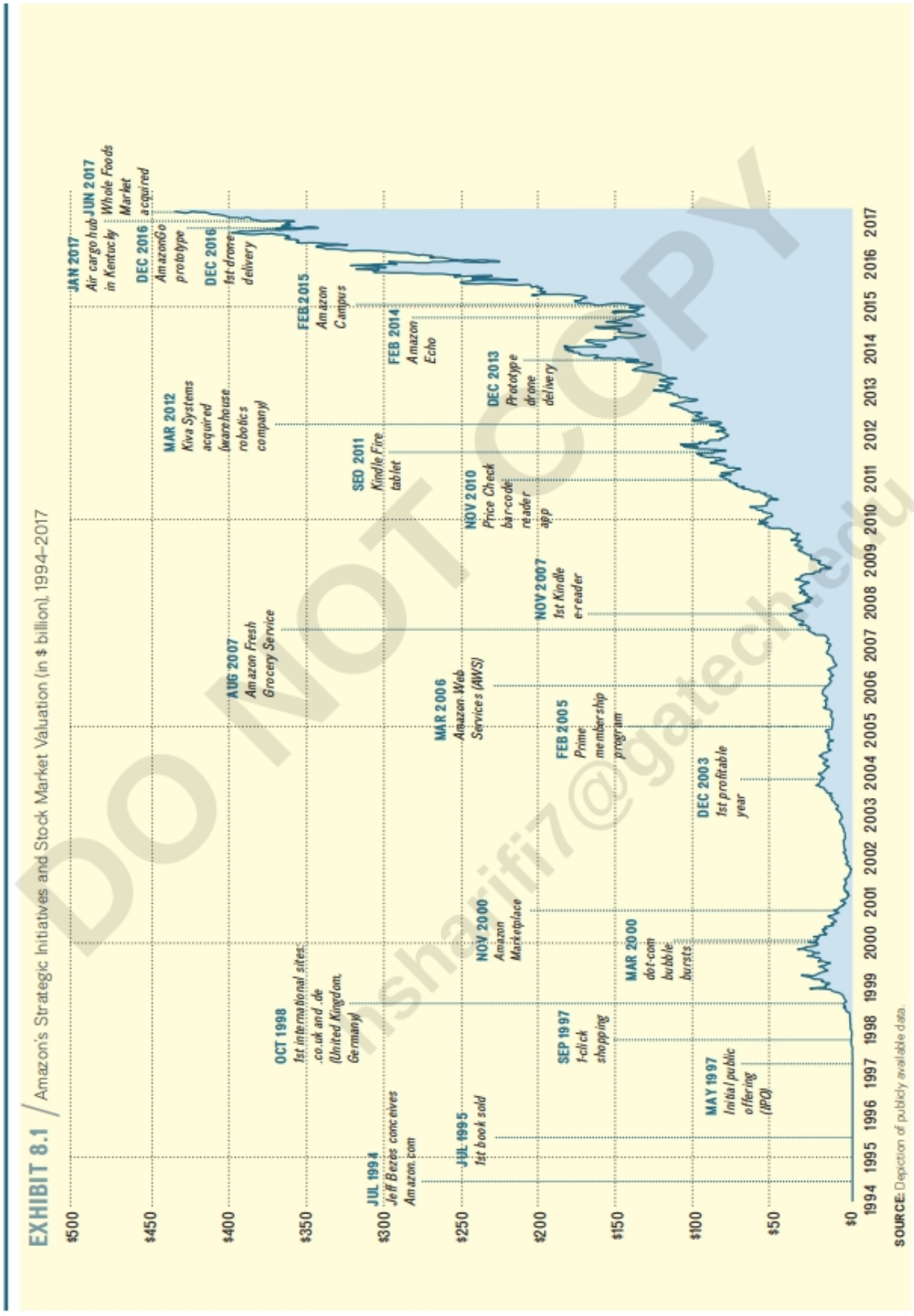

EXHIBIT 8.1 / Amazon's Strategic Initiatives and Stock Market Valuation (in $ billion), 1994–2017

SOURCE Depiction of publicly available data

$136 billion was 9 percent, while its profit contribution was 74 percent. By developing its own streaming video content (such as *The Man in the High Castle,* an alternative history about the Axis winning World War II), Amazon integrated into media production.

Amazon continues to innovate. Besides offering same-day delivery of groceries in some metropolitan areas and testing drones for even faster distribution, Amazon has introduced checkout free shopping in physical retail outlets (AmazonGo). In 2017 it became apparent these actions were a prelude to its acquisition of Whole Foods Market. Amazon will use AmazonGo at Whole Foods, reduce its labor force, and cut prices by a large margin to further grow its business.

Another recent innovation was AmazonCampus, a student-centered program. Amazon runs co-branded university-specific websites (such as purdue.amazon.com) that offer textbooks, paraphernalia such as the ubiquitous logo sweatshirts and baseball hats, and even ramen noodles! As part of this new campus initiative, Amazon offers its Prime membership to students at a 50 percent discount ($49 a year) and guarantees unlimited next-day delivery of any goods ordered online, besides all the other Prime membership benefits (free streaming of media content, lending one e-book a month for free, discounts on hardware, etc.). To accomplish next-day delivery, Amazon is building fashionable delivery centers on campus, co-branded with the local university such as "amazon@purdue." Once a package arrives, students receive a text message and can then retrieve it via code-activated lockers or from Amazon employees directly. The on-campus delivery facilities also serve as convenient return centers.

With a market capitalization of some $500 billion, Amazon is one of the top five most valuable technology companies in the world, besides Apple, Alphabet (Google's parent company), Microsoft, and Facebook. Over the past decade, Amazon's stock appreciated by 2,000 percentage points, while the stock market overall (as proxied by the Dow Jones Industrial Average) grew by 62 percentage points over the same time period.[1]

You will learn more about Amazon.com by reading this chapter; related questions appear in "ChapterCase 8 / Consider This. . . ."

OVER TIME, AMAZON.COM has morphed from a mere online book retailer into the "everything store."[2] In the process, it transformed into one of the world's largest retailers (larger than both brick-and-mortar retailers such as Walmart and most other online retailers). From books, Amazon diversified into consumer electronics, media content, cloud-computing services, and other business endeavors. Jeff Bezos decided to compete in a number of different industries, some related to Amazon's core business of online retailing, some unrelated.

How does an online bookseller turn into one of the most valuable tech companies on the planet? The short answer: Vertical integration and diversification! Amazon is now a widely diversified as well as integrated technology company. *Vertical integration* refers to the firm's ownership of its production of needed inputs or of the channels by which it distributes its outputs. Amazon, for example, now creates its own video content, which it distributes through its streaming services. *Diversification* encompasses the variety of products and services a firm offers or markets and the geographic locations in which it competes. Amazon offers a wide range of products and services. By virtue of being an online business, Amazon has a global presence, reinforced by country-specific investments in specialized sites (such as amazon.de in Germany).

But how does a business such as Amazon.com decide exactly *where to compete?* Answers to this important question—in terms of products and services offered, value chain activities, or geographic markets—are captured in a firm's *corporate strategy,* which we cover in the next three chapters. In this chapter, we define corporate strategy and then look at two fundamental corporate strategy topics: vertical integration and diversification. We conclude the chapter with *Implications for Strategic Leaders,* providing a practical application of dynamic corporate strategy at Nike and Adidas.

LO 8-1
Define corporate strategy and describe the three dimensions along which it is assessed.

8.1 What Is Corporate Strategy?

Strategy formulation centers around the key questions of *where and how* to compete. *Business strategy* concerns the question of *how to compete* in a *single product market.* As discussed in Chapter 6, the two generic business strategies that firms can follow to pursue their quest for competitive advantage are to increase differentiation (while containing cost) *or* lower costs (while maintaining differentiation). If trade-offs can be reconciled, some firms might be able to pursue a blue ocean strategy by increasing differentiation *and* lowering costs. As firms grow, they are frequently expanding their business activities through seeking new markets both by offering new products and services and by competing in different geographies. Strategic leaders must formulate a corporate strategy to guide continued growth. To gain and sustain competitive advantage, therefore, any corporate strategy must align with and strengthen a firm's business strategy, whether it is a differentiation, cost-leadership, or blue ocean strategy.

corporate strategy The decisions that senior management makes and the goal-directed actions it takes to gain and sustain competitive advantage in several industries and markets simultaneously.

Corporate strategy comprises the decisions that leaders make and the goal-directed actions they take in the quest for competitive advantage in several industries and markets simultaneously.[3] It provides answers to the key question of *where to compete.* Corporate strategy determines the boundaries of the firm along three dimensions: *vertical integration* along the industry value chain, *diversification* of products and services, and *geographic scope* (regional, national, or global markets). Strategic leaders must determine corporate strategy along the three dimensions:

1. *Vertical integration:* In what stages of the industry value chain should the company participate? The industry value chain describes the transformation of raw materials into finished goods and services along distinct vertical stages.
2. *Diversification:* What range of products and services should the company offer?
3. *Geographic scope:* Where should the company compete geographically in terms of regional, national, or international markets?

In most cases, underlying these three questions is an implicit desire for growth. The need for growth is sometimes taken so much for granted that not every manager understands all the reasons behind it. A clear understanding will help strategic leaders to pursue growth for the right reasons and make better decisions for the firm and its stakeholders.

LO 8-2
Explain why firms need to grow, and evaluate different growth motives.

WHY FIRMS NEED TO GROW

Several reasons explain *why firms need to grow.* These can be summarized as follows:

1. Increase profits.
2. Lower costs.
3. Increase market power.
4. Reduce risk.
5. Motivate management.

Let's look at each reason in turn.

INCREASE PROFITS. Profitable growth allows businesses to provide a higher return for their shareholders, or owners, if privately held. For publicly traded companies, the stock market valuation of a firm is determined to some extent by expected future revenue and profit streams. As featured in the ChapterCase, Amazon's high stock market valuation is based to a large extent on expectations of future profitability, because the company invests for the long term and as such has yet to show consistent profitability.

If firms fail to achieve their growth target, their stock price often falls. With a decline in a firm's stock price comes a lower overall market capitalization, exposing the firm to the risk of a hostile takeover. Moreover, with a lower stock price, it is more costly for firms to raise the required capital to fuel future growth by issuing stock.

LOWER COSTS. Firms are also motivated to grow in order to lower their cost. As discussed in detail in Chapter 6, a larger firm may benefit from *economies of scale,* thus driving down average costs as their output increases. Firms need to grow to achieve minimum efficient scale, and thus stake out the lowest-cost position achievable through economies of scale.

INCREASE MARKET POWER. Firms might be motivated to achieve growth to increase their market share and with it their market power. When discussing an industry's structure in Chapter 3, we noted that firms often consolidate industries through horizontal mergers and acquisitions (buying competitors) to change the industry structure in their favor (we'll discuss mergers and acquisitions in detail in Chapter 9). Fewer competitors generally equates to higher industry profitability. Moreover, larger firms have more bargaining power with suppliers and buyers (see the discussion of the five forces in Chapter 3).

REDUCE RISK. Firms might be motivated to grow in order to diversify their product and service portfolio through competing in a number of different industries. The rationale behind these diversification moves is that falling sales and lower performance in one sector (e.g., GE's oil and gas unit) might be compensated by higher performance in another (e.g., GE's health care unit). Such conglomerates attempt to achieve *economies of scope* (as first discussed in Chapter 6).

MOTIVATE MANAGEMENT. Firms need to grow to motivate management. Growing firms afford career opportunities and professional development for employees. Firms that achieve profitable growth can also pay higher salaries and spend more on benefits such as health care insurance for its employees and paid parental leave, among other perks.

Research in behavioral economics, moreover, suggests that firms may grow to achieve goals that benefit managers more than stockholders.[4] As we will discuss in detail when presenting the *principal–agent problem* later in the chapter, managers may be more interested in pursuing their own interests such as empire building and job security—plus managerial perks such as corporate jets or executive retreats at expensive resorts—rather than increasing shareholder value. Although there is a weak link between CEO compensation and firm performance, the CEO pay package often correlates more strongly with firm size.[5]

Finally, we should acknowledge that promising businesses can fail because they grow unwisely—usually too fast too soon, and based on shaky assumptions about the future. There is a small movement counter to the need for growth, seen both in small businesses and social activism. Sometimes small-business owners operate a business for convenience, stability, and lifestyle; growth could threaten those goals. In social entrepreneurship, business micro-solutions are often operated outside of capital motives, where the need to solve a social problem outweighs the need of the firm to insure longevity beyond the solution of the problem.

THREE DIMENSIONS OF CORPORATE STRATEGY

All companies must navigate the three dimensions of vertical integration, diversification, and geographic scope. Although many managers provide input, the responsibility for corporate strategy ultimately rests with the CEO. Jeff Bezos, Amazon's CEO, determined in *what stages of the industry value chain Amazon would participate* (question 1). With its prevalent delivery lockers in large metropolitan areas and its first brick-and-mortar retail store opened

in New York City, Amazon moved forward in the industry value chain to be closer to its end customer. With its offering of Amazon-branded electronics and other everyday items, it also moved backward in the industry value chain toward manufacturing, production. Similarly, the creation of AWS, now the largest cloud-computing service provider globally with some 100 million customers, is a backward vertical integration move. AWS provides Amazon with back-end IT services such as website hosting, computing power, data storage and management, etc., which in turn are all critical inputs to its online retail business.

Bezos also chooses *what range of products and services to offer,* and which not to offer (question 2). The ChapterCase discusses Amazon's diversification over time. Finally, Bezos also decided to customize certain country-specific websites despite the instant global reach of ecommerce firms. With this strategic decision, he decided where to compete globally in terms of different geographies beyond the United States. In short, Bezos determined *where Amazon competes geographically* (question 3).

Where to compete in terms of industry value chain, products and services, and geography are the fundamental corporate strategic decisions. The underlying strategic management concepts that will guide our discussion of vertical integration, diversification, and geographic competition are *core competencies, economies of scale, economies of scope,* and *transaction costs.*

- *Core competencies* are unique strengths embedded deep within a firm (as discussed in Chapter 4). Core competencies allow a firm to differentiate its products and services from those of its rivals, creating higher value for the customer or offering products and services of comparable value at lower cost. According to the *resource-based view of the firm,* a firm's boundaries are delineated by its knowledge bases and core competencies.[6] Activities that draw on what the firm knows how to do well (e.g., Amazon's core competency in developing proprietary recommendation algorithms) should be done in-house, while noncore activities such as payroll and facility maintenance can be outsourced. In this perspective, the internally held knowledge underlying a core competency determines a firm's boundaries.
- *Economies of scale* occur when a firm's average cost per unit decreases as its output increases (as discussed in Chapter 6). Anheuser-Busch InBev (AB InBev), the largest global brewer (producer of some 225 brands worldwide, including famous ones such as Budweiser, Bud Light, Miller, Stella Artois, and Beck's), reaps significant economies of scale. After AB InBev merged with SABMiller in a more than $100 billion deal in 2016, it now captures some 30 percent of global beer consumption.[7] As a consequence of its huge scale, the beer giant captures some 50 percent of global beer profits. In terms of beer volume, the new AB InBev is also more than double the size of Heineken, the number-two competitor worldwide. Given its tremendous size, AB InBev is able to spread its fixed costs over the millions of gallons of beer it brews each year, in addition to the significant buyer power its large market share affords. Larger market share, therefore, often leads to lower costs.
- *Economies of scope* are the savings that come from producing two (or more) outputs or providing different services at less cost than producing each individually, though using the same resources and technology (as discussed in Chapter 6). Leveraging its online retailing expertise, for example, Amazon benefits from economies of scope: It can offer a large range of different product and service categories at a lower cost than it would take to offer each product line individually.
- *Transaction costs* are all costs associated with an economic exchange. Applying the logic of transaction cost economics enables managers to answer the question of whether it is cost-effective for their firm to expand its boundaries through vertical integration or diversification. This implies taking on greater ownership of the production of needed inputs or of the channels by which it distributes its outputs, or adding business units that offer new products and services.

We continue our study of corporate strategy by drawing on transaction cost economics to explain vertical integration, meaning the choices a firm makes concerning its boundaries. Later, we will explore managerial decisions relating to diversification, which directly affect the firm's range of products and services in multi-industry competition. The third question of geographic scope will receive attention later, especially in Chapter 10.

8.2 The Boundaries of the Firm

LO 8-3 Describe and evaluate different options firms have to organize economic activity.

Determining the boundaries of the firm so that it is more likely to gain and sustain a competitive advantage is the critical challenge in corporate strategy.[8] **Transaction cost economics** provides useful theoretical guidance to explain and predict the boundaries of the firm. Insights gained from transaction cost economics help strategic leaders decide what activities to do in-house versus what services and products to obtain from the external market. This stream of research was initiated by Nobel Laureate Ronald Coase, who asked a fundamental question: Given the efficiencies of free markets, why do firms even exist? The key insight of transaction cost economics is that different *institutional arrangements*—markets versus firms—have different costs attached.

Transaction costs are all internal and external costs associated with an economic exchange, whether it takes place within the boundaries of a firm or in markets.[9] Exhibit 8.2 visualizes the notion of transaction costs. It shows the respective internal transactions costs within Firm A and Firm B, as well as the external transactions that occur when Firm A and Firm B do business with one another.

The total costs of transacting consist of external and internal transaction costs, as follows:

- When companies transact in the open market, they incur **external transaction costs**: the costs of searching for a firm or an individual with whom to contract, and then negotiating, monitoring, and enforcing the contract.
- Transaction costs can occur within the firm as well. Considered **internal transaction costs** these include costs pertaining to organizing an economic exchange within a firm—for example, the costs of recruiting and retaining employees; paying salaries and benefits; setting up a shop floor; providing office space and computers; and organizing,

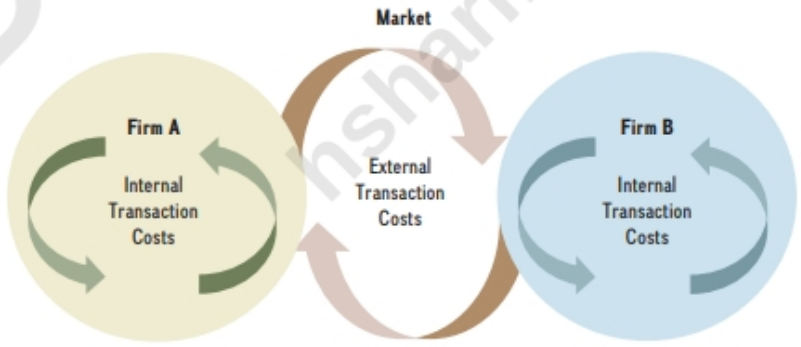

EXHIBIT 8.2 Internal and External Transaction Costs

transaction cost economics A theoretical framework in strategic management to explain and predict the boundaries of the firm, which is central to formulating a corporate strategy that is more likely to lead to competitive advantage.

transaction costs All internal and external costs associated with an economic exchange, whether within a firm or in markets.

external transaction costs Costs of searching for a firm or an individual with whom to contract, and then negotiating, monitoring, and enforcing the contract.

internal transaction costs Costs pertaining to organizing an economic exchange within a hierarchy; also called *administrative* costs.

monitoring, and supervising work. Internal transaction costs also include administrative costs associated with coordinating economic activity between different business units of the same corporation such as transfer pricing for input factors, and between business units and corporate headquarters including important decisions pertaining to resource allocation, among others. Internal transaction costs tend to increase with organizational size and complexity.

FIRMS VS. MARKETS: MAKE OR BUY?

Predictions derived from transaction cost economics guide strategic leaders in deciding which activities a firm should pursue in-house ("make") versus which goods and services to obtain externally ("buy"). These decisions help determine the boundaries of the firm. In some cases, costs of using the market such as search costs, negotiating and drafting contracts, monitoring work, and enforcing contracts when necessary may be higher than integrating the activity within a single firm and coordinating it through an organizational hierarchy. When the costs of pursuing an activity in-house are less than the costs of transacting for that activity in the market ($C_{\text{in-house}} < C_{\text{market}}$), then the firm should *vertically integrate* by owning production of the needed inputs or the channels for the distribution of outputs. In other words, when *firms* are more efficient in organizing economic activity than are *markets*, which rely on contracts among many independent actors, firms should vertically integrate.[10]

For example, rather than contracting in the open market for individual pieces of software code, Google (a unit of Alphabet) hires programmers to write code in-house. Owning these software development capabilities is valuable to the firm because its costs, such as salaries and employee benefits to in-house computer programmers, are less than what they would be in the open market. More importantly, Google gains economies of scope in software development resources and capabilities and reduces the monitoring costs. Skills acquired in writing software code for its different internet-based service offerings are transferable to new offerings. Programmers working on the original proprietary software code for the Google search engine leveraged these skills in creating a highly profitable online advertising business (AdWords and AdSense).[11] Although some of Google's software products are open source, such as the Android operating system, many of the company's internet services are based on closely guarded and proprietary software code. Google, like many leading high-tech companies such as Amazon, Apple, Facebook, and Microsoft, relies on proprietary software code and algorithms, because using the open market to transact for individual pieces of software would be prohibitively expensive. Also, the firms would need to disclose the underlying software code to outside developers, thus negating the value-creation potential.

Firms and markets, as different institutional arrangements for organizing economic activity, have their own distinct advantages and disadvantages, summarized in Exhibit 8.3.

EXHIBIT 8.3 / Organizing Economic Activity: Firms vs. Markets

	Firm	Markets
Advantages	• Command and control - Fiat - Hierarchical lines of authority • Coordination • Transaction-specific investments • Community of knowledge	• High-powered incentives • Flexibility
Disadvantages	• Administrative costs • Low-powered incentives • Principal–agent problem	• Search costs • Opportunism - Hold-up • Incomplete contracting - Specifying & measuring performance - Information asymmetries • Enforcement of contracts

The advantages of firms include:

- The ability to make *command-and-control decisions* by fiat along clear hierarchical lines of authority.
- *Coordination* of highly complex tasks to allow for specialized division of labor.
- *Transaction-specific investments,* such as specialized robotics equipment that is highly valuable within the firm, but of little or no use in the external market.
- Creation of a *community of knowledge,* meaning employees within firms have ongoing relationships, exchanging ideas and working closely together to solve problems. This facilitates the development of a deep knowledge repertoire and ecosystem within firms. For example, scientists within a biotech company who worked together developing a new cancer drug over an extended time period may have developed group-specific knowledge and routines. These might lay the foundation for innovation, but would be difficult, if not impossible, to purchase on the open market.[12]

The disadvantages of organizing economic activity within firms include:

- *Administrative costs* because of necessary bureaucracy.
- *Low-powered incentives,* such as hourly wages and salaries. These often are less attractive motivators than the entrepreneurial opportunities and rewards that can be obtained in the open market.
- The *principal–agent problem.*

principal–agent problem Situation in which an agent performing activities on behalf of a principal pursues his or her own interests.

The **principal–agent problem** is a major disadvantage of organizing economic activity within firms, as opposed to within markets. It can arise when an agent such as a manager, performing activities on behalf of the principal (the owner of the firm), pursues his or her own interests.[13] Indeed, the *separation of ownership and control* is one of the hallmarks of a publicly traded company, and so some degree of the principal–agent problem is almost inevitable.[14] For example, a manager may pursue his or her own interests such as job security and managerial perks (e.g., corporate jets and golf outings) that conflict with the principal's goals—in particular, creating shareholder value. One potential way to overcome the principal–agent problem is to give stock options to managers, thus making them owners. We will revisit the principal–agent problem, with related ideas, in Chapters 11 and 12.

The advantages of markets include:

- *High-powered incentives.* Rather than work as a salaried engineer for an existing firm, for example, an individual can start a new venture offering specialized software. High-powered incentives of the open market include the entrepreneur's ability to capture the venture's profit, to take a new venture through an initial public offering (IPO), or to be acquired by an existing firm. In these so-called *liquidity events,* a successful entrepreneur can make potentially enough money to provide financial security for life.[15]
- *Increased flexibility.* Transacting in markets enables those who wish to purchase goods to compare prices and services among many different providers.

The disadvantages of markets include:

- *Search costs.* On a very fundamental level, perhaps the biggest disadvantage of transacting in markets, rather than owning the various production and distribution activities within the firm itself, entails nontrivial *search costs.* In particular, a firm faces search costs when it must scour the market to find reliable suppliers from among the many firms competing to offer similar products and services. Even more difficult can be the search to find suppliers when the specific products and services needed are not offered by firms currently in the market. In this case, production of supplies would require transaction-specific investments, an advantage of firms.

- *Opportunism by other parties. Opportunism* is behavior characterized by self-interest seeking with guile (we'll discuss this in more detail later).
- *Incomplete contracting.* Although market transactions are based on implicit and explicit contracts, all contracts are incomplete to some extent, because not all future contingencies can be anticipated at the time of contracting. It is also difficult to specify expectations (e.g., What stipulates "acceptable quality" in a graphic design project?) or to measure performance and outcomes (e.g., What does "excess wear and tear" mean when returning a leased car?). Another serious hazard inherent in contracting is *information asymmetry* (which we discuss next).
- *Enforcement of contracts.* It often is difficult, costly, and time-consuming to enforce legal contracts. Not only does litigation absorb a significant amount of managerial resources and attention, but also it can easily amount to several million dollars in legal fees. Legal exposure is one of the major hazards in using markets rather than integrating an activity within a firm's hierarchy.

information asymmetry Situation in which one party is more informed than another because of the possession of private information.

Frequently, sellers have better information about products and services than buyers, which creates **information asymmetry**, a situation in which one party is more informed than another, because of the possession of private information. When firms transact in the market, such unequal information can lead to a *lemons problem.* Nobel Laureate George Akerlof first described this situation using the market for used cars as an example.[16] Assume only two types of used cars are sold: good cars and bad cars (lemons). Good cars are worth $8,000 and bad ones are worth $4,000. Moreover, only the seller knows whether a car is good or is a lemon. Assuming the market supply is split equally between good and bad cars, the probability of buying a lemon is 50 percent. Buyers are aware of the general possibility of buying a lemon and thus would like to hedge against it. Therefore, they split the difference and offer $6,000 for a used car. This discounting strategy has the perverse effect of crowding out all the good cars because the sellers perceive their value to be above $6,000. Assuming that to be the case, all used cars offered for sale will be lemons.

The important take-away here is *caveat emptor*—buyer beware. Information asymmetries can result in the crowding out of desirable goods and services by inferior ones. This has been shown to be true in many markets, not just for used cars, but also in ecommerce (e.g., eBay), mortgage-backed securities, and even collaborative R&D projects.[17]

ALTERNATIVES ON THE MAKE-OR-BUY CONTINUUM

The "make" and "buy" choices *anchor each end of a continuum* from markets to firms, as depicted in Exhibit 8.4. Several alternative hybrid arrangements are available between these two extremes.[18] Moving from transacting in the market ("buy") to full integration ("make"), alternatives include short-term contracts as well as various forms of strategic alliances (long-term contracts, equity alliances, and joint ventures) and parent–subsidiary relationships.

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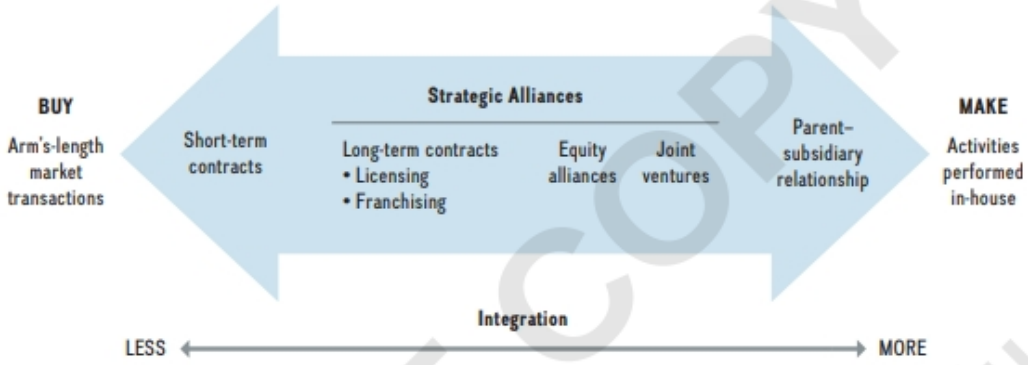
SHORT-TERM CONTRACTS. When engaging in *short-term contracting,* a firm sends out *requests for proposals* (*RFPs*) to several companies, which initiates competitive bidding for contracts to be awarded with a short duration, generally less than one year.[19] The benefit to this approach lies in the fact that it allows a somewhat longer planning period than individual market transactions. Moreover, the buying firm can often demand lower prices due to the competitive bidding process. The drawback, however, is that firms responding to the RFP have no incentive to make any transaction-specific investments (e.g., buy new machinery to improve product quality) due to the short duration of the contract. This is exactly what happened in the U.S. automotive

EXHIBIT 8.4 / Alternatives on the Make-or-Buy Continuum



industry when GM used short-term contracts for standard car components to reduce costs. When faced with significant cost pressures, suppliers reduced component quality in order to protect their eroding margins. This resulted in lower-quality GM cars, contributing to a competitive advantage vis-à-vis competitors, most notably Toyota but also Ford, which used a more cooperative, longer-term partnering approach with suppliers.[20]

STRATEGIC ALLIANCES. As we move toward greater integration on the make-or-buy continuum, the next organizational forms are strategic alliances. **Strategic alliances** are voluntary arrangements between firms that involve the sharing of knowledge, resources, and capabilities with the intent of developing processes, products, or services.[21] Alliances have become a ubiquitous phenomenon, especially in high-tech industries. Moreover, strategic alliances can facilitate investments in transaction-specific assets without encountering the internal transaction costs involved in owning firms in various stages of the industry value chain.

strategic alliances Voluntary arrangements between firms that involve the sharing of knowledge, resources, and capabilities with the intent of developing processes, products, or services.

Strategic alliances is an umbrella term that denotes different hybrid organizational forms—among them, long-term contracts, equity alliances, and joint ventures. Given their prevalence in today's competitive landscape as a key vehicle to execute a firm's corporate strategy, we take a quick look at strategic alliances here and then study them in more depth in Chapter 9.

Long-Term Contracts. We noted that firms in short-term contracts have no incentive to make transaction-specific investments. *Long-term contracts,* which work much like short-term contracts but with a duration generally greater than one year, help overcome this drawback. Long-term contracts help facilitate transaction-specific investments. **Licensing**, for example, is a form of long-term contracting in the manufacturing sector that enables firms to commercialize intellectual property such as a patent. The first biotechnology drug to reach the market, Humulin (human insulin), was developed by Genentech and commercialized by Eli Lilly based on a licensing agreement.

licensing A form of long-term contracting in the manufacturing sector that enables firms to commercialize intellectual property.

In service industries, **franchising** is an example of long-term contracting. In these arrangements, a franchisor, such as McDonald's, Burger King, 7-Eleven, H&R Block, or Subway, grants a franchisee (usually an entrepreneur owning no more than a few outlets) the right to use the franchisor's trademark and business processes to offer goods and services that carry the franchisor's brand name. Besides providing the capital to finance the expansion of the chain, the franchisee generally pays an up-front (buy-in) lump sum to the franchisor plus a percentage of revenues.

franchising A long-term contract in which a franchisor grants a franchisee the right to use the franchisor's trademark and business processes to offer goods and services that carry the franchisor's brand name.

Equity Alliances. Yet another form of strategic alliance is an *equity alliance*—a partnership in which at least one partner takes partial ownership in the other partner. A partner purchases an ownership share by buying stock or assets (in private companies), and thus making an equity investment. The taking of equity tends to signal greater commitment to the partnership. Strategy Highlight 8.1 describes how soft drink giant Coca-Cola Co. formed an equity alliance with energy-drink maker Monster.

Why is the Coca-Cola Co. forming an equity alliance with Monster Beverage Corp. and not just entering a short- or long-term contract, such as a distribution and profit-sharing agreement? One reason is that an equity investment in Monster might give Coca-Cola an inside look into the company. Gaining more information could be helpful if Coca-Cola decides to acquire Monster in the future. Gaining such private information might not be possible with a mere contractual agreement. Buying time is also helpful so Coca-Cola Co. can see how the wrongful death lawsuits play out, and thus limit the potential downside to Coke's wholesome brand image (as mentioned in Strategy Highlight 8.1).

Strategy Highlight 8.1

Is Coke Becoming a Monster?

While Americans are drinking ever more nonalcoholic beverages, the demand for longtime staples such as the full-calorie Coke or Pepsi are in free fall. More health-conscious consumers are moving away from sugary drinks at the expense of Coke and Pepsi, the two archrivals among regular colas. Unlike in the 1990s, however, Americans are not replacing them with diet sodas, but rather with bottled water and energy drinks. Indeed, Coca-Cola was slow to catch the trend toward bottled water and other more healthy choices such as vitamin water. Protecting its wholesome image, the conservative Coca-Cola Co. shunned energy drinks. The makers of energy drinks, such as 5-hour Energy, Red Bull, Monster, Rockstar, and Amp Energy, have faced wrongful death lawsuits. PepsiCo, on the other hand, was much more aggressive in moving into the energy-drink business with Amp Energy (owned by PepsiCo) and Rockstar (distributed by PepsiCo).

Albeit late to the party, Coca-Cola decided to not miss out completely on energy drinks, one of the fastest-growing segments in nonalcoholic beverages. After years of deliberation, in 2014 the Coca-Cola Co. formed an equity alliance with Monster Beverage Corp., spending $2 billion for a 16.7 percent stake in the edgy energy-drink company. This values the privately held Monster Beverage at roughly $12 billion. What might have finally persuaded Coca-Cola to make this decision? Not only was Monster now number one with 40 percent market share of the over $6 billion energy-drink industry, but the company also had settled a number of wrongful death lawsuits out of court. Meanwhile, however, the U.S. Food and Drug Administration is still investigating some 300 "adverse event" reports allegedly linked to the consumption of energy drinks, including 31 deaths. While the Coca-Cola Co. insists that it completed its due diligence before concluding that energy drinks are safe, it hedges its bets with a minority investment in Monster rather than an outright acquisition. This allows the market leader in nonalcoholic beverages to benefit from the explosive growth in energy drinks, while limiting potential exposure of Coca-Cola's wholesome image and brand. Meanwhile, Monster paid about $20 million to sponsor NASCAR's top racing series in 2017.[22]

The Coca-Cola Co. holds an ownership stake through an equity alliance in the Monster Beverage Corp., which sponsors the NASCAR top racing series.
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Moreover, in strategic alliances based on a mere contractual agreement, one transaction partner could attempt to *hold up* the other by demanding lower prices or threatening to walk away from the agreement (with whatever financial penalties might be included in the contract). This might be a real concern for Monster because Coca-Cola, with about $50 billion in annual sales, is about 20 times larger than Monster with $2.5 billion in revenues. To assuage Monster's concerns, with its equity investment, Coca-Cola made a **credible commitment**—a long-term strategic decision that is both difficult and costly to reverse.

credible commitment A long-term strategic decision that is both difficult and costly to reverse.

Joint Ventures. In a **joint venture**, which is another special form of strategic alliance, two or more partners create and jointly own a new organization. Since the partners contribute equity to a joint venture, they make a long-term commitment, which in turn facilitates transaction-specific investments. Dow Corning, initially created and owned jointly by Dow Chemical and Corning, is an example of a joint venture. Dow Corning focuses on silicone-based technology and employs roughly 10,000 people with $5 billion in annual revenues. That success shows that some joint ventures can be quite large.[23] Since 2017, Dow Corning is now owned by DowDuPont, after Dow Chemical and DuPont merged, creating a chemical-agricultural giant with some $120 billion in annual sales.

joint venture A stand-alone organization created and jointly owned by two or more parent companies.

Hulu, a subscription video-on-demand service, is also a joint venture, owned NBCUniversal, Fox, Disney-ABC, and Turner Broadcasting System (TBS). In the United States, Hulu, with some 12 million subscribers in 2017, is a smaller competitor to Netflix (50 million) and to Amazon Prime with its 65 million members.[24]

PARENT–SUBSIDIARY RELATIONSHIP. The *parent–subsidiary relationship* describes the most-integrated alternative to performing an activity within one's own corporate family (and thus anchors the make-or-buy continuum in Exhibit 8.4 on the "make" side). The corporate parent owns the subsidiary and can direct it via command and control. Transaction costs that arise are frequently due to political turf battles, which may include the capital budgeting process and transfer prices, among other areas. Other areas of potential conflict concern how centralized or decentralized a subsidiary unit should be run.

GM CEO Mary Barra divested both Opel and Vauxhall by selling the GM subsidiaries to Peugeot, a French carmaker. Over many years the conflict in the parent–subsidiary relationship between GM and its European units shows that even the most integrated form of corporate relationships can be prone to high transaction costs.

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For example, although GM owned its European carmakers (Opel in Germany and Vauxhall in the United Kingdom), it had problems bringing some of their know-how and design of small fuel-efficient cars back into the United States. This failure put GM at a competitive disadvantage vis-à-vis the Japanese competitors when they were first entering the U.S. market with more fuel-efficient cars. In addition, the Japanese carmakers were able to improve the quality and design of their vehicles faster, which enabled them to gain a competitive advantage, especially in an environment of rising gas prices.

The GM versus Opel and Vauxhall parent–subsidiary relationship was burdened by political problems because managers in Detroit did not respect the engineering behind the small, fuel-efficient cars that Opel and Vauxhall made. They were not interested in using European know-how for the U.S. market and didn't want to pay much or anything for it. Moreover, Detroit was tired of subsidizing the losses of Opel and Vauxhall, and felt that its European subsidiaries were manipulating the capital budgeting process.[25] In turn, the Opel and Vauxhall subsidiaries felt resentment toward their parent company: GM had threatened to shut them down as part of its bankruptcy restructuring, whereas they instead hoped to be divested as independent companies.[26]

After many years of acrimonious parent–subsidiary relationships, GM sold Opel and Vauxhall to Peugeot, a French carmaker, for a bit over $2 billion in 2017.[27] This marks GM's exit from the European car market, which has been a notorious money-losing venture for the Detroit automaker. Europe is one of the most competitive automobile markets in the world, and home to several strong car brands. The European market also is consistently plagued by excess capacity because of fickle consumer tastes. Rather than focusing on being the world's largest carmaker in terms of volume, GM CEO Mary Barra is now focusing more on profitability. In contrast to Europe, GM is much stronger in its home market and highly profitable, especially in large pickup trucks and SUVs. Divesting its European operations also allows Barra to focus the Detroit-based carmaker more on growth markets in Asia, especially in China, where GM holds a strong position, with Shanghai GM Co., the 50-50 joint venture between GM and SAIC Motor Corp., a Chinese carmaker.

Having laid a strong theoretical foundation by fully considering transaction cost economics and the boundaries of the firm, we now turn our attention to the firm's position along the vertical industry value chain.

vertical integration The firm's ownership of its production of needed inputs or of the channels by which it distributes its outputs.

industry value chain Depiction of the transformation of raw materials into finished goods and services along distinct vertical stages, each of which typically represents a distinct *industry* in which a number of different firms are competing.

8.3 Vertical Integration along the Industry Value Chain

The first key question when formulating corporate strategy is: In what stages of the industry value chain should the firm participate? Deciding whether to make or buy the various activities in the industry value chain involves the concept of vertical integration. **Vertical integration** is the firm's ownership of its production of needed inputs or of the channels by which it distributes its outputs. Vertical integration can be measured by a firm's value added:

- *What percentage of a firm's sales is generated within the firm's boundaries?*[28] The degree of vertical integration tends to correspond to the number of industry value chain stages in which a firm directly participates.

EXHIBIT 8.5 / Backward and Forward Vertical Integration along an Industry Value Chain

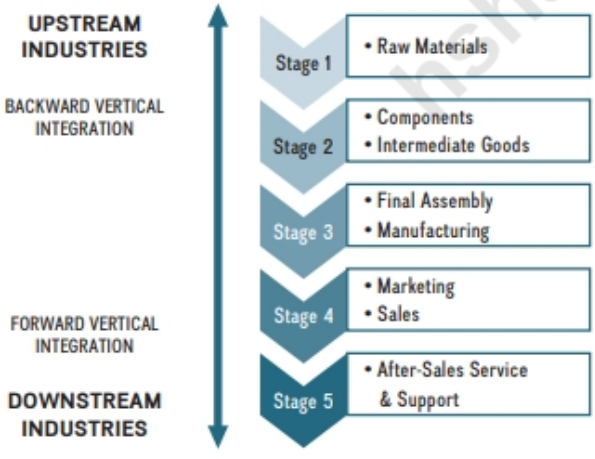


Exhibit 8.5 depicts a generic **industry value chain**. Industry value chains are also called *vertical value chains,* because they depict the transformation of raw materials into finished goods and services along distinct vertical stages. Each stage of the vertical value chain typically represents a distinct *industry* in which a number of different firms are competing. This is also why the expansion of a firm up or down the *vertical* industry value chain is called *vertical* integration.

To explain the concept of vertical integration along the different stages of the industry value chain more fully, let's use your cell phone as an example. This ubiquitous device is the result of a globally coordinated industry value chain of different products and services:

- *Stage 1: Raw Materials.* The raw materials to make your cell phone, such as chemicals, ceramics, metals, oil for plastic, and so on,

are commodities. In each of these commodity businesses are different companies, such as DuPont (United States), BASF (Germany), Kyocera (Japan), and ExxonMobil (United States).

- *Stage 2: Intermediate Goods and Components.* Elements such as integrated circuits, displays, touchscreens, cameras, and batteries are provided by firms such as ARM Holdings (United Kingdom), Jabil (United States), Intel (United States), LG Display (Korea), Altek (Taiwan), and BYD (China).
- *Stage 3: Final Assembly and Manufacturing.* Original equipment manufacturing firms (OEMs) such as Flextronics (Singapore) or Foxconn (China) typically assemble cell phones under contract for consumer electronics and telecommunications companies such as Apple (United States), Samsung and LG (both South Korea), Huawei and Oppo Electronics (both China), and others. If you look closely at an iPhone, for example, you'll notice it says, "Designed by Apple in California. Assembled in China."
- *Stages 4 and 5: Marketing, Sales, After-Sales Service, Support.* Finally, to get wireless data and voice service, you pick a service provider such as AT&T, Sprint, T-Mobile, or Verizon in the United States; América Móvil in Mexico; Oi in Brazil; Orange in France; T-Mobile or Vodafone in Germany; NTT Docomo in Japan; Airtel in India; or China Mobile in China, among others. In 2015, Google launched a low-cost wireless service in the United States. Called ProjectFi, the wireless service plans offered by Google cost $20 a month for talk and text, including Wi-Fi and international coverage. Each gigabyte of data costs $10 per month. Google's goal is that by providing lower-priced wireless services, more people will connect to the internet, which means more demand for its core online search business and ad-supported YouTube video service. On the downside, initially it is available only with Google phones such as the Pixel.[29]

LO 8-4

Describe the two types of vertical integration along the industry value chain: backward and forward vertical integration.

All of these companies—from the raw-materials suppliers to the service providers—make up the global industry value chain that, as a whole, delivers you a working cell phone. Determined by their corporate strategy, each firm decides where in the industry value chain to participate. This in turn defines the vertical boundaries of the firm.

E&J Gallo, the California winery, is fully vertically integrated, following its corporate strategy mantra "from grape to glass." E&J Gallo is also the largest exporter of California wines.
©Sherri Camp/123RF

TYPES OF VERTICAL INTEGRATION

Along the industry value chain, firms pursue varying degrees of vertical integration in their corporate strategy. Some firms participate in only one or a few stages of the industry value chain, while others comprise many if not all stages. In general, fewer firms are fully vertically integrated. Most firms concentrate on only a few stages in the industry value chain, and some firms just focus on one. The following examples illuminate different degrees of vertical integration along the industry value chain.

E&J Gallo Winery is the world's largest family-owned winery. With sales in some 90 countries, it is also the largest exporter of California wines. As a fully vertically integrated producer and distributor, it participates in all stages of the industry value chain. E&J Gallo's corporate strategy and resulting activities along the industry value chain are guided by the mantra "from grape to glass." E&J Gallo owns its own vineyards, bottling

plants, distribution and logistics network, and retails via the internet where allowed. (Some states in the United States ban direct-to-consumer sale of alcoholic beverages.)

Being fully vertically integrated allows E&J Gallo to achieve *economies of scale*, resulting in lower cost. Additional operational efficiency is achieved by effective coordination such as scheduling along the industry value chain. E&J Gallo also emphasizes that being fully vertically integrated allows it to control quality better and to provide the end user with a better experience. Offering a house of brands, consisting of many different wines at different price points, also allows E&J Gallo to differentiate its product and to reap economies of scope. E&J Gallo's value added approaches 100 percent. The California winery, therefore, competes in a number of different industries along the entire vertical value chain. As a consequence, it faces different competitors in each stage of the industry value chain, both domestically and internationally.

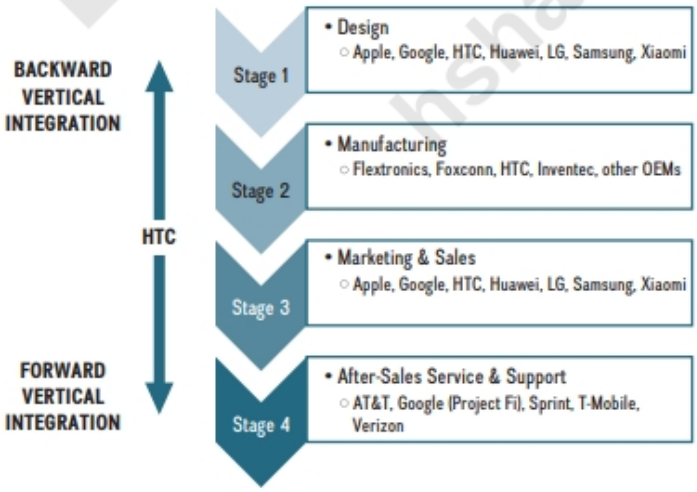
On the other end of the spectrum are firms that are more or less vertically disintegrated with a low degree of vertical integration. These firms focus on only one or a few stages of the industry value chain. Apple, for example, focuses only on design, marketing, and retailing; all other value chain activities are outsourced.

Be aware that not all industry value chain stages are equally profitable. Apple captures significant value by designing mobile devices through integration of hardware and software in novel ways, but it outsources the manufacturing to generic OEMs. The logic behind these decisions can be explained by applying Porter's five forces model and the VRIO model. The many small cell phone OEMs are almost completely interchangeable and are exposed to the perils of perfect competition. However, Apple's competencies in innovation, system integration, and marketing are valuable, rare, and unique (non-imitable) resources, and Apple is organized to capture most of the value it creates. Apple's continued innovation through new products and services provides it with a string of temporary competitive advantages.

backward vertical integration Changes in an industry value chain that involve moving ownership of activities upstream to the originating (inputs) point of the value chain.

Exhibit 8.6 displays part of the industry value chain for smartphones. In this figure, note HTC's transformation from a no-name OEM manufacturer in stage 2 of the vertical value chain to a player in the design, manufacture, and sale of smartphones (stages 1 and 3). It now offers a lineup of innovative and high-performance smartphones under the HTC label.[30]

EXHIBIT 8.6 / HTC's Backward and Forward Integration along the Industry Value Chain in the Smartphone Industry



Firms regularly start out as OEMs and then vertically integrate along the value chain in either a backward and/or forward direction. With these moves, former contractual partners to brand-name phone makers such as Apple and Samsung then become their competitors. OEMs are able to vertically integrate because they acquire the skills needed to compete in adjacent industry value chain activities from their alliance partners, which need to share the technology behind their proprietary phone to enable large-scale manufacturing.

Over time, HTC was able to upgrade its capabilities from merely manufacturing smartphones to also designing products.[31] In doing so, HTC engaged in **backward vertical integration**—moving ownership of activities upstream to the originating inputs of the value chain. Moreover,

by moving downstream into sales and increasing its branding activities, HTC has also engaged in **forward vertical integration**—moving ownership of activities closer to the end customer. Although HTC has long benefited from *economies of scale* as an OEM, it is now also benefiting from *economies of scope* through participating in different stages of the industry value chain. For instance, it now can share competencies in product design, manufacturing, and sales, while at the same time attempting to reduce transaction costs.

forward vertical integration Changes in an industry value chain that involve moving ownership of activities closer to the end (customer) point of the value chain.

Although, HTC with some 9 percent market share in the smartphone industry (in 2011) was the third largest handset maker–just behind Samsung and Apple—the Taiwanese smartphone has fallen on hard times since. By 2017, HTC's market share had plummeted to less than 1 percent. New technology firms from China such as Huawei, Oppo, Vivo, and Xiaomi performed better than HTC. Yet, HTC's vertical integration into design as well as manufacturing and sales and marketing of smartphones allowed it build a core competency that Google, a unit of Alphabet found valuable. Google contracted HTC to design and build its new high-end phone (the Pixel) for the California-based high-tech company. In 2017, Google acquired HTC's smartphone engineering group for $1.1 billion. Integrating HTC's smartphone unit within Google will allow engineers to more tightly integrate hardware and software. This in turn will allow Google to differentiate its high-end Pixel phone more from the competition, especially Apple's newly released iPhone X and Samsung's Galaxy 8 line of phone, including the Note 8. Even though HTC by itself lost out to Samsung, Apple, and a handful of new Chinese firms in the highly competitive smartphone industry, vertical integration along the industry value chain allowed HTC to build a core competency in the design and manufacturing of smartphones for which Google paid over $1 billion to acquire, and thus to integrate it more fully with its Android group that develops the software for Google's mobile operating system.

Likewise, Foxconn, Apple's largest OEM, is also vertically integrating along the industry value chain.[32] In 2016, it purchased the struggling Japanese electronics manufacturer Sharp for some $4 billion. Sharp is known for its high-quality display panels (used in smartphones and elsewhere) as well as other innovative consumer electronics such as microwave ovens and air purifiers.

Foxconn hopes to move upmarket by leveraging Sharp's strong brand name, and to benefit from the Japanese high-tech company's efforts to produce organic light-emitting diode (OLED) displays. Similarly to HTC, Foxconn is moving backward in the industry value chain into design of consumer electronics and forward into marketing and sales by using the Sharp brand. This shows that OEMs, over time, tend to acquire skills, know-how, and ambition to move beyond mere manufacturing, where profit margins are often razor thin.

BENEFITS AND RISKS OF VERTICAL INTEGRATION

LO 8-5 Identify and evaluate benefits and risks of vertical integration.

To decide the degree and type of vertical integration to pursue, strategic leaders need to understand the possible benefits and risks of vertical integration. At a minimum, they need to proceed with caution, and carefully consider the countervailing risks at the same time they consider the benefits.

BENEFITS OF VERTICAL INTEGRATION. Vertical integration, either backward or forward, can have a number of benefits, including[33]

- Lowering costs.
- Improving quality.
- Facilitating scheduling and planning.
- Facilitating investments in specialized assets.
- Securing critical supplies and distribution channels.

As noted earlier, HTC started as an OEM for brand-name mobile device companies such as Motorola and Nokia (both defunct) and telecom service providers AT&T and T-Mobile. More recently, HTC has been manufacturing phones for Google (which uses Motorola's patents after its acquisition of Motorola; the handset-making unit of Motorola was sold later by Google to Lenovo, a Chinese computer company). HTC backwardly integrated into smartphone design by acquiring One & Co., a San Francisco-based design firm.[34] The acquisition allowed HTC to secure scarce design talent and capabilities that it leveraged into the design of smartphones with superior quality and features, enhancing the differentiated appeal of its products. Moreover, HTC can now design phones that leverage its low-cost manufacturing capabilities.

Likewise, forward integration into distribution and sales allows companies to more effectively plan for and respond to changes in demand. HTC's forward integration into sales enables it to offer its products directly to wireless providers such as AT&T, Sprint, and Verizon. HTC even offers unlocked phones directly to the end consumer via its own website. With ownership and control of more stages of the industry value chain, HTC is now in a much better position to respond if, for example, demand for its latest phone should suddenly pick up.

Vertical integration along the industry value chain can also facilitate *investments in specialized assets*. What does this mean? **Specialized assets** have a high opportunity cost: They have significantly more value in their intended use than in their next-best use.[35] They can come in several forms:[36]

specialized assets Unique assets with high opportunity cost: They have significantly more value in their intended use than in their next-best use. They come in three types: site specificity, physical-asset specificity, and human-asset specificity.

- *Site specificity*—assets required to be co-located, such as the equipment necessary for mining bauxite and aluminum smelting.
- *Physical-asset specificity*—assets whose physical and engineering properties are designed to satisfy a particular customer. Examples include the bottling machinery for E&J Gallo. Given the many brands of wine offered by E&J Gallo, unique equipment, such as molds and a specific production process, is required to produce the different and trademarked bottle shapes.
- *Human-asset specificity*—investments made in human capital to acquire unique knowledge and skills, such as mastering the routines and procedures of a specific organization, which are not transferable to a different employer.

Investments in specialized assets tend to incur high opportunity costs because making the specialized investment opens up the threat of opportunism by one of the partners. *Opportunism* is defined as self-interest seeking with guile.[37] Backward vertical integration is often undertaken to overcome the threat of opportunism and to secure key raw materials.

In an effort to secure supplies and reduce the costs of jet fuel, Delta was the first airline to acquire an oil refinery. In 2012, it purchased a Pennsylvania-based facility from ConocoPhillips. Delta estimates that this backward vertical integration move not only will allow it to provide 80 percent of its fuel internally, but will also save it some $300 million in costs annually. Fuel costs are quite significant for airlines; for Delta, they are some 40 percent of its total operating cost.[38]

RISKS OF VERTICAL INTEGRATION. It is important to note that the risks of vertical integration can outweigh the benefits. Depending on the situation, vertical integration has several risks, some of which directly counter the potential benefits, including[39]

- Increasing costs.
- Reducing quality.
- Reducing flexibility.
- Increasing the potential for legal repercussions.

A higher degree of vertical integration can lead to increasing costs for a number of reasons. In-house suppliers tend to have higher cost structures because they are not exposed to market competition. Knowing there will always be a buyer for their products reduces their incentives to lower costs. Also, suppliers in the open market, because they serve a much larger market, can achieve economies of scale that elude in-house suppliers. Organizational complexity increases with higher levels of vertical integration, thereby increasing administrative costs such as determining the appropriate transfer prices between an in-house supplier and buyer. Administrative costs are part of internal transaction costs and arise from the coordination of multiple divisions, political maneuvering for resources, the consumption of company perks, or simply from employees slacking off.

The knowledge that there will always be a buyer for their products not only reduces the incentives of in-house suppliers to lower costs, but also can reduce the incentive to increase quality or come up with innovative new products. Moreover, given their larger scale and greater exposure to more customers, external suppliers often can reap higher learning and experience effects and so develop unique capabilities or quality improvements.

A higher degree of vertical integration can also reduce a firm's strategic flexibility, especially when faced with changes in the external environment such as fluctuations in demand and technological change.[40] For instance, when technological process innovations enabled significant improvements in steelmaking, mills such as U.S. Steel and Bethlehem Steel were tied to their fully integrated business models and were thus unable to switch technologies, leading to the bankruptcy of many integrated steel mills. Non-vertically integrated mini-mills such as Nucor and Chaparral, on the other hand, invested in the new steelmaking process and grew their business by taking market share away from the less flexible integrated producers.[41]

U.S. regulators such as the Federal Trade Commission (FTC) and the Justice Department (DOJ) tend to allow vertical integration, arguing that it generally makes firms more efficient and lowers costs, which in turn can benefit customers. However, due to monopoly concerns, vertical integration has not gone entirely unchallenged.[42] Before engaging in vertical integration, therefore, strategic leaders need to be aware that this corporate strategy can increase the potential for legal repercussions.

Amazon.com, featured in the ChapterCase, is facing potential legal repercussions because of its increasing scale and scope. Amazon now accounts for roughly one-half of all internet retail spending in the United States. In addition, with AWS, physical retail stores, and drone deliveries, Amazon is increasingly becoming a fully vertically integrated enterprise. Many argue that Amazon is much like a utility, providing the backbone for internet commerce, both in the business-to-consumer (B2C) as well as in the business-to-business (B2B) space. This paints a future picture in which rivals are depending more and more on Amazon's products and services to conduct their own business. Amazon's tremendous scale and scope can bring it increasingly into conflict with governments. Antitrust enforcers such as the Department of Justice might train their sights on Amazon.

WHEN DOES VERTICAL INTEGRATION MAKE SENSE?

U.S. business saw a number of periods of higher than usual vertical integration, and looking back may reveal useful lessons on how a company can make better decisions around its corporate strategy.[43]

In the early days of automobile manufacturing, Ford Motor Co. was frustrated by shortages of raw materials and the limited delivery of parts suppliers. In response, Henry Ford decided to own the whole supply chain, so his company soon ran mining operations, rubber plantations, freighters, blast furnaces, glassworks, and its own parts manufacturer. In Ford's River Rogue plant, raw materials entered on one end, new cars rolled out the other

end. But over time, the costs of vertical integration caught up, both financial costs that undid earlier cost savings and operational costs that hampered the manufacturer's flexibility to respond to changing conditions. Indeed, Ford experienced diseconomies of scale (see Exhibit 6.5) due to its level of vertical integration and the unwieldy size of its huge plants.

In the 1970s, the chipmakers and the manufacturers of electronic products tried to move into each others' business. Texas Instruments went downstream into watches and calculators. Bowmar, which at first led the calculator market, tried to go upstream into chip manufacturing and failed. The latter 2000s saw a resurgence of vertical integration. In 2009, General Motors was trying to reacquire Delphi, a parts supplier that it had sold in 1997. In the 2010s, PepsiCo and Coca-Cola, the two major soft drink companies, purchased bottling plants (and later divested them again).

Rita McGrath suggested that the siren call of vertical integration looms large for companies seeking to completely change the customer's experience: "An innovator who can figure out how to eliminate annoyances and poor interfaces in the chain can build an incredible advantage, based on the customers' desire for that unique solution."[44] So what should company executives do as they contemplate a firm's corporate strategy? As far back as the 1990s, the consulting firm McKinsey was counseling clients that firms had to consider carefully *why* they were looking at integrating along their industry value chain. McKinsey identified the main reason to vertically integrate: failure of vertical markets.

vertical market failure When the markets along the industry value chain are too risky, and alternatives too costly in time or money.

Vertical market failure occurs when transactions within the industry value chain are too risky, and alternatives to integration are too costly or difficult to administer. This recommendation corresponds with the one derived from transaction cost economics earlier in this chapter. When discussing research on vertical integration, *The Economist* concluded, "Although reliance on [external] supply chains has risks, owning parts of the supply chain can be riskier—for example, few clothing-makers want to own textile factories, with their pollution risks and slim profits." The findings suggest that when a company vertically integrates two or more steps away from its core competency, it fails two-thirds of the time.[45]

The risks of vertical integration and the difficulty of getting it right bring us to look at alternatives that allow companies to gain some of the benefits of vertical integration without the risks of full ownership of the supply chain.

ALTERNATIVES TO VERTICAL INTEGRATION

LO 8-6 Describe and examine alternatives to vertical integration.

Ideally, one would like to find alternatives to vertical integration that provide similar benefits without the accompanying risks. Taper integration and strategic outsourcing are two such alternatives.

taper integration A way of orchestrating value activities in which a firm is backwardly integrated but also relies on outside-market firms for some of its supplies and/or is forwardly integrated but also relies on outside-market firms for some of its distribution.

TAPER INTEGRATION. One alternative to vertical integration is **taper integration**. It is a way of orchestrating value activities in which a firm is backwardly integrated, but it also relies on outside-market firms for some of its supplies, and/or is forwardly integrated but also relies on outside-market firms for some if its distribution.[46] Exhibit 8.7 illustrates the concept of taper integration along the vertical industry value chain. Here, the firm sources intermediate goods and components from in-house suppliers as well as outside suppliers. In a similar fashion, a firm sells its products through company-owned retail outlets and through independent retailers. Both Apple and Nike, for example, use taper integration: They own retail outlets but also use other retailers, both the brick-and-mortar type and online.

Taper integration has several benefits:[47]

- It exposes in-house suppliers and distributors to market competition so that performance comparisons are possible. Rather than hollowing out its competencies by relying too much on outsourcing, taper integration allows a firm to retain and

fine-tune its competencies in upstream and downstream value chain activities.[48]

- Taper integration also enhances a firm's flexibility. For example, when adjusting to fluctuations in demand, a firm could cut back on the finished goods it delivers to external retailers while continuing to stock its own stores.
- Using taper integration, firms can combine internal and external knowledge, possibly paving the path for innovation.

Based on a study of 3,500 product introductions in the computer industry, researchers have provided empirical evidence that taper integration can be beneficial.[49] Firms that pursued taper integration achieved superior performance in both innovation and financial performance when compared with firms that relied more on vertical integration or strategic outsourcing.

EXHIBIT 8.7 / Taper Integration along the Industry Value Chain

STRATEGIC OUTSOURCING. Another alternative to vertical integration is **strategic outsourcing**, which involves moving one or more internal value chain activities outside the firm's boundaries to other firms in the industry value chain. A firm that engages in strategic outsourcing reduces its level of vertical integration. Rather than developing their own human resource management systems, for instance, firms outsource these noncore activities to companies such as PeopleSoft (owned by Oracle), EDS (owned by HP), or Perot Systems (owned by Dell), which can leverage their deep competencies and produce scale effects.

strategic outsourcing Moving one or more internal value chain activities outside the firm's boundaries to other firms in the industry value chain.

In the popular media and in everyday conversation, you may hear the term *outsourcing* used to mean sending jobs out of the country. Actually, when outsourced activities take place outside the home country, the correct term is *offshoring* (or *offshore outsourcing*). For example, Infosys, one of the world's largest technology companies and providers of IT services to many Fortune 100 companies, is located in Bangalore, India. The global offshoring market for services peaked at more than $1 trillion in 2015, but has since been declining somewhat.[50] Banking and financial services, IT, and health care are the most active sectors in such offshore outsourcing. More recently, U.S. law firms began to offshore low-end legal work, such as drafting standard contracts and background research, to India.[51] We discuss *global strategy* in detail in Chapter 10.

8.4 Corporate Diversification: Expanding Beyond a Single Market

Early in the chapter, we listed three questions related to corporate strategy and, in particular, the boundaries of the firm. We discussed the first question of defining corporate strategy in detail:

1. *Vertical integration: In what stages of the industry value chain should the firm participate?*

We explored this question primarily in terms of firm boundaries based on the *degree of vertical integration.* We now turn to the second and third questions that determine corporate strategy and the boundaries of the firm.

2. *Product diversification: What range of products and services should the firm offer?*

The second question relates to the firm's *degree of product diversification:* What range of products and services should the firm offer? In particular, why do some companies compete in a single product market, while others compete in several different product markets? Coca-Cola, for example, focuses on soft drinks and thus on a *single* product market. Its archrival PepsiCo competes directly with Coca-Cola by selling a wide variety of soft drinks and other beverages, and also offering different types of chips such as Lay's, Doritos, and Cheetos, as well as Quaker Oats products such as oatmeal and granola bars. Although PepsiCo is more diversified than Coca-Cola, it has reduced its level of diversification in recent years.

3. *Geographic diversification: Where should the firm compete in terms of regional, national, or international markets?*

The third and final of the key questions concerns the question of *where to compete* in terms of regional, national, or international markets. This decision determines the firm's *degree of geographic diversification.* For example, why do some firms compete beyond state boundaries, while others are content to focus on the local market? Why do some firms compete beyond their national borders, while others prefer to focus on the domestic market?

Kentucky Fried Chicken (KFC), the world's largest quick-service chicken restaurant chain, operates 20,000 outlets in some 120 countries.[52] Interestingly, KFC has more restaurants in China with over 5,000 outlets than in the United States, its birthplace, with some 4,500 outlets. Of course, China has 1.4 billion people and the United States has a mere 320 million. PepsiCo CEO Indra Nooyi was instrumental in spinning out KFC, as well as Pizza Hut and Taco Bell, to reduce PepsiCo's level of diversification. In 1997, the three fast food chains were established as an independent company under the name Yum Brands. In 2014, Yum Brands annual revenues were $13 billion. In 2016, after being pressured by activist investors, Yum Brands sold a stake in its China operation to Alibaba Group (a Chinese internet conglomerate) and an individual Chinese investor. (After spinning out its China operation, the remaining Yum Brands had annual revenues of $4.2 billion.)[53] The activist investors argued that Yum's China operation was really the crown jewel in Yum Brand's portfolio, and that more value for shareholders would be unlocked if the China operation would be managed as a standalone unit, rather than being part of the geographically diversified Yum Brands.[54]

Compare KFC, active in 120 countries across the globe, with the privately held Chick-fil-A, the world's second-largest quick-service chicken restaurant.[55] KFC and Chick-fil-A are direct competitors in the United States, both specializing in chicken in the fast food market. But Chick-fil-A operates only in the United States; by 2016 it had some 2,100 locations across 45 states and earned $6 billion in sales.[56]

Why are KFC and Chick-fil-A pursuing different corporate strategies? Although both companies were founded roughly during the same time period (KFC in 1930 and Chick-fil-A in 1946), one big difference between KFC and Chick-fil-A is the ownership structure. KFC is a publicly traded stock company, as part of Yum Brands (stock ticker symbol: YUM) and Yum China (traded under YUMC, also on the New York Stock Exchange). Chick-fil-A, in contrast, is privately owned. Indeed, the privately owned Chick-fil-A is one of the largest family-owned businesses in the United States.

Public companies are often expected by shareholders to achieve profitable growth to result in an appreciation of the stock price and thus an increase in shareholder value (see the discussion in Chapter 5). That is also the reason Yum's China operation was spun off from Yum Brands, because it is performing much better. In addition, investors were

concerned that the lower-performing units at Yum Brands (e.g., KFC in the United States) would continue to be subsidized by the higher-performing China unit.

In contrast, private companies generally grow slower than public companies because their growth is mostly financed through retained earnings and debt rather than equity. Before an initial public offering, private companies do not have the option to sell shares (equity) to the public to fuel growth. This is one explanation why KFC focuses on international markets, especially China, where future expected growth continues to be high, while Chick-fil-A focuses on the domestic U.S. market. KFC is geographically diversified, while Chick-fil-A is not.

Answers to questions about the number of markets to compete in and where to compete geographically relate to the broad topic of **diversification**. A firm that engages in diversification increases the variety of products and services it offers or markets and the geographic regions in which it competes. A *non-diversified company* focuses on a single market, whereas a *diversified company* competes in several different markets simultaneously.[57]

There are various general diversification strategies:

- A firm that is active in several different product markets is pursuing a **product diversification strategy**.
- A firm that is active in several different countries is pursuing a **geographic diversification strategy**.
- A company that pursues *both* a product *and* a geographic diversification strategy simultaneously follows a **product–market diversification strategy**.

Because shareholders expect continuous growth from public companies, strategic leaders frequently turn to product and geographic diversification to achieve it. It is therefore not surprising that the vast majority of the Fortune 500 companies are diversified to some degree. Achieving performance gains through diversification, however, is not guaranteed. Some forms of diversification are more likely to lead to performance improvements than others. We now discuss which diversification types are more likely to lead to a competitive advantage, and why.

diversification An increase in the variety of products and services a firm offers or markets and the geographic regions in which it competes.

product diversification strategy Corporate strategy in which a firm is active in several different product markets.

geographic diversification strategy Corporate strategy in which a firm is active in several different countries.

product–market diversification strategy Corporate strategy in which a firm is active in several different product markets *and* several different countries.

TYPES OF CORPORATE DIVERSIFICATION

LO 8-7
Describe and evaluate different types of corporate diversification.

To understand the different types and degrees of corporate diversification, Richard Rumelt developed a helpful classification scheme that identifies four main types of diversification by identifying two key variables:[58]

- The *percentage of revenue* from the dominant or primary business.
- The *relationship of the core competencies* across the business units.

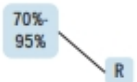
Note that this classification scheme concerns product markets, and not geographic diversification. Knowing the percentage of revenue of the dominant business (the first variable), lets us identify the first two types of diversification: *single business* and *dominant business*. Asking questions about the relationship of core competencies across business units allows us to identify the other two types: *related diversification* and *unrelated diversification*. Taken together, the four main types of business diversification are

1. Single business.
2. Dominant business.
3. Related diversification.
4. Unrelated diversification: the conglomerate.

Please note that related diversification (type 3) is divided into two subcategories. We discuss each type of diversification below.

SINGLE BUSINESS. A *single-business firm* is characterized by a low level of diversification, if any, because it derives more than 95 percent of its revenues from one business. The remainder of less than 5 percent of revenue is not (yet) significant to the success of the firm.

Founded in 1774, the German company Birkenstock only makes one product: its namesake contoured cork shoes. Although of a more recent vintage, Facebook is also a single business at this point because it receives almost all of its revenues from online advertising.



DOMINANT BUSINESS. A *dominant-business firm* derives between 70 and 95 percent of its revenues from a single business, but it pursues at least one other business activity that accounts for the remainder of revenue. The dominant business shares competencies in products, services, technology, or distribution. In the schematic figure shown here and those to follow, the remaining revenue (*R*) is generally obtained in other strategic business units (SBU) within the firm. This remaining revenue is by definition less than that of the primary business. (Note: The areas of the boxes in this and following graphics are not scaled to specific percentages.)

Harley-Davidson, the Milwaukee-based manufacturer of the iconic Harley motorcycles, is a dominant-business firm. Of its $5 billion in annual revenues, some 80 percent comes from selling its iconic motorcycles.[59] The remaining 20 percent of revenues come from other business activities such as motorcycle parts and accessories as well as general merchandise, including licensing the Harley logo. The brand has a loyal following overseas as well as in the United States.

related diversification strategy Corporate strategy in which a firm derives less than 70 percent of its revenues from a single business activity and obtains revenues from other lines of business that are linked to the primary business activity.

RELATED DIVERSIFICATION. A firm follows a **related diversification strategy** when it derives less than 70 percent of its revenues from a single business activity and obtains revenues from other lines of business linked to the primary business activity. The rationale behind related diversification is to benefit from economies of scale and scope: These multi-business firms can pool and share resources as well as leverage competencies across different business lines. The two variations of this type, which we explain next, relate to how much the other lines of business benefit from the core competencies of the primary business activity.

Related-Constrained Diversification. A firm follows a **related-constrained diversification strategy** when it derives less than 70 percent of its revenues from a single business activity and obtains revenues from other lines of business related to the primary business activity. Executives engage in a new business opportunity only when they can leverage their existing competencies and resources. Specifically, the choices of alternative business activities are limited—constrained—by the fact that they need to be related through common resources, capabilities, and competencies.

related-constrained diversification strategy A kind of related diversification strategy in which executives pursue only businesses where they can apply the resources and core competencies already available in the primary business.

ExxonMobil's strategic move into natural gas is an example of related diversification. In 2009, ExxonMobil bought XTO Energy, a natural gas company, for $31 billion.[60] XTO Energy is known for its core competency to extract natural gas from unconventional places such as shale rock—the type of deposits currently being exploited in the United States. ExxonMobil hopes to leverage its core competency in the exploration and commercialization of oil into natural gas extraction. The company is producing nearly equal amounts of crude oil and natural gas, making it the world's largest producer of natural gas. The company believes that roughly 50 percent of the world's energy for the next 50 years will continue to come from fossil fuels, and that its diversification into natural gas, the cleanest of the fossil fuels in terms of greenhouse gas emissions, will pay off. ExxonMobil's strategic

scenario may be right on the mark. Because of major technological advances in hydraulic fracking to extract oil and natural gas from shale rock by companies such as XTO Energy, the United States has emerged as the world's richest country in natural gas resources and the third-largest producer of crude oil, just behind Saudi Arabia and Russia.[61]

Related-Linked Diversification. If executives consider new business activities that share only a limited number of linkages, the firm is using a **related-linked diversification strategy**.

related-linked diversification strategy A kind of related diversification strategy in which executives pursue various businesses opportunities that share only a limited number of linkages.

Amazon.com, featured in the ChapterCase, began business by selling only one product: books. Over time, it expanded into CDs and later gradually leveraged its online retailing capabilities into a wide array of product offerings. As the world's largest online retailer, and given the need to build huge data centers to service its peak holiday demand, Amazon decided to leverage spare capacity into cloud computing, again benefiting from economies of scope and scale. Amazon also offers a variety of consumer electronics such as tablets, e-readers, and digital virtual assistants in speakers, as well as proprietary content that can be streamed via the internet and is free for its Prime service. Amazon follows a related-linked diversification strategy.

UNRELATED DIVERSIFICATION: THE CONGLOMERATE. A firm follows an **unrelated diversification strategy** when less than 70 percent of its revenues comes from a single business and there are few, if any, linkages among its businesses. A company that combines two or more strategic business units under one overarching corporation and follows an unrelated diversification strategy is called a **conglomerate**.

unrelated diversification strategy Corporate strategy in which a firm derives less than 70 percent of its revenues from a single business and there are few, if any, linkages among its businesses.

conglomerate A company that combines two or more strategic business units under one overarching corporation; follows an unrelated diversification strategy.

Some research evidence suggests that an unrelated diversification strategy can be advantageous in emerging economies.[62] Such an arrangement helps firms gain and sustain competitive advantage because it allows the conglomerate to overcome institutional weaknesses in emerging economies, such as a lack of capital markets and well-defined legal systems and property rights. Companies such as Samsung and LG (representing a uniquely South Korean form of organization, the *chaebol*), Warren Buffet's Berkshire Hathaway, and the Japanese Yamaha group are all considered conglomerates due to their unrelated diversification strategy. Strategy Highlight 8.2 features the Tata group of India, a conglomerate that follows an unrelated diversification strategy.

Strategy Highlight 8.2

The Tata Group: Integration at the Corporate Level

Founded in 1868 as a trading company by then 29-year-old entrepreneur Jamsetji Nusserwanji Tata, the Tata group today has roughly 660,000 employees and $105 billion in annual revenues. A widely diversified multinational conglomerate, headquartered in Mumbai, India, its activities include tea, hospitality, steel, IT, communications, power, and automobiles. Some of its strategic business units are giants in their own right. Tata includes Asia's largest software and steel companies (TCS and Tata Steel) and the renowned Taj Hotels Resorts and Palaces.

This diversified approach can be seen in microcosm within two divisions of one of its holdings in the automotive industry. Tata Motors started producing cars in the 1950s. In 2008 it bought luxury brands Jaguar and Land Rover from Ford for $2.3 billion. In a seemingly disjointed effort, in 2009 the company unveiled the Tata Nano, the world's lowest-priced car. Each division follows a separate business strategy (low-cost versus differentiation).

(continued)

Tata Nano GenX starts at $3,100.
©PUNIT PARANJPE/AFP/Getty Images

The Range Rover 5.0L V8 Supercharged SV Autobiography starts at $200,000.
©Bloomberg/Getty Images

Tata Motors designed the Nano to wean India's emerging middle class from mopeds and bikes, expanding the market. Ratan Tata, then chairman of the Tata group, famously conceived of the Nano while seeing a family of four cramped on a moped in heavy rains.

LOW-COST LEADER Tata Motors hoped the Nano, engineered for a price point about 50 percent cheaper than the previously available cheapest car, would reach tens of millions of customers in the Indian and Chinese markets. But initial sales were flat. Families able to trade up from two wheels apparently found more value in a used full-featured car than a stripped-down version of a new car. The tiny Nano used much less steel than traditional cars; lacked such basics as a radio, glove compartment, and operable rear hatch; would not accommodate passengers much over 6 feet tall; and could barely reach speeds topping 60 mph. As a plus, however, the Nano gets 67 mpg, beating the Toyota Prius for fuel consumption.

Tata Motors tried again with the Nano GenX in 2015, which brought more customizability and such features as USB ports, an audio system, Bluetooth compatibility, and an automatic transmission with a special "creeping" mode—designed to allow the car to creep forward with the engine at idle if the brake is released—a valuable feature in China and India with their massive traffic jams.

When Ratan Tata saw a family cramped on a motorcycle in heavy rains, he conceived of the Tata Nano, a super low-cost and affordable car. As the lowest-cost car on the market, the Tata Nano does not compete with other cars (the next lowest is twice the price of a Nano), but with motorcycles, thus with current nonconsumption.
©NARINDER NANU/AFP/Getty Images

HIGH-END ICONS Contrast the Nano car division strategy of focused cost-leadership with the luxury division's strategy of focused differentiation. Launched in 2017, the Range Rover Autobiography starts at $200,000. Tata is attempting to carve out different strategic positions in its different segments of the automotive industry. To accomplish this, the company integrates distinctly different business strategies at the corporate level.

FUTURE AT THE LOW END Sales of the Nano models had their ups and downs but generally declined in 2016 and 2017. Consumers were more tempted by competing low-cost options priced roughly at the Nano GenX price point. One competitor was the Renault Kwid. But the other Nano competitor came from Tata Motors itself. Its new Tiago model, launched in 2016 and priced similarly to the Nano GenX, is faring much better. With the Tiago, Tata may yet realize some of its ambition around the Nano.

Taken together, we can see that Tata's corporate strategy pursues distinctly different strategic positions by different strategic business units, each with its own profit and loss responsibility, and with integration at the corporate and not the operational level.[63]