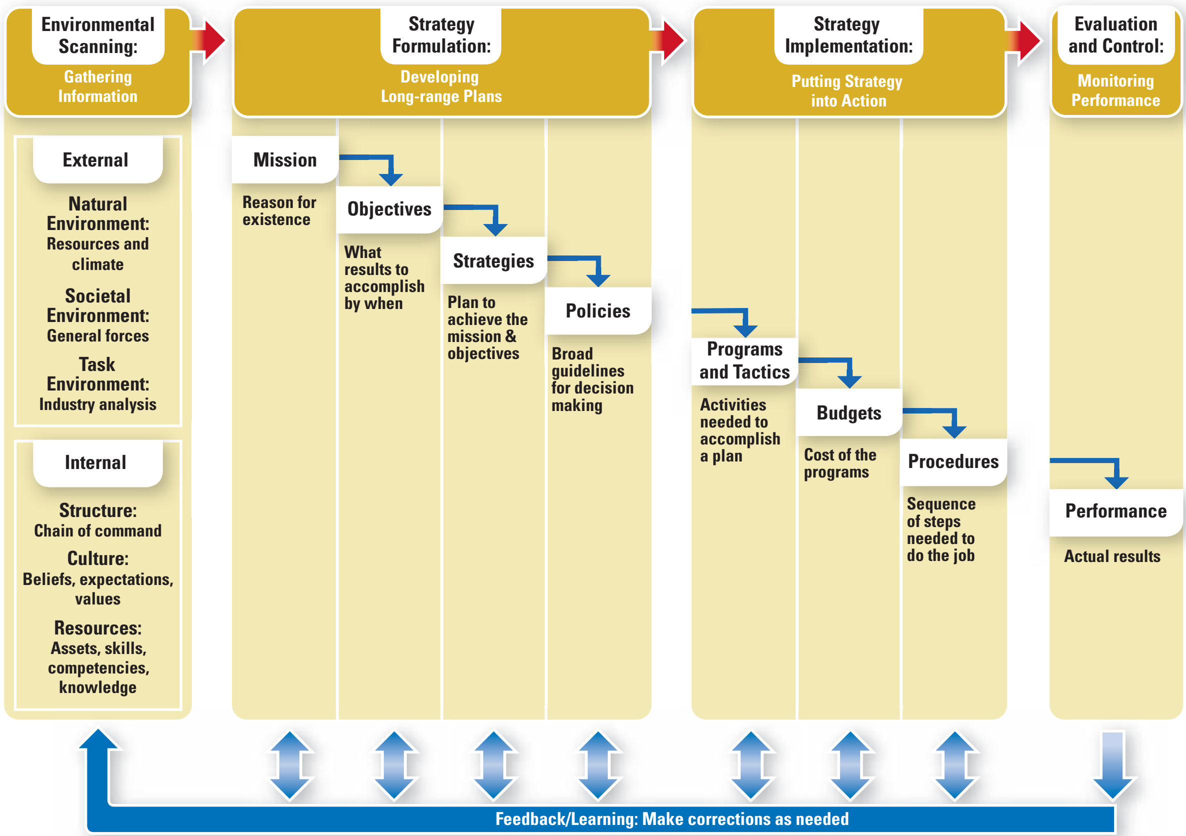
CHAPTER 1

Basic Concepts of Strategic Management



Pearson MyLab Management®

Improve Your Grade!

Over 10 million students improved their results using the Pearson MyLabs. Visit **mymanagementlab.com** for simulations, tutorials, and end-of-chapter problems.

The Study of Strategic Management

1-1. Discuss the benefits of strategic management

Strategic management is a set of managerial decisions and actions that help determine the long-term performance of an organization. It includes environmental scanning (both external and internal), strategy formulation (strategic or long-range planning), strategy implementation, and evaluation and control. Originally called *business policy,* strategic management has advanced substantially with the concentrated efforts of researchers and practitioners. Today, we recognize both a science and an art to the application of strategic management techniques.

PHASES OF STRATEGIC MANAGEMENT

Many of the concepts and techniques that deal with strategic management have been developed and used successfully by the largest business organizations in the world as well as the newest startups. Over time, business practitioners and academic researchers have expanded and refined these concepts. One of the most critical drivers of business success is a leader's ability to design and implement a strategy for the company. Increasing risks of error, costly mistakes, and even economic ruin are causing today's professional managers in all organizations to take strategic management seriously in order to keep their companies competitive in an increasingly volatile environment.

As managers attempt to better deal with their changing world, a firm generally evolves through the following four **phases of strategic management**:[1]

Phase 1—Basic financial planning: Managers initiate serious planning when they are requested to propose the following year's budget. Projects are proposed on the basis of very little analysis, with most information coming from within the firm. The sales force usually provides the small amount of environmental information used in this effort. Such simplistic operational planning only pretends to be strategic management, yet it is quite time consuming. Normal company activities are often suspended for weeks while managers try to cram ideas into the proposed budget. The time horizon is usually one year.

Phase 2—Forecast-based planning: As annual budgets become less useful at stimulating long-term planning, managers attempt to propose five-year plans. At this point, they consider projects that may take more than one year. In addition to internal information, managers gather any available environmental data—usually on an ad hoc basis—and extrapolate current trends. This phase is also time consuming, often involving a full month or more of managerial activity to make sure all the proposed budgets fit together. The process gets very political as managers compete for larger shares of limited funds. Seemingly endless meetings take place to evaluate proposals and justify assumptions. The time horizon is usually three to five years.

Phase 3—Externally oriented (strategic) planning: Frustrated with highly political yet ineffectual five-year plans, top management takes control of the planning process by initiating a formal strategic planning system. The company seeks to increase its responsiveness to changing markets and competition by thinking and acting strategically. Planning is taken out of the hands of lower-level managers and concentrated in a planning staff whose task is to develop strategic plans for the corporation. Consultants often provide the sophisticated and innovative techniques that the planning staff uses to gather information and forecast future trends. Organizations start competitive intelligence units. Upper-level managers meet once a year at a resort "retreat" led by key members of the planning staff to evaluate and update the current strategic plan. Such top-down planning emphasizes formal strategy formulation and leaves the implementation issues to lower-management levels. Top management typically develops long-term plans with help from consultants but minimal input from lower levels.

Phase 4—Strategic management: Realizing that even the best strategic plans are worthless without the input and commitment of lower-level managers, top management forms planning groups of managers and key employees at many levels, from various departments and workgroups. They develop and integrate a series of plans focused on emphasizing the company's true competitive advantages. Strategic plans at this point detail the implementation, evaluation, and control issues. Rather than attempting to perfectly forecast the future, the plans emphasize probable scenarios and contingency strategies. The sophisticated annual five-year strategic plan is replaced with strategic thinking at all levels of the organization throughout the year. Strategic information, previously available only centrally to top management, is used by people throughout the organization. Instead of a large centralized planning staff, internal and external planning consultants are available to help guide group strategy discussions. Although top management may still initiate the strategic planning process, the resulting strategies may come from anywhere in the organization. Planning is typically interactive across levels and is no longer strictly top down. People at all levels are now involved.

General Electric, one of the pioneers of strategic planning, led the transition from strategic planning to strategic management during the 1980s.[2] By the 1990s, most other corporations around the world had also begun the conversion to strategic management.

BENEFITS OF STRATEGIC MANAGEMENT

Strategic management emphasizes long-term performance. Many companies can manage short-term bursts of high performance, but only a few can sustain it over a longer period of time. Since the release of the original *Fortune 500* companies listing in 1955, more than 1,800 companies have made the list. In 2015, 18 new companies joined the list for the first time meaning that 18 others fell from the list.[3] To be successful in the long-run, companies must not only be able to *execute* current activities to satisfy an existing market, but they must also *adapt* those activities to satisfy new and changing markets.[4]

Research reveals that organizations that engage in strategic management generally outperform those that do not.[5] The attainment of an appropriate match, or "fit," between an organization's environment and its strategy, structure, and processes has positive effects on the organization's performance.[6] Strategic planning becomes increasingly important as the environment becomes more unstable.[7] For example, studies of the impact of deregulation on the U.S. railroad and trucking industries found that companies that changed their strategies and structures as their environment changed outperformed companies that did not change.[8]

A survey of nearly 50 corporations in a variety of countries and industries found the three most highly rated benefits of strategic management to be:

- A clearer sense of strategic vision for the firm.
- A sharper focus on what is strategically important.
- An improved understanding of a rapidly changing environment.[9]

Organizations that are willing to experiment and are able to learn from their experiences are more successful than those that are not.[38] This was seen in a study of U.S. manufacturers of diagnostic imaging equipment, the most successful firms were those that improved products sold in the United States by incorporating some of what they had learned from their manufacturing and sales experiences in other countries. The less successful firms used their foreign operations primarily as sales outlets, not as important sources of technical knowledge.[39] Research also reveals that multidivisional corporations that establish ways to transfer knowledge across divisions are more innovative than other diversified corporations that do not.[40]

Basic Model of Strategic Management

1-5. Describe the basic model of strategic management and its components

Strategic management consists of four basic elements:

- Environmental scanning
- Strategy formulation
- Strategy implementation
- Evaluation and control.

Figure 1–1 illustrates how these four elements interact; **Figure 1–2** expands each of these elements and serves as the model for this book. This model is both rational and prescriptive. It is a planning model that presents what a corporation *should* do in terms of the strategic management process, not what any particular firm may actually do. The rational planning model predicts that as environmental uncertainty increases, corporations that work diligently to analyze and predict more accurately the changing situation in which they operate will outperform those that do not. Empirical research studies support this model.[41] The terms used in **Figure 1–2** are explained in the following pages.

ENVIRONMENTAL SCANNING

Environmental scanning is the monitoring, evaluating, and disseminating of information from the external and internal environments to key people within the corporation. Its purpose is to identify **strategic factors**—those external and internal elements that will assist in the analysis of the strategic decisions of the corporation. The simplest way to represent the outcomes of environmental scanning is through a **SWOT approach**. SWOT is an acronym used to describe the particular **S**trengths, **W**eaknesses, **O**pportunities, and **T**hreats that appear to be strategic factors for a specific company. The **external environment** consists of variables (opportunities and threats) that are outside the organization and not typically within the short-run control of top management. These variables form the context within which the corporation exists.

FIGURE 1–1 Basic Elements of the Strategic Management Process

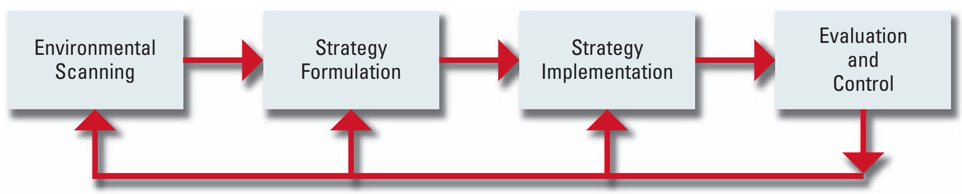
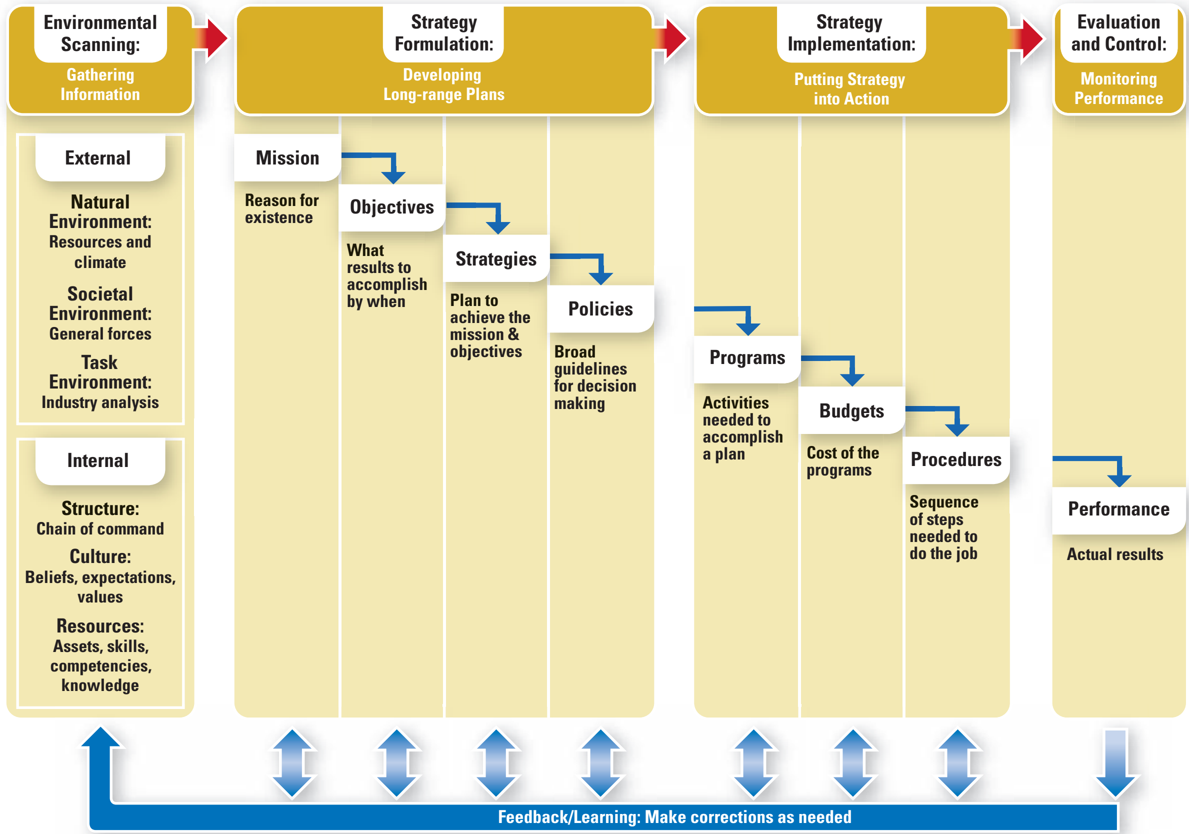


FIGURE 1–2 Strategic Management Model

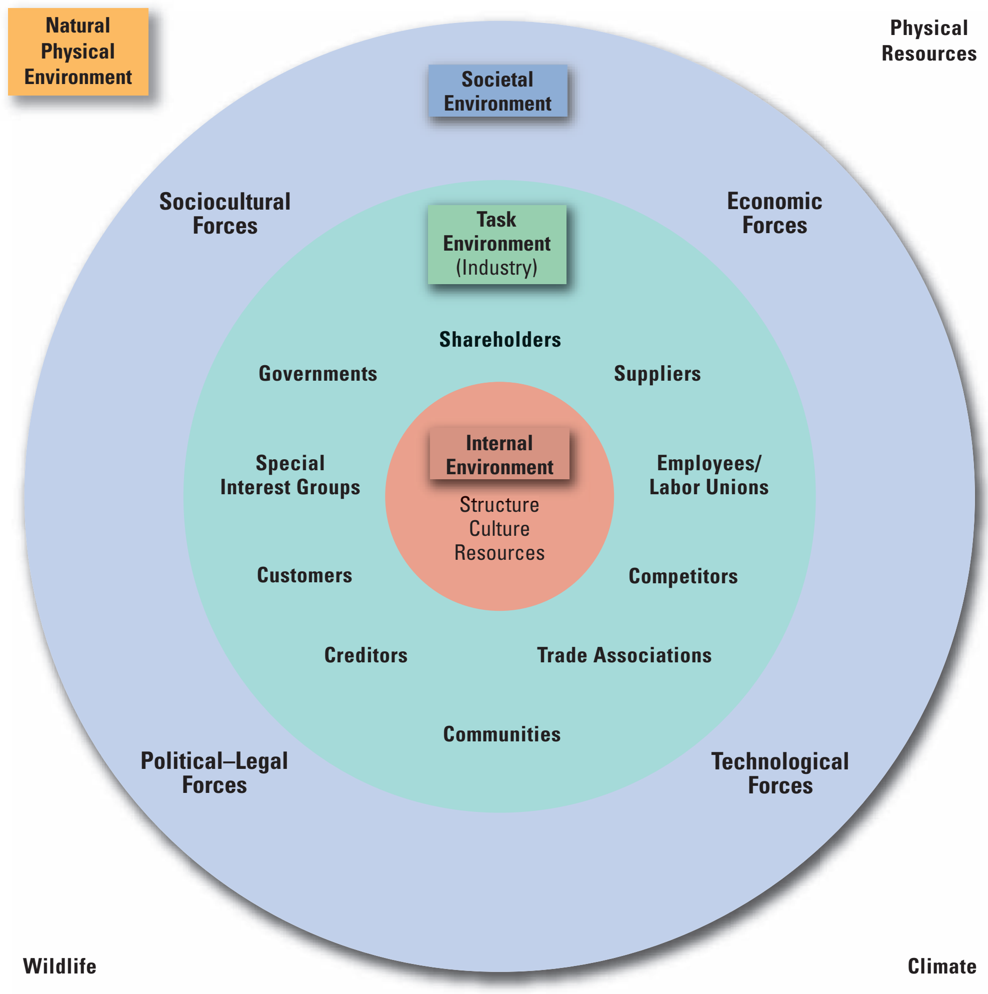


SOURCE: T. L. Wheelen, "Strategic Management Model," adapted from "Concepts of Management," presented to Society for Advancement of Management (SAM), International Meeting, Richmond, VA, 1981. Kathryn E. Wheelen solely owns all of (Dr.) Thomas L. Wheelen's copyright materials. Kathryn E. Wheelen requires written reprint permission for each book that this material is to be printed in. Copyright © 1981 by T. L. Wheelen and SAM. Copyright © 1982, 1985, 1988, and 2005 by T. L. Wheelen and J. D. Hunger. Revised 1989, 1995, 1998, 2000, 2005, 2009, and 2013. Reprinted by permission of the copyright holders.

Figure 1–3 depicts key environmental variables. They may be general forces and trends within the natural or societal environments or specific factors that operate within an organization's specific task environment—often called its *industry*. The analysis techniques available for the examination of these environmental variables are the focus of **Chapter 4**.

The **internal environment** of a corporation consists of variables (strengths and weaknesses) that are within the organization itself and are within the short-run control of top management. These variables form the context in which work is done. They include the corporation's structure, culture, capabilities, and resources. Key strengths form a set of core competencies that the corporation can use to gain competitive advantage. Although strategic management is fundamentally concerned with what constitutes an organization's strengths, weaknesses, opportunities, and threats, the methods to analyze each has developed substantially in the past two decades. No longer do we simply list the SWOT variables and have employees try to populate the quadrants. Each of the four is rich with processes and techniques that will allow for a robust and sophisticated understanding of the company. This will be examined in detail beginning with **Chapter 5** of the text.

FIGURE 1–3 Environmental Variables



STRATEGY FORMULATION

Strategy formulation is the process of investigation, analysis, and decision making that provides the company with the criteria for attaining a competitive advantage. It includes defining the competitive advantages of the business, identifying weaknesses that are impacting the company's ability to grow, crafting the corporate mission, specifying achievable objectives, and setting policy guidelines.

Mission: Stating Purpose

An organization's **mission** is the purpose or reason for the organization's existence. It announces what the company is providing to society—either a service such as consulting, a set of products such as automobile tires, or a combination of the two such as tablets and their associated Apps. A well-conceived mission statement defines the fundamental, unique purpose that sets a company apart from other firms of its type. Research reveals that firms with mission statements containing explicit descriptions of their competitive advantages have significantly higher growth than firms without such statements.[42] A mission statement may also include the firm's values and philosophy about how it does business and treats its employees; however, that is usually better kept as a separate document. A well-crafted mission statement describes what the company is now and what it wants to become—management's strategic vision of the firm's future. The mission statement promotes a sense of shared expectations in employees and communicates a public image to important stakeholder groups in the company's task environment. Some people like to consider vision and mission as two different concepts: Mission describes what the organization is now; **vision** describes what the organization would like to become. We prefer to combine these ideas into a single mission statement.[43]

A classic example is that etched in bronze at Newport News Shipbuilding, unchanged since its founding in 1886:

> *We shall build good ships here—at a profit if we can—at a loss if we must—but always good ships.*[44]

A mission may be defined narrowly or broadly in scope. An example of a *broad* mission statement is that used by many corporations: "Serve the best interests of shareowners, customers, and employees." A broadly defined mission statement such as this keeps the company from restricting itself to one field or product line, but it fails to clearly identify either what it makes or which products/markets it plans to emphasize. Broad statements are relatively useless while narrow statements provide direction and value to the organization.

Objectives: Listing Expected Results

Objectives are the end results of planned activity. They should be stated as *action verbs* and tell employees what is to be accomplished and when, with appropriate metrics. The achievement of corporate objectives should result in the fulfillment of a corporation's mission. In effect, this is what society gives back to the corporation when the corporation does a good job of fulfilling its mission. Coca-Cola has set the standard of a focused, international company. In their Vision 2020 plan, they have laid out specific objectives including reducing the overall carbon footprint of their business operations by 15% by 2020, as compared to the 2007 baseline, and reducing the impact of their packaging by maximizing their use of renewable, reusable, and recyclable resources to recover the equivalent of 100% of their packaging. This type of focus has made Coca-Cola a perennial member of the Fortune 500, one of the Fortune 50 Most Admired Companies, one of Barron's Most Respected Companies in the World, and a Diversity, Inc. Top 50 company. Over the past 10 years, they have raised their dividend an average of 9.8% per year and the company's earnings per share have jumped 11.3% per year over the past five years.[45]

The term *goal* is often used interchangeably with the term objective. In this book, we prefer to differentiate the two terms. In contrast to an objective, we consider a *goal* as an open-ended statement of what one wants to accomplish, with no quantification of what is to be achieved and no time criteria for completion. For example, a simple statement of "increased profitability" is thus a goal, not an objective, because it does not state how much profit the firm wants to make the next year. A good objective should be action-oriented and begin with the word *to*. An example of an objective is "to increase the firm's profitability in 2017 by 10% over 2016."

Some of the areas in which a corporation might establish its goals and objectives are:

- Profitability (net profits)
- Efficiency (low costs, etc.)
- Growth (increase in total assets, sales, etc.)
- Shareholder wealth (dividends plus stock price appreciation)
- Utilization of resources (Return on Equity (ROE) or Return on Investment (ROI))

- Reputation (being considered a "top" firm)
- Contributions to employees (employment security, wages, diversity)
- Contributions to society (taxes paid, participation in charities, providing a needed product or service)
- Market leadership (market share)
- Technological leadership (innovations, creativity)
- Survival (avoiding bankruptcy)
- Personal needs of top management (using the firm for personal purposes, such as providing jobs for relatives)

Strategy: Defining the Competitive Advantages

An organization must examine the external environment in order to determine who constitutes the perfect customer for the business as it exists today, who the most direct competitors are for that customer, what the company does that is necessary to compete, and what the company does that truly sets it apart from its competitors. These elements can be rephrased into the strengths of the business, the understanding of its weaknesses relative to its competitors, what opportunities would be most prudent, and what threats might affect the business's primary competitive advantages.

A **strategy** of a business forms a comprehensive master approach that states how the business will achieve its mission and objectives. It maximizes competitive advantage and minimizes competitive disadvantage. Pfizer, the giant drug company has embraced the need for this type of approach. Faced with the rapid fall-off of its biggest blockbuster drugs (patents expiring), Pfizer was faced with the question of how to generate the R&D to create new drugs. Historically, the company had relied upon its cadre of scientists, but this changed in the past few years. Pfizer moved aggressively to acquire drug makers in the emerging biosimiliar market (small molecule biologics made from living cells). Pfizer's late-stage biosimiliar drugs have a very good chance of allowing the company to capture a significant part of what is expected to be a US$20 billion market by 2020. This is the crucial new ground from which they hope to replace such blockbusters as Lipitor, which saw its sales drop from US$12 billion in 2012 to just over US$2 billion in 2015 after the patent expired.[46]

The typical larger business addresses three types of strategy: corporate, business, and functional.

- **Corporate strategy** describes a company's overall direction in terms of growth and the management of its various businesses. Corporate strategies generally fit within the three main categories of stability, growth, and retrenchment.
- **Business strategy** usually occurs at the business unit or product level, and it emphasizes improvement of the competitive position of a corporation's products or services in the specific industry or market segment served by that business unit. Business strategies may fit within the two overall categories: *competitive* and *cooperative* strategies. For example, Staples, the U.S. office supply store chain, has used a competitive strategy to differentiate its retail stores from its competitors by adding services to its stores, such as copying, UPS shipping, and hiring mobile technicians who can fix computers and install networks. British Airways has followed a cooperative strategy by forming an alliance with American Airlines in order to provide global service. Cooperative strategy may be used to provide a competitive advantage in situations where the cooperating entities are not in direct competition for customers. Intel, a manufacturer of computer microprocessors, uses its alliance (cooperative strategy) with Microsoft to differentiate itself (competitive strategy) from AMD, its primary competitor.

- **Functional strategy** is the approach taken by a functional area to achieve corporate and business unit objectives and strategies by maximizing resource productivity. It is concerned with developing and nurturing a distinctive competence to provide a company or business unit with a competitive advantage. Examples of research and development (R&D) functional strategies are technological followership (imitation of the products of other companies) and technological leadership (pioneering an innovation). For years, Magic Chef had been a successful appliance maker by spending little on R&D but by quickly imitating the innovations of other competitors. This helped the company keep its costs lower than those of its competitors and consequently to compete with lower prices. In terms of marketing functional strategies, Procter & Gamble (P&G) is a master of marketing "pull"—the process of spending huge amounts on advertising in order to create customer demand. This supports P&G's competitive strategy of differentiating its products from those of its competitors.

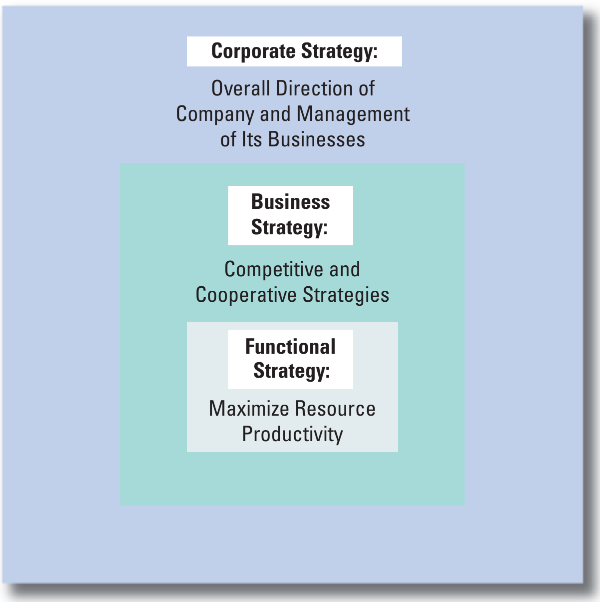
Business firms use all three types of strategy simultaneously. A **hierarchy of strategy** is a grouping of strategy types by level in the organization. Hierarchy of strategy is a nesting of one strategy within another so that they complement and support one another. (See **Figure 1–4**.) Functional strategies support business strategies, which, in turn, support the corporate strategy(ies).

Policies: Setting Guidelines

A **policy** is a broad guideline for decision making that links the formulation of a strategy with its implementation. Companies use policies to make sure that employees throughout the firm make decisions and take actions that support the corporation's mission, objectives, and strategies. For example, when Cisco decided on a strategy of growth through acquisitions, it established a policy to consider only companies with no more than 75 employees, 75% of whom were engineers.[47] Consider the following company policies:

- **3M:** 3M says researchers should spend 15% of their time working on something other than their primary project. (This supports 3M's strong product development strategy.)

FIGURE 1–4
Hierarchy of Strategy



- **Google:** Google's health care plan includes their onsite medical staff. Any employee who feels ill at work can make an appointment with the doctor at the Googleplex. This supports the Google HRM functional strategy to support its employees.
- **General Electric:** GE must be number one or two wherever it competes. (This supports GE's objective to be number one in market capitalization.)
- **Starbucks:** All Starbucks employees are offered a Total Pay Package that includes a 401(k) savings plan, stock options, and an employee stock purchase plan. This goes a long way toward their goal of having every employee feel like a partner in the business.
- **Ryanair:** Ryanair charges for everything a passenger might want or need on a flight. The only thing you get with your ticket is the right to a seat on the plane (and that seat depends upon how fast you can run across the tarmac to the plane).

Policies such as these provide clear guidance to managers throughout the organization. (Strategy formulation is discussed in greater detail in **Chapter 6, 7,** and **8**.)

STRATEGY IMPLEMENTATION

Strategy implementation is a process by which strategies and policies are put into action through the development of programs, budgets, and procedures. This process might involve changes within the overall culture, structure, and/or management system of the entire organization. Except when such drastic corporatewide changes are needed, however, the implementation of strategy is typically conducted by middle- and lower-level managers, with review by top management. Sometimes referred to as *operational planning*, strategy implementation often involves day-to-day decisions in resource allocation.

Programs and Tactics: Defining Actions

A **program** or a **tactic** is a statement of the activities or steps needed to support a strategy. The terms are interchangeable. In practice, a program is a collection of tactics where a tactic is the individual action taken by the organization as an element of the effort to accomplish a plan. A program or tactic makes a strategy action-oriented. It may involve restructuring the corporation, changing the company's internal culture, or beginning a new research effort. For example, Boeing's strategy to regain industry leadership with its 787 Dreamliner meant that the company had to increase its manufacturing efficiency in order to keep the price low. To significantly cut costs, management decided to implement a series of tactics:

- Outsource approximately 70% of manufacturing.
- Reduce final assembly time to three days (compared to 20 for its 737 plane) by having suppliers build completed plane sections.
- Use new, lightweight composite materials in place of aluminum to reduce inspection time.
- Resolve poor relations with labor unions caused by downsizing and outsourcing.

Another example is a set of programs or tactics used by automaker BMW to achieve its objective of increasing production efficiency by 5% each year: (a) shorten new model development time from 60 to 30 months, (b) reduce preproduction time from a year to no more than five months, and (c) build at least two vehicles in each plant so that production can shift among models depending upon demand.

Budgets: Costing Programs

A **budget** is a statement of a corporation's programs in terms of dollars. Used in planning and control, a budget lists the detailed cost of each program. Many corporations demand a certain percentage return on investment, often called a "hurdle rate," before management will approve a new program. This is done so that the new program has the potential to significantly add to the corporation's profit performance and thus build shareholder value. The budget not only serves as a detailed plan of the new strategy in action, it also specifies through proforma financial statements the expected impact on the firm's financial future.

A company that has really invested in the future is Nordstrom. The company plans to spend upwards of US$4.3 billion over the next few years to dramatically grow their online and store presence. The company has a goal of reaching US$20 billion in sales by 2020 (up from roughly US$13 billion in 2015). The CEO is aiming to integrate their ecommerce platform and store operations, both in their luxury stores as well as their rack outlets.[48]

Procedures: Detailing Activities

Procedures, sometimes termed Standard Operating Procedures (SOP), are a system of sequential steps or techniques that describe in detail how a particular task or job is to be done. They typically detail the various activities that must be carried out in order to complete the corporation's program. For example, when the home improvement retailer Home Depot noted that sales were lagging because its stores were full of clogged aisles and had long checkout times and too few salespeople, management changed its procedures for restocking shelves and pricing the products. Instead of requiring its employees to do these activities at the same time they were working with customers, management moved these activities to when the stores were closed at night. Employees were then able to focus on increasing customer sales during the day. Both UPS and FedEx put such an emphasis on consistent, quality service that both companies have strict rules for employee behavior, ranging from how a driver dresses to how keys are held when approaching a customer's door. (Strategy implementation is discussed in more detail in **Chapter 9** and **10**.)

EVALUATION AND CONTROL

Evaluation and control is a process in which corporate activities and performance results are monitored so that actual performance can be compared with desired performance. Managers at all levels use the resulting information to take corrective action and resolve problems. Although evaluation and control is the final major element of strategic management, it can also pinpoint weaknesses in previously implemented strategic plans and thus stimulates the entire process to begin again.

Performance is the end result of activities.[49] It includes the actual outcomes of the strategic management process. The practice of strategic management is justified in terms of its ability to improve an organization's performance, typically measured in terms of profits and return on investment. For evaluation and control to be effective, managers must obtain clear, prompt, and unbiased information from the people below them in the corporation's hierarchy. Using this information, managers compare what is actually happening with what was originally planned in the formulation stage.

Starbucks had created a mystique around the enjoyment of coffee. Carefully designed stores and an experience that encouraged people to stay and chat had built Starbucks into a powerhouse. Howard Schultz (founder and CEO) stepped down from active management of the business and Jim Donald took over as CEO and drove the company toward efficiency, pricing growth, and diversification. The company went from an American success story to one with a 97% drop in net income and same store sales in negative territory. Despite a well-known e-mail from Schultz to Donald in 2007 encouraging him to return to core elements of the business, things did not improve, and in January 2008 Schultz replaced Donald as CEO. In February 2008, all 7,100+ Starbucks in North America shut their doors for a three-hour video conference with Schultz so they could reset the Starbucks experience. He shut down almost 1,000 outlets and instituted a series of moves aimed at returning the company to its preeminent position. The turnaround at Starbucks has been a remarkable story of regaining the cache they almost lost.[50]

The evaluation and control of performance completes the strategic management model. Based on performance results, management may need to make adjustments in its strategy formulation, in implementation, or in both. (Evaluation and control is discussed in more detail in **Chapter 12**.)

FEEDBACK/LEARNING PROCESS

Note that the strategic management model depicted in **Figure 1–2** includes a feedback/learning process. Arrows are drawn coming out of each part of the model and taking information to each of the previous parts of the model. As a firm or business unit develops strategies, programs, and the like, it often must go back to revise or correct decisions made earlier in the process. For example, poor performance (as measured in evaluation and control) usually indicates that something has gone wrong with either strategy formulation or implementation. It could also mean that a key variable, such as a new competitor, a change in the environment, or a significant regulatory change has occurred. Just after Shultz took back the reigns at Starbucks, the recession hit and the mantra in the country became, "save money, don't buy Starbucks." The business was built on an image as the comfortable place away from home, but had trended toward a fast-food operation. Schultz eliminated hot sandwiches which were filling the place with the smell of burnt cheese instead of coffee, refocused on the services provided by the baristas, started grinding coffee on-site to add the smells so loved at a Starbucks, and put in new coffee machines that allowed baristas to talk with customers. Starbucks reassessed the environment and found a better way to profitably apply its core competencies.

Initiation of Strategy: Triggering Events

1-6. Identify some common triggering events that act as stimuli for strategic change

After much research, Henry Mintzberg concluded that strategy formulation is not a regular, continuous process: "It is most often an irregular, discontinuous process, proceeding in fits and starts. There are periods of stability in strategy development, but also there are periods of flux, of groping, of piecemeal change, and of global change."[51] This view of strategy formulation as an irregular process can be explained by the very human tendency to continue on a particular course of action until something goes wrong or a person is forced to question his or her actions. This period of strategic drift may result from inertia on the part of the organization, or it may reflect management's belief that the current strategy is still appropriate and needs only some fine-tuning.

Most large organizations tend to follow a particular strategic orientation for a period of years before making a significant change in direction.[52] This phenomenon, called *punctuated equilibrium*, describes corporations as evolving through relatively long periods of stability (equilibrium periods) punctuated by relatively short bursts of fundamental change (revolutionary periods).[53] After this rather long period of fine-tuning an existing strategy, some sort of shock to the system is needed to motivate management to seriously reassess the corporation's situation.

A **triggering event** is something that acts as a stimulus for a change in strategy. Some possible triggering events are:[54]

- **New CEO:** By asking a series of embarrassing questions, a new CEO cuts through the veil of complacency and forces people to question the very reason for the corporation's existence.