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Case Analysis

How to Conduct a Case Analysis

THE CASE STUDY is a fundamental learning tool in strategic management. We carefully wrote and chose the cases in this book to expose you to a wide variety of key concepts, industries, protagonists, and strategic problems.

In simple terms, cases tell the story of a company facing a strategic dilemma. The firms may be real or fictional in nature, and the problem may be current or one that the firm faced in the past. Although the details of the cases vary, in general they start with a description of the challenge(s) to be addressed, followed by the history of the firm up until the decision point, and then additional information to help you with your analysis. The strategic dilemma is often faced by a specific manager, who wonders what he or she should do. To address the strategic dilemma, you will use the AFI framework to conduct a case analysis using the tools and concepts provided in this textbook. After careful analysis, you will be able to formulate a strategic response and make recommendations about how to implement it.

Why Do We Use Cases?

Strategy is something that people learn by doing; it cannot be learned simply by reading a book or listening carefully in class. While those activities will help you become more familiar with the concepts and models used in strategic management, the only way to improve your skills in analyzing, formulating, and implementing strategy is to *practice*.

We encourage you to take advantage of the cases in this text as a "laboratory" in which to experiment with the strategic management tools you have been given, so that you can learn more about how, when, and where they might work in the "real world." Cases are valuable because they expose you to a number and variety of situations in which you can refine your strategic management skills without worrying about making mistakes. The companies in these cases will not lose profits or fire you if you miscalculate a financial ratio, misinterpret someone's intentions, or make an incorrect prediction about environmental trends.

Cases also invite you to "walk in" and explore many more kinds of companies in a wider array of industries than you will ever be able to work at in your lifetime. With this strategy content, you will find MiniCases (i.e., shorter cases) about athletes (Michael Phelps), social networks (Facebook), fashion (LVMH), and entertainment (Cirque du Soleil), among others, as well as longer cases with complete financial data about companies such as Google, Tesla Motors, Apple, to name just a few. Your personal organizational experiences are usually much more limited, defined by the jobs held by your family members or by your own forays into the working world. Learning about companies involved in so many different types of products and services may open up new employment possibilities for you. Diversity also forces us to think about the ways in which industries (as well as people) are both similar and yet distinct, and to critically examine the degree to which lessons learned in one forum transfer to other settings (i.e., to what degree are they "generalizable"). In short, cases are a great training tool, and they are fun to study.

You will find that many of our cases are written from the perspective of the CEO or general manager responsible for strategic decision making in the organization. While you do not need to be a member of a top management team to utilize the strategic management process, these senior leaders are usually responsible for determining strategy in most of the organizations we study. Importantly, cases allow us to put ourselves "in the shoes" of strategic leaders and invite us to view the issues from their perspective. Having responsibility for the performance of an entire organization is quite different from managing a single project team, department, or functional area. Cases can help you see the *big picture* in a way that most of us are not accustomed to in our daily, organizational

lives. We recognize that most undergraduate students and even MBAs do not land immediately in the corporate boardroom. Yet having a basic understanding of the types of conversations going on in the boardroom not only increases your current value as an employee, but also improves your chances of getting there someday, should you so desire.

Finally, cases help give us a *long-term* view of the firms they depict. Corporate history is immensely helpful in understanding how a firm got to its present position and why people within that organization think the way they do. Our case authors (both the author of this book and authors of cases from respected third-party sources) have spent many hours poring over historical documents and news reports in order to recreate each company's heritage for you, a luxury that most of us do not have when we are bombarded on a daily basis with homework, tests, and papers or project team meetings, deadlines, and reports. We invite you not just to learn from but also to savor reading each company's story.

STRATEGIC CASE ANALYSIS. The first step in analyzing a case is to *skim it for the basic facts.* As you read, jot down your notes regarding the following basic questions:

- What company or companies is the case about?
- Who are the principal actors?
- What are the key events? When and where do they happen (in other words, what is the timeline)?

Second, go back and reread the case in greater detail, this time with a focus on *defining the problem.* Which facts are relevant and why? Just as a doctor begins by interviewing the patient ("What hurts?"), you likewise gather information and then piece the clues together in order to figure out what is wrong. Your goal at this stage is to identify the "symptoms" in order to figure out which "tests" to run in order to make a definitive "diagnosis" of the main "disease." Only then can you prescribe a "treatment" with confidence that it will actually help the situation. Rushing too quickly through this stage often results in "malpractice" (that is, giving a patient with an upset stomach an antacid when she really has the flu), with effects that range from unhelpful to downright dangerous. The best way to ensure that you "do no harm" is to analyze the facts carefully, fighting the temptation to jump right to proposing a solution.

The third step, continuing the medical analogy, is to determine which analytical tools will help you to most accurately diagnose the problem(s). Doctors may choose to run blood tests or take an X-ray. In doing case analysis, we follow the steps of the *strategic management process.* You have any and all of the following models and frameworks at your disposal:

1. Perform an **external environmental analysis** of the:
   - Macro-level environment (PESTEL analysis).
   - Industry environment (e.g., Porter's five forces).
   - Competitive environment.
2. Perform an **internal analysis** of the firm using the resource-based view:
   - What are the firm's resources, capabilities, and competencies?
   - Does the firm possess valuable, rare, costly to imitate resources, and is it organized to capture value from those resources (VRIO analysis)?
   - What is the firm's value chain?
3. Analyze the firm's current **business-level** and **corporate-level** strategies:
   - Business-level strategy (product market positioning).
   - Corporate-level strategy (diversification).
   - International strategy (geographic scope and mode of entry).
   - How are these strategies being implemented?
4. Analyze the firm's **performance**:
   - Use both financial and market-based measures.
   - How does the firm compare to its competitors as well as the industry average?
   - What trends are evident over the past three to five years?
   - Consider the perspectives of multiple stakeholders (internal and external).
   - Does the firm possess a competitive advantage? If so, can it be sustained?

CALCULATING FINANCIAL RATIOS. Financial ratio analysis is an important tool for assessing the outcomes of a firm's strategy. Although financial performance is not the only relevant outcome measure, long-term profitability is a necessary precondition for firms to remain in business and to be

able to serve the needs of all of their stakeholders. Accordingly, at the end of this introductory module, we have provided a table of financial measures that can be used to assess firm performance (see Table 1).

All of the following aspects of performance should be considered, because each provides a different type of information about the financial health of the firm:

- Profitability ratios—how efficiently a company utilizes its resources.
- Activity ratios—how effectively a firm manages its assets.
- Leverage ratios—the degree to which a firm relies on debt versus equity (capital structure).
- Liquidity ratios—a firm's ability to pay off its short-term obligations.
- Market ratios—returns earned by shareholders who hold company stock.

MAKING THE DIAGNOSIS. With all of this information in hand, you are finally ready to *make a "diagnosis."* Describe the problem(s) or opportunity(ies) facing the firm at this time and/or in the near future. How are they interrelated? (For example, a runny nose, fever, stomach upset, and body aches are all indicative of the flu.) Support your conclusions with data generated from your analyses.

The following general themes may be helpful to consider as you try to pull all the pieces together into a cohesive summary:

- Are the firm's value chain (primary and support) activities mutually reinforcing?
- Do the firm's resources and capabilities fit with the demands of the external environment?
- Does the firm have a clearly defined strategy that will create a competitive advantage?
- Is the firm making good use of its strengths and taking full advantage of its opportunities?
- Does the firm have serious weaknesses or face significant threats that need to be mitigated?

Keep in mind that "problems" can be positive (how to manage increased demand) as well as negative (declining stock price) in nature. Even firms that are currently performing well need to figure out how to maintain their success in an ever-changing and highly competitive global business environment.

Formulation: Proposing Feasible Solutions

When you have the problem figured out (your diagnosis), the next step is to *propose a "treatment plan"* or solution. There are two parts to the treatment plan: the *what* and the *why*. Using our medical analogy: The *what* for a patient with the flu might be antiviral medication, rest, and lots of fluids. The *why:* antivirals attack the virus directly, shortening the duration of illness; rest enables the body to recuperate naturally; and fluids are necessary to help the body fight fever and dehydration. *The ultimate goal is to restore the patient to wellness.* Similarly, when you are doing case analysis, your task is to figure out *what* the leaders of the company should do and *why* this is an appropriate course of action. Each part of your proposal should be justifiable based on your analyses.

One word of caution about the formulation stage: By nature, humans are predisposed to engage in "local" and "simplistic" searches for solutions to the problems they face.[1] On the one hand, this can be an efficient approach to problem solving, because relying on past experiences (what worked before) does not waste time reinventing the wheel. The purpose of doing case analysis, however, is to *look past* the easy answers and to help us figure out not just what works (satisficing) but what might be the *best* answer (optimizing). In other words, do not just take the first idea that comes to your mind and run with it. Instead, write down that idea for subsequent consideration but then think about what other solutions might achieve the same (or even better) results. Some of the most successful companies engage in scenario planning, in which they develop several possible outcomes and estimate the likelihood that each will happen. If their first prediction turns out to be incorrect, then they have a Plan B ready and waiting to be executed.

Plan for Implementation

The final step in the AFI framework is to develop a plan for implementation. Under formulation, you came up with a proposal, tested it against alternatives, and used your research to support why it provides the best solution to the problem at hand. To demonstrate its feasibility, however, you must be able to explain *how to put it into action.* Consider the following questions:

1. *What activities need to be performed?* The value chain is a very useful tool when you need to figure out how different parts of the company are likely to be affected. What are the implications of your plan with respect to both primary activities (e.g., operations and sales/marketing/service) and support activities (e.g., human resources and infrastructure)?
2. *What is the timeline?* What steps must be taken first and why? Which ones are most critical? Which activities can proceed simultaneously, and which ones are sequential in nature? How long is your plan going to take?
3. *How are you going to finance your proposal?* Does the company have adequate cash on hand, or does it need to consider debt and/or equity financing? How long until your proposal breaks even and pays for itself?
4. *What outcomes is your plan likely to achieve?* Provide goals that are "SMART": specific, measurable, achievable, realistic, and timely in nature. Make a case for how your plan will help the firm to achieve a strategic competitive advantage.

In-Class Discussion

Discussing your ideas in class is often the most valuable part of a case study. Your professor will moderate the class discussion, guiding the AFI process and asking probing questions when necessary. Case discussion classes are most effective and interesting when everybody comes prepared and participates in the exchange.

Actively listen to your fellow students; mutual respect is necessary in order to create an open and inviting environment in which people feel comfortable sharing their thoughts with one another. This does not mean you need to agree with what everyone else is saying, however. Everyone has unique perspectives and biases based on differences in life experiences, education and training, values, and goals. As a result, no two people will interpret the same information in exactly the same way. Be prepared to be challenged, as well as to challenge others, to consider the case from another vantage point. Conflict is natural and even beneficial as long as it is managed in constructive ways.

Throughout the discussion, you should be prepared to support your ideas based on the analyses you conducted. Even students who agree with you on the general steps to be taken may disagree on the order of importance. Alternatively, they may like your plan in principle but argue that it is not feasible for the company to accomplish. You should not be surprised if others come up with an altogether different diagnosis and prescription. For better or worse, a good idea does not stand on its own merit—you must be able to convince your peers of its value by backing it up with sound logic and support.

Things to Keep in Mind while Doing Case Analysis

While some solutions are clearly better than others, it is important to remember that there is no single correct answer to any case. Unlike an optimization equation or accounting spreadsheet, cases cannot be reduced to a mathematical formula. Formulating and implementing strategy involves people, and working with people is inherently messy. Thus, the best way to get the maximum value from case analysis is to maintain an open mind and carefully consider the strengths and weaknesses of all of the options. Strategy is an iterative process, and it is important not to rush to a premature conclusion.

For some cases, your instructor may be able to share with you what the company actually did, but that does not necessarily mean it was the best course of action. Too often students find out what happened in the "real world" and their creative juices stop flowing. Whether due to lack of information, experience, or time, companies quite often make the most expedient decision. With your access to additional data and time to conduct more detailed analyses, you may very well arrive at a different (and better) conclusion. Stand by your findings as long as you can support them with solid research data. Even Fortune 500 companies make mistakes.

Unfortunately, to their own detriment, students sometimes discount the value of cases based on fictional scenarios or set some time in the past. One significant advantage of fictional cases is that everybody has access to the same information. Not only does this level the playing field, but it also prevents you from being unduly biased by actual events, thus cutting short your own learning process. Similarly, just because a case occurred in the past does not mean it is no longer relevant. The players and technology may change over time, but many questions that businesses face are timeless in nature: how to adapt to a changing environment, the best way to compete against other firms, and whether and how to expand.

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Case Limitations

As powerful a learning tool as case analysis can be, it does come with some limitations. One of the most important for you to be aware of is that case analysis relies on a process known as *inductive reasoning,* in which you study specific business cases in order to derive general principles of management. Intuitively, we rely on inductive reasoning across almost every aspect of our lives. We know that we need oxygen to survive, so we assume that all living organisms need oxygen. Similarly, if all the swans we have ever seen are white, we extrapolate this to mean that all swans are white. While such relationships are often built upon a high degree of probability, it is important to remember that they are not empirically proven. We have in fact discovered life forms (microorganisms) that rely on sulfur instead of oxygen. Likewise, just because all the swans you have seen have been white, black swans do exist.

What does this caution mean with respect to case analysis? First and foremost, do not assume that just because one company utilized a joint venture to commercialize a new innovation, another company will be successful employing the same strategy. The first company's success may not be due to the particular organizational form it selected; it might instead be a function of its competencies in managing interfirm relationships or the particularities of the external environment. Practically speaking, this is why the analysis step is so fundamental to good strategic management. Careful research helps us to figure out all of the potential contributing factors and to formulate hypotheses about which ones are most likely critical to success. Put another way, what happens at one firm does not necessarily generalize to others. However, solid analytical skills go a long way toward enabling you to make informed, educated guesses about when and where insights gained from one company have broader applications.

In addition, we have a business culture that tends to put on a pedestal high-performance firms and their leaders. Critical analysis is absolutely essential in order to discern the reasons for such firms' success. Upon closer inspection, we have sometimes found that their image is more a mirage than a direct reflection of sound business practices. Many business analysts have been taken in by the likes of Enron, WorldCom, and Bernie Madoff, only to humbly retract their praise when the company's shaky foundation crumbles. We selected many of the firms in these cases because of their unique stories and positive performance, but we would be remiss if we let students interpret their presence in this book as a wholehearted endorsement of all of their business activities.

Finally, our business culture also places a high premium on benchmarking and best practices. Although we present you with a sample of firms that we believe are worthy of in-depth study, we would again caution you against uncritical adoption of their activities in the hope of emulating their achievements. Even when a management practice has broad applications, strategy involves far more than merely copying the industry leader. The company that invents a best practice is already far ahead of its competitors on the learning curve, and even if other firms do catch up, the best they can usually hope for is to match (but not exceed) the original firm's success. By all means, learn as much as you can from whomever you can, but use that information to strengthen your organization's *own* strategic identity.

Frequently Asked Questions about Case Analysis

1. *Is it OK to utilize outside materials?*

Ask your professor. Some instructors utilize cases as a springboard for analysis and will want you to look up more recent financial and other data. Others may want you to base your analysis on the information from the case only, so that you are not influenced by the actions actually taken by the company.

2. *Can I talk about the case with other students?*

Again, you should check with your professor, but many will strongly encourage you to meet and talk about the case with other students as part of your preparation process. The goal is not to come to a group consensus, but to test your ideas in a small group setting and revise them based on the feedback you receive.

3. *Is it OK to contact the company for more information?*

If your professor permits you to gather outside information, you may want to consider contacting the company directly. If you do so, it is imperative that you represent yourself and your school in the most professional and ethical manner possible. Explain to them that you are a student studying the firm and that you are seeking additional information, with your instructor's permission. Our experience is that some companies are quite receptive to student inquiries; others are not. You cannot know how a particular company will respond unless you try.

4. *What should I include in my case analysis report?*

Instructors generally provide their own guidelines regarding content and format, but a general outline for a case analysis report is as follows: (1) analysis of the problem; (2) proposal of one or more alternative solutions; and (3) justification for which solution you believe is best and why. The most important thing to remember is not to waste precious space repeating facts from the case. You can assume that your professor has read the case carefully. What he or she is most interested in is your analysis of the situation and your rationale for choosing a particular solution.

Endnote

1. Cyert, R.M., and J.G. March (2001), *A Behavioral Theory of the Firm,* 2nd ed. (Malden, MA: Blackwell Publishers Inc.).

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Chapter 1

What Is Strategy?

Chapter Outline

1.1 What Strategy Is: Gaining and Sustaining Competitive Advantage
What Is Competitive Advantage?
Industry vs. Firm Effects in Determining Firm Performance

1.2 Stakeholders and Competitive Advantage
Stakeholder Strategy
Stakeholder Impact Analysis

1.3 The AFI Strategy Framework

1.4 Implications for the Strategist

Learning Objectives

LO 1-1 Explain the role of strategy in a firm's quest for competitive advantage.

LO 1-2 Define competitive advantage, sustainable competitive advantage, competitive disadvantage, and competitive parity.

LO 1-3 Differentiate the roles of firm effects and industry effects in determining firm performance.

LO 1-4 Evaluate the relationship between stakeholder strategy and sustainable competitive advantage.

LO 1-5 Conduct a stakeholder impact analysis.

CHAPTERCASE 1

Does Twitter Have a Strategy?

TWITTER IS NOT FLYING HIGH. In the summer of 2015, Twitter's stock price was 50 percent lower than what it was shortly after the social networking service went public November 7, 2013. Twitter's disappointing performance led to the departure of its CEO, Dick Costolo, who served from 2010 to 2015. Co-founder Jack Dorsey was brought back as Twitter's CEO. With several high-profile departures and continuing unabated demotions, the young company faced turmoil among its executive ranks.

Jack Dorsey, co-founder and CEO of Twitter.
© Thomas Samson/Getty Images

Launched in 2006, Twitter is often called the "SMS of the Internet" because it allows users to send short messages or "tweets" restricted to 140 characters with pictures and videos often attached.[1] Twitter's leader described the social media service as an "indispensable companion to life in the moment" and "the world's largest information network."[2] Users can follow other people on the social network. For example, Katy Perry, the American singer, songwriter, and actress, has more than 70 million followers. Justin Bieber (with 65 million) and President Barack Obama (with 60 million) round out the top three in terms of followers. When a user follows another, she can see that person's status updates in her Twitter feed.

CEO of Square; Dick Costolo, CEO of Twitter, 2010–2015.
© AP Photo/Lionel Cironneau

Twitter has some 300 million worldwide active users, that is, people who log in at least once a month. Core users stay connected pretty much permanently, providing multiple status updates throughout the day. Although most tweets cover trivia, Twitter's claim to significance rises from its role in political revolutions such as the Arab Spring or live coverage of breaking news, including the raid on Osama bin Laden's compound in Pakistan. Twitter also appears constantly in the mass media. TV channels show tweets of athletes, politicians, or other celebrities, often live during their shows. Some 20 percent of smartphone users in the United States, and close to 10 percent internationally, use Twitter regularly.

Twitter's business model is to grow its user base and then charge advertisers for promoting goods and services to that base of users. Individual users pay nothing. Their tweets give Twitter free user-generated content to drive more traffic. Companies pay for "promoted tweets" that are directly inserted into a user's news stream. Advertisers value how Twitter can deliver their ads in real time. In one famous episode, when a blackout halted the 2013 Super Bowl for over half an hour, Nabisco promoted Oreo cookies by tweeting, "Power out? No problem. You can still dunk in the dark." Advertisers can also target their ads based on the user's interests or location, the time of day, and so on.

Twitter faces several challenges that make its future prospects highly uncertain. Amid turnover and reshuffling in the management and engineering ranks, Twitter struggles to grow its user base. Compare Twitter's

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300 million monthly users to Facebook's 1.5 billion. Twitter needs a larger user base to attract more online advertisers and better monetize its social media service. When serving as CEO, Costolo made the tweet-worthy declaration that Twitter's "ambition is to have the largest audience in the world."[3] Yet, the trend runs in the opposite direction as Twitter's user growth has slowed considerably while Facebook is getting even larger, with a steep rise in users on mobile devices. If Twitter fails to grow in user size to increase the value of the communication platform for online advertisers, it might become either a takeover target for much larger digital advertising companies such as Google or be overtaken by a new social media news app.[4]

You will learn more about Twitter by reading the chapter; related questions appear on page 23.

WHY IS TWITTER STRUGGLING? In contrast, why are Facebook and Google so successful? For that matter, why is any company successful? What enables some firms to gain and then sustain their competitive advantage over time? Why do once-great firms fail? How can managers influence firm performance? These are the big questions that define strategic management. Answering these questions requires integrating the knowledge you've obtained in your studies of various business disciplines to understand what leads to superior performance, and how you can help your organization achieve it.

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

Strategic management is the integrative management field that combines *analysis, formulation,* and *implementation* in the quest for competitive advantage. Mastery of strategic management enables you to view a firm in its entirety. It also enables you to think like a general manager to help position your firm for superior performance. The *AFI strategy framework* (shown on page 3) embodies this view of strategic management. It will guide our exploration of strategic management through the course of your study.

In this chapter, we lay the groundwork for the study of strategic management. We'll introduce foundational ideas about strategy and competitive advantage and then consider the role of business in society. Next, we take a closer look at the components of the AFI framework and provide an overview of the entire strategic management process. We conclude this introductory chapter, as we do with all others in this text, with a section titled "Implications for the Strategist." Here we provide practical applications and considerations of the material developed in the chapter. Let's begin the exciting journey to understand strategic management and competitive advantage.

LO 1-1
Explain the role of strategy in a firm's quest for competitive advantage.

1.1 What Strategy Is: Gaining and Sustaining Competitive Advantage

strategy
The set of goal-directed actions a firm takes to gain and sustain superior performance relative to competitors.

Strategy is a set of goal-directed actions a firm takes to gain and sustain superior performance *relative* to competitors.[5] To achieve superior performance, companies compete for resources: New ventures compete for financial and human capital. Existing companies compete for profitable growth. Charities compete for donations, and universities compete for the best students and professors. Sports teams compete for championships, while celebrities compete for media attention. As highlighted in the ChapterCase, Twitter is competing for more users against other social media such as SnapChat, Facebook and its messaging service WhatsApp,and others. In any competitive situation, therefore, a *good strategy* enables a firm to achieve superior performance. This leads to the question: What is a good strategy?

A *good strategy* consists of three elements:[6]

1. A *diagnosis* of the competitive challenge. This element is accomplished through *analysis* of the firm's external and internal environments (Part 1 of the AFI framework).

2. A *guiding policy* to address the competitive challenge. This element is accomplished through strategy *formulation,* resulting in the firm's corporate, business, and functional strategies (Part 2 of the AFI framework).
3. A *set of coherent actions* to implement the firm's guiding policy. This element is accomplished through strategy *implementation* (Part 3 of the AFI framework).

Let's revisit ChapterCase 1 to see whether Twitter is pursuing a good strategy. A quick rereading indicates that Twitter appears to be underperforming, and thus its strategy does not seem to be a good one. Let's take a closer look at the three elements of a good strategy to see how Twitter's CEO could turn a bad strategy into a winning one.[7]

THE COMPETITIVE CHALLENGE. A good strategy needs to start with a clear and critical diagnosis of the competitive challenge. ChapterCase 1 indicates that the biggest competitive challenge for Twitter is to grow its user base to become more valuable for online advertisers. With some 300 million active users compared to Facebook's roughly 1.5 billion monthly users, Twitter is viewed by advertisers as a niche application. Companies direct the bulk of their digital ad dollars to Facebook and Google rather than Twitter. Moreover, Twitter suffers in comparison to Facebook for reasons other than sheer scale. Facebook allows advertisers to target their online ads much more precisely based on a host of demographic data that the social network collects and infers about each user, including birth year, university affiliation, network of friends, interests, and so on.

A GUIDING POLICY. Next, after the diagnosis of the competitive challenge, the strategist needs to formulate an effective guiding policy in response. The formulated strategy needs to be consistent, often backed up with strategic commitments such as sizable investments or changes to an organization's incentive and reward system—big changes that cannot be easily reversed. Without consistency in a firm's guiding policy, a firm's employees become confused and cannot make effective day-to-day decisions that support the overall strategy. Without consistency in strategy, moreover, other stakeholders, including investors, also become frustrated.

Here is where Twitter's problems begin. While its leaders are well aware of the competitive challenge it faces and have diagnosed this challenge correctly, they still lack a clear, guiding policy for facing this challenge. They could respond to it by taking steps to accelerate user sign-ups and usage. For example, such steps could include making the sign-up process and use of the services easier, explaining the sometimes idiosyncratic conventions on Twitter to a broader audience, and rooting out offensive content. However, rather than formulating a guiding policy to grow active core users, Twitter has emphasized defining its user base more broadly. When serving as CEO, Costolo specifically declared that the company should be seen as "three geometrically [con]centric circles" reflecting three types of users. The first inner circle represents direct users of the social media service; the second, visitors to the Twitter site who do not log in; and the third, people who view Twitter content on affiliate sites such as cable news networks, live sportscasts, and other websites. Twitter decided that it should henceforth pursue all three types of users.

The goal of providing a new definition of Twitter users is clear: To expand the perception of its reach so as to compare more favorably to Facebook. Changing the definition of users, however, is not sufficient to address the competitive challenge of growing the base of core users. Moreover, users in the second and third circle are harder to track, and more importantly, they are also much less valuable to advertisers than core users.

COHERENT ACTIONS. Finally, a clear guiding policy needs to be implemented with a set of coherent actions. Changing the goalpost of which users to go after not only confused management, but it also limited functional guidance for employees in day-to-day

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operations. Consequences of an unclear mission followed: Frustration among managers and engineers increased, leading to turnover of key personnel. Internal turmoil was further stoked by a number of management demotions as well as promotions of close personal friends of the respective CEO. From its inception, Twitter's culture has been hampered by infighting and public intrigues among co-founders and other early leaders.

In summary, a good strategy is more than a mere goal or a company slogan. Declaring that Twitter's "ambition is to have the largest audience in the world"[8] is not a good strategy; it is no strategy at all. Rather it is a mere statement of desire. In creating a good strategy, three steps are crucial. First, a good strategy defines the competitive challenges facing an organization through a critical and honest assessment of the status quo. Second, a good strategy provides an overarching approach on how to deal with the competitive challenges identified. The approach needs to be communicated in policies that provide clear guidance for all employees involved. Last, a good strategy requires effective implementation through a coherent set of actions.

LO 1-2

Define competitive advantage, sustainable competitive advantage, competitive disadvantage, and competitive parity.

WHAT IS COMPETITIVE ADVANTAGE?

Competitive advantage is always *relative,* not absolute. To assess competitive advantage, we compare firm performance to a *benchmark*—that is, either the performance of other firms in the same industry or an industry average. A firm that achieves superior performance relative to other competitors in the same industry or the industry average has a **competitive advantage**.[9] Google has a competitive advantage over Facebook, Twitter, and Yahoo in digital advertising. In smartphones, Apple has achieved a competitive advantage over Samsung, Microsoft, and BlackBerry. A firm that is able to outperform its competitors or the industry average over a prolonged period of time has a **sustainable competitive advantage**.

If a firm underperforms its rivals or the industry average, it has a **competitive disadvantage**. For example, a 15 percent return on invested capital may sound like superior firm performance. In the consulting industry, though, where the average return on invested capital is often above 20 percent, such a return puts a firm at a competitive disadvantage. In contrast, if a firm's return on invested capital is 2 percent in a declining industry, like newspaper publishing, where the industry average has been negative (−5 percent) for the past few years, then the firm has a competitive advantage. Should two or more firms perform at the same level, they have **competitive parity**. In Chapter 5, we'll discuss in greater depth how to evaluate and assess competitive advantage and firm performance.

To gain a competitive advantage, a firm needs to provide either goods or services consumers value more highly than those of its competitors, or goods or services similar to the competitors' at a lower price.[10] The rewards of superior value creation and capture are profitability and market share. Sam Walton was driven by offering lower prices than his competitors. Steve Jobs wanted to "put a ding in the universe"—making a difference by delivering products and services people love. Mark Zuckerberg built Facebook to make the world more open and connected. Google co-founders Larry Page and Sergey Brin are motivated to make the world's information universally accessible. For Walton, Jobs, Zuckerberg, Page, Brin, and numerous other entrepreneurs

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

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

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

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

and businesspeople, creating shareholder value and making money is the *consequence* of filling a need and providing a product, service, or experience consumers wanted, at a price they could afford.

The important point here is that strategy is about creating superior value, while containing the cost to create it. Managers achieve this combination of value and cost through *strategic positioning.* That is, they stake out a unique position within an industry that allows the firm to provide value to customers, while controlling costs. The greater the difference between value creation and cost, the greater the firm's *economic contribution* and the more likely it will gain competitive advantage.

Strategic positioning requires *trade-offs,* however. As a low-cost retailer, Walmart has a clear strategic profile and serves a specific market segment. Upscale retailer Nordstrom has also built a clear strategic profile by providing superior customer service to a higher end, luxury market segment. Although these companies are in the same industry, their customer segments overlap very little, and they are not direct competitors. Walmart and Nordstrom have each chosen a distinct but different strategic position. The managers make conscious trade-offs that enable each company to strive for competitive advantage in the retail industry, using different competitive strategies: leadership versus differentiation. In regard to the customer service dimension, Walmart provides acceptable service by low-skill employees in a big-box retail outlet offering "everyday low prices," while Nordstrom provides a superior customer experience by professional salespeople in a luxury setting. A clear strategic profile—in terms of product differentiation, cost, and customer service—allows each retailer to meet specific customer needs. Competition focuses on creating value for customers (through lower prices or better service and selection, in this example) rather than destroying rivals. Even though Walmart and Nordstrom compete in the same industry, both can win if they achieve a clear strategic position through a well-executed competitive strategy.

Since clear strategic positioning requires trade-offs, strategy is as much about deciding what *not* to do, as it is about deciding what to do.[11] Because resources are limited, managers must carefully consider their strategic choices in the quest for competitive advantage. Trying to be everything to everybody will likely result in inferior performance.

Given Twitter's new emphasis on its target audience as comprising three discrete segments, many employees at Twitter lament confusion in deciding how to serve all three. As Twitter attempts to be more attractive to different types of users simultaneously, it encounters trade-offs that are hard if not impossible to reconcile. Consider the functionality of an application such as search or mobile use, for example: Core users have very different needs from the needs of casual visitors or passive viewers of Twitter content. In an attempt to match Facebook's scale, Twitter is attempting to be everything to everybody, without considering the strategic trade-offs. This resulted not only in low employee morale, but also in inferior performance. In contrast, Facebook is fully committed to providing a superior user experience for its 1.5 billion active core users on mobile devices.[12]

The key to successful strategy is to combine a set of activities to stake out a *unique position* within an industry. Competitive advantage has to come from performing different activities or performing the same activities differently than rivals are doing. Ideally, these activities reinforce one another rather than create trade-offs. For instance, Walmart's strategic activities strengthen its position as cost leader: Big retail stores in rural locations, extremely high purchasing power, sophisticated IT systems, regional distribution centers, low corporate overhead, and low base wages and salaries combined with employee profit sharing reinforce each other, to maintain the company's cost leadership. Strategy Highlight 1.1 takes a closer look at how the online startup Threadless used different activities than rivals to gain a competitive advantage in the apparel industry.

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Strategy Highlight 1.1

Threadless: Leveraging Crowdsourcing to Design Cool T-Shirts

Jacob DeHart, left, and Jake Nickell, center, (co-founders) and Jeffrey Kalmikoff (early CEO) created Threadless, an online company that sells millions of dollars' worth of T-shirts annually.
© Jason Wambsgans/MCT/Newscom

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

Members of the Threadless community, which is some 2.5 million strong, do most of the work, which they consider fun: They submit T-shirt designs online, and community members vote on which designs they like best. The designs receiving the most votes are put in production, printed, and sold online. Each Monday, Threadless releases 10 new designs and reprints more T-shirts throughout the week as inventory is cleared out. The cost of Threadless T-shirts is a bit higher than that of competitors, about $25.

Threadless leverages *crowdsourcing*, a process in which a group of people voluntarily perform tasks that were traditionally completed by a firm's employees. Rather than doing the work in-house, Threadless outsources its T-shirt design to its website community. The concept of leveraging a firm's own customers via Internet-enabled technology to help produce better products is explicitly included in the Threadless business model. In particular, Threadless is leveraging the *wisdom of the crowds*, where the resulting decisions by many participants in the online forum are often better than decisions that could have been made by a single individual. To more effectively leverage this idea, the crowds need to be large and diverse.

At Threadless, the customers play a critical role across the entire value chain, from idea generation to design, marketing, sales forecasting, and distribution. The Threadless business model translates real-time market research and design contests into quick sales. Threadless produces only T-shirts that were approved by its community. Moreover, it has a good understanding of market demand because it knows the number of people who participated in each design contest. In addition, when scoring each T-shirt design in a contest, Threadless users have the option to check "*I'd buy it.*" These features give the Threadless community a voice in T-shirt design and also coax community members into making a prepurchasing commitment. Threadless does not make any significant investments until the design and market size are determined, minimizing its downside.

Not surprisingly, Threadless has sold every T-shirt that it has printed. Moreover, it has a cult-like following and is outperforming established companies American Eagle, Old Navy, and Urban Outfitters with their more formulaic T-shirt designs.[13]

In addition, operational effectiveness, marketing skills, and other functional expertise all strengthen a unique strategic position. Those capabilities, though, do not substitute for competitive strategy. Competing to be similar but just a bit better than your competitor is likely to be a recipe for cut-throat competition and low profit potential. Let's take this idea to its extreme in a quick thought experiment: If all firms in the same industry pursued a low-cost position through application of competitive benchmarking, all firms would have identical cost structures. None could gain a competitive advantage. Everyone would be running faster, but nothing would change in terms of relative strategic positions.

There would be little if any value creation for customers because companies would have no resources to invest in product and process improvements. Moreover, the least-efficient firms would be driven out, further reducing customer choice.

To gain a deeper understanding of what strategy is, it may be helpful to think about what strategy is *not*.[14] Be on the lookout for the following major hallmarks of what strategy is NOT:

1. *Grandiose statements are not strategy.* You may have heard firms say things like, "Our strategy is to win" or "We will be No. 1." Twitter declared its "ambition is to have the largest audience in the world." Such statements of desire, on their own, are not strategy. They provide little managerial guidance and often lead to goal conflict and confusion. Moreover, such wishful thinking frequently fails to address economic fundamentals. As we will discuss in the next chapter, an effective vision and mission *can* lay the foundation upon which to craft a good strategy. This foundation must be backed up, however, by strategic actions that allow the firm to address a competitive challenge with clear consideration of economic fundamentals, in particular, value creation and costs.
2. *A failure to face a competitive challenge is not strategy.* If the firm does not define a clear competitive challenge, managers have no way of assessing whether they are making progress in addressing it. Managers at the now-defunct video rental chain Blockbuster, for example, failed to address the competitive challenges posed by new players Netflix, Redbox, Amazon Prime, and Hulu.
3. *Operational effectiveness, competitive benchmarking, or other tactical tools are not strategy.* People casually refer to a host of different policies and initiatives as some sort of strategy: pricing strategy, Internet strategy, alliance strategy, operations strategy, IT strategy, brand strategy, marketing strategy, HR strategy, China strategy, and so on. All these elements may be a *necessary* part of a firm's functional and global initiatives to support its competitive strategy, but these elements are *not sufficient* to achieve competitive advantage. In this text, though, we will reserve the term *strategy* for describing the firm's overall efforts to *gain and sustain competitive advantage.*

INDUSTRY VS. FIRM EFFECTS IN DETERMINING FIRM PERFORMANCE

LO 1-3

Differentiate the roles of firm effects and industry effects in determining firm performance.

Firm performance is determined primarily by two factors: industry and firm effects. **Industry effects** describe the underlying economic structure of the industry. They attribute firm performance to the industry in which the firm competes. The structure of an industry is determined by elements common to all industries, elements such as entry and exit barriers, number and size of companies, and types of products and services offered. In a series of empirical studies, academic researchers have found that about 20 percent of a firm's profitability depends on the industry it's in.[15] In Chapter 3, when studying external analysis, we'll gain a deeper understanding of an industry's underlying structure and how it affects firm performance.

industry effects
Firm performance attributed to the structure of the industry in which the firm competes.

Firm effects attribute firm performance to the actions managers take. In Chapter 4, we'll look inside the firm to understand why firms within the same industry differ, and how differences among firms can lead to competitive advantage.

firm effects
Firm performance attributed to the actions managers take.

For now, the key point is that managers' actions tend to be more important in determining firm performance than the forces exerted on the firm by its external environment.[16] Empirical research studies indicate that a firm's strategy can explain up to 55 percent of its performance.[17] Exhibit 1.1 shows these findings.

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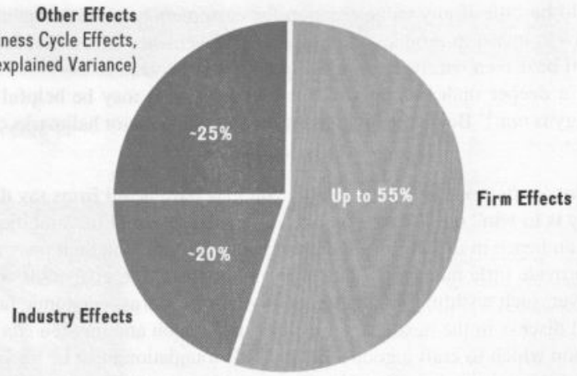
EXHIBIT 1.1

Industry, Firm, and Other Effects Explaining Superior Firm Performance



Although a firm's industry environment is not quite as important as the firm's strategy within its industry, they jointly determine roughly 75 percent of overall firm performance. The remaining 25 percent relates partly to business cycles and other effects.

Competition—the ongoing struggle among firms to gain and sustain competitive advantage—does not take place in isolation. Managers therefore must understand the relationship between strategic management and the role of business in society, which we will turn to next.

LO 1-4

Evaluate the relationship between stakeholder strategy and sustainable competitive advantage.

1.2 Stakeholders and Competitive Advantage

Companies with a good strategy generate value for society. When firms compete in their own self-interest while obeying the law and acting ethically, they ultimately create value. Value creation occurs because companies with a good strategy are able to provide products or services to consumers at a price point that they can afford while making a profit at the same time. Both parties benefit from this trade as each captures a part of the value created. In so doing, they make society better.[18] Value creation in turn lays the foundation for the benefits that successful economies can provide: education, public safety, and health care, among others. Superior performance allows a firm to reinvest some of its profits and to grow, which in turn provides more opportunities for employment and fulfilling careers. Although Google started as a research project in graduate school by Larry Page and Sergey Brin, it is worth roughly $350 billion and employs some 55,000 people worldwide, not to mention the billions of people across the world who rely on it for information gathering.[19]

Strategic failure, in contrast, can be expensive. Once a leading technology company, Hewlett-Packard was known for innovation, resulting in superior products. The "HP way of management" included lifetime employment, generous benefits, work/life balance, and freedom to explore ideas, among other perks.[20] However, HP has not been able to address the competitive challenges of mobile computing or business IT services effectively. As a result, HP's stakeholders suffered. Shareholder value was destroyed. The company also had to lay off tens of thousands of employees in recent years. Its customers no longer received the innovative products and services that made HP famous.

The contrasting examples of Google and HP illustrate the relationship between individual firms and society at large. Recently, this relationship received more critical scrutiny due to some major shocks to free-market capitalism.

In the first decade of the 21st century, several **black swan events** eroded the public's trust in business as an institution and capitalism as an economic system.[21] In the past, most people assumed that all swans are white, so when they first encountered swans that were black, they were surprised. Today, the metaphor of a black swan describes the *high impact of a highly improbable event.*[22] Examples of black swan events include the fall of the Berlin Wall and the subsequent collapse of the Soviet Union, the 9/11 terrorist attacks, the Fukushima nuclear disaster in Japan, and the Arab Spring. Such events were considered to be highly improbable and thus unexpected, but when they did occur, each had a very profound impact.

black swan events
Incidents that describe highly improbable but high-impact events.

© Krys Bailey/Alamy

The implicit trust relationship between the corporate world and society at large has deteriorated because of the arrival of several black swans. One of the first black swan events of the 21st century occurred when the accounting scandals at Enron, Arthur Andersen, WorldCom, Tyco, Adelphia, and Parmalat (of Italy) came to light. Those events led to bankruptcies, large-scale job loss, and the destruction of billions of dollars in shareholder value. As a result, the public's trust in business and free market capitalism began to erode.

Another black swan event occurred in the fall of 2008 with the global financial crisis, which shook the entire free market system to its core.[23] A real estate bubble had developed in the United States, fueled by cheap credit and the availability of subprime mortgages. When that bubble burst, many entities faced financial stress or bankruptcy—those who had unsustainable mortgages, investors holding securities based on those mortgages, and the financial institutions that had sold the securities. Some went under, and others were sold at fire-sale prices. Home foreclosures skyrocketed as a large number of borrowers defaulted on their mortgages. House prices in the United States plummeted by roughly 30 percent. The Dow Jones Industrial Average (DJIA) lost about half its market value, plunging the United States into a deep recession.

The impact was worldwide. The freezing of capital markets during the global financial crisis triggered a debt crisis in Europe. Some European governments (notably Greece) defaulted on government debt; other countries were able to repay their debts only through the assistance of other, more solvent European countries. This severe financial crisis not only put Europe's common currency, the euro, at risk, but also led to a prolonged and deep recession in Europe.

In the United States, the Occupy Wall Street protest movement was born out of dissatisfaction with the capitalist system. Issues of income disparity, corporate ethics, corporate influence on governments, and ecological sustainability were key drivers. The Occupy movement, organized through social media platforms such as Twitter and Facebook, eventually expanded around the world.

Although these black swan events in the business world differed in their specifics, two common features are pertinent to our study of strategic management.[24] First, these events demonstrate that managerial actions can affect the economic well-being of large numbers of people around the globe. Most of the events resulted from executive actions (or inactions) within a single organization, or compounded across a specific industry or government.

The second pertinent feature relates to **stakeholders**—organizations, groups, and individuals that can affect or be affected by a firm's actions.[25] This leads us to *stakeholder strategy,* which we discuss next.

stakeholders
Organizations, groups, and individuals that can affect or are affected by a firm's actions.

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STAKEHOLDER STRATEGY

Stakeholders have a vested claim or interest in the performance and continued survival of the firm. Stakeholders can be grouped by whether they are internal or external to a firm. As shown in Exhibit 1.2, *internal stakeholders* include stockholders, employees (including executives, managers, and workers), and board members. *External stakeholders* include customers, suppliers, alliance partners, creditors, unions, communities, governments at various levels, and the media.

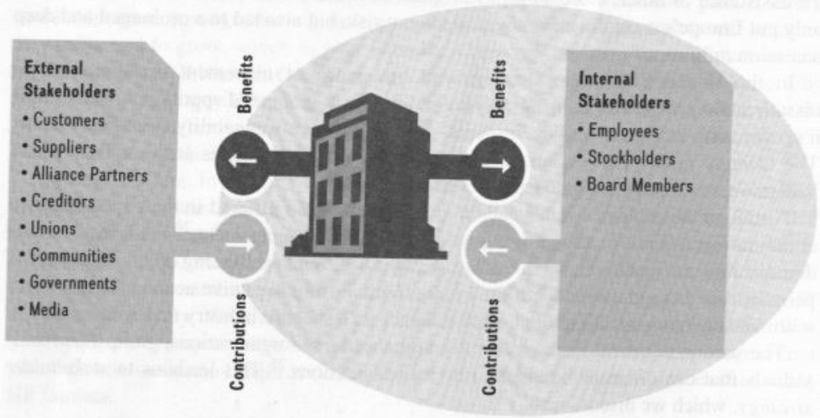
All stakeholders make specific contributions to a firm, which in turn provides different types of benefits to different stakeholders. Employees contribute their time and talents to the firm, receiving wages and salaries in exchange. Shareholders contribute capital in the hope that the stock will rise and the firm will pay dividends. Communities provide real estate, infrastructure, and public safety. In return, they expect that companies will pay taxes, provide employment, and not pollute the environment. The firm, therefore, is embedded in a multifaceted *exchange relationship* with a number of diverse internal and external stakeholders.

If any stakeholder withholds participation in the firm's exchange relationships, it can negatively affect firm performance. The aerospace company Boeing, for example, has a long history of acrimonious labor relations, leading to walk-outs and strikes. This in turn has not only delayed production of airplanes but also raised costs. Borrowers who purchased subprime mortgages are stakeholders (in this case, customers) of financial institutions. When they defaulted in large numbers, they threatened the survival of these financial institutions and, ultimately, of the entire financial system.

stakeholder strategy
An integrative approach to managing a diverse set of stakeholders effectively in order to gain and sustain competitive advantage.

Stakeholder strategy is an integrative approach to managing a diverse set of stakeholders effectively in order to gain and sustain competitive advantage.[26] The unit of analysis is the web of exchange relationships a firm has with its stakeholders (see Exhibit 1.2). Stakeholder strategy allows firms to analyze and manage how various external and internal stakeholders interact to jointly create and trade value.[27] A core tenet of stakeholder strategy is that a single-minded focus on shareholders alone exposes a firm to undue risks. Simply putting shareholder interest above all else can undermine economic performance and even threaten the very survival of the enterprise. The strategist, therefore, must understand the complex web of exchange relationships among different stakeholders. With that understanding, the firm can proactively shape the various relationships to maximize the

EXHIBIT 1.2 /
Internal and External Stakeholders in an Exchange Relationship with the Firm



joint value created and manage the distribution of this larger pie in a fair and transparent manner. Effective stakeholder management exemplifies how managers can act to improve firm performance, thereby enhancing the firm's competitive advantage and the likelihood of its continued survival.[28]

Target Corporation has gathered numerous awards that reflect its strong relationship with its stakeholders. It has been named on lists such as best places to work, most admired companies, most ethical companies, best in class for corporate governance, and grassroots innovation. Since its founding, Target has contributed 5 percent of its profits to education, the arts, and social services in the communities in which it operates and reached the milestone of contributing $4 million per week in 2012. To demonstrate its commitment to minorities and women, Target launched a program to bring minority- and women-owned businesses into its supply chain. Volunteerism and corporate giving strengthen the relationship Target has with its employees, consumers, local communities, and suppliers. These actions, along with many others, can help Target gain competitive advantage as a retailer as long as the benefits Target accrues from its stakeholder strategy exceed the costs of such programs.[29]

Strategy scholars have provided several arguments as to why effective stakeholder management can benefit firm performance:[30]

- Satisfied stakeholders are more cooperative and thus more likely to reveal information that can further increase the firm's value creation or lower its costs.
- Increased trust lowers the costs for firms' business transactions.
- Effective management of the complex web of stakeholders can lead to greater organizational adaptability and flexibility.
- The likelihood of negative outcomes can be reduced, creating more predictable and stable returns.
- Firms can build strong reputations that are rewarded in the marketplace by business partners, employees, and customers. Most managers do care about public perception of the firm, and frequently celebrate and publicize high-profile rankings such as the "World's Most Admired Companies" published annually by *Fortune*.[31] In 2014, the top five companies in this ranking were Apple, Amazon, Google, Berkshire Hathaway (the conglomerate led by Warren Buffett), and Starbucks. Because of its continued innovation in products, services, and delivery, Apple has been ranked as the world's most admired company for the past several years by *Fortune*.

STAKEHOLDER IMPACT ANALYSIS

LO 1-5
Conduct a stakeholder impact analysis.

The key challenge of stakeholder strategy is to effectively balance the needs of various stakeholders. The firm needs to ensure that its primary stakeholders—the firm's shareholders and other investors—achieve their objectives. At the same time, the firm needs to recognize and address the concerns of other stakeholders—employees, suppliers, and customers—in an ethical and fair manner, so that they too are satisfied. This all sounds good in theory, but how can managers go about this in practice?

stakeholder impact analysis
A decision tool with which managers can recognize, prioritize, and address the needs of different stakeholders, enabling the firm to achieve competitive advantage while acting as a good corporate citizen.

Stakeholder impact analysis provides a decision tool with which managers can recognize, prioritize, and address the needs of different stakeholders. This tool helps the firm achieve a competitive advantage while acting as a good corporate citizen. Stakeholder impact analysis takes managers through a five-step process of recognizing stakeholders' claims. In each step, managers must pay particular attention to three important stakeholder attributes: *power, legitimacy,* and *urgency.*[32]

- A stakeholder has *power* over a company when it can get the company to do something that it would not otherwise do.

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- A stakeholder has a *legitimate claim* when it is perceived to be legally valid or otherwise appropriate.
- A stakeholder has an *urgent claim* when it requires a company's immediate attention and response.

Exhibit 1.3 depicts the five steps in stakeholder impact analysis and the key questions to be asked. Let's look at each step in detail.

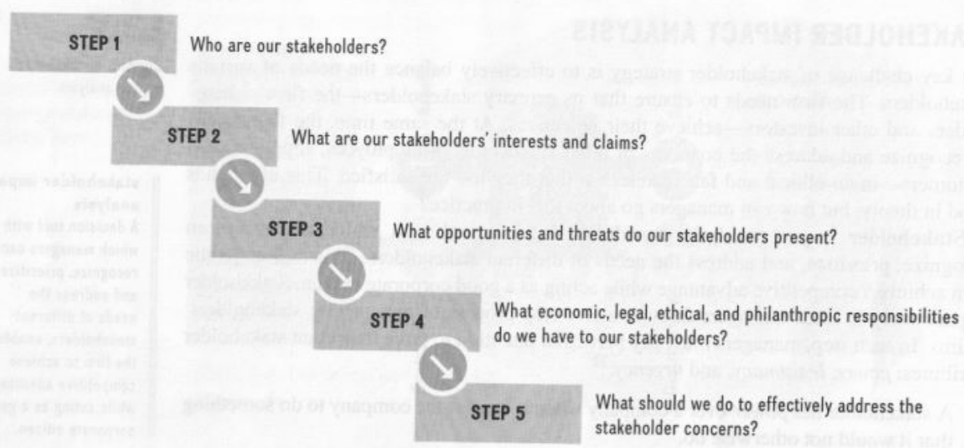
STEP 1: IDENTIFY STAKEHOLDERS. In step 1, the firm asks, "Who are our stakeholders?" In this step, the firm focuses on stakeholders that currently have, or potentially can have, a material effect on a company. This prioritization identifies the most powerful internal and external stakeholders as well as their needs. For public-stock companies, key stakeholders are the shareholders and other suppliers of capital. If shareholders are not satisfied with returns to investment, they will sell the company's stock, leading to depreciation in the firm's market value. If this process continues, it can make the company a takeover target, or launch a vicious cycle of continued decline.

A second group of stakeholders includes customers, suppliers, and unions. Local communities and the media are also powerful stakeholders that can materially affect the smooth operation of the firm. Any of these groups, if their needs are not met, can materially affect the company's operations.

For example, Boeing opened a new airplane factory in South Carolina in 2011 to move production away from its traditional plant near Seattle, Washington. In contrast to Washington state, in South Carolina the work force is nonunionized, which should lead to fewer work interruptions due to strikes, higher productivity, and improvements along other performance dimensions (like on-time delivery of new airplanes). In 2014, Boeing announced that its new 787 Dreamliner jet would be exclusively built in its nonunionized South Carolina factory.[33]

STEP 2: IDENTIFY STAKEHOLDERS' INTERESTS. In step 2, the firm asks, "What are our stakeholders' interests and claims?" Managers need to specify and assess the interests and claims of the pertinent stakeholders using the power, legitimacy, and urgency criteria

EXHIBIT 1.3 / Stakeholder Impact Analysis



introduced earlier. As the legal owners, shareholders have the most legitimate claim on a company's profits. However, the wall separating the claims of ownership (by shareholders) and of management (by employees) has been eroding. Many companies incentivize top executives by paying part of their overall compensation with stock options. They also turn employees into shareholders through *employee stock ownership plans (ESOPs)*. These plans allow employees to purchase stock at a discounted rate or use company stock as an investment vehicle for retirement savings. For example, Coca-Cola, Google, Microsoft, Southwest Airlines, Starbucks, Walmart, and Whole Foods all offer ESOPs. Clearly, the claims and interests of stakeholders who are employed by the company, and who depend on the company for salary and other benefits, will be somewhat different from those of stakeholders who merely own stock. The latter are investors who are primarily interested in the increased value of their stock holdings through appreciation and dividend payments. Executives, managers, and workers tend to be more interested in career opportunities, job security, employer-provided health care, paid vacation time, and other perks.

Even within stakeholder groups there can be significant variation in the power a stakeholder may exert on the firm. For example, public companies pay much more attention to large investors than to the millions of smaller, individual investors. *Shareholder activists,* such as Carl Icahn, Daniel Loeb, or T. Boone Pickens, tend to buy equity stakes in a corporation that they believe is underperforming to put public pressure on a company to change its strategy. Examples include the takeover battle at Dell Computer (which founder Michael Dell subsequently took private), the pressure on PepsiCo to spin off its Frito-Lay brand, or on eBay to sell PayPal, which it did. Even top-performing companies are not immune to pressure by shareholder activists.[34] As a result of a sustained competitive advantage over the last decade, Apple had not only become the most valuable company on the planet but also amassed some $200 billion in cash in the process. Apple CEO Tim Cook faced significant pressure from Carl Icahn, who held roughly $4 billion worth of Apple stock, to buy back more of its shares and thus to further raise Apple's share price.

Although both individual and activist investors may claim the same legitimacy as stockholders, shareholder activists have much more power over a firm. They can buy and sell a large number of shares at once, or exercise block-voting rights in the *corporate-governance process* (which we'll discuss in detail in Chapter 12). Shareholder activists frequently also demand seats on the company's boards to more directly influence its corporate governance, and with it exert more pressure to change a company's strategy. These abilities make activist investors potent stakeholders.

STEP 3: IDENTIFY OPPORTUNITIES AND THREATS. In step 3, the firm asks, "What opportunities and threats do our stakeholders present?" Since stakeholders have a claim on the company, opportunities and threats are two sides of the same coin. Consumer boycotts, for example, can be a credible threat to a company's behavior. Some consumers boycotted Nestlé products when the firm promoted infant formula over breast milk in developing countries. PETA[35] called for a boycott of McDonald's due to alleged animal-rights abuses.

In the best-case scenario, managers transform such threats into opportunities. Sony Corp., for example, was able to do just that.[36] During one holiday season, the Dutch government blocked Sony's entire holiday season shipment of PlayStation game systems, valued at roughly $500 million, into the European Union because of a small but legally unacceptable amount of toxic cadmium discovered in one of the system's cables. This incident led to an 18-month investigation in which Sony inspected over 6,000 supplier factories around the world to track down the source of the problem. The findings allowed Sony to redesign and develop a cutting-edge supplier management system that now adheres to a stringent extended value chain responsibility.

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STEP 4: IDENTIFY SOCIAL RESPONSIBILITIES. In step 4, the firm asks, "What economic, legal, ethical, and philanthropic responsibilities do we have to our stakeholders?" To identify these responsibilities more effectively, scholars have advanced the notion of **corporate social responsibility (CSR).** This framework helps firms recognize and address the economic, legal, ethical, and philanthropic expectations that society has of the business enterprise at a given point in time.[37] According to the CSR perspective, managers need to realize that society grants shareholders the right and privilege to create a publicly traded stock company. Therefore, the firm owes something to society.[38] Moreover, CSR provides managers with a conceptual model that more completely describes a society's expectations and can guide strategic decision making more effectively. In particular, CSR has four components: economic, legal, ethical, and philanthropic responsibilities.[39]

corporate social responsibility (CSR) A framework that helps firms recognize and address the economic, legal, social, and philanthropic expectations that society has of the business enterprise at a given point in time.

Economic Responsibilities. The business enterprise is first and foremost an economic institution. Investors expect an adequate return for their risk capital. Creditors expect the firm to repay its debts. Consumers expect safe products and services at appropriate prices and quality. Suppliers expect to be paid in full and on time. Governments expect the firm to pay taxes and to manage natural resources such as air and water under a decent stewardship. To accomplish all this, firms must obey the law and act ethically in their quest to gain and sustain competitive advantage.

Legal Responsibilities. Laws and regulations are a society's codified ethics, embodying notions of right and wrong. They also establish the rules of the game. For example, business as an institution can function because property rights exist and contracts can be enforced in courts of law. Managers must ensure that their firms obey all the laws and regulations, including but not limited to labor, consumer protection, and environmental laws.

One far-reaching piece of U.S. legislation in terms of business impact, for example, is the Patient Protection and Affordable Care Act (PPACA), more commonly known as Affordable Care Act (ACA) or Obamacare. Key provisions of this federal law include, among others, that firms with 50 or more full-time employees must offer affordable health insurance to their employees and dependents, or pay a fine for each worker. This will make it harder for entrepreneurs to grow their ventures above this threshold. One reaction of many small businesses has been to reduce the number of full-time workers to 49 employees and add part-time employees only, which do not fall under this provision. Another reaction of employers is to offer lower wages to compensate for higher health care costs. Moreover, health insurance providers are no longer allowed to deny coverage based on preexisting medical conditions. Some observers are concerned that this may drive up health care premiums further as the overall risk pool of insurers will be less healthy. In an attempt to balance the risk pool, however, the ACA also includes the so-called individual mandate, which requires every individual, including young and healthy people, to carry health insurance or pay a fine. People who cannot afford health insurance will receive government subsidies.[40]

Ethical Responsibilities. Legal responsibilities, however, often define only the minimum acceptable standards of firm behavior. Frequently, managers are called upon to go beyond what is required by law. The letter of the law cannot address or anticipate all possible business situations and newly emerging concerns such as Internet privacy or advances in DNA testing, genetic engineering, and stem-cell research.

A firm's ethical responsibilities, therefore, go beyond its legal responsibilities. They embody the full scope of expectations, norms, and values of its stakeholders. Managers are called upon to do what society deems just and fair. Starbucks, for example, developed an ethical sourcing policy to help source coffee of the highest quality, while adhering to fair trade and responsible growing practices. On the other hand, Starbucks has been criticized for not paying an adequate amount of taxes in the United Kingdom. Albeit entirely legal, Starbucks did pay very little in corporate income taxes since opening its first store in the UK in 1998 (around $13.5 million total). In an attempt to silence the critics, to stop protests, and to please its British customers, Starbucks volunteered an additional tax payment of $16 million for the 2013–14 tax year, despite having no legal obligation to do so.[41]

Philanthropic Responsibilities. Philanthropic responsibilities are often subsumed under the idea of *corporate citizenship,* reflecting the notion of voluntarily giving back to society. Over the years, Microsoft's corporate philanthropy program has donated more than $3 billion in cash and software to people who can't afford computer technology.[42]

The pyramid in Exhibit 1.4 summarizes the four components of corporate social responsibility.[43] Economic responsibilities are the foundational building block, followed by legal, ethical, and philanthropic responsibilities. Note that society and shareholders *require* economic and legal responsibilities. Ethical and philanthropic responsibilities result from a society's expectations toward business. The pyramid symbolizes the need for firms to carefully balance their social responsibilities. Doing so ensures not only effective strategy implementation, but also long-term viability.

STEP 5: ADDRESS STAKEHOLDER CONCERNS. Finally, in step 5, the firm asks, "What should we do to effectively address any stakeholder concerns?" In the last step in stakeholder impact analysis, managers need to decide the appropriate course of action for the firm, given all of the preceding factors. Thinking about the attributes of power, legitimacy, and urgency helps to prioritize the legitimate claims and to address them accordingly. Strategy Highlight 1.2 describes how the U.S. government legitimized claims by thousands of businesses and individuals in the aftermath of the BP oil spill in the Gulf of Mexico, causing the claims to become of great urgency to BP.

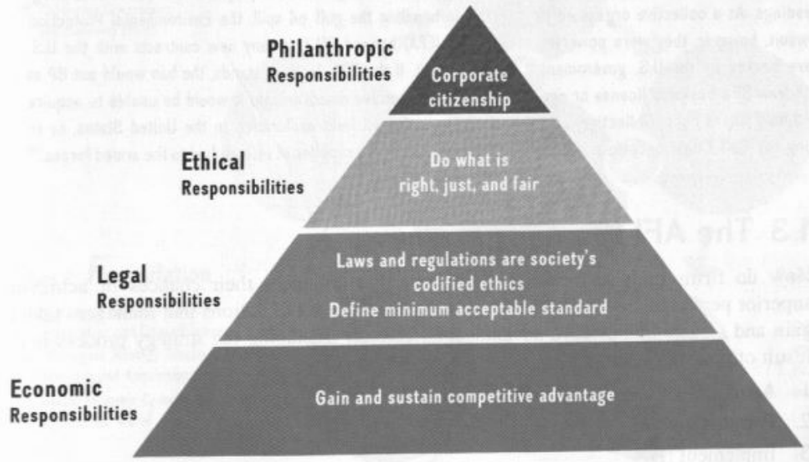

EXHIBIT 1.4 / The Pyramid of Corporate Social Responsibility

Source: Adapted from A. B. Carroll (1991), "The pyramid of corporate social responsibility: Toward the moral management of organizational stakeholders," *Business Horizons,* July–August: 42.

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Strategy Highlight 1.2

BP "Grossly Negligent" in Gulf of Mexico Disaster

Source: U.S. Coast Guard

On April 20, 2010, an explosion occurred on BP's Deepwater Horizon oil drilling rig off the Louisiana coastline, killing 11 workers. The subsequent oil spill continued unabated for over three months. It released an estimated 5 million barrels of crude oil into the Gulf of Mexico, causing the largest environmental disaster in U.S. history. Two BP employees even faced manslaughter charges. The cleanup alone cost BP $14 billion. Because of the company's haphazard handling of the crisis, Tony Hayward, BP's CEO at the time, was fired.

Technical problems aside, many experts argued that BP's problems were systemic, because management had repeatedly failed to put an adequate safety culture in place. In 2005, for example, BP experienced a catastrophic accident at a Texas oil refinery, which killed 15 workers. A year later, a leaking BP pipeline caused the largest oil spill ever on Alaska's North Slope. BP's strategic focus on cost reductions, initiated a few years earlier, may have significantly compromised safety across the board. In a fall 2014 ruling, a federal judge declared that BP's measures to cut costs despite safety risks "evince an extreme deviation from the standard of care and a conscious disregard of known risks."[44]

In the aftermath of the gulf oil spill, BP faced thousands of claims by many small business owners in the tourism and seafood industries. These business owners were not powerful individually, and pursuing valid legal claims meant facing protracted and expensive court proceedings. As a collective organized in a potential class-action lawsuit, however, they were powerful. Moreover, their claims were backed by the U.S. government, which has the power to withdraw BP's business license or cancel current permits and withhold future ones. Collectively, the small business owners along the Gulf Coast became powerful BP stakeholders, with a legitimate claim that needed to be addressed. In response, BP agreed to pay over $25 billion to settle their claims and cover other litigation costs.

Even so, this was not the end of the story for BP. Additional fines and other environmental costs added another $8.5 billion. BP's total tab for the Gulf of Mexico disaster was some $43 billion.[45] To make matters worse, BP was found to have committed "gross negligence" (reckless and extreme behavior) by a federal court in the fall of 2014. This could result in an additional pollution fine of around $18 billion, bringing the total to a staggering $60 billion. BP CEO Bob Dudley sold about $40 billion in assets so far, turning BP into a smaller company that aims to become more profitable in coming years.

Moreover, claiming that BP displayed a "lack of business integrity" in handling the gulf oil spill, the Environmental Protection Agency (EPA) banned BP from any new contracts with the U.S. government. If the EPA decision stands, the ban would put BP at a major competitive disadvantage. It would be unable to acquire new leases for oil field exploration in the United States, or to continue as a major supplier of refined fuel to the armed forces.[46]

1.3 The AFI Strategy Framework

How do firms craft and execute a strategy that enhances their chances of achieving superior performance? A successful strategy details a set of actions that managers take to gain and sustain competitive advantage. Effectively managing the strategy process is the result of three broad tasks:

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

The tasks of analyze, formulate, and implement are the pillars of research and knowledge about strategic management. Although we will study each of these tasks one at a time, they are highly interdependent and frequently happen simultaneously. Effective managers do not formulate strategy without thinking about how to implement it, for instance. Likewise, while implementing strategy, managers are analyzing the need to adjust to changing circumstances.

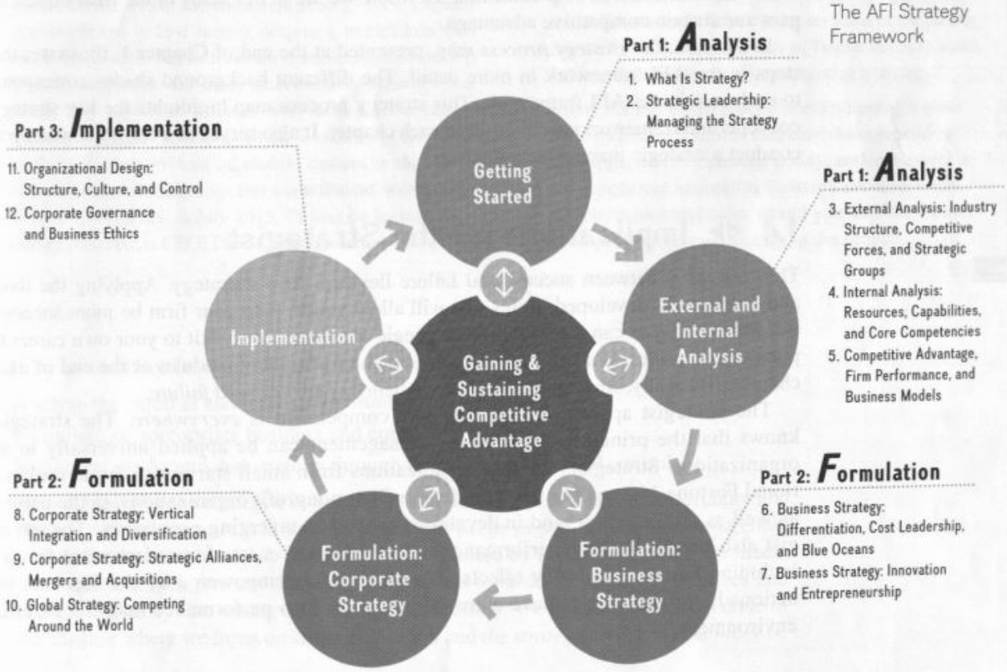
We've captured these interdependent relationships in the **AFI strategy framework** shown in Exhibit 1.5. This framework (1) explains and predicts differences in firm performance, and (2) helps managers formulate and implement a strategy that can result in superior performance. In each of the three broad management tasks, managers focus on specific *questions,* listed below. We address these questions in specific chapters, as indicated.

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

Strategy Analysis *(A)* Topics and Questions

- Strategic leadership and the strategy process: *What roles do strategic leaders play? What are the firm's vision, mission, and values? What is the firm's process for creating strategy and how does strategy come about?* (Chapter 2)
- External analysis: *What effects do forces in the external environment have on the firm's potential to gain and sustain a competitive advantage? How should the firm deal with them?* (Chapter 3)

EXHIBIT 1.5 / The AFI Strategy Framework



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- Internal analysis: *What effects do internal resources, capabilities, and core competencies have on the firm's potential to gain and sustain a competitive advantage? How should the firm leverage them for competitive advantage?* (Chapter 4)
- Competitive advantage, firm performance, and business models: *How does the firm make money? How can one assess and measure competitive advantage? What is the relationship between competitive advantage and firm performance?* (Chapter 5)

Strategy Formulation *(F)* Topics and Questions

- Business strategy: *How should the firm compete: cost leadership, differentiation, or value innovation* (Chapters 6 and 7)
- Corporate strategy: *Where should the firm compete: industry, markets, and geography?* (Chapters 8 and 9)
- Global strategy: *How and where should the firm compete: local, regional, national, or international?* (Chapter 10)

Strategy Implementation *(I)* Topics and Questions

- Organizational design: *How should the firm organize to turn the formulated strategy into action?* (Chapter 11)
- Corporate governance and business ethics: *What type of corporate governance is most effective? How does the firm anchor strategic decisions in business ethics?* (Chapter 12)

The AFI strategy framework shown in Exhibit 1.5 will be repeated at the beginning of each part of this text to help contextualize where we are in our study of the firm's quest to gain and sustain competitive advantage.

In addition, the *strategy process map,* presented at the end of Chapter 1, illustrates the steps in the AFI framework in more detail. The different background shades correspond to each step in the AFI framework. This strategy process map highlights the key strategy concepts and frameworks we'll cover in each chapter. It also serves as a checklist when you conduct a strategic management analysis.

1.4 ◀▶ Implications for the Strategist

The difference between success and failure lies in a firm's strategy. Applying the tools and frameworks developed in this text will allow you to help your firm be more successful. Moreover, you can also apply the strategic management toolkit to your own career to pursue your professional and other goals (see the *my*Strategy modules at the end of each chapter). Basically, *strategy is the art and science of success and failure.*

The strategist appreciates the fact that competition is *everywhere.* The strategist knows that the principles of strategic management can be applied universally to all organizations. Strategists work in organizations from small startups to large, multinational Fortune 100 companies, from for-profit to nonprofit organizations, in the private as well as public sector, and in developed as well as emerging economies. The strategist also knows that firm performance is determined by a set of interdependent factors, including firm and industry effects. The strategist is empowered by the fact that the actions he or she creates have more influence on firm performance than the external environment.

CHAPTERCASE 1 / Consider This...

The excitement was high when Twitter went public in the fall of 2013. Twitter's share price soared from $26 at its initial public offering (IPO) to over $73 within a few short weeks. But a year and a half later, after ups and downs, Twitter was trading well under the IPO price. To add insult to injury, Twitter's debt was rated "junk," reflecting the higher risk of default in relation to investment-grade bonds. At the same time, Twitter's market capitalization was about $25 billion (share price × outstanding shares) with annual revenues of $1.4 billion, while losing roughly $1 billion a year.

By the summer of 2015, Dick Costolo was coming under increasing pressure because of Twitter's lack of user and revenue growth. As a consequence, he was forced to resign July 1. A former improv comedian, Costolo's leadership style involved not only frequent but also often unexpected and rapid shifts in strategy. This may have worked well in Twitter's early days when he turned the rough-and-tumble startup into a highly sought-after candidate by Wall Street for an initial public offering (IPO). Costolo struggled to define a clear and consistent strategy for a business that continued to lose money despite a tremendous cultural impact. This led to frustration and confusion among Twitter employees and other stakeholders. What Twitter needs, they argued, is a leader who takes a more proactive and strategic stance, as Mark Zuckerberg did when he declared that services on mobile devices is the future of Facebook and backed up this commitment with a high level of investments. In July 2015, Twitter co-founder Jack Dorsey returned as CEO; Dick Costolo tweeted "Welcome back, @jack!!" The question remains whether Jack Dorsey, who serverd as Twitter's CEO from 2008 to 2010, can turn the company around. He is quite busy, because he is also the CEO of Square, a mobile payment services company.[47]

Questions

1. Why is Twitter struggling? What role do industry and firm effects play here?
2. What grade would you give Dick Costolo, Twitter's CEO from 2010 to 2015? Support your decision with specifics. Also, list some of his leadership strengths and weaknesses. What recommendations would you have for the new Twitter CEO to be a more effective strategic leader?
3. Why is a *good strategy* so important, especially at high-tech startups like Twitter? Why is crafting a *good strategy* at Twitter so difficult? What are some of the pitfalls that a CEO of a company such as Twitter needs to watch out for when crafting and implementing a strategy?
4. Apply the three-step process for developing a *good strategy* outlined above (diagnose the competitive challenge, derive a guiding policy, and implement a set of coherent actions) to Twitter's situation today. Which recommendations would you have for Twitter to outperform its competitors in the future?

To be more effective, the strategist follows a three-step process:

1. Analyze the external and internal environments.
2. Formulate an appropriate business and corporate strategy.
3. Implement the formulated strategy through structure, culture, and controls.

Keep in mind that the strategist is making decisions under conditions of uncertainty and complexity. As the strategist is following the AFI steps, he or she maintains an awareness of key stakeholders and how they can affect or be affected by the decisions that are made. The strategist then monitors and evaluates the progress toward key strategic objectives and makes adjustments by fine-tuning the strategy as necessary. We discuss how this is done in the next chapter where we focus on *strategic leaders* and *the strategic management process.*

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TAKE-AWAY CONCEPTS

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

LO 1-1 / Explain the role of strategy in a firm's quest for competitive advantage.

- Strategy is the set of goal-directed actions a firm takes to gain and sustain superior performance relative to competitors.
- A good strategy enables a firm to achieve superior performance. It consists of three elements:
  1. A diagnosis of the competitive challenge.
  2. A guiding policy to address the competitive challenge.
  3. A set of coherent actions to implement the firm's guiding policy.
- A successful strategy requires three integrative management tasks—analysis, formulation, and implementation.

LO 1-2 / Define competitive advantage, sustainable competitive advantage, competitive disadvantage, and competitive parity.

- Competitive advantage is always judged relative to other competitors or the industry average.
- To obtain a competitive advantage, a firm must either create more value for customers while keeping its cost comparable to competitors, or it must provide the value equivalent to competitors but at a lower cost.
- A firm able to outperform competitors for prolonged periods of time has a sustained competitive advantage.
- A firm that continuously underperforms its rivals or the industry average has a competitive disadvantage.
- Two or more firms that perform at the same level have competitive parity.
- An effective strategy requires that strategic tradeoffs be recognized and addressed—for example, between value creation and the costs to create the value.

LO 1-3 / Differentiate the roles of firm effects and industry effects in determining firm performance.

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

LO 1-4 / Evaluate the relationship between stakeholder strategy and sustainable competitive advantage.

- Stakeholders are individuals or groups that have a claim or interest in the performance and continued survival of the firm. They make specific contributions for which they expect rewards in return.
- *Internal stakeholders* include stockholders, employees (for instance, executives, managers, and workers), and board members.
- *External stakeholders* include customers, suppliers, alliance partners, creditors, unions, communities, governments at various levels, and the media.
- Several recent black swan events eroded the public's trust in business as an institution and in free market capitalism as an economic system.
- The effective management of stakeholders—the organization, groups, or individuals that can materially affect or are affected by the action of a firm—is necessary to ensure the continued survival of the firm and to sustain any competitive advantage.

LO 1-5 / Conduct a stakeholder impact analysis.

- Stakeholder impact analysis considers the needs of different stakeholders, which enables the firm to perform optimally and to live up to the expectations of good citizenship.
- In a stakeholder impact analysis, managers pay particular attention to three important stakeholder attributes: power, legitimacy, and urgency.

- Stakeholder impact analysis is a five-step process that answers the following questions for the firm:
  1. Who are our stakeholders?
  2. What are our stakeholders' interests and claims?
  3. What opportunities and threats do our stakeholders present?
  4. What economic, legal, ethical, and philanthropic responsibilities do we have to our stakeholders?
  5. What should we do to effectively address the stakeholder concerns?

KEY TERMS

AFI strategy framework *(p. 21)*
Black swan events *(p. 13)*
Competitive advantage *(p. 8)*
Competitive disadvantage *(p. 8)*
Competitive parity *(p. 8)*
Corporate social responsibility (CSR) *(p. 18)*
Firm effects *(p. 11)*
Industry effects *(p. 11)*
Stakeholders *(p. 13)*
Stakeholder impact analysis *(p. 15)*
Stakeholder strategy *(p. 14)*
Strategic management *(p. 6)*
Strategy *(p. 6)*
Sustainable competitive advantage *(p. 8)*

DISCUSSION QUESTIONS

1. Consider the brief description of Target's stakeholder relationships and combine that information with your experience shopping in a Target store. How might Target's stakeholders, in particular its employees, customers, local communities, and suppliers, influence the manager's decisions about building competitive advantage in the analysis stage of the AFI framework? How might Target gather information from its stakeholders to inspire a better customer experience in the formulation stage in order to differentiate? Or in order to lower costs? Brainstorm by jotting down as many ideas as you can think of about how key stakeholders may affect or be affected by the implementation stage.
2. BP's experience in the Gulf of Mexico has made it the poster company for how *not* to manage stakeholder relationships effectively (see Strategy Highlight 1.2). What advice would you give to BP's managers to help them continue to rebuild stakeholder relationships in the gulf region and beyond? How can BP repair its damaged reputation? Brainstorm ways that top management might leverage the experience gained by reactions in the gulf and use that knowledge to motivate local managers and employees in other locales to build stakeholder relationships proactively so that BP avoids this type of negative publicity.
3. As noted in the chapter, research found that firm effects are more important than industry effects. What does this mean? Can you think of situations where this might not be true? Explain.
4. Choose an industry with a clear leader, and then examine the differences between the leader and one or two of the other competitors in the industry. How do the strategies differ? What has the leader done differently? Or what different things has the leader done?

ETHICAL/SOCIAL ISSUES

1. Choose one of the companies discussed in the chapter (including BP, Target, Threadless, Twitter, or Facebook). By looking at the company's annual report on its website or conducting an Internet search for news about the company, identify instances where the company

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Chapter 2

Strategic Leadership: Managing the Strategy Process

Chapter Outline

2.1 Vision, Mission, and Values
Vision
Mission
Values

2.2 Strategic Leadership
What Do Strategic Leaders Do?
How Do You Become a Strategic Leader?
Formulating Strategy across Levels

2.3 The Strategic Management Process
Top-Down Strategic Planning
Scenario Planning
Strategy as Planned Emergence: Top-Down and Bottom-Up

2.4 Implications for the Strategist

Learning Objectives

LO 2-1 Describe the roles of vision, mission, and values in the strategic management process.

LO 2-2 Evaluate the strategic implications of product-oriented and customer-oriented vision statements.

LO 2-3 Explain why anchoring a firm in ethical core values is essential for long-term success.

LO 2-4 Outline how managers become strategic leaders.

LO 2-5 Describe the roles of corporate, business, and functional managers in strategy formulation and implementation.

LO 2-6 Evaluate top-down strategic planning, scenario planning, and strategy as planned emergence.

CHAPTERCASE 2

Marissa Mayer: Turnaround at Yahoo?

APPOINTED CEO IN 2012, Marissa Mayer has just one job at Yahoo: Turn it around.

Yahoo was once the go-to Internet leader, a web portal with e-mail and finance, sports, social media, and video-sharing services. Advertisers loved it. During the peak of the Internet boom, Yahoo's share price reached an all-time high of close to $120. In 2000 when the bubble burst, Yahoo's stock sank to $5. Despite rebounding as high as $40 in the mid-2000s, the stock had long hovered around $15 by the time Mayer got the job. From its peak to Mayer's hiring, Yahoo's stock valuation (share price × number of outstanding shares) lost more than 80 percent, falling from $125 billion to a mere $20 billion.

Marissa Mayer, CEO Yahoo
© AP Photo/Julie Jacobson

You can measure Yahoo's challenges by CEO turnover. When Mayer took the job, she became the fifth CEO in three years. So who is Marissa Mayer to break the Yahoo CEO jinx? How is she turning Yahoo around?

PRE-YAHOO

Mayer grew up in Wausau, Wisconsin, but took her higher education and built her career in California's Silicon Valley. She entered Stanford University in 1993, majoring in symbolic systems, a discipline that combines cognitive sciences, artificial intelligence, and human–computer interaction. Still at Stanford, Mayer earned a master's degree in computer science. On graduation in 1999, she declined over a dozen job offers, ranging from prestigious consulting firms to top-tier universities. Instead she went to a garage that housed a small startup with a handful of employees, just a few months old. It was called Google.

Google's 20th hire and its first female engineer, Mayer became a star. With a superior skill set and strong work ethic, she rose quickly to the rank of vice president. She helped develop many of Google's best known features: Gmail, images, news, and maps. In particular, she designed the functionality and uncluttered look and feel of Google's iconic search site. Mayer is known for her attention to detail, her commitment of time, and her desire to provide the very best user experience possible, putting products before profits. She maintains that if you build the best products possible, profits will come.

In 2012 Yahoo's site had long been stale. The former search leader was third in traffic behind Google and Bing. No doubt Mayer's pedigree at Google appealed to the Yahoo board. She was deeply involved in everything that Google had done right. And she was ready.

AT YAHOO

Mayer's first acts at Yahoo revolved around culture and cash. To change Yahoo's culture, she retooled the company's vision and mission statements. (We'll visit them later in the chapter.) She also took on Yahoo's organizational culture. Yahoo had become overly bureaucratic and lost the zeal characteristic of high-tech startups. Many Yahoo employees worked from home. For those who worked in the office, weekends began Thursday afternoons, leaving empty parking garages at Yahoo's campus in Sunnyvale, California.

In response, Mayer withdrew the option to work remotely. All of Yahoo's 12,000 employees would have to come to the office. She also installed a weekly town-hall style meeting called FYI to review Yahoo's progress and take questions. All Yahoo employees were expected to attend, either in person or via satellite link if they did not work in the Sunnyvale offices—every Friday afternoon.

To raise cash, Mayer sold part of Yahoo's ownership stake in Alibaba, the Chinese e-commerce company, for over $6 billion. Mayer spent about $2 billion acquiring more than three dozen tech ventures, including $1.1 billion for microblogging and social networking site Tumblr and $640 million for video ad company BrightRoll. The acquisitions filled gaps in product line and brought in new engineering talent.

Is it working? A number of signs are positive. By 2015, Yahoo's various websites had more than 800 million monthly visitors, with 400 million of those on mobile devices, up from a mere 160 million in 2014. Yahoo's market cap has more than doubled to over $45 billion, and its share price has more than tripled since Mayer's appointment as CEO.[1]

You will learn more about Yahoo by reading this chapter; related questions appear on page 55.

HOW DO STRATEGIC LEADERS like Marissa Mayer develop and implement a vision for their company to achieve strategic goals? How do they guide and motivate employees? In Chapter 2, we move from thinking about why strategy is important to considering how firms and other organizations define their vision, mission, and values, and how strategic leaders manage the strategy process across different levels in the organization. We also explore some of the frameworks they use to develop strategy. And finally, we summarize some of the most important practical insights in our "Implications for the Strategist."

2.1 Vision, Mission, and Values

LO 2-1

Describe the roles of vision, mission, and values in the strategic management process.

strategic management process
Method put in place by strategic leaders to formulate and implement a strategy, which can lay the foundation for a sustainable competitive advantage.

strategic leadership
Executives' use of power and influence to direct the activities of others when pursuing an organization's goals.

An effective **strategic management process** lays the foundation for sustainable competitive advantage. Strategic leaders design a process to formulate and implement strategy. **Strategic leadership** pertains to executives' use of power and influence to direct the activities of others when pursuing an organization's goals.[2] The first step in this process is to define a firm's vision, mission, and values.

To define these basic principles, strategic leaders can ask these questions:

- **Vision.** What do we want to accomplish ultimately?
- **Mission.** How do we accomplish our goals?
- **Values.** What commitments do we make, and what guardrails do we put in place, to act both legally and ethically as we pursue our vision and mission?

Because the vision succinctly identifies the primary goal of the organization, it is the first item to define. Strategic leaders need to begin with the end in mind.[3] In fact, early on strategic success is created *twice*. Leaders create the vision in the abstract by formulating strategies that enhance the chances of gaining and sustaining competitive advantage, before any actions of strategy implementation are taken in a second round of strategy creation. This process is similar to building a house. The future owner must communicate her vision to the architect, who draws up a blueprint of the home for her review. The process is iterated a couple of times until all the homeowner's ideas have been translated into the blueprint. Only then does the building of the house begin. The same holds for strategic success; it is first created through strategy formulation based on careful analysis before any actions are taken. Because the vision succinctly identifies the primary objective of the organization, it is the first item to define. Let's look at this process in more detail.

VISION

vision
A statement about what an organization ultimately wants to accomplish; it captures the company's aspiration.

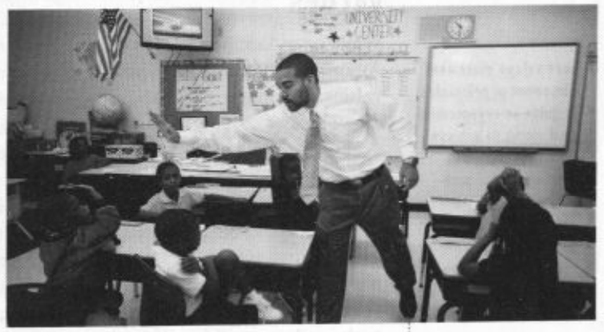
A **vision** captures an organization's aspiration and spells out what it ultimately wants to accomplish. An effective vision pervades the organization with a sense of winning and motivates employees at all levels to aim for the same target, while leaving room for individual and team contributions. Marissa Mayer developed a new vision for Yahoo—*to make the world's daily habits more inspiring and entertaining*—to help reinvigorate Yahoo's employees and get its customers excited again. Mayer's vision attempts to inspire Yahoo's employees to resume leadership in online advertising.

Employees in visionary companies tend to feel part of something bigger than themselves. An inspiring vision helps employees find meaning in their work. Beyond monetary rewards, it allows employees to experience a greater sense of purpose. People have an intrinsic motivation to make the world a better place through their work activities.[4] This greater individual purpose can in turn lead to higher organizational performance.[5] Basing actions on its vision, a firm will build the necessary resources and capabilities through continuous organizational learning, including learning from failure, to translate into reality what begins as a stretch goal or *strategic intent*.[6]

To provide meaning for employees in pursuit of the organization's ultimate goals, vision statements should be forward-looking and inspiring. Consider, for example, the vision of the nonprofit organization Teach for America (TFA): *One day, all children in this nation will have the opportunity to attain an excellent education.*[7] That vision effectively and clearly communicates what TFA ultimately wants to accomplish, while providing an inspiring target.

It's not surprising that vision statements can be inspiring and motivating in the nonprofit sector. Many people would find meaning in wanting to help children attain an excellent education (TFA) or wanting *to be always there*, touching the lives of people in need, the vision of the American Red Cross. But what about for-profit firms?

Many companies in the for-profit sector measure success primarily by financial performance. However, this is not always the case. Visionary companies, such as 3M, General Electric, Procter & Gamble (P&G), and Walmart, provide more aspirational ideas that are not exclusively financial. The upscale retailer Nordstrom's vision, for example, is *to provide outstanding service every day, one customer at a time.* Visionary companies often outperform their competitors over the long run. Tracking the stock market performance of companies over several decades, strategy scholars found that visionary companies outperformed their peers by a wide margin.[8] A truly meaningful and inspiring vision makes employees feel they are part of something bigger. This is highly motivating and, in turn, can improve financial performance.



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Moreover, more companies big and small are responding to the desire of society and individual employees to find meaning in work, beyond financial success.[9] While sometimes the effort results in overreach, the trend appears to be positive. For example, Travelzoo CEO Chris Loughlin is convinced that, "If we all traveled, there would be significantly more peace on Earth." Less specific but also lofty is the take of a motorcycle marketing director at a recent investor conference: "There is a higher purpose to the Harley-Davidson brand that is more than motorcycles." One possible explanation for this shift has to do with the increasing demands of work. "In part, professionals are demanding more meaning from their careers

because work simply takes up more of life than before, thanks to longer hours, competitive pressures and technological tethers of the modern job."[10]

MISSION

mission
Description of what an organization actually does—the products and services it plans to provide, and the markets in which it will compete.

Building on the vision, organizations establish a **mission**, which describes what an organization actually does—that is, the products and services it plans to provide, and the markets in which it will compete. People sometimes use the terms *vision* and *mission* interchangeably, but in the strategy process they differ.

- A vision defines what an organization wants to accomplish ultimately, and thus the goal can be described by the verb *to*. For instance, TFA's vision is *to attain an excellent education for all children.*
- A mission describes what an organization does; it defines the means *by* which vision is accomplished. Accordingly, TFA says it will achieve its vision *by enlisting our nation's most promising future leaders in the effort.*

strategic commitments
Actions to achieve the mission that are costly, long-term oriented, and difficult to reverse.

To be effective, firms need to back up their visions and missions with **strategic commitments**, in which the enterprise puts its money where its mouth is. Such commitments are costly, long-term oriented, and difficult to reverse.[11] For instance, the vision of EADS, the parent company of Airbus, is *to be the world's leading aerospace company.* Airbus translates this ultimate goal into its mission *by manufacturing the world's best aircraft, with passengers at heart and airlines in mind.* In service of its mission, Airbus spent 10 years and $15 billion to develop the A380 super jumbo, which can accommodate over 850 passengers and fly almost 10,000 miles, a sufficient range to fly non-stop from New York to Singapore. The company's vision is backed by a powerful strategic commitment. However noble the mission statement, for competitive advantage companies still need strategic actions informed by economic fundamentals of value creation.

Consider the strategic commitments made by Mayer to help turn Yahoo around. Its sale of Alibaba holdings and purchases of various startups show the kind of bold commitment required of strategic leaders. To retain existing talent and restore morale, she also had to sell her workers on the new vision and mission. She did so by sharing this mantra with them via tweets and other means: *People then products then traffic then revenue.* Employees understood they were the start of the transformation.

VALUES

core values statement
Statement of principles to guide an organization as it works to achieve its vision and fulfill its mission, for both internal conduct and external interactions; it often includes explicit ethical considerations.

While many companies have powerful vision and mission statements, they are not enough. An organization's values should also be clearly articulated in the strategy process. A **core values statement** matters because it provides touchstones for the employees to understand the company culture. It offers bedrock principles that employees at all levels can use to deal with complexity and to resolve conflict. Such statements can help provide the organization's employees with a moral compass.

Consider that much of unethical behavior, while repugnant, may not be illegal. Often we read the defensive comment from a company under investigation or fighting a civil suit that "we have broken no laws." However, any firm that fails to establish extra-legal, ethical standards will be more prone to behaviors that can threaten its very existence. A company whose culture is silent on moral lapses breeds further moral lapses. Over time such a culture could result in a preponderance of behaviors that cause the company to ruin its reputation, at the least, or slide into outright legal violations with resultant penalties and punishment, at the worst.

EXHIBIT 2.1 / Teach for America: Vision, Mission, and Values

VISION	One day, all children in this nation will have the opportunity to attain an excellent education.
MISSION	Teach for America is growing the movement of leaders who work to ensure that kids growing up in poverty get an excellent education.
VALUES	**Transformational Change:** We seek to expand educational opportunity in ways that are life-changing for children and transforming for our country. Given our deep belief in children and communities, the magnitude of educational inequity and its consequences, and our optimism about the solvability of the problem, we act with high standards, urgency, and a long-term view. **Leadership:** We strive to develop and become the leaders necessary to realize educational excellence and equity. We establish bold visions and invest others in working towards them. We work in purposeful, strategic, and resourceful ways, define broadly what is within our control to solve, and learn and improve constantly. We operate with a sense of possibility, persevere in the face of challenges, ensure alignment between our actions and beliefs, and assume personal responsibility for results. **Team:** We value and care about each other, operate with a generosity of spirit, and have fun in the process of working together. To maximize our collective impact, we inspire, challenge, and support each other to be our best and sustain our effort. **Diversity:** We act on our belief that the movement to ensure educational equity will succeed only if it is diverse in every respect. In particular, we value the perspective and credibility that individuals who share the racial and economic backgrounds of the students with whom we work can bring to our organization, classrooms, and the long-term effort for change. **Respect & Humility:** We value the strengths, experiences, and perspectives of others, and we recognize our own limitations. We are committed to partnering effectively with families, schools, and communities to ensure that our work advances the broader good for all children.

Source: www.teachforamerica.org

To see how all three components—vision, mission, and values—work together, see Exhibit 2.1, which provides a snapshot of aspirations at Teach for America.

LO 2-2
Evaluate the strategic implications of product-oriented and customer-oriented vision statements.

Do vision statements help firms gain and sustain competitive advantage? It depends. The effectiveness of vision statements differs based on type. *Customer-oriented* vision statements allow companies to adapt to changing environments. *Product-oriented* vision statements often constrain this ability. This is because customer-oriented vision statements focus employees to think about how best to solve a problem for a consumer.[12] Clayton Christensen shares how a customer focus let him help a fast-food chain increase sales of milk shakes.[13] The company approached Christensen after it had made several changes to its milk-shake offering based on extensive customer feedback but sales failed to improve. Rather than asking customers what kind of milk shake they wanted, he thought of the problem in a different way. He observed customer behavior and then asked customers, "What job were you trying to do that caused you to hire that milk shake?"[14] He wanted to know what problem the customers were trying to solve. Surprisingly he found that roughly half of the milk shakes were purchased in the mornings, because customers wanted an easy breakfast to eat in the car and a diversion on long commutes. Based on the insights gained from this problem-solving perspective, the company expanded its milk-shake offerings to include healthier options with fruit chunks and provided a prepaid dispensing machine to speed up the drive-through, and thus improve customers' morning commute. A customer focus made finding a solution much easier.

You could say that the restaurant company had a product orientation that prevented its executives from seeing unmet customer needs. Product-oriented vision statements focus employees on improving existing products and services without consideration of

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underlying customer problems to be solved. Our environments are ever-changing and sometimes seem chaotic. The increased strategic flexibility afforded by customer-oriented vision statements can provide companies with a competitive advantage.[15] Let's look at both types of vision statements in more detail.

PRODUCT-ORIENTED VISION STATEMENTS. A product-oriented vision defines a business in terms of a good or service provided. Product-oriented visions tend to force managers to take a more myopic view of the competitive landscape. Consider the strategic decisions of U.S. railroad companies. Railroads are in the business of moving goods and people from point A to point B by rail. When they started in the 1850s, their short-distance competition was the horse or horse-drawn carriage. There was little long-distance competition (e.g., ship canals or good roads) to cover the United States from coast to coast. Because of their monopoly, especially in long-distance travel, these companies were initially extremely profitable. Not surprisingly, the early U.S. railroad companies saw their vision as being in the railroad business, clearly a product-based definition.

However, the railroad companies' monopoly did not last. Technological innovations changed the transportation industry dramatically. After the introduction of the automobile in the early 1900s and the commercial jet in the 1950s, consumers had a wider range of choices to meet their long-distance transportation needs. Rail companies were slow to respond; they failed to redefine their business in terms of services provided to the consumer. Had they envisioned themselves as serving the full range of transportation and logistics needs of people and businesses across America (a customer-oriented vision), they might have become successful forerunners of modern logistics companies such as FedEx or UPS.

Recently, the railroad companies seem to be learning some lessons: CSX Railroad is now redefining itself as a green-transportation alternative. It claims it can move one ton of freight 423 miles on one gallon of fuel. However, its vision remains product-oriented: *to be the safest, most progressive North American railroad.*

CUSTOMER-ORIENTED VISION STATEMENTS. *A customer-oriented vision* defines a business in terms of providing solutions to customer needs. For example, "We provide solutions to professional communication needs." Companies with customer-oriented visions can more easily adapt to changing environments. Exhibit 2.2 provides additional examples of companies with customer-oriented vision statements. In contrast, companies that define themselves based on product-oriented statements (e.g., "We are in the typewriter business") tend to be less flexible and thus more likely to fail. The lack of an inspiring needs-based vision can cause the long-range problem of failing to adapt to a changing environment.

EXHIBIT 2.2 /

Companies with Customer-Oriented Vision Statements

Amazon: To be earth's most customer centric company; to build a place where people can come to find and discover anything they might want to buy online.
Alibaba: To make it easy to do business anywhere.
GE: To turn imaginative ideas into leading products and services that help solve some of the world's toughest problems.
Google: To organize the world's information and make it universally accessible and useful.
IBM: To be the best service organization in the world.
Microsoft: To enable people and businesses throughout the world to realize their full potential.
Nike: To bring inspiration and innovation to every athlete in the world.
Walmart: To give ordinary folk the chance to buy the same thing as rich people.
Yahoo: To make the world's daily habits more inspiring and entertaining.

Customer-oriented visions identify a critical need but leave open the means of how to meet that need. Customer needs may change, and the *means* of meeting those needs can change. The future is unknowable, and innovation may provide new ways to meet needs that we cannot fathom today.[16] For example, consider the need to transmit information over long distances. Communication needs have persisted throughout the millennia, but the technology to solve this problem has changed drastically over time.[17] During the reign of Julius Caesar, moving information over long distances required papyrus, ink, a chariot, a horse, and a driver. During Abraham Lincoln's time, railroads handled this task, while an airplane was used when Franklin Delano Roosevelt was president. Today, we use connected mobile devices to move information over long distances at the speed of light. The problem to be solved—moving information over long distance—has remained the same over the millennia, but the technology employed to do this job has changed quite drastically. Christensen recommends that strategic leaders think hard about how the means of getting a job done have changed over time and ask themselves, "Is there an even better way to get this job done?"

It is critical that an organization's vision should be flexible to allow for change and adaptation. Consider how Ford Motor Company has addressed the problem of personal mobility over the past 100 years. Before Ford entered the market in the early 1900s, people traveled long distances by horse-drawn buggy, horseback, boat, or train. But Henry Ford had a different idea. In fact, he famously said, "If I had listened to my customers, I would have built a better horse and buggy."[18] Instead, Henry Ford's original vision was *to make the automobile accessible to every American.* He succeeded, and the automobile dramatically changed how mobility was achieved.

Fast-forward to today: Ford Motor Company's vision is *to provide personal mobility for people around the world.* Note that it does not even mention the automobile. By focusing on the consumer need for personal mobility, Ford is leaving the door open for exactly how it will fulfill that need. Today, it's mostly with traditional cars and trucks propelled by gas-powered internal combustion engines, with some hybrid electric vehicles in its lineup. In the near future, Ford is likely to provide vehicles powered by alternative energy sources such as electric power or hydrogen. In the far-reaching future, perhaps Ford will get into the business of individual flying devices. Throughout all of this, its vision would still be relevant and compel its managers to engage in future markets. In contrast, a product-oriented vision would have greatly constrained Ford's degree of strategic flexibility.

MOVING FROM PRODUCT-ORIENTED TO CUSTOMER-ORIENTED VISION STATEMENTS. In some cases, product-oriented vision statements do not interfere with the firm's success in achieving superior performance and competitive advantage. Consider Intel Corporation, one of the world's leading silicon innovators. Intel's early vision was *to be the preeminent building-block supplier of the PC industry.* Intel designed the first commercial microprocessor chip in 1971 and set the standard for microprocessors in 1978. During the personal computer (PC) revolution in the 1980s, microprocessors became Intel's main line of business. Intel's customers were original equipment manufacturers that produced consumer end-products, such as computer manufacturers HP, IBM, Dell, and Compaq.

In the Internet age, though, the standalone PC as the end-product has become less important. Customers want to stream video and share selfies and other pictures online. These activities consume a tremendous amount of computing power. To reflect this shift, Intel in 1999 changed its vision to focus on being *the preeminent building-block supplier to the Internet economy.* Although its product-oriented vision statements did not impede performance or competitive advantage, in 2008 Intel fully made the shift to a customer-oriented vision: *to delight our customers, employees, and shareholders by relentlessly delivering the platform and technology advancements that become essential to the way we work and live.*

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Part of this shift was reflected by the hugely successful "Intel Inside" advertising campaign in the 1990s that made Intel a household name worldwide.

Intel accomplished superior firm performance over decades through continuous adaptations to changing market realities. Its formal vision statement lagged behind the firm's strategic transformations. Intel regularly changed its vision statement *after* it had accomplished each successful transformation.[19] In such a case, vision statements and firm performance are clearly not related to one another.

Taken together, empirical research shows that sometimes vision statements and firm performance are *associated* with one another. A positive relationship between vision statements and firm performance is more likely to exist under certain circumstances:

- The visions are customer-oriented.
- Internal stakeholders are invested in defining the vision.
- Organizational structures such as compensation systems align with the firm's vision statement.[20]

The upshot is that an effective vision statement can lay the foundation upon which to craft a strategy that creates competitive advantage.

LO 2-3

Explain why anchoring a firm in ethical core values is imperative for long-term success.

organizational core values Ethical standards and norms that govern the behavior of individuals within a firm or organization.

Organizational core values are the ethical standards and norms that govern the behavior of individuals within a firm or organization. Strong ethical values have two important functions. First, they form a solid foundation on which a firm can build its vision and mission, and thus lay the groundwork for long-term success. Second, values serve as the guardrails put in place to keep the company on track when pursuing its vision and mission in its quest for competitive advantage.

The values espoused by a company provide answers to the question, *how do we accomplish our goals?* They help individuals make choices that are both ethical and effective in advancing the company's goals. Strategy Highlight 2.1, featuring the pharmaceutical company Merck, provides an example of how values can drive strategic decision making, and what can happen if a company deviates from its core values.

One last point about organizational values: Without commitment and involvement from top managers, any statement of values remains merely a public relations exercise. Employees tend to follow values practiced by strategic leaders. They observe the day-to-day decisions of top managers and quickly decide whether managers are merely paying lip service to the company's stated values. Organizational core values must be lived with integrity, especially by the top management team. Unethical behavior by top managers is like a virus that spreads quickly throughout an entire organization. It is imperative that strategic leaders set an example of ethical behavior by living the core values. Since strategic leaders have such a strong influence in setting an organization's vision, mission, and values, we next discuss strategic leadership.

LO 2-4

Outline how managers become strategic leaders.

2.2 Strategic Leadership

Strategic leadership describes the executives' successful use of power and influence to direct the activities of others when pursuing an organization's goals. Executives whose vision and actions enable their organizations to achieve competitive advantage demonstrate strategic leadership.[21] Marissa Mayer demonstrated strategic leadership in defining a new vision and mission for Yahoo. To put Yahoo's new vision and mission into action, she worked to rejuvenate Yahoo's bureaucratic culture and engaged in more open and frequent communication, with weekly FYI town-hall meetings where she and other executives provide updates and field questions.[22] All employees are expected to attend and encouraged to participate in the Q&A. Questions are submitted online during the week, and the employees vote which questions executives should respond to.

Strategy Highlight 2.1

Merck: Reconfirming Its Core Values

Merck's vision is *to preserve and improve human life.* The words of founder George W. Merck still form the basis of the company's values today: *We try to never forget that medicine is for the people. It is not for profits. The profits follow, and if we have remembered that, they have never failed to appear.*[23]

ENDING RIVER BLINDNESS In 1987, Ray Vagelos, a former Merck scientist turned CEO, announced that the company would donate its recently discovered drug Mectizan, without charge, to treat river blindness. For centuries, river blindness—a parasitic disease that leads to loss of eyesight—plagued remote communities in Africa and other parts of the world. Merck's executives formed a novel private-public partnership, the Mectizan Donation Program (MDP), to distribute the drug in remote areas, where health services are often not available.

After 25 years, more than 1 billion treatments, and some 120,000 communities served, the disease had effectively been eradicated. Merck's current CEO, Kenneth Frazier, announced himself "humbled" by the result of the company's value-driven actions.[24]

WITHDRAWING VIOXX In the case of another drug, though, Merck's values were brought into question. Vioxx was a painkiller developed to produce fewer gastrointestinal side-effects than aspirin or ibuprofen. Once the Food and Drug Administration (FDA) approved the new drug in 1999, Merck engaged in typical big pharma promotional practices:

- Heavy direct-to-consumer advertising via TV and other media.
- Luxury doctor inducements, including consulting contracts and free retreats at exotic resorts.

Merck's new drug was a blockbuster, generating revenues of $2.5 billion a year by 2002 and growing fast.

Allegations began to appear, however, that Vioxx caused heart attacks and strokes. Critics alleged that Merck had suppressed evidence about Vioxx's dangerous side-effects from early clinical trials. In 2004, Merck voluntarily recalled the drug. Merck's CEO at the time, Raymond Gilmartin, framed the situation in terms of knowledge learned *after* the initial release. He said he received a phone call from the head of research. "He told me that our long-term safety study of Vioxx was showing an increased risk of cardiovascular events compared to placebo, and the trial was being discontinued . . . After analyzing the data further and consulting with outside experts, the Merck scientists recommended that we voluntarily withdraw the drug."[25]

Merck CEO Kenneth Frazier
© The Star-Ledger/Saed Hindash/The Image Works

Regardless of what Merck knew when, the voluntary withdrawal reconfirmed in a costly way its core value that patients come before profits. Merck's reputation damaged, its stock fell almost 30 percent to $33, eradicating $27 billion in market value almost overnight—an amount much greater than the estimated net present value of the profits that Merck would have obtained from continued sales of Vioxx. Merck has been hit by lawsuits ever since; legal liabilities have cost the company up to $30 billion thus far.

Some corporate social responsibility experts argue that Merck should have never put Vioxx on the market in the first place, or that it should have at least provided up-front, clear assessments of the risks associated with Vioxx.[26]

Mayer took some heat when she announced that Yahoo employees could no longer work from home, but needed to come into the office instead. Her rationale is that working in the same shared space encourages collaboration, teamwork, and the creative spark to foster innovation. She moved out of her corner office and instead works in a cubicle among other Yahoo rank-and-file employees. To ease the transition into now being required to work on the Yahoo campus in Sunnyvale, California, Mayer ordered a renovation and upgrade to Yahoo's cafeteria. Now, gourmet meals—breakfast, lunch, and dinner—are available free for all Yahoos.

There are other less-than-popular changes. Where before Yahoos enjoyed a casual work culture, now they faced a stacked ranking system of employee performance. Managers had to

grade their direct reports along a bell curve, with a fixed percentage as "underperforming." Team leaders were now to rank their employees in defined groups: 10 percent in "greatly exceeds," 25 percent in "exceeds," 50 percent in "achieves," 10 percent in "occasionally misses," and 5 percent in "misses." Unintended consequences ensued. High performers refused to work with one another in the same team. Managers cynically traded team members to fill their quotas. Political infighting increased.[27]

While the effect of strategic leaders varies, they still matter to firm performance.[28] Think of great business founders and their impact on the companies they built—Jack Ma at Alibaba, Steve Jobs at Apple, Jeff Bezos at Amazon, and so on. There are also strategic leaders who have shaped and revitalized existing businesses: Tim Cook at Apple, Chung Mong-Koo at Hyundai, Satya Nadella at Microsoft, etc.[29] Or continue with the example of Marissa Mayer. In 2014, *Forbes* listed her as number eight in its annual ranking of the most powerful women in business, just behind other great business leaders such as Mary Barra (GM), Sheryl Sandberg (Facebook), and Virginia Rometty (IBM), among others. One of the world's top business leaders, Mayer, born 1975, is one of the youngest.

At the other end of the spectrum, some CEOs have massively destroyed shareholder value: Charles Prince at Citigroup, Richard Wagoner at GM, Robert Nardelli at The Home Depot and later Chrysler, Martin Winterkorn at VW, and Ron Johnson at JCPenney, among many others.

Why do some leaders create great companies or manage them to greatness, while others lead them into decline and sometimes even demise? To answer that question, let's first consider what strategic leaders actually do.

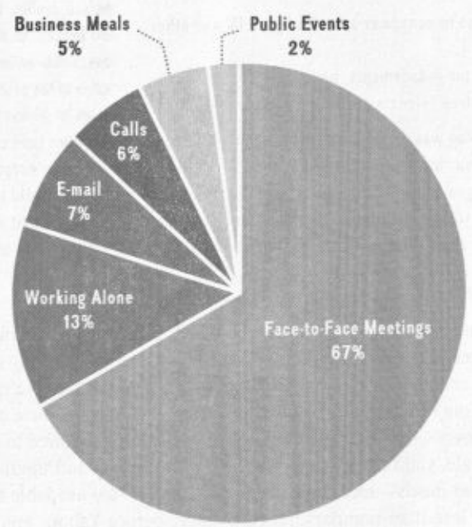
WHAT DO STRATEGIC LEADERS DO?

What do strategic leaders do that makes some strategic leaders more effective than others? In a recent study of more than 350 CEOs, strategy scholars found that they spend, on average, 67 percent of their time in meetings, 13 percent working alone, 7 percent on e-mail, 6 percent on phone calls, 5 percent on business meals, and 2 percent on public events such as ribbon-cutting for a new factory (see Exhibit 2.3).[30] Other studies have also found that

EXHIBIT 2.3 /

How CEOs Spend Their Days

Source: Data from O. Bandiera, A. Prat, and R. Sadun (2012). "Management capital at the top: Evidence from the time use of CEOs." London School of Economics and Harvard Business School Working Paper.



most managers prefer oral communication: CEOs spend most of their time "interacting—talking, cajoling, soothing, selling, listening, and nodding—with a wide array of parties inside and outside the organization."[31] Surprisingly given the advances in information technology, CEOs today spend most of their time in face-to-face meetings. They consider face-to-face meetings most effective in getting their message across and obtaining the information they need. Not only do meetings present data through presentations and verbal communications, but they also enable CEOs to pick up on rich nonverbal cues such as facial expressions, body language, and mood, that are not apparent to them if they use e-mail or Skype, for example.[32]

HOW DO YOU BECOME A STRATEGIC LEADER?

Is becoming an ethical and effective strategic leader innate? Can it be learned? According to the **upper-echelons theory**, organizational outcomes including strategic choices and performance levels reflect the values of the top management team.[33] These are the individuals at the upper echelons, or levels, of an organization. The theory states that executives interpret situations through the lens of their unique perspectives, shaped by personal circumstances, values, and experiences. Their leadership actions reflect characteristics of age, education, and career experiences, filtered through personal interpretations of the situations they face. The upper-echelons theory favors the idea that strong leadership is the result of both innate abilities *and* learning.

upper-echelons theory A conceptual framework that views organizational outcomes—strategic choices and performance levels—as reflections of the values of the members of the top management team.

In the bestseller *Good to Great,* Jim Collins explored over 1,000 *good* companies to find 11 *great* ones. He identified *great companies* as those that transitioned from average performance to sustained competitive advantage. He measured that transition as "cumulative stock returns of almost seven times the general market in the 15 years following their transition points."[34] A lot has happened since the book was published over a decade ago. Today only a few of the original 11 stayed all that great, specifically Kimberly-Clark and Walgreens. Some fell back to mediocrity; a few no longer exist in their earlier form or at all. Anyone remember Circuit City or Fannie Mae? Let's agree that competitive advantage is hard to achieve and even harder to sustain. But the book remains valuable for its thought-provoking observations. Studying these large corporations, Collins found consistent patterns of leadership among the top companies, as pictured in the **Level-5 leadership pyramid** in Exhibit 2.4.[35] The pyramid is a conceptual framework that shows leadership progression through five distinct, sequential levels. Collins found that all the companies he identified as *great* were led by Level-5 executives. So if you are interested in becoming an ethical and strategic leader, the leadership pyramid suggests the areas of growth required.

Level-5 leadership pyramid A conceptual framework of leadership progression with five distinct, sequential levels.

According to the Level-5 leadership pyramid, effective strategic leaders go through a natural progression of five levels. Each level builds upon the previous one; the manager can move on to the next level of leadership only when the current level has been mastered. On the left (in Exhibit 2.4) are the capabilities associated with each level. But not all companies are Fortune 500 behemoths. On the right we suggest that the model is valuable as well to the individual looking to develop the capacity for greater success.

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

LO 2-5

Describe the roles of corporate, business, and functional managers in strategy formulation and implementation.

According to the upper-echelons theory, the top management team primarily determines a firm's ability to gain and sustain a competitive advantage through the strategies they pursue. Given the importance of such strategies, we need to gain a deeper understanding of how they are formed.

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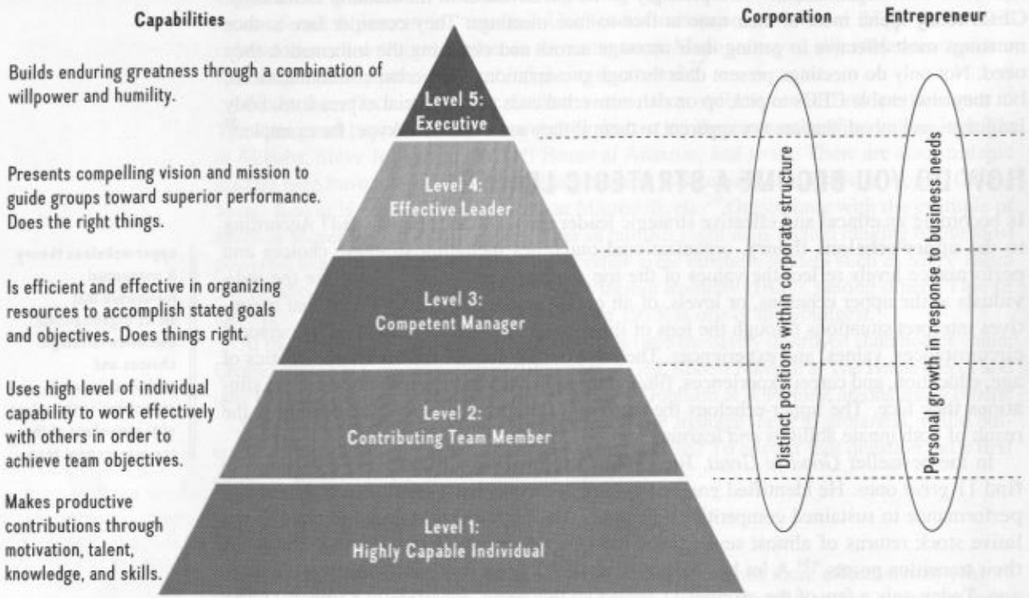
EXHIBIT 2.4 / Strategic Leaders: The Level-5 Pyramid

Adapted to compare corporations and entrepreneurs



Source: Adapted from J. Collins (2001), *Good to Great: Why Some Companies Make the Leap . . . And Others Don't* (New York: HarperCollins), 20.

strategy formulation
The part of the strategic management process that concerns the choice of strategy in terms of where and how to compete.

strategy implementation
The part of the strategic management process that concerns the organization, coordination, and integration of how work gets done, or strategy execution.

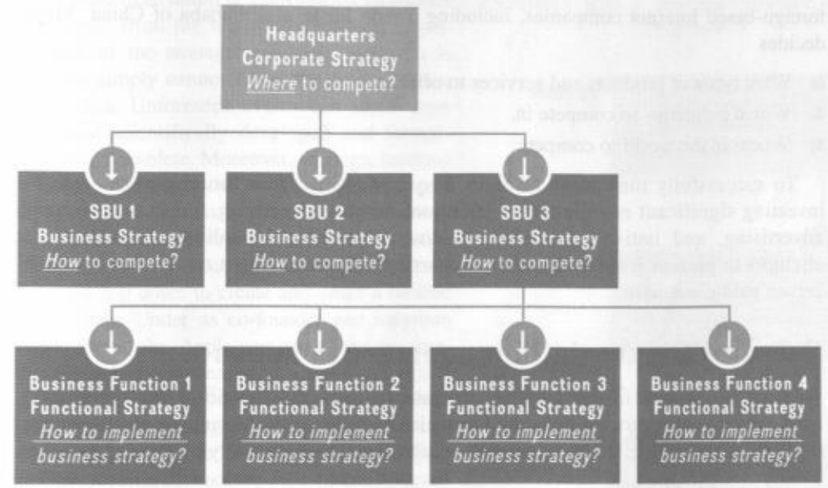
Strategy formulation concerns the choice of strategy in terms of *where and how to compete*. In contrast, **strategy implementation** concerns the organization, coordination, and integration of *how work gets done*. In short, it concerns the *execution of strategy*. It is helpful to break down strategy formulation and implementation into three distinct areas—corporate, business, and functional.

- *Corporate strategy* concerns questions relating to where to compete in terms of industry, markets, and geography.
- *Business strategy* concerns the question of how to compete. Three generic business strategies are available: cost leadership, differentiation, or value innovation.
- *Functional strategy* concerns the question of how to implement a chosen business strategy.

Exhibit 2.5 shows the three areas of strategy formulation.

Although we generally speak of the firm in an abstract form, individual employees make strategic decisions—whether at the corporate, business, or functional level. *Corporate executives* at headquarters formulate corporate strategy. Think of corporate executives including Mukesh Ambani (Reliance Industries), Ursula Burns (Xerox), Sheryl Sandberg (Facebook), or Marillyn Hewson (Lockheed Martin). Corporate executives need to decide in which industries, markets, and geographies their companies should compete. They need to formulate a strategy that can create synergies across business units that may be quite different, and determine the boundaries of the firm by deciding whether to enter certain industries and markets and whether to sell certain divisions. They are responsible for setting

EXHIBIT 2.5 / Strategic Formulation and Implementation across Levels: Corporate, Business, and Functional Strategy



overarching strategic objectives and allocating scarce resources among different business divisions, monitoring performance, and making adjustments to the overall portfolio of businesses as needed. The objective of corporate-level strategy is to increase overall corporate value so that it is higher than the sum of the individual business units.

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

Business strategy occurs within **strategic business units**, or **SBUs**, the standalone divisions of a larger conglomerate, each with its own profit-and-loss responsibility. General managers in SBUs must answer business strategy questions relating to how to compete in order to achieve superior performance. Within the guidelines received from corporate headquarters, they formulate an appropriate generic business strategy, including cost leadership, differentiation, or value innovation, in their quest for competitive advantage.

Rosalind Brewer, CEO of Sam's Club, pursues a somewhat different business strategy from the strategy of parent company Walmart. By offering higher-quality products and brand names with bulk offerings and by prescreening customers via required Sam's Club memberships to establish creditworthiness, Brewer is able to achieve annual revenues of roughly $60 billion. This would place Sam's Club in the top 50 in the Fortune 500 list. Although as CEO of Sam's Club, Brewer is responsible for the performance of this strategic business unit, she reports to Walmart's CEO, C. Douglas McMillon, who as corporate executive oversees Walmart's entire operations, with close to $500 billion in annual revenues and over 11,000 stores globally.

Rosalind Brewer, Sam's Club CEO
© AP Photo/April L. Brown

Within each strategic business unit are various business *functions:* accounting, finance, human resources, product development, operations, manufacturing, marketing, and customer service. Each *functional manager* is responsible for decisions and actions within a single functional area. These decisions aid in the implementation of the business-level strategy, made at the level above.

Returning to our ChapterCase, CEO Marissa Mayer determines Yahoo's corporate strategy and is responsible for the performance of the entire organization. The far-flung Yahoo has its own wide range of Internet services and products, and it owns parts of several

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foreign-based Internet companies, including Yahoo Japan and Alibaba of China. Mayer decides

- What types of products and services to offer.
- Which industries to compete in.
- Where in the world to compete.

To successfully turn around Yahoo, Mayer identified four future growth areas for investing significant resources and attention: mobile advertising, video, social media advertising, and native advertising. *Native advertising* is online advertising that attempts to present itself as naturally occurring editorial content rather than a search-driven paid placement.

LO 2-6

Evaluate top-down strategic planning, scenario planning, and strategy as planned emergence.

2.3 The Strategic Management Process

We have gained some insight into the corporate, business, and functional levels of strategy. Next, we turn to the process or method by which strategic leaders formulate and implement strategy. When strategizing for competitive advantage, managers rely on three approaches:

1. Strategic planning.
2. Scenario planning.
3. Strategy as planned emergence.

This order also reflects how these approaches were developed: strategic planning, then scenario planning, and then strategy as planned emergence. The first two are relatively formal, top-down planning approaches. The third approach begins with a strategic plan but offers a less formal and less stylized approach. Each approach has its strengths and weaknesses, depending on the circumstances under which it is employed.

TOP-DOWN STRATEGIC PLANNING

top-down strategic planning
A rational, data-driven strategy process through which top management attempts to program future success.

The prosperous decades after World War II resulted in tremendous growth of corporations. As company executives needed a way to manage ever more complex firms more effectively, they began to use strategic planning.[36] **Top-down strategic planning**, derived from military strategy, is a rational process through which executives attempt to program future success.[37] In this approach, all strategic intelligence and decision-making responsibilities are concentrated in the office of the CEO. The CEO, much like a military general, leads the company strategically through competitive battles.

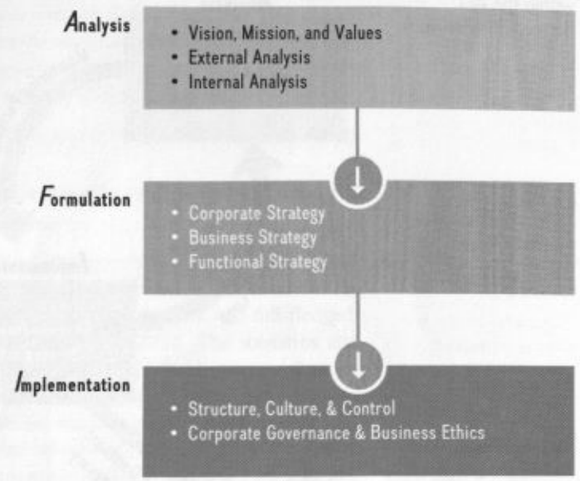
Exhibit 2.6 shows the three steps of analysis, formulation, and implementation in a traditional top-down strategic planning process. Strategic planners provide detailed analyses of internal and external data and apply it to all quantifiable areas: prices, costs, margins, market demand, head count, and production runs. Five-year plans, revisited regularly, predict future sales based on anticipated growth. Top executives tie the allocation of the annual corporate budget to the strategic plan and monitor ongoing performance accordingly. Based on a careful analysis of these data, top managers reconfirm or adjust the company's vision, mission, and values before formulating corporate, business, and functional strategies. Appropriate organizational structures and controls as well as governance mechanisms aid in effective implementation.

Top-down strategic planning more often rests on the assumption that we can predict the future from the past. The approach works reasonably well when the environment does not change much. One major shortcoming of the top-down strategic planning approach is that the formulation of strategy is separate from implementation, and thinking about strategy

is separate from doing it. Information flows one way only: from the top down. Another shortcoming of the strategic planning approach is that we simply cannot know the future. There is no data. Unforeseen events can make even the most scientifically developed and formalized plans obsolete. Moreover, strategic leaders' visions of the future can be downright wrong; a few notable exceptions prove the rule, however.

At times, strategic leaders impose their visions onto a company's strategy, structure, and culture from the top down to create and enact a desired future state. Under its co-founder and longtime CEO, Steve Jobs, Apple was one of the few successful tech companies using a top-down strategic planning process.[38] Jobs felt that he knew best what the next big thing should be. Under his top-down, autocratic leadership, Apple did not engage in market research, because Jobs firmly believed that "people don't know what they want until you show it to them."[39] This traditional top-down strategy process served Apple well as it became the world's most valuable company. Since Jobs' death, however, Apple's strategy process has become more flexible under CEO Tim Cook, and the company is now trying to incorporate the possibilities of different future scenarios and bottom-up strategic initiatives.[40]

EXHIBIT 2.6 / Top-Down Strategic Planning in the AFI Framework



SCENARIO PLANNING

Given that the only constant is change, should managers even try to strategically plan for the future? The answer is yes—but they also need to expect that unpredictable events will happen. We can compare strategic planning in a fast-changing environment to a fire department operation.[41] There is no way to know where and when the next emergency will arise, nor can we know its magnitude beforehand. Nonetheless, fire chiefs put contingency plans in place to address a wide range of emergencies along different dimensions.

scenario planning
Strategy-planning activity in which top management envisions different what-if scenarios to anticipate plausible futures in order to derive strategic responses.

In the same way, **scenario planning** asks those "what if" questions. Similar to top-down strategic planning, scenario planning also starts with a top-down approach to the strategy process. In addition, in scenario planning, top management envisions different scenarios, to anticipate plausible futures in order to derive strategic responses. For example, new laws might restrict carbon emissions or expand employee health care. Demographic shifts may alter the ethnic diversity of a nation; changing tastes or economic conditions will affect consumer behavior. Technological advance may provide completely new products, processes, and services. How would any of these changes affect a firm, and how should it respond? Scenario planning takes place at both the corporate and business levels of strategy.

Typical scenario planning addresses both optimistic and pessimistic futures. For instance, strategy executives at UPS recently identified a number of issues as critical to shaping its future competitive scenarios: (1) big data analytics; (2) being the target of a terrorist attack, or having a security breach or IT system disruption; (3) large swings in energy prices, including gasoline, diesel and jet fuel, and interruptions in supplies of these commodities; (4) fluctuations in exchange rates or interest rates; and (5) climate change.[42] Managers then formulate strategic plans they could activate and implement should the envisioned optimistic or pessimistic scenarios begin to appear.

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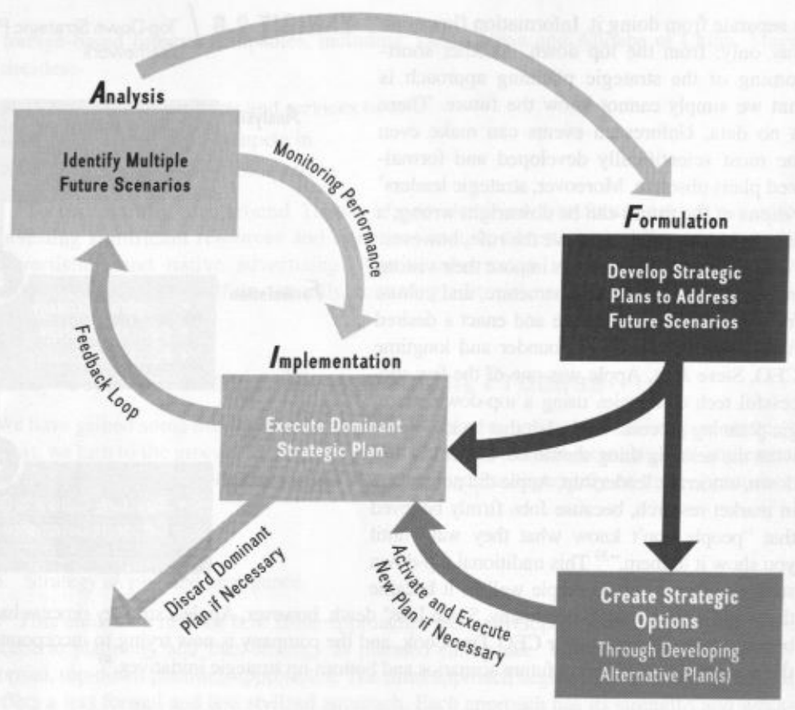
EXHIBIT 2.7

Scenario Planning within the AFI Strategy Framework



To model the scenario-planning approach, place the elements in the AFI strategy framework in a continuous feedback loop, where Analysis leads to Formulation to Implementation and back to Analysis. Exhibit 2.7 elaborates on this simple feedback loop to show the dynamic and iterative method of scenario planning.

The goal is to create a number of detailed and executable strategic plans. This allows the strategic management process to be more flexible and more effective than the more static strategic-planning approach with one master plan. In the *analysis stage,* managers brainstorm to identify possible future scenarios. Input from several different hierarchies within the organization and from different functional areas such as R&D, manufacturing, and marketing and sales is critical. UPS executives considered, for example, how they would compete if the price of a barrel of oil was $35, or $100, or even $200. Managers may also attach probabilities (highly likely versus unlikely, or 85 percent likely versus 2 percent likely) to different future states.

Although managers often tend to overlook pessimistic future scenarios, it is imperative to consider negative scenarios carefully. An exporter such as Boeing, Harley-Davidson, or John Deere would want to analyze the impact of shifts in exchange rates on profit margins. They go through an exercise to derive different strategic plans based on large exchange rate fluctuations of the U.S. dollar against major foreign currencies such as the euro, Japanese yen, or Chinese yuan. What if the euro depreciated to below $1 per euro, or the Chinese yuan depreciated rather than appreciated? How would Disney compete if the dollar were to appreciate so much as to make visits by foreign tourists to its California and Florida theme parks prohibitively expensive? Managers might also consider how black swan events (discussed in Chapter 1) might affect their strategic planning. The BP oil spill was such a black swan for many businesses on the Gulf Coast, including the tourism, fishing, and energy industries.

In the *formulation stage* in scenario planning, management teams develop different strategic plans to address possible future scenarios. This kind of what-if exercise forces managers to develop detailed contingency plans before events occur. Each plan relies on an entire set of analytical tools, which we will introduce in upcoming chapters. They capture the firm's internal and external environments and answer several key questions:

- What resources and capabilities do we need to compete successfully in each future scenario?
- What strategic initiatives should we put in place to respond to each respective scenario?
- How can we shape our expected future environment?

By formulating responses to the varying scenarios, managers build a portfolio of future options. They then continue to integrate additional information over time, which in turn influences future decisions. Finally, managers transform the most viable options into full-fledged, detailed strategic plans that can be activated and executed as needed. The scenarios and planned responses promote strategic flexibility for the organization. This is because if a new scenario should emerge, the company won't lose any time coming up with a new strategic plan. It can activate a new plan quickly based on careful scenario analysis done earlier.

In the *implementation stage,* managers execute the **dominant strategic plan**, the option that top managers decide most closely matches the current reality. If the situation changes, managers can quickly retrieve and implement any of the alternate plans developed in the formulation stage. The firm's subsequent performance in the marketplace gives managers real-time feedback about the effectiveness of the dominant strategic plan. If performance feedback is positive, managers continue to pursue the dominant strategic plan, fine-tuning it in the process. If performance feedback is negative, or if reality changes, managers consider whether to modify further the dominant strategic plan in order to enhance firm performance or to activate an alternative strategic plan.

dominant strategic plan The strategic option that top managers decide most closely matches the current reality and which is then executed.

The circular nature of the scenario-planning model in Exhibit 2.7 highlights the continuous interaction among analysis, formulation, and implementation. Through this interactive process, managers can adjust and modify their actions as new realities emerge. The interdependence among analysis, formulation, and implementation also enhances organizational learning and flexibility.

STRATEGY AS PLANNED EMERGENCE: TOP-DOWN *AND* BOTTOM-UP

Critics of top-down and scenario planning argue that *strategic planning* is not the same as *strategic thinking.*[43] In fact, they argue the strategic-planning processes are often too regimented and confining. As such, they lack the flexibility needed for quick and effective response. Managers engaged in a more formalized approach to the strategy process may also fall prey to an **illusion of control**, which describes a tendency by managers to overestimate their ability to control events.[44] Hard numbers in a strategic plan can convey a false sense of security. According to critics of strategic planning, to be successful, a strategy should be based on an inspiring vision and not on hard data alone. They advise that managers should focus on all types of information sources, including soft sources that can generate new insights, such as personal experience, deep domain expertise, or the insights of front-line employees. The important work, according to this viewpoint, is to synthesize all available input from different internal and external sources into an overall strategic vision. This vision in turn should then guide the firm's strategy, as discussed earlier in this chapter.

illusion of control A tendency by people to overestimate their ability to control events.

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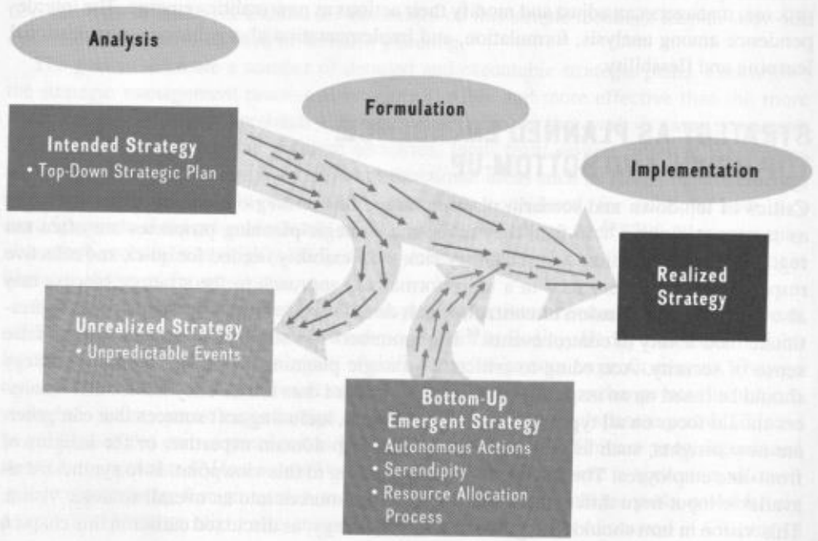
In today's complex and uncertain world, the future cannot be predicted from the past with any degree of certainty. Black swan events can profoundly disrupt businesses and society. Moreover, the other approaches to planning just discussed do not account sufficiently for the role employees at all levels of the hierarchy may play. This is because lower-level employees not only implement the given strategy, but they also frequently come up with initiatives on their own that may alter a firm's strategy. In many instances, front-line employees have unique insights based on constant customer feedback that may elude the more removed top executives. Moreover, hugely successful strategic initiatives are occasionally the result of serendipity, or unexpected but pleasant surprises.

In 1990, for example, online retailing was nonexistent. Today, almost all Internet users have purchased goods and services online. As a total of all sales, online retailing is approaching 10 percent in 2015, with an annual growth rate of almost 20 percent.[45] Given the success of Amazon as the world's leading online retailer and eBay as the largest online marketplace in the United States, brick-and-mortar companies such as Best Buy, The Home Depot, JCPenney, Kmart, Sears, and Walmart have all been forced to respond and adjust their strategy. Others such as Circuit City and RadioShack went out of business. In the business-to-business online space, Alibaba is emerging as the leading Internet-based wholesaler connecting manufacturing businesses in China to buyers in the West. In a similar fashion, Uber and Lyft, the app-based taxi hailing services, are disrupting the existing taxi and limousine businesses in many metropolitan areas across the world. Having been protected by decades of regulations, existing taxi and limo services scramble to deal with the unforeseen competition. Many try to block Uber and Lyft using the court or legislative system, alleging the app-based services violate safety and other regulations.

The critics of more formalized approaches to strategic planning, most notably Henry Mintzberg, propose a third approach to the strategic management process. In contrast to the two top-down approaches discussed above, this one is a less formal and less stylized approach to the development of strategy. To reflect the reality that strategy can be planned *or* emerge from the bottom up, Exhibit 2.8 shows a more integrative approach to managing the strategy process. Please note that even in strategy as planned emergence, the overall strategy process still unfolds along the AFI framework of analysis, formulation, and implementation.

EXHIBIT 2.8 / Realized Strategy Is a Combination of Top-Down Intended Strategy and Bottom-Up Emergent Strategy



According to this more holistic model, the strategy process also begins with a top-down strategic plan based on analysis of external and internal environments. This analysis completes the first stage of the AFI framework (see Exhibit 2.8). Top-level executives then design an **intended strategy**—the outcome of a rational and structured, top-down strategic plan. Exhibit 2.8 illustrates how parts of a firm's *intended strategy* are likely to fall by the wayside because of unpredictable events and turn into *unrealized strategy*.

A firm's **realized strategy** is generally formulated through a combination of its top-down strategic intentions and bottom-up emergent strategy. An **emergent strategy** describes any unplanned strategic initiative bubbling up from the bottom of the organization. If successful, emergent strategies have the potential to influence and shape a firm's overall strategy.

The strategic initiative is a key feature in the strategy as a planned emergence model. A **strategic initiative** is any activity a firm pursues to explore and develop new products and processes, new markets, or new ventures. Strategic initiatives can come from anywhere. They could be the result of a response to external trends or come from internal sources. As such, strategic initiatives can be the result of top-down planning by executives, or they can also emerge through a *bottom-up process*. The arrows in Exhibit 2.8 represent different strategic initiatives. In particular, strategic initiatives can bubble up from deep within a firm through:

- Autonomous actions.
- Serendipity.
- Resource-allocation process (RAP).[46]

intended strategy The outcome of a rational and structured top-down strategic plan.

realized strategy Combination of intended and emergent strategy.

emergent strategy Any unplanned strategic initiative bubbling up from the bottom of the organization.

strategic initiative Any activity a firm pursues to explore and develop new products and processes, new markets, or new ventures.

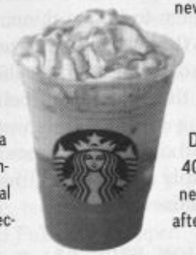
autonomous actions Strategic initiatives undertaken by lower-level employees on their own volition and often in response to unexpected situations.

AUTONOMOUS ACTIONS. **Autonomous actions** are strategic initiatives undertaken by lower-level employees on their own volition and often in response to unexpected situations. Strategy Highlight 2.2 illustrates that successful emergent strategies are sometimes the result of *autonomous actions* by lower-level employees.

Strategy Highlight 2.2

Starbucks' CEO: "It's Not What We Do"

Diana, a Starbucks store manager in Southern California, received several requests a day for an iced beverage offered by a local competitor. After receiving more than 30 requests one day, she tried the beverage herself. Thinking it might be a good idea for Starbucks to offer a similar iced beverage, she requested that headquarters consider adding it to the product lineup. Diana had an internal champion in Howard Behar, then one of Starbucks' top executives. Behar presented this strategic initiative to the Starbucks executive committee. The committee voted down the idea in a 7:1 vote. Starbucks' CEO Howard Schultz commented, "We do coffee, we don't do iced drinks."


© Bloomberg/Getty Images

Diana, however, was undeterred. She experimented until she created the iced drink, and then she began to offer it in her store. When Behar visited Diana's store, he was shocked to see this new drink on the menu—all Starbucks stores were supposed to offer only company-approved drinks. But Diana told him the new drink was selling well.

Behar flew Diana's team to Starbucks headquarters in Seattle to serve the iced-coffee drink to the executive committee. They liked its taste, but still said no. Then Behar pulled out the sales numbers that Diana had carefully kept. The drink was selling like crazy: 40 drinks a day the first week, 50 drinks a day the next week, and then 70 drinks a day in the third week after introduction. They had never seen such growth numbers. These results persuaded the executive team to give reluctant approval to introduce the drink in all Starbucks stores.

You've probably guessed by now that we're talking about Starbucks' Frappuccino. Frappuccino is now a billion-dollar business for Starbucks. At one point, this iced drink brought in more than 20 percent of Starbucks' total revenues, which were $17 billion in 2014.[47]

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Functional managers such as Diana, the Starbucks store manager featured in Strategy Highlight 2.2, are much closer to the final products, services, and customers than the more removed corporate- or business-level managers. As a result, functional managers may start strategic initiatives based on autonomous actions that can influence the direction of the company. To be successful, however, top-level executives need to support emergent strategies that they believe fit with the firm's vision and mission. Diana's autonomous actions might not have succeeded or might have got her in trouble if she did not garner the support of a senior Starbucks executive. This executive championed her initiative and helped persuade other top executives.

Although emergent strategies can arise in the most unusual circumstances, it is important to emphasize the role that top management teams play in this type of strategy process. In the strategy-as-planned-emergence approach, executives need to decide which of the bottom-up initiatives to pursue and which to shut down. This critical decision is made on the basis of whether the strategic initiative fits with the company's vision and mission, and whether it provides an opportunity worth exploiting. At General Electric, CEO Jeffrey Immelt decided to move ahead with a strategic initiative to buy the wind energy company Enron Wind from the bankruptcy proceedings of Enron, because he saw the acquisition as supporting the company's vision and mission.[48] But the initiative only survived to get Immelt's attention because of the tireless persistence of a mid-level engineer who saw its value during a transition of leadership from Jack Welch to Immelt. GE provided appropriate resources and structures to grow this emergent strategy into a major strategic initiative that's now worth billions of dollars.

serendipity
Any random events, pleasant surprises, and accidental happenstances that can have a profound impact on a firm's strategic initiatives.

SERENDIPITY. **Serendipity** describes random events, pleasant surprises, and accidental happenstances that can have a profound impact on a firm's strategic initiatives.

There are dozens of examples where serendipity had a crucial influence on the course of business and entire industries. The discovery of 3M's Post-it Notes or Pfizer's Viagra, first intended as a drug to treat hypertension, are well known.[49] Less well known is the discovery of potato chips.[50] The story goes that in the summer of 1853, George Crum was working as a cook at the Moon Lake Lodge resort in Saratoga Springs, New York. A grumpy patron ordered Moon's resort signature fried potatoes. These potatoes were served in thick slices and eaten with a fork as was in the French tradition. When the patron received the fries, he immediately returned them to the kitchen, asking for them to be cut thinner. Crum prepared a second plate in order to please the patron, but this attempt was returned as well. The third plate was prepared by an annoyed Crum who, trying to mock the patron, sliced the potatoes sidewise as thin as he could and fried them. Instead of being offended, the patron was ecstatic with the new fries and suddenly other patrons wanted to try them as well. Crum later opened his own restaurant and offered the famous "Saratoga Chips," which he set up in a box and some clients simply took home. Today, PepsiCo's line of Frito-Lay's chips are a multibillion-dollar business.

resource-allocation process (RAP)
The way a firm allocates its resources based on a predetermined policies, which can be critical in shaping its realized strategy.

RESOURCE-ALLOCATION PROCESS. A firm's **resource-allocation process (RAP)** determines the way it allocates its resources and can be critical in shaping its realized strategy.[51] Emergent strategies can result from a firm's resource-allocation process (RAP).[52] Intel Corp. illustrates this concept.[53] Intel was founded in 1968 to produce DRAM (dynamic random-access memory) chips. From the start, producing these chips was the firm's top-down strategic plan, and initially it worked well. In the 1980s, Japanese competitors brought better-quality chips to the market at lower cost, threatening Intel's position and obsoleting its top-down strategic plan. However, Intel was able to

pursue a strategic transformation because of the way it set up its resource-allocation process. In a sense, Intel was using functional-level managers to drive business and corporate strategy in a bottom-up fashion. In particular, during this time Intel had only a few fabrication plants (called "fabs") to produce silicon-based products. It would have taken several years and billions of dollars to build additional capacity by bringing new fabs online.

With constrained capacity, Intel had implemented the production-decision rule *to maximize margin-per-wafer-start.* Each time functional managers initiated a new production run, they were to consider the profit margins for DRAM chips and for semiconductors, the "brains" of personal computers. The operations managers then could produce *whichever product* delivered the higher margin. By following this simple rule, front-line managers shifted Intel's production capacity away from the lower-margin DRAM business to the higher-margin semiconductor business. The firm's focus on semiconductors emerged from the bottom up, based on resource allocation. Indeed, by the time top management finally approved the de facto strategic switch, the company's market share in DRAM had dwindled to less than 3 percent.[54]

Taken together, a firm's realized strategy is frequently a combination of top-down strategic intent and bottom-up emergent strategies, as Exhibit 2.8 shows. This type of strategy process is called **planned emergence**. In that process, organizational structure and systems allow bottom-up strategic initiatives to emerge and be evaluated and coordinated by top management.[55] These bottom-up strategic initiatives can be the result of autonomous actions, serendipity, or the resource allocation process.

planned emergence
Strategy process in which organizational structure and systems allow bottom-up strategic initiatives to emerge and be evaluated and coordinated by top management.

2.4 ◄► Implications for the Strategist

Two ingredients are needed to create a powerful foundation upon which to formulate and implement a strategy in order to gain and sustain a competitive advantage: First, the firm needs an inspiring vision and mission backed up by ethical values. Customer-oriented or problem-defining vision statements are often correlated with firm success over long periods of time. This is because they allow firms strategic flexibility to change in order to meet changing customer needs and exploit external opportunities. Second, the strategic leader must put an effective strategic management process in place.

Each of the three strategy processes introduced in this chapter has its strengths and weaknesses. The effectiveness of the chosen strategy process is *contingent* upon the rate of change in the internal and external environments of the firm. In a slow-moving and stable environment, top-down strategic planning might be the most effective approach. Besides the rate of change, a second dimension is firm size. Larger firms tend to use either a top-down strategic-planning process or scenario planning. For a nuclear power provider such as Areva in France that provides over 75 percent of the country's energy and has the long-term backing of the state, for instance, using a top-down strategy approach might work well. Given that nuclear accidents are rare, but when they occur they have a tremendous impact such as in Chernobyl, Russia, and Fukushima, Japan, Areva might use scenario planning to prepare for black swan events. In fast-moving environments, in contrast, Internet-based companies such as Alibaba, Facebook, Google, Dropbox, Pinterest, Twitter, or Uber tend to use the strategy-as-planned-emergence process.

Another important implication of our discussion is that all employees should be involved in setting an inspiring vision and mission to create more meaningful work. Belief in a company's vision and mission motivates its employees. Moreover, every employee plays a strategic role. Lower-level employees focus mainly on strategy implementation when a firm is using top-down or scenario planning. As the examples have shown, however, *any*

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employee, even at the entry level, can have great ideas that might become *strategic initiatives* with the potential to transform companies. Exhibit 2.9 compares and contrasts the three different approaches to the strategic management process: top-down strategic planning, scenario planning, and strategy as planned emergence.

Here we conclude our discussion of the strategic management process, which marks the end of the "getting started" portion of the AFI framework. The next three chapters cover the analysis part of the framework, where we begin by studying external and internal analyses before taking a closer look at competitive advantage, firm performance, and business models.

EXHIBIT 2.9 / Comparing and Contrasting Top-Down Strategic Planning, Scenario Planning, and Strategy as Planned Emergence

Strategy Process	Description	Pros	Cons	Where Best Used
Top-Down Strategic Planning	A rational strategy process through which top management attempts to program future success; typically concentrates strategic intelligence and decision-making responsibilities in the office of the CEO.	• Provides a clear strategy process and lines of communication. • Affords coordination and control of various business activities. • Readily accepted and understood as process is well established and widely used. • Works relatively well in stable environments.	• Fairly rigid and inhibits flexibility. • Top-down, one-way communication limits feedback. • Assumes that the future can usually be predicted based on past data. • Separates elements of AFI framework so that top management (analysis & formulation) are removed from line employees (implementation).	• Highly regulated and stable industries such as utilities, e.g., Georgia Power in Southeast United States or Areva, state-owned nuclear operator in France. • Government • Military
Scenario Planning	Strategy-planning activity in which top management envisions different what-if scenarios to anticipate plausible futures in order to plan optimal strategic responses.	• Provides a clear strategy process and lines of communication. • Affords coordination and control of various business activities. • Readily accepted and understood as process is well established and widely used. • Provides some strategic flexibility.	• Top-down, one-way communication limits feedback. • Separates elements of AFI framework so that top management (analysis & formulation) are removed from line employees (implementation). • As the future is unknown, responses to all possible events cannot be planned. • Leaders tend to avoid planning for pessimistic scenarios.	• Fairly stable industries, often characterized by some degree of regulation such as airlines, logistics, or medical devices, e.g., American Airlines, Delta Air Lines and United Airlines; FedEx and UPS; Medtronic. • Larger firms in industries with a small number of other large competitors (oligopoly).

Strategy Process	Description	Pros	Cons	Where Best Used
Strategy as Planned Emergence	Blended strategy process in which organizational structure and systems allow both top-down vision and bottom-up strategic initiatives to emerge for evaluation and coordination by top management.	• Combines all elements of the AFI framework in a holistic and flexible fashion. • Provides provisional direction through intended strategy. • Accounts for unrealized strategy (not all strategic initiatives can be implemented). • Accounts for emergent strategy (good ideas for strategic initiatives can bubble up from lower levels of hierarchy through autonomous actions, serendipity, and RAP). • The firm's realized strategy is a combination of intended and emergent strategy. • Highest degree of strategic flexibility and buy-in by employees.	• Unclear strategy process and lines of communication can lead to employee confusion and lack of focus. • Many ideas that bubble up from the bottom may not be worth pursuing. • Firms may lack a clear process of how to evaluate emergent strategy, increasing the chances of missing mega opportunities or pursuing dead ends; may also contribute to employee frustration and lower morale.	• New ventures and smaller firms. • High-velocity industries such as technology ventures. • Internet companies (e.g., Alibaba, Amazon, Baidu, Facebook, eBay, Google, Salesforce.com, Twitter, Uber, and Yahoo. • Biotech companies (e.g., Amgen, Biogen, Gilead Sciences, Genentech, and Genzyme).

CHAPTERCASE 2 / Consider This . . .

LET'S TAKE ONE more look at Yahoo. Once a leader in online advertising in the Web 1.0 portal world, Yahoo had fallen to third place, behind Google and Facebook, well before its current CEO took charge. As CEO, Marissa Mayer wants Yahoo to "own" (be the market leader in) the mobile Internet in creating the best user experience, just as Yahoo once owned the user experience in the early days of the Internet for desktop users.

But much has changed. In the early days, the Internet was hard to use. Yahoo provided a web portal that solved this problem for millions of users worldwide. It was their first stop once they logged in. With successful Yahoo products like Yahoo Mail, Yahoo Finance, and Yahoo Sports, many users spent their entire time online at Yahoo. In the first decade of the Internet, this made Yahoo extremely attractive for online advertisers.

By 2012, however, the Internet had undergone a dramatic shift from the Web 1.0 on personal computers to a Web 2.0 on mobile devices. The mobile experience, and with it mobile advertising, had become the new frontier.

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The difficulty that Mayer encountered as the new Yahoo CEO was that Google, Facebook, and Twitter all had moved faster and more successfully into the mobile space and thus mobile advertising.

To generate much-needed cash for the turnaround and to keep investors happy, Mayer sold part of Yahoo's ownership in Alibaba Group, when the Chinese Internet company went public in the fall of 2014. In 2015, Mayer announced that Yahoo would spin out the remaining 15 percent ownership of Alibaba, valued at close to $40 billion out of the roughly $45 billion market value for Yahoo.[56] With this strategic move, Mayer may be trying to buy herself even more time to turn Yahoo around. Unfortunately, Yahoo continues to decline in its core advertising business. Some of the money will be returned to shareholders, some will be used to buy more companies to strengthen Yahoo's technical capabilities and engineering skills, especially in the four key areas of focus: mobile, video, social media, and native advertising.

Perhaps the thorniest problem that Mayer faces is that investors still don't see much value in Yahoo's core business. Given Yahoo's $45 billion market capitalization, some analysts argue that Yahoo's holdings in Alibaba and in Yahoo Japan account for *all* of the value in Yahoo, if not more. They say if you subtract the value of Yahoo's remaining equity holdings from its market cap, the true valuation of Yahoo's core business is zero or less than zero. And financial results on Yahoo's core business continues to decline.

Questions

1. In an attempt to turn around Yahoo, Mayer defined a new vision and mission for the Internet company. How useful are the new vision and mission in Yahoo's turnaround attempt?
2. What are some of the major changes Mayer has undertaken to turn Yahoo around? How do you evaluate them?
3. What "grade" would you give Mayer for her job performance as strategic leader? What are her strengths and her weaknesses? Where would you place her on the Level-5 pyramid of strategic leaders (see Exhibit 2.4), and why? Support your answers.
4. Some investors remain skeptics about Yahoo's future, essentially valuing the company close to zero dollars were it to sell its stake in Alibaba. Do you share their pessimism, or do you think that Mayer will be able turn Yahoo around? Why or why not?

TAKE-AWAY CONCEPTS

This chapter explained the role of vision, mission, and values in the strategic management process. It provided an overview of strategic leadership and explained different processes to create strategy, as summarized by the following learning objectives and related take-away concepts.

LO 2-1 / Describe the roles of vision, mission, and values in the strategic management process.

- A vision captures an organization's aspirations. An effective vision inspires and motivates members of the organization.
- A mission statement describes what an organization actually does—what its business is—and why and how it does it.
- Core values define the ethical standards and norms that should govern the behavior of individuals within the firm.

LO 2-2 / Evaluate the strategic implications of product-oriented and customer-oriented vision statements.

- Product-oriented vision statements define a business in terms of a good or service provided.
- Customer-oriented vision statements define business in terms of providing solutions to customer needs.
- Customer-oriented vision statements provide managers with more strategic flexibility than product-oriented missions.
- To be effective, visions and missions need to be backed up by hard-to-reverse strategic commitments and tied to economic fundamentals.

LO 2-3 / Explain why anchoring a firm in ethical core values is essential for long-term success.

- Ethical core values form a solid foundation on which a firm can build its vision and mission, and thus lay the groundwork for long-term success.

- Ethical core values are the guardrails that help keep the company on track when pursuing its mission and its quest for competitive advantage.

LO 2-4 / Outline how managers become strategic leaders.

- To become an effective strategic leader, a manager needs to develop skills to move sequentially through five different leadership levels: highly capable individual, contributing team member, competent manager, effective leader, and executive.
- The Level-5 strategic leadership pyramid applies to both distinct corporate positions and personal growth.

LO 2-5 / Describe the roles of corporate, business, and functional managers in strategy formulation and implementation.

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

LO 2-6 / Evaluate top-down strategic planning, scenario planning, and strategy as planned emergence.

- Top-down strategic planning is a sequential, linear process that works reasonably well when the environment does not change much.
- In scenario planning, managers envision what-if scenarios and prepare contingency plans that can be called upon when necessary.
- Strategic initiatives can be the result of top-down planning or can emerge through a bottom-up process from deep within the organization. They have the potential to shape a firm's strategy.
- A firm's realized strategy is generally a combination of its top-down intended strategy and bottom-up emergent strategy, resulting in planned emergence.

KEY TERMS

Autonomous actions *(p. 51)*
Core values statement *(p. 36)*
Dominant strategic plan *(p. 49)*
Emergent strategy *(p. 51)*
Illusion of control *(p. 49)*
Intended strategy *(p. 51)*
Level-5 leadership pyramid *(p. 43)*
Mission *(p. 36)*
Organizational core values *(p. 40)*
Planned emergence *(p. 53)*
Realized strategy *(p. 51)*
Resource-allocation process (RAP) *(p. 52)*
Scenario planning *(p. 47)*
Serendipity *(p. 52)*
Strategic business unit (SBU) *(p. 45)*
Strategic commitments *(p. 36)*
Strategy formulation *(p. 44)*
Strategy implementation *(p. 44)*
Strategic initiative *(p. 51)*
Strategic leadership *(p. 34)*
Strategic management process *(p. 34)*
Top-down strategic planning *(p. 46)*
Upper-echelons theory *(p. 43)*
Vision *(p.35)*

DISCUSSION QUESTIONS

1. What characteristics does an effective mission statement have?
2. In what situations is top-down planning likely to be superior to bottom-up emergent strategy development?
3. This chapter introduces three different levels appropriate for strategic considerations (see Exhibit 2.5). In what situations would some of these levels be more important than others? For example, what issues might be considered

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Chapter 3

External Analysis: Industry Structure, Competitive Forces, and Strategic Groups

Chapter Outline

3.1 The PESTEL Framework
Political Factors
Economic Factors
Sociocultural Factors
Technological Factors
Ecological Factors
Legal Factors

3.2 Industry Structure and Firm Strategy: The Five Forces Model
Competition in the Five Forces Model
The Threat of Entry
The Power of Suppliers
The Power of Buyers
The Threat of Substitutes
Rivalry among Existing Competitors
A Sixth Force: The Strategic Role of Complements

3.3 Changes over Time: Industry Dynamics

3.4 Performance Differences within the Same Industry: Strategic Groups
The Strategic Group Model
Mobility Barriers

3.5 Implications for the Strategist

Learning Objectives

LO 3-1 Generate a PESTEL analysis to evaluate the impact of external factors on the firm.

LO 3-2 Apply Porter's five competitive forces to explain the profit potential of different industries.

LO 3-3 Explain how competitive industry structure shapes rivalry among competitors.

LO 3-4 Describe the strategic role of complements in creating positive-sum co-opetition.

LO 3-5 Appraise the role of industry dynamics and industry convergence in shaping the firm's external environment.

LO 3-6 Generate a strategic group model to reveal performance differences between clusters of firms in the same industry.

CHAPTERCASE 3

Tesla Motors and the U.S. Automotive Industry

THE BIG THREE—GM, Ford, and Chrysler—ruled the U.S. car market for most of the 20th century. Protected by high entry barriers, highly profitable GM had over half of the U.S. market to itself. Ford and Chrysler both did well too. Then, in the 1960s and 1970s, foreign carmakers entered the U.S. market, at first mainly by importing vehicles from overseas plants. Foreign makes included the German brands Volkswagen (also owner of the Porsche and Audi brands), Daimler, and BMW, and the Japanese brands Toyota, Honda, and Nissan. By the 1980s, these foreign entrants had intensified competition and threatened the Big Three's market share, such that the U.S. Congress passed significant import restrictions. Not to be stopped, the new players responded by building U.S. plants to comply with the new rules. More recently, Korean carmakers Hyundai and Kia have begun making and selling cars in the United States.

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Although globalization paved the way for significant new entry into the U.S. auto market, the worldwide car manufacturing industry has seen few new entrants. In fact, no new major car manufacturers have emerged in the past couple of decades simply because few industrial products, save for jet airplanes and nuclear power plants, are as complex to build as traditional cars powered by internal combustion engines. Large-scale production is necessary for car manufacturers to be cost-competitive. Taken together, these factors create significant entry barriers into the car manufacturing industry. Would you say, then, that a Silicon Valley technology startup, attempting to break into this industry, might be running a fool's errand?

Enter serial entrepreneur Elon Musk, who creates and runs new ventures to address not only economic but also social and environmental challenges. Musk looms large in the public imagination and has even been likened to the fictional Tony Stark, aka the Iron Man, Marvel Comics' eccentric inventor. Indeed, Musk made a cameo appearance in *Iron Man 2*. During the Internet boom, Musk made his fortune by developing an early version of Google maps and by co-founding the online payment system PayPal. The sale of both companies amounted to close to $2 billion, and Musk's share allowed him to focus on his lifelong passions in science, engineering, and space.

His most recent companies include SpaceX, the first private company to deliver a cargo payload to the International Space Station; SolarCity, basically the Walmart of solar panel installations; and, of course, Tesla Motors. Currently, Tesla receives most of Musk's attention.

Faced with the formidable entry barrier of large-scale production, Tesla sidesteps the hurdle by producing all-electric cars. Compared to complex gasoline engines, electric power trains use relatively simple motors and gearboxes with few parts. The Tesla Roadster, a $110,000 sports coupe with faster acceleration than a Porsche 911 GT, served as a prototype to demonstrate that electric vehicles can be more than mere golf carts.

After selling some 2,500 Roadsters, Tesla discontinued its production to focus on its next car: the Model S, a four-door family sedan, with a base price of $71,000 before tax credits. The line appeals to a larger market and thus allows for larger production runs to drive down unit costs. The Model S received an outstanding market reception. It was awarded not only the 2013 *Motor Trend* Car of the Year, but also received the highest score of any car ever tested by *Consumer Reports* (99/100). Tesla manufactures the Model S in the Fremont, California, factory that it purchased from Toyota. By 2015, it had sold some 60,000 of the Model S worldwide. Tesla is also working

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on a newly designed seven-seat electric vehicle—the Model X—in an attempt to combine the best features of an SUV with the benefits of a minivan; the first deliveries are scheduled for 2016. The third model in Tesla's lineup is a smaller vehicle that will cost around $35,000 and has a range of 200 miles per battery charge. The Model 3 is slated to go on sale in 2017.[1]

You will learn more about Tesla Motors by reading this chapter; related questions appear on page 95.

THE TESLA MOTORS ChapterCase illustrates that competitive forces in an industry have a direct bearing on a firm's profit potential. Globalization led to extensive entry by foreign car manufacturers in the U.S. auto market, increasing the number of competitors and competitive rivalry. The Japanese automakers, for example, were successful in the U.S. market early on because their cars were generally of better quality, their production systems were more efficient, and they were more responsive to changes in customer preferences. Today, Korean carmakers are attempting to duplicate this feat. At the same time, U.S. automakers Ford and GM are experiencing a resurgence. Moreover, technological innovations have allowed startups such as Tesla Motors to enter the electric car segment (or strategic group), effectively circumventing high entry barriers into the broader automotive market. With more firms vying for a share of the U.S. auto market, competitive intensity is likely to increase.

In this chapter, we present a set of frameworks to analyze the firm's *external environment*—that is, the industry in which the firm operates, and the competitive forces that surround the firm from the outside. We move from a more macro perspective to a more micro understanding of how the external environment affects a firm's quest for competitive advantage.

We begin with the PESTEL framework, which allows us to scan, monitor, and evaluate changes and trends in the firm's macroenvironment. Next, we study Porter's five forces model of competition, which helps us to determine an industry's profit potential. Depending on the firm's strategic position, these forces can affect its performance for good or ill. We then move from a static analysis of a firm's industry environment to a dynamic understanding of how industries and competition change over time. Next we introduce the strategic group model for understanding performance differences among clusters of firms in the same industry. Finally, we offer practical "Implications for the Strategist."

LO 3-1

Generate a PESTEL analysis to evaluate the impact of external factors on the firm.

3.1 The PESTEL Framework

A firm's external environment consists of all the factors that can affect its potential to gain and sustain a competitive advantage. By analyzing the factors in the external environment, managers can mitigate threats and leverage opportunities. One common approach to understanding how external factors impinge upon a firm is to consider the source or proximity of these factors. For example, external factors in the firm's *general environment* are ones that managers have little direct influence over, such as macroeconomic factors (e.g., interest or currency exchange rates). In contrast, external factors in the firm's *task environment* are ones that managers do have some influence over, such as the composition of their strategic groups (a set of close rivals) or the structure of the industry. We will now look at each of these environmental layers in detail, moving from a firm's general environment to its task environment. Following along in Exhibit 3.1, we will be working from the outer ring to the inner ring.

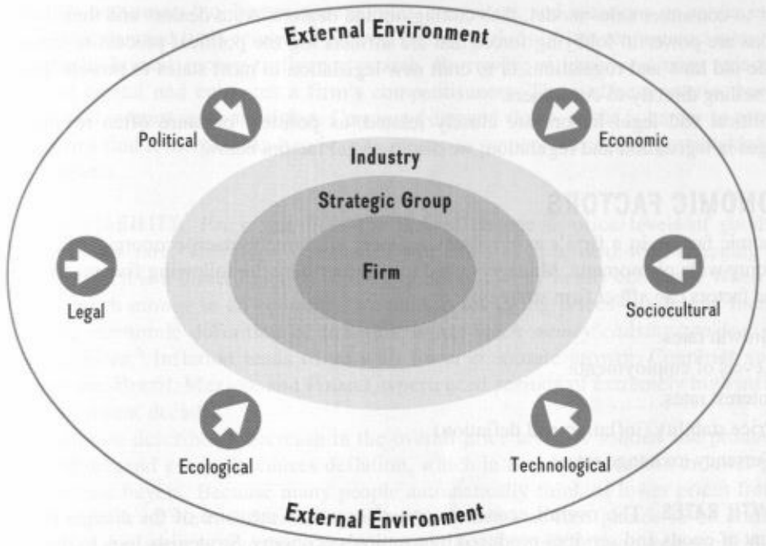

EXHIBIT 3.1 The Firm within Its External Environment, Industry, and Strategic Group, Subject to PESTEL Factors

The **PESTEL model** groups the factors in the firm's general environment into six segments:

- Political
- Economic
- Sociocultural
- Technological
- Ecological
- Legal

Together these form the acronym PESTEL. The PESTEL model provides a relatively straightforward way to *scan, monitor,* and *evaluate* the important external factors and trends that might impinge upon a firm. With more open markets and international trade in recent decades, the PESTEL factors have become more global. Such factors create both opportunities and threats.

PESTEL model A framework that categorizes and analyzes an important set of external factors (political, economic, sociocultural, technological, ecological, and legal) that might impinge upon a firm. These factors can create both opportunities and threats for the firm.

POLITICAL FACTORS

Political factors result from the processes and actions of government bodies that can influence the decisions and behavior of firms.[2]

While political factors are located in the firm's general environment, where firms traditionally wield little influence, companies nevertheless increasingly work to shape and influence this realm. They do so by applying *nonmarket strategies*—that is, through lobbying, public relations, contributions, litigation, and so on, in ways that are favorable to the firm.[3] For example, traditional car dealers have been challenging Tesla's build-to-order sales model that allows customers to purchase a Tesla vehicle online and have it delivered to their home, anywhere in the United States.[4] Traditional car dealers, which often benefit from geographic monopolies, are not so much concerned about Tesla Motors as they are that their own brand names, such as GM or Ford, will also adopt an online,

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direct-to-consumer sales model, thus cutting out the dealers. Auto dealers and their associations are powerful lobbying forces that are influencing the political process to invoke decade-old laws and regulations or to craft new legislation in most states to prevent Tesla from selling directly to consumers.

Political and legal factors are closely related, as political pressure often results in changes in legislation and regulation; we discuss legal factors below.

ECONOMIC FACTORS

Economic factors in a firm's external environment are largely macroeconomic, affecting economy-wide phenomena. Managers need to consider how the following five macroeconomic factors can affect firm strategy:

- Growth rates.
- Levels of employment.
- Interest rates.
- Price stability (inflation and deflation).
- Currency exchange rates.

GROWTH RATES. The overall economic *growth rate* is a measure of the change in the amount of goods and services produced by a nation's economy. Strategists look to the *real growth rate,* which adjusts for inflation. This real growth rate indicates the current business cycle of the economy—that is, whether business activity is expanding or contracting. In periods of economic expansion, consumer and business demands are rising, and competition among firms frequently decreases. During economic booms, businesses expand operations to satisfy demand and are more likely to be profitable. The reverse is generally true for recessionary periods, although certain companies that focus on low-cost solutions may benefit from economic contractions because demand for their products or services rises in such times. For customers, expenditures on luxury products are often the first to be cut during recessionary periods. For instance, you might switch from a $4 venti latte at Starbucks to a $1 alternative from McDonald's.

Occasionally, boom periods can overheat and lead to speculative asset bubbles. In the early 2000s, the United States experienced an asset bubble in real estate.[5] Easy credit, made possible by the availability of subprime mortgages and other financial innovations, fueled an unprecedented demand in housing. Real estate, rather than stocks, became the investment vehicle of choice for many Americans, propelled by the common belief that house prices could only go up. When the housing bubble burst, the deep economic recession of 2008–2009 began, impacting in some way nearly all businesses in the United States and worldwide.

LEVELS OF EMPLOYMENT. Growth rates directly affect the *level of employment.* In boom times, unemployment tends to be low, and skilled human capital becomes a scarce and more expensive resource. In economic downturns, unemployment rises. As more people search for employment, skilled human capital is more abundant and wages usually fall.

INTEREST RATES. Another key macroeconomic variable for managers to track is real *interest rates*—the amount that creditors are paid for use of their money and the amount that debtors pay for that use, adjusted for inflation. The economic boom during the early years in the 21st century, for example, was fueled by cheap credit. Low real interest rates have a direct bearing on consumer demand. When credit is cheap because interest rates are low, consumers buy homes, automobiles, computers, and vacations on credit; in turn, all of this demand fuels economic growth. During periods of low real interest rates, firms can easily borrow money to finance growth. Borrowing at lower real rates reduces the cost of capital and enhances a firm's competitiveness. These effects reverse, however, when real interest rates are rising. Consumer demand slows, credit is harder to come by, and firms find it more difficult to borrow money to support operations, possibly deferring investments.

PRICE STABILITY. *Price stability*—the lack of change in price levels of goods and services—is rare. Therefore, companies will often have to deal with changing price levels, which is a direct function of the amount of money in any economy. When there is too much money in an economy, we tend to see rising prices—*inflation.* Indeed, a popular economic definition of inflation is *too much money chasing too few goods and services.*[6] Inflation tends to go with lower economic growth. Countries such as Argentina, Brazil, Mexico, and Poland experienced periods of extremely high inflation rates in recent decades.

Deflation describes a decrease in the overall price level. A sudden and pronounced drop in demand generally causes deflation, which in turn forces sellers to lower prices to motivate buyers. Because many people automatically think of lower prices from the buyer's point of view, a decreasing price level seems at first glance to be attractive. However, deflation is actually a serious threat to economic growth because it distorts expectations about the future.[7] For example, once price levels start falling, companies will not invest in new production capacity or innovation because they expect a further decline in prices. In recent decades, the Japanese economy has been plagued with persistent deflation.

CURRENCY EXCHANGE RATES. The *currency exchange rate* determines how many dollars one must pay for a unit of foreign currency. It is a critical variable for any company that buys or sells products and services across national borders. For example, if the U.S. dollar appreciates against the euro, and so increases in real value, firms need more euros to buy one dollar. This in turn makes U.S. exports such as Boeing aircraft, Intel chips, or John Deere tractors more expensive for European buyers and reduces demand for U.S. exports overall. This process reverses when the dollar depreciates (decreases in real value) against the euro. In this scenario it would take more dollars to buy one euro, and European imports such as LVMH luxury accessories or BMW automobiles become more expensive for U.S. buyers.

In a similar fashion, if the Chinese yuan appreciates in value, Chinese goods imported into the United States are relatively more expensive. At the same time, Chinese purchasing power increases, which in turn allows their businesses to purchase more U.S. capital goods such as sophisticated machinery and other cutting-edge technologies.

In summary, economic factors affecting businesses are ever-present and rarely static. Managers need to fully appreciate the power of these factors, in both domestic and global markets, to assess their effects on firm performance.

SOCIOCULTURAL FACTORS

Sociocultural factors capture a society's cultures, norms, and values. Because sociocultural factors not only are constantly in flux but also differ across groups, managers need to closely monitor such trends and consider the implications for firm strategy. In recent years, for example, a growing number of U.S. consumers have become more health-conscious

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about what they eat. This trend led to a boom for businesses such as Chipotle, Subway, and Whole Foods. At the same time, traditional fast-food companies McDonald's and Burger King, along with grocery chains such as Albertsons and Kroger, have all had to scramble to provide healthier choices in their product offerings.

Demographic trends are also important sociocultural factors. These trends capture population characteristics related to age, gender, family size, ethnicity, sexual orientation, religion, and socioeconomic class. Like other sociocultural factors, demographic trends present opportunities but can also pose threats. The most recent U.S. census revealed that 51 million Americans (16.4 percent of the total population) are Hispanic. It is now the second-largest ethnic group in the United States and growing fast. On average, Hispanics are also younger and their incomes are climbing quickly. This trend is not lost on companies trying to benefit from this opportunity. For example, MundoFox and ESPN Deportes (specializing in soccer) have joined Univision and NBC's Telemundo in the Spanish-language television market. In the United States, Univision is now the fifth most popular network overall, just behind the four major English-language networks (ABC, NBC, CBS, and Fox). Likewise, advertisers are pouring dollars into the Spanish-language networks to promote their products and services.[8]

TECHNOLOGICAL FACTORS

Technological factors capture the application of knowledge to create new processes and products. Major innovations in process technology include lean manufacturing, Six Sigma quality, and biotechnology. The nanotechnology revolution, which is just beginning, promises significant upheaval for a vast array of industries ranging from tiny medical devices to new-age materials for earthquake-resistant buildings.[9] Recent product innovations include the smartphone, computer tablets, and high-performing electric cars such as the Tesla Model S. Recent service innovations include social media and online search engines that respond to voice commands. If one thing seems certain, technological progress is relentless and seems to be picking up speed.[10] Not surprisingly, changes in the technological environment bring both opportunities and threats for companies. Given the importance of a firm's innovation strategy to competitive advantage, we discuss the effect of technological factors in greater detail in Chapter 7.

Strategy Highlight 3.1 details how BlackBerry fell victim by not paying sufficient attention to the PESTEL factors.

ECOLOGICAL FACTORS

Ecological factors involve broad environmental issues such as the natural environment, global warming, and sustainable economic growth. Organizations and the natural environment coexist in an interdependent relationship. Managing these relationships in a responsible and sustainable way directly influences the continued existence of human societies and the organizations we create. Managers can no longer separate the natural and the business worlds; they are inextricably linked.[11]

Negative examples come readily to mind, as many business organizations have contributed to the pollution of air, water, and land, as well as depletion of the world's natural resources. BP's infamous oil spill in the Gulf of Mexico destroyed fauna and flora along the U.S. shoreline from Texas to Florida. This disaster led to a decrease in fish and wildlife populations, triggered a decline in the fishery and tourism industries, and threatened the livelihood of thousands of people. It also cost BP some $50 billion and one-half of its market value (see Strategy Highlight 1.2).

Strategy Highlight 3.1

BlackBerry's Bust

A pioneer in smartphones, BlackBerry was the undisputed industry leader in the early 2000s. IT managers preferred BlackBerry. Its devices allowed users to receive e-mail and other data in real time globally, with enhanced security features. For executives, a BlackBerry was not just a tool to increase productivity—and to free them from their laptops—but also an important status symbol. As a consequence, by 2008 BlackBerry's market cap had peaked at $75 billion. Yet by 2015, this valuation had fallen more than 90 percent, to less than $7 billion. What happened?

Being Canadian, BlackBerry's longtime co-CEO, Jim Balsillie, not surprisingly sees ice hockey as his favorite sport. He likes to quote Wayne Gretzky, "The Great One," whom many consider the best ice hockey player ever: "Skate to where the puck is going to be, not to where it is." Alas, BlackBerry did not follow that advice. BlackBerry fell victim to two important PESTEL factors in its external environment: sociocultural and technological.

Let's start with technology. The introduction of the iPhone by Apple in 2007 changed the game in the mobile device industry. Equipped with a camera, the iPhone's slick design offered a user interface with a touchscreen including a virtual keyboard. The iPhone connected seamlessly other cellular networks and Wi-Fi. Combined with thousands of apps via the Apple iTunes store, the iPhone provided a powerful user experience, or as the late Steve Jobs said, "the Internet in your pocket."

Wayne Gretzky: Skate to where the puck is going to be, not to where it is.
© AP Photo/Jim Rogash

However, BlackBerry engineers and executives initially dismissed the iPhone as a mere toy with poor security features. Everyday users thought differently. They had less concern for encrypted software security than they had desire for having fun with a device that allowed them to text, surf the web, take pictures, play games, and do e-mail. Although BlackBerry devices were great in productivity applications, such as receiving and responding to e-mail via typing on its iconic physical keyboard, they provided a poor mobile web browsing experience.

The second external development that helped erode BlackBerry's dominance was sociocultural. Initially, mobile devices were issued top-down by corporate IT departments. The only available device for execs was a company-issued BlackBerry. This made life easy for IT departments, ensuring network security. Consumers, however, began to bring their personal iPhones to work and used them for corporate communication and productivity applications. This bottom-up groundswell of the BYOT ("bring your own technology") movement forced corporate IT departments to open up their services beyond the BlackBerry.

Caught in the oncoming gale winds of two PESTEL factors—technological and sociocultural—BlackBerry was pushed backward in the smartphone market. Unlike Gretzky, it failed to skate where the puck was going to be and therefore continued to focus on its existing customer base of corporate IT departments and government. Later, feeble modifications in product lineup appeared to be a "too little, too late." Apple continued to drive innovation in the smartphone industry by bringing out more advanced iPhone models and enhancing the usefulness of its apps for the various business and productivity applications.[12]

Let's think about the rapid progress in mobile computing. BlackBerry, once an undisputed leader in the smartphone industry, did not recognize early enough or act upon changes in the external environment. Consumer preferences changed quickly as the iPhone and later the iPad became available. Professionals brought their own Apple or other devices to work instead of using company-issued BlackBerrys. Although the Canadian technology company made a valiant effort to make up lost ground with its new BlackBerry 10 operating system and several new models, it was too little, too late.

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The relationship between organizations and the natural environment need not be adversarial, however. Ecological factors can also provide business opportunities. As we saw in the ChapterCase, Tesla Motors is addressing environmental concerns regarding the carbon emissions of gasoline-powered cars by building zero-emission battery-powered vehicles. The question of how to generate the power needed to charge the batteries in a sustainable way, however, still needs to be addressed.

LEGAL FACTORS

Legal factors include the official outcomes of political processes as manifested in laws, mandates, regulations, and court decisions—all of which can have a direct bearing on a firm's profit potential. In fact, regulatory changes tend to affect entire industries at once. Many industries in the United States have been deregulated over the last few decades, including airlines, telecom, energy, and trucking, among others.

As noted earlier, legal factors often coexist with or result from political will. Governments especially can directly affect firm performance by exerting both political pressure and legal sanctions, including court rulings and industry regulations. Consider how several European countries and the European Union (EU) apply political and legal pressure on U.S. tech companies. European targets include Apple, Amazon, Facebook, Google, and Microsoft—the five largest U.S. tech companies—but also startups such as Uber, the taxi-hailing mobile app. Europe's policy makers seek to retain control over important industries ranging from transportation to the Internet to ensure that profits earned in Europe by Silicon Valley firms are taxed locally. The EU parliament even proposed legislation to break up "digital monopolies" such as Google. This proposal would require Google to offer search services independently as a standalone company from its other online services, including Google Drive, a cloud-based file storage and synchronization service. But the EU wariness extends beyond tax revenue: The Eurozone has much stronger legal requirements and cultural expectations concerning data privacy. Taken together, political/legal environments can have a direct bearing on a firm's performance.

Amazon is preparing to use drones for package delivery. © Amazon/Zuma Press/Newscom

LO 3-2

Apply Porter's five competitive forces to explain the profit potential of different industries.

Governments can often wield positive legal and political mechanisms to achieve desired changes in consumer behavior. For example, to encourage consumers to buy zero-emission vehicles, the U.S. government offers a $7,500 federal tax credit with the purchase of a new electric vehicle such as the Chevy Bolt, Nissan Leaf, or Tesla Model S.

You see the influence of multiple PESTEL factors affecting the implementation of drones for commercial purposes. Amazon and Alibaba were initially bullish on drones for doorstep delivery of products, but governmental, legal, and technological factors are proving a serious challenge and are delaying the introduction of drones for commercial applications.[13]

industry
A group of incumbent companies that face more or less the same set of suppliers and buyers.

industry analysis
A method to (1) identify an industry's profit potential and (2) derive implications for a firm's strategic position within an industry.

3.2 Industry Structure and Firm Strategy: The Five Forces Model

We now move one step closer to the firm (in the center of Exhibit 3.1) and come to the industry in which it competes. An **industry** is a group of incumbent companies facing more or less the same set of suppliers and buyers. Firms competing in the same industry tend to offer similar products or services to meet specific customer needs. Although the PESTEL framework allows us to scan, monitor, and evaluate the external environment to identify opportunities and threats, **industry analysis** provides a more rigorous basis not only to identify an industry's profit potential—the level of profitability that can be

expected for the *average* firm—but also to derive implications for one firm's strategic position within an industry. A firm's **strategic position** relates to its ability to create value for customers (V) while containing the cost to do so (C). Competitive advantage flows to the firm that is able to create as large a gap as possible between the value the firm's product or service generates and the cost required to produce it ($V - C$).

strategic position
A firm's strategic profile based on the difference between value creation and cost ($V - C$).

five forces model
A framework that identifies five forces that determine the profit potential of an industry and shape a firm's competitive strategy.

Michael Porter developed the highly influential **five forces model** to help managers understand the profit potential of different industries and how they can position their respective firms to gain and sustain competitive advantage.[14] By combining theory from industrial organization economics with hundreds of detailed case studies, Porter derived two key insights that form the basis of his seminal five forces model:

1. Rather than defining competition narrowly as the firm's closest competitors to explain and predict a firm's performance, competition must be viewed more broadly, to also encompass the other forces in an industry: buyers, suppliers, potential new entry of other firms, and the threat of substitutes.
2. The profit potential of an industry is neither random nor entirely determined by industry-specific factors. Rather, it is a function of the five forces that shape competition: *threat of entry, power of suppliers, power of buyers, threat of substitutes,* and *rivalry among existing firms.*

COMPETITION IN THE FIVE FORCES MODEL

Because the five forces model has especially powerful implications for strategy and competitive advantage, we will explore it in some detail. We start with the concept of competition. The first major insight this model provides is that competition involves more than just creating economic value; firms must also capture a significant share of it or they will see the economic value they create lost to suppliers, customers, or competitors. Firms create economic value by expanding as much as possible the gap between the value (V) the firm's product or service generates and the cost (C) to produce it. *Economic value* thus equals V minus C. To succeed, creating value is not enough. Firms must also be able to capture a significant share of the value created to gain and sustain a competitive advantage.

In Porter's five forces model, competition is more broadly defined beyond the firm's closest competitors (e.g., Nike vs. Under Armour, The Home Depot vs. Lowe's, Merck vs. Pfizer, and so on) to include other industry forces: buyers, suppliers, potential new entry of other firms, and the threat of substitutes. Competition describes the struggle among these forces to capture as much of the economic value created in an industry as possible. A firm's managers, therefore, must be concerned not only with the intensity of rivalry among direct competitors, but also with the strength of the other competitive forces that are attempting to extract part or all of the economic value the firm creates. When faced with competition in this broader sense, strategy explains how a firm is able to achieve superior performance.

The second major insight from the five forces model is that it enables managers to not only understand their industry environment but also shape their firm's strategy. As a rule of thumb, *the stronger the five forces, the lower the industry's profit potential*—making the industry less attractive for competitors. The reverse is also true: *the weaker the five forces, the greater the industry's profit potential*—making the industry more attractive. Therefore, from the perspective of a manager of an existing firm competing for advantage in an established industry, the company should be positioned in a way that relaxes the constraints of strong forces and leverages weak forces. The goal of crafting a strategic position is of course to improve the firm's ability to achieve a competitive advantage.

Strategy Highlight 3.2 provides an overview of the five competitive forces that shape strategy, with an application to the U.S. domestic airline industry. We will take up the topic of competitive positioning in Chapter 6 when studying business-level strategy.

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Strategy Highlight 3.2

The Five Forces in the Airline Industry

Although many of the mega-airlines such as American, Delta, and United have lost billions of dollars over the past few decades and continue to struggle to generate consistent profitability, other players in this industry have been quite profitable because they were able to extract some of the economic value created. The airlines, however, benefited from a windfall because the prices for jet fuel fell from a high of $3.25 per gallon (in 2011) to $1.50 (in 2015), giving some reprieve to cash-strapped airlines.

Regardless, the *nature of rivalry* among airlines is incredibly intense, as consumers primarily make decisions based on price. In inflation-adjusted dollars, ticket prices have been falling since industry deregulation in 1978. Thanks to Internet travel sites such as Orbitz, Travelocity, and Kayak, price comparisons are effortless. Consumers benefit from cut-throat price competition between carriers and capture significant value. Low switching costs and nearly perfect information combine to strengthen buyer power. Moreover, large corporate customers can contract with airlines to serve all of their employees' travel needs; such *powerful buyers* further reduce profit margins for air carriers.

Entry barriers are relatively low, resulting in a number of new airlines popping up. To enter the industry (on a small scale, serving a few select cities), a prospective new entrant needs only a couple of airplanes, which can be rented; a few pilots and crew members; some routes connecting city pairs; and gate access in airports. Indeed, despite notoriously low industry profitability, Virgin America entered the U.S. market in 2007. Virgin America is the brainchild of Sir Richard Branson, founder and chairman of the Virgin Group, a UK conglomerate of hundreds of companies using the Virgin brand, including the international airline Virgin Atlantic. Its business strategy is to offer low-cost service between major metropolitan cities on the American East and West Coasts.

In the airline industry, the *supplier power* is also strong. The providers of airframes (e.g., Boeing or Airbus), makers of aircraft engines (e.g., GE or Rolls-Royce), aircraft maintenance companies (e.g., Goodrich), caterers (e.g., Marriott), labor unions, and airports controlling gate access all bargain away the profitability of airlines.

To make matters worse, *substitutes* are also readily available: If prices are seen as too high, customers can drive their cars or use the train or bus. As an example, the route between Atlanta and Orlando (roughly 400 miles) used to be one of the busiest and most profitable ones for Delta. Given the increasing security delays at airports, more and more people now prefer to drive. Taken together, the competitive forces are quite unfavorable for generating a profit potential in the airline industry: low entry barriers, high supplier power, high buyer power combined with low customer switching costs, and the availability of low-cost substitutes. This type of hostile environment leads to intense rivalry among existing airlines and low overall industry profit potential.

The surprising conclusion is that while the mega-airlines themselves (i.e., American, Delta, and United) frequently struggle to make a profit, the other players in the industry—such as the suppliers of aircraft engines, aircraft maintenance companies, IT companies providing reservation and logistics services, caterers, airports, and so on—are quite profitable, all extracting significant value from the air transportation industry. Customers also are better off, as ticket prices have decreased and travel choices increased.[15]

Taking a closer look at the U.S. domestic airline industry in Strategy Highlight 3.2 shows how the five forces framework is a powerful and versatile tool to analyze industries. The five forces model allows managers to analyze all players using a wider industry lens, which in turn enables a deeper understanding of an industry's profit potential. Moreover, a five forces analysis provides the basis for how a firm should position itself to gain and sustain a competitive advantage. We are now ready to take a deep dive and look closer at each of the five competitive forces.

As Exhibit 3.2 shows, Porter's model identifies five key competitive forces that managers need to consider when analyzing the industry environment and formulating competitive strategy:

1. Threat of entry.
2. Power of suppliers.

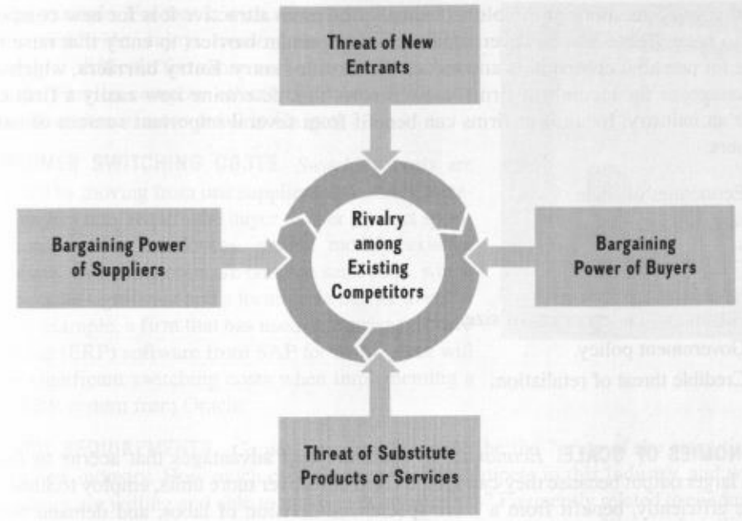

EXHIBIT 3.2 Porter's Five Forces Model

Source: Michael E. Porter, "The five competitive forces that shape strategy," *Harvard Business Review*, January 2008.

3. Power of buyers.
4. Threat of substitutes.
5. Rivalry among existing competitors.

THE THREAT OF ENTRY

The **threat of entry** describes the risk that potential competitors will enter the industry. Potential new entry depresses industry profit potential in two major ways:

threat of entry The risk that potential competitors will enter an industry.

1. With the threat of additional capacity coming into an industry, incumbent firms may lower prices to make entry appear less attractive to the potential new competitors, which would in turn reduce the overall industry's profit potential, especially in industries with slow or no overall growth in demand. Consider the market for new microwaves. Demand consists of the replacement rate for older models and the creation of new households. Since this market grows slowly, if at all, any additional entry would likely lead to excess capacity and lower prices overall.
2. The threat of entry by additional competitors may force incumbent firms to spend more to satisfy their existing customers. This spending reduces an industry's profit potential, especially if firms can't raise prices. Consider how Starbucks has chosen to constantly upgrade and refresh its stores and service offerings. Starbucks has over 11,000 U.S. stores and 22,000 globally. By raising the value of its offering in the eyes of the consumers, it slows others from entering the industry or from rapidly expanding. This allows Starbucks to hold at bay smaller regional competitors, such as Peet's Coffee & Tea, with fewer than 200 stores mostly on the West Coast, and prevents smaller national chains, such as Caribou Coffee, with 415 stores nationally, from increasing the level of competition. Starbucks is willing to accept a lower profit margin to maintain its market share.

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entry barriers Obstacles that determine how easily a firm can enter an industry and often significantly predict industry profit potential.

Of course, the more profitable an industry, the more attractive it is for new competitors to enter. There are, however, a number of important barriers to entry that raise the costs for potential competitors and reduce the threat of entry. **Entry barriers**, which are advantageous for incumbent firms, are obstacles that determine how easily a firm can enter an industry. Incumbent firms can benefit from several important sources of entry barriers:

- Economies of scale.
- Network effects.
- Customer switching costs.
- Capital requirements.
- Advantages independent of size.
- Government policy.
- Credible threat of retaliation.

ECONOMIES OF SCALE. *Economies of scale* are cost advantages that accrue to firms with larger output because they can spread fixed costs over more units, employ technology more efficiently, benefit from a more specialized division of labor, and demand better terms from their suppliers. These factors in turn drive down the cost per unit, allowing large incumbent firms to enjoy a cost advantage over new entrants who cannot muster such scale.

We saw the important relationship between scale and production cost in the Tesla ChapterCase. Usually entrants into the broad automobile industry need large-scale production to be efficient. Tesla Motors leveraged new technology to circumvent this entry barrier. Yet, reaching sufficient manufacturing scale to be cost-competitive is critical for Tesla as it is moving more into the mass market.

To benefit from economies of scale, Tesla is introducing new models, helping it move away from small-scale and costly production of niche vehicles to larger production runs of cars with a stronger mass-market appeal. Tesla's first vehicle, the Roadster (costing over $110K) was more or less a prototype to prove the viability of an all-electric car that outperforms high-performance traditional sports cars. For consumers, it created a new mind-set of what electric cars can do. Tesla ended production of the Roadster to focus more fully on its next model: the family sedan, Model S (over $70K). Tesla's manufacturing scale increased more than 20-fold, from some 2,500 Roadsters to 60,000 Model S's. The all-electric car company is hoping for an even broader customer appeal with its Model X, a crossover between an SUV and a family van. Finally, Tesla is betting that its next model, the smaller and lower-priced Model 3 ($35K) will allow the new company to break into the mass market and manufacture many more cars. Tesla CEO Musk set an audacious goal of selling 500,000 cars a year by 2020, which is needed for the company to be profitable.[16] Tesla's new product introductions over time are motivated by an attempt to capture benefits that accrue to economies of scale.

network effects The value of a product or service for an individual user increases with the number of total users.

NETWORK EFFECTS. **Network effects** describe the positive effect that one user of a product or service has on the value of that product or service for other users. When network effects are present, the value of the product or service increases with the number of users. The threat of potential entry is reduced when network effects are present.

For example, Facebook, with some 1.5 billion active users worldwide, enjoys tremendous network effects, making it difficult for more recent entrants such as Google Plus to compete effectively. We will discuss network effects in more detail in Chapter 7.

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CUSTOMER SWITCHING COSTS. *Switching costs* are incurred by moving from one supplier to another. Changing vendors may require the buyer to alter product specifications, retrain employees, and/or modify existing processes. Switching costs are onetime sunk costs, which can be quite significant and a formidable barrier to entry.

For example, a firm that has used enterprise resource planning (ERP) software from SAP for many years will incur significant switching costs when implementing a new ERP system from Oracle.

CAPITAL REQUIREMENTS. *Capital requirements* describe the "price of the entry ticket" into a new industry. How much capital is required to compete in this industry, and which companies are willing and able to make such investments? Frequently related to economies of scale, capital requirements may encompass investments to set up plants with dedicated machinery, run a production process, and cover start-up losses.

Tesla Motors made a sizable capital investment of roughly $150 million when it purchased the Fremont, California, manufacturing plant from Toyota and upgraded it with a highly automated production process using robots to produce cars of the highest quality at large scale.[17] This strategic commitment, however, is dwarfed by the $5 billion that Tesla is investing to build its battery "gigafactory" in Nevada.[18] The new factory allows Tesla to not only secure supplies of lithium-ion batteries, the most critical and expensive component of an all-electric car, but also build as many as 500,000 vehicles a year.[19] In such cases, the likelihood of entry is determined by not only the level of capital investment required to enter the industry, but also the expected return on investment. The potential new entrant must carefully weigh the required capital investments, the cost of capital, and the expected return. Taken together, the threat of entry is high when capital requirements are low in comparison to the expected returns. If an industry is attractive enough, efficient capital markets are likely to provide the necessary funding to enter an industry. Capital, unlike proprietary technology and industry-specific know-how, is a fungible resource that can be relatively easily acquired in the face of attractive returns.

ADVANTAGES INDEPENDENT OF SIZE. Incumbent firms often possess cost and quality advantages that are independent of size. These advantages can be based on brand loyalty, proprietary technology, preferential access to raw materials and distribution channels, favorable geographic locations, and cumulative learning and experience effects.

Tesla Motors has loyal customers, which strengthens its competitive position and reduces the threat of entry into the all-electric car segment, at least by other start-up companies.[20] Unlike GM or Ford, which spend billions each year on advertising, Tesla doesn't have a large marketing budget. Rather, it relies on word of mouth. It luckily has its own "cool factor" of being different, similar to Apple in its early days. Tesla can back this perception with beautifully designed cars of top-notch quality made domestically in California. Indeed, when *Consumer Reports* tested the Model S, the usually understated magazine concluded: "The Tesla Model S is the best car we ever tested."[21] In addition, many Tesla

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owners feel an emotional connection to the company because they deeply believe in the company's vision "to accelerate the advent of sustainable transport by bringing compelling mass market electric cars to market as soon as possible."[22]

Patents and trade secrets, such as the original Coke formula, are examples of proprietary technology and know-how that can also reduce the threat of entry. The value of trade secrets to a firm is reflected in the efforts to improve cybersecurity so that trade secrets cannot be stolen by hacking into corporate computers.

Preferential access to raw materials and key components can bestow absolute cost advantages. As mentioned, lithium-ion batteries are not only the most expensive and critical parts of an all-electric vehicle, but they are also in short supply. Tesla's new battery "gigafactory" will afford it independence from the few worldwide suppliers, such as Panasonic of Japan, and also likely bestow an absolute cost advantage.[23] This should further reduce the threat of new entry in the all-electric vehicle segment, assuming no radical technological changes are to be expected in battery-cell technology in the next few years.

Favorable locations, such as Silicon Valley for Tesla Motors, often present advantages that other locales cannot match easily, including access to human and venture capital, and world-class research and engineering institutions.

Finally, incumbent firms often benefit from cumulative learning and experience effects accrued over long periods of time. Tesla Motors now has more than 10 years of experience in designing and building high-performance all-electric vehicles of superior quality and design. Attempting to obtain such deep knowledge within a shorter time frame is often costly, if not impossible, which in turn constitutes a formidable barrier to entry.

GOVERNMENT POLICY. Frequently government policies restrict or prevent new entrants. Until recently, India did not allow foreign retailers such as Walmart or IKEA to own stores and compete with domestic companies in order to protect the country's millions of small vendors and wholesalers. China frequently requires foreign companies to enter joint ventures with domestic ones and to share technology.

In contrast, deregulation in industries such as airlines, telecommunications, and trucking have generated significant new entries. Therefore, the threat of entry is high when restrictive government policies do not exist or when industries become deregulated.

CREDIBLE THREAT OF RETALIATION. Potential new entrants must also anticipate how incumbent firms will react. A credible threat of retaliation by incumbent firms often deters entry. Should entry still occur, however, incumbents are able to retaliate quickly, through initiating a price war, for example. The industry profit potential can in this case easily fall below the cost of capital. Incumbents with deeper pockets than new entrants are able to withstand price competition for a longer time and wait for the new entrants to exit the industry—then raise prices again. Other weapons of retaliation include increased product and service innovation, advertising, sales promotions, and litigation.

Potential new entrants should expect a strong and vigorous response beyond price competition by incumbent firms in several scenarios. If the current competitors have deep pockets, unused excess capacity, reputational clout with industry suppliers and buyers, a history of vigorous retaliation during earlier entry attempts, or heavy investments in resources specific to the core industry and ill-suited for adaptive use, then they are likely to press these advantages. Moreover, if industry growth is slow or stagnant, incumbents are more likely to retaliate against new entrants to protect their market share, often initiating a price war with the goal of driving out these new entrants.

In contrast, the threat of entry is high when new entrants expect that incumbents will not or cannot retaliate. For example, in the southeastern United States, TV cable company

Comcast has entered the market for residential and commercial telephone services and Internet connectivity (as an ISP, Internet service provider), emerging as a direct competitor for AT&T. Comcast also acquired NBC Universal, combining delivery and content. AT&T responded to Comcast's threat by introducing U-verse, a product combining high-speed Internet access with cable TV and telephone service, all provided over its fast fiber-optic network.

THE POWER OF SUPPLIERS

The bargaining power of suppliers captures pressures that industry suppliers can exert on an industry's profit potential. This force reduces a firm's ability to obtain superior performance for two reasons: Powerful suppliers can raise the cost of production by demanding higher prices for their inputs or by reducing the quality of the input factor or service level delivered. Powerful suppliers are a threat to firms because they reduce the industry's profit potential by capturing part of the economic value created.

To compete effectively, companies generally need a wide variety of inputs into the production process, including raw materials and components, labor (via individuals or labor unions, when the industry faces collective bargaining), and services. The relative bargaining power of suppliers is high when

- The suppliers' industry is more concentrated than the industry it sells to.
- Suppliers do not depend heavily on the industry for a large portion of their revenues.
- Incumbent firms face significant switching costs when changing suppliers.
- Suppliers offer products that are differentiated.
- There are no readily available substitutes for the products or services that the suppliers offer.
- Suppliers can credibly threaten to forward-integrate into the industry.

In Strategy Highlight 3.2, we noted that the airline industry faces strong supplier power. Let's take a closer look at one important supplier group to this industry: Boeing and Airbus, the makers of large commercial jets. The reason airframe manufacturers are powerful suppliers to airlines is because their industry is much more concentrated (only two firms) than the industry it sells to. Compared to two airframe suppliers, there are hundreds of commercial airlines around the world. Given the trend of large airlines merging to create even larger mega-airlines, however, increasing buyer power may eventually balance this out a bit. Nonetheless, the airlines face nontrivial switching costs when changing suppliers because pilots and crew would need to be retrained to fly a new type of aircraft, maintenance capabilities would need to be expanded, and some routes may even need to be reconfigured due to differences in aircraft range and passenger capacity. Moreover, while some of the aircraft can be used as substitutes, Boeing and Airbus offer differentiated products. This fact becomes clearer when considering the most recent models from each company. Boeing introduced the 787 Dreamliner to capture long-distance point-to-point travel (close to an 8,000-mile range, sufficient to fly non-stop from Los Angeles to Sydney), while Airbus introduced the A-380 Superjumbo to focus on high-volume transportation (close to 900 passengers) between major airport hubs (e.g., Tokyo's Haneda Airport and Singapore's International Airport). When considering long-distance travel, there are no readily available substitutes for commercial airliners, a fact that strengthens supplier power.

All in all, the vast strengths of these factors lead us to conclude that the supplier power of commercial aircraft manufacturers is quite significant. This puts Boeing and Airbus in a strong position to extract profits from the airline industry, thus reducing the profit potential of the airlines themselves.

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Retailers claim they schedule Black Friday sales events because the buyers demand it. We can see this phenomenon as one example of the power of buyers demanding discounted goods, thus reducing the ability of retailers to retain the economic value they have created.
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Although the supplier power of Boeing and Airbus is strong, several factors moderate their bargaining positions somewhat. First, the suppliers of commercial airliners depend heavily on commercial airlines for their revenues. Second, Boeing and Airbus are unlikely to threaten forward integration and become commercial airlines themselves. Third, Bombardier of Canada and Embraer of Brazil, both manufacturers of smaller commercial airframes, have begun to increase the size of the jets they offer, and thus now compete with some of the smaller planes such as Boeing's 737 and Airbus' A-320. Finally, industry structures are not static, but can change over time. In the last few years, several of the remaining large domestic U.S. airlines have merged (Delta and Northwest, United and Continental, and American and U.S. Airways), which changed the industry structure in their favor. There are now fewer but even larger airlines remaining. This fact increases their buyer power, which we turn to next.

THE POWER OF BUYERS

In many ways, the bargaining power of buyers is the flip side of the bargaining power of suppliers. Buyers are the customers of an industry. The power of buyers concerns the pressure an industry's customers can put on the producer's margins in the industry by demanding a lower price or higher product quality. When buyers successfully obtain price discounts, it reduces a firm's top line (revenue). When buyers demand higher quality and more service, it generally raises production costs. Strong buyers can therefore reduce industry profit potential and a firm's profitability. Powerful buyers are a threat to the producing firms because they reduce the industry's profit potential by capturing part of the economic value created.

As with suppliers, an industry may face many different types of buyers. The buyers of an industry's product or service may be individual consumers—like you or me when we decide which provider we want to use for our wireless devices. In many areas, you can choose between several providers such as AT&T, Sprint, T-Mobile, or Verizon. Although we might be able to find a good deal when carefully comparing their individual service plans, as individual consumers we generally do not have significant buyer power. On the other hand, large institutions such as businesses or universities have significant buyer power when deciding which provider to use for their wireless services, because they are able to sign up or move several thousand employees at once.

The power of buyers is high when

- There are a few buyers and each buyer purchases large quantities relative to the size of a single seller.
- The industry's products are standardized or undifferentiated commodities.
- Buyers face low or no switching costs.
- Buyers can credibly threaten to backwardly integrate into the industry.

In addition, companies need to be aware of situations when buyers are especially price sensitive. This is the case when:

- The buyer's purchase represents a significant fraction of its cost structure or procurement budget.
- Buyers earn low profits or are strapped for cash.
- The quality (cost) of the buyers' products and services is not affected much by the quality (cost) of their inputs.

The retail giant Walmart provides perhaps the most potent example of tremendous buyer power. Walmart is not only the largest retailer worldwide (with over 11,000 stores and 2.2 million employees), but it is also one of the largest companies in the world (with $485 billion in revenues in 2014). Walmart is one of the few large big-box global retail chains and frequently purchases large quantities from its suppliers. Walmart leverages its buyer power by exerting tremendous pressure on its suppliers to lower prices and to increase quality or risk losing access to shelf space at the largest retailer in the world. Walmart's buyer power is so strong that many suppliers co-locate offices directly next to Walmart's headquarters in Bentonville, Arkansas, because such proximity enables Walmart's managers to test the supplier's latest products and negotiate prices.

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The bargaining power of buyers also increases when their switching costs are low. Having multiple suppliers of a product category located close to its headquarters allows Walmart to demand further price cuts and quality improvements because it can easily switch from one supplier to the next. This threat is even more pronounced if the products are non-differentiated commodities from the consumers' perspective. For example, Walmart can easily switch from Rubbermaid plastic containers to Sterlite containers by offering more shelf space to the producer that offers the greatest price cut or quality improvement.

Buyers are also powerful when they can credibly threaten backward integration. Backward integration occurs when a buyer moves upstream in the industry value chain, into the seller's business. Walmart has exercised the threat to backward-integrate by producing a number of products as private-label brands such as Equate health and beauty items, Ol'Roy dog food, and Parent's Choice baby products. Taken together, powerful buyers have the ability to extract a significant amount of the value created in the industry, leaving little or nothing for producers.

In regard to any of the five forces that shape competition, it is important to note that their relative strengths are context-dependent. For example, the Mexican multinational CEMEX, one of the world's leading cement producers, faces very different buyer power in the United States than domestically. In the United States, cement buyers consist of a few large and powerful construction companies that account for a significant percentage of CEMEX's output. The result? Razor-thin margins. In contrast, the vast majority of CEMEX's customers in its Mexican home market are numerous, small, individual customers facing a few large suppliers, with CEMEX being the biggest. CEMEX earns high profit margins in its home market. With the same undifferentiated product, CEMEX competes in two different industry scenarios in terms of buyer strength.

THE THREAT OF SUBSTITUTES

Substitutes meet the same basic customer needs as the industry's product but in a different way. The threat of substitutes is the idea that products or services available from *outside the*

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given industry will come close to meeting the needs of current customers.[24] For example, many software products are substitutes to professional services, at least at the lower end. Tax preparation software such as Intuit's TurboTax is a substitute for professional services offered by H&R Block and others. LegalZoom, an online legal documentation service, is a threat to professional law firms. Other examples of substitutes are energy drinks versus coffee, videoconferencing versus business travel, e-mail versus express mail, gasoline versus biofuel, and wireless telephone services versus Voice over Internet Protocol (VoIP), offered by Skype or Vonage.

A high threat of substitutes reduces industry profit potential by limiting the price the industry's competitors can charge for their products and services. The threat of substitutes is high when:

- The substitute offers an attractive price-performance trade-off.
- The buyer's cost of switching to the substitute is low.

The movie rental company Redbox, which uses 44,000 kiosks in the United States to make movie rentals available for just $1.50, is a substitute for buying movie DVDs. For buyers, video rental via Redbox offers an attractive price-performance trade-off with low switching costs in comparison to DVD ownership. Moreover, for customers that view only a few movies a month, Redbox is also a substitute for Netflix's on-demand Internet movie streaming service, which costs $7.99 a month. Rather than a substitute, however, Redbox is a direct competitor to Netflix's DVD rental business, where plans also cost $7.99 a month (for one DVD out at a time).

In addition to a lower price, substitutes may also become more attractive by offering a higher value proposition.[25] In Spain, some 6 million people travel annually between Madrid and Barcelona, roughly 400 miles apart. The trip by car or train takes most of the day, and 90 percent of travelers would choose to fly, creating a highly profitable business for local airlines. This all changed when the Alta Velocidad Española (AVE), an ultramodern high-speed train, was completed in 2008. Taking into account total time involved, high-speed trains are faster than short-haul flights. Passengers travel in greater comfort than airline passengers and commute from one city center to the next, with only a short walk or cab ride to their final destinations.

The AVE example highlights the two fundamental insights provided by Porter's five forces framework. First, competition must be defined more broadly to go beyond direct industry competitors. In this case, rather than defining competition narrowly as the firm's closest competitors, airline executives in Spain must look beyond other airlines and consider substitute offerings such as high-speed trains. Second, any of the five forces on its own, if sufficiently strong, can extract industry profitability. In the AVE example, the threat of substitutes is limiting the airline industry's profit potential. With the arrival of the AVE, the airlines' monopoly on fast transportation between Madrid and Barcelona vanished, and with it the airlines' high profits. The strong threat of substitutes in this case increased the rivalry among existing competitors in the Spanish air transportation industry.

LO 3-3

Explain how competitive industry structure shapes rivalry among competitors.

RIVALRY AMONG EXISTING COMPETITORS

Rivalry among existing competitors describes the intensity with which companies within the same industry jockey for market share and profitability. It can range from genteel to cut-throat. The other four forces—threat of entry, the power of buyers and suppliers, and the threat of substitutes—all exert pressure upon this rivalry, as indicated by the arrows pointing toward the center in Exhibit 3.2. The stronger the forces, the stronger the expected competitive intensity, which in turn limits the industry's profit potential.

Competitors can lower prices to attract customers from rivals. When intense rivalry among existing competitors brings about price discounting, industry profitability erodes. Alternatively, competitors can use non-price competition to create more value in terms of product features and design, quality, promotional spending, and after-sales service and support. When non-price competition is the primary basis of competition, costs increase, which can also have a negative impact on industry profitability. However, when these moves create unique products with features tailored closely to meet customer needs and willingness to pay, then average industry profitability tends to increase because producers are able to raise prices and thus increase revenues and profit margins.

The intensity of rivalry among existing competitors is determined largely by the following factors

- Competitive industry structure.
- Industry growth.
- Strategic commitments.
- Exit barriers.

COMPETITIVE INDUSTRY STRUCTURE. The **competitive industry structure** refers to elements and features common to all industries. The structure of an industry is largely captured by

- The number and size of its competitors.
- The firms' degree of pricing power.
- The type of product or service (commodity or differentiated product).
- The height of entry barriers.[26]

competitive industry structure
Elements and features common to all industries, including the number and size of competitors, the firms' degree of pricing power, the type of product or service offered, and the height of entry barriers.

Exhibit 3.3 shows different industry types along a continuum from fragmented to consolidated structures. At one extreme, a *fragmented industry* consists of many small firms and tends to generate low profitability. At the other end of the continuum, a *consolidated industry* is dominated by a few firms, or even just one firm, and has the potential to be highly profitable. The four main competitive industry structures are

(1) perfect competition,
(2) monopolistic competition,
(3) oligopoly, and
(4) monopoly.

Perfect Competition. A *perfectly competitive* industry is fragmented and has many small firms, a commodity product, ease of entry, and little or no ability for each individual firm to raise its prices. The firms competing in this type of industry are approximately similar in size and resources. Consumers make purchasing decisions solely on price, because the commodity product offerings are more or less identical. The resulting performance of the industry shows low profitability. Under these conditions, firms in perfect competition have difficulty achieving even a temporary competitive advantage and can achieve only competitive parity. Although perfect competition is a rare industry structure in its pure form, markets for commodities such as natural gas, copper, and iron tend to approach this structure.

Modern high-tech industries are also not immune to the perils of perfect competition. Many Internet entrepreneurs learned the hard way that it is difficult to beat the forces of perfect competition. Fueled by eager venture capitalists, about 100 online pet supply stores such as *pets.com, petopia.com,* and *pet-store.com* had sprung up by 1999, at the height of the Internet bubble.[27] Cut-throat competition ensued, with online retailers selling products

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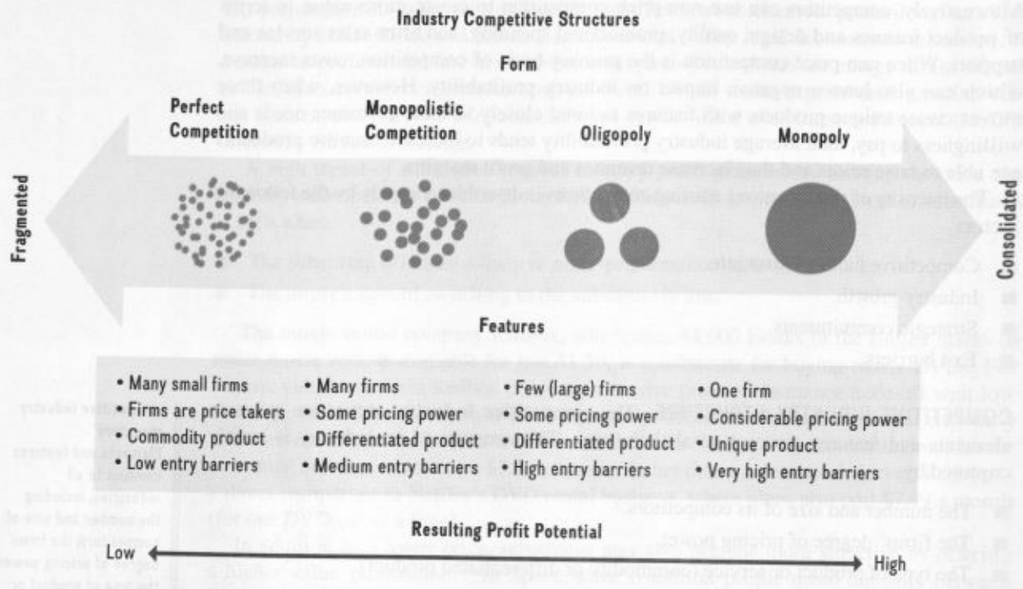
EXHIBIT 3.3 / Industry Competitive Structures along the Continuum from Fragmented to Consolidated



below cost. When there are many small firms offering a commodity product in an industry that is easy to enter, no one is able to increase prices and generate profits. To make matters worse, at the same time, category-killers such as PetSmart and PetCo were expanding rapidly, opening some 2,000 brick-and-mortar stores in the United States and Canada. The ensuing price competition led to an industry shakeout, leaving online retailers in the dust. Looking at the competitive industry structures depicted in Exhibit 3.3, we might have predicted that online pet supply stores were unlikely to be profitable.

Monopolistic Competition. A *monopolistically competitive* industry has many firms, a differentiated product, some obstacles to entry, and the ability to raise prices for a relatively unique product while retaining customers. The key to understanding this industry structure is that the firms now offer products or services with unique features.

The computer hardware industry provides one example of monopolistic competition. Many firms compete in this industry, and even the largest of them (Apple, ASUS, Dell, HP, or Lenovo) have less than 20 percent market share. Moreover, while products between competitors tend to be similar, they are by no means identical. As a consequence, firms selling a product with unique features tend to have some ability to raise prices. When a firm is able to differentiate its product or service offerings, it carves out a niche in the market in which it has some degree of monopoly power over pricing, thus the name "monopolistic competition." Firms frequently communicate the degree of product differentiation through advertising.

Oligopoly. An *oligopolistic* industry is consolidated with a few large firms, differentiated products, high barriers to entry, and some degree of pricing power. The degree of pricing power depends, just as in monopolistic competition, on the degree of product differentiation.

A key feature of an oligopoly is that the competing firms are *interdependent*. With only a few competitors in the mix, the actions of one firm influence the behaviors of the

others. Each competitor in an oligopoly, therefore, must consider the strategic actions of the other competitors. This type of industry structure is often analyzed using *game theory*, which attempts to predict strategic behaviors by assuming that the moves and reactions of competitors can be anticipated.[28] Due to their strategic interdependence, companies in oligopolies have an incentive to coordinate their strategic actions to maximize joint performance. Although explicit coordination such as price fixing is illegal in the United States, tacit coordination such as "an unspoken understanding" is not.

The express-delivery industry is an example of an oligopoly. The main competitors in this space are FedEx and UPS. Any strategic decision made by FedEx (e.g., to expand delivery services to ground delivery of larger-size packages) directly affects UPS; likewise, any decision made by UPS (e.g., to guarantee next-day delivery before 8:00 a.m.) directly affects FedEx. Other examples of oligopolies include the soft drink industry (Coca-Cola vs. Pepsi), airframe manufacturing business (Boeing vs. Airbus), home-improvement retailing (The Home Depot vs. Lowe's), toys and games (Hasbro vs. Mattel), and detergents (P&G vs. Unilever).[29]

Companies in an oligopoly tend to have some pricing power if they are able to differentiate their product or service offerings from those of their competitors. *Non-price competition*, therefore, is the preferred mode of competition. This means competing by offering unique product features or services rather than competing based on price alone. When one firm in an oligopoly cuts prices to gain market share from its competitor, the competitor typically will respond in kind and also cut prices. This process initiates a price war, which can be especially detrimental to firm performance if the products are close rivals.

In the early years of the soft drink industry, for example, whenever Pepsi lowered prices, Coca-Cola followed suit. These actions only resulted in reduced profitability for both companies. In recent decades, both Coca-Cola and Pepsi have repeatedly demonstrated that they have learned this lesson. They shifted the basis of competition from price-cutting to new product introductions and lifestyle advertising. Any price adjustments are merely short-term promotions. By leveraging innovation and advertising, Coca-Cola and Pepsi have moved to non-price competition, which in turn allows them to charge higher prices and to improve industry and company profitability.[30]

Monopoly. An industry is a *monopoly* when there is only one, often large firm supplying the market. The firm may offer a unique product, and the challenges to moving into the industry tend to be high. The monopolist has considerable pricing power. As a consequence, firm and thus industry profit tends to be high. The one firm is the industry.

In some instances, the government will grant one firm the right to be the sole supplier of a product or service. This is often done to incentivize a company to engage in a venture that would not be profitable if there was more than one supplier. For instance, public utilities incur huge fixed costs to build plants and to supply a certain geographic area. Public utilities supplying water, gas, and electricity to businesses and homes are frequently monopolists. As examples, Georgia Power is the only supplier of electricity for some 2.5 million customers in the southeastern United States. Philadelphia Gas Works is the only supplier of natural gas in the city of Philadelphia, Pennsylvania, serving some 500,000 customers. These are so-called *natural monopolies*. Without them, the governments involved believe the market would not supply these products or services. In the past few decades, however, more and more of these natural monopolies have been deregulated in the United States, including airlines, telecommunications, railroads, trucking, and ocean transportation. This deregulation has allowed competition to emerge, which frequently leads to lower prices, better service, and more innovation.

While natural monopolies appear to be disappearing from the competitive landscape, so-called *near monopolies* are of much greater interest to strategists. These are firms that have

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accrued significant market power, for example, by owning valuable patents or proprietary technology. In the process, they are changing the industry structure in their favor, generally from monopolistic competition or oligopolies to near monopolies. These near monopolies are firms that have accomplished product differentiation to such a degree that they are in a class by themselves, just like a monopolist. The European Union, for example, views Google with its 90 percent market share in online search as a "digital monopoly."[31] This is an enviable position in terms of the ability to extract profits by leveraging its data to provide targeted online advertising and other customized services, so long as Google can steer clear of monopolistic behavior, which may attract antitrust regulators and lead to legal repercussions.

INDUSTRY GROWTH. Industry growth directly affects the intensity of rivalry among competitors. In periods of high growth, consumer demand rises, and price competition among firms frequently decreases. Because the pie is expanding, rivals are focused on capturing part of that larger pie rather than taking market share and profitability away from one another. The demand for knee replacements, for example, is a fast-growing segment in the medical products industry. In the United States, robust demand is driven by the need for knee replacements for an aging population as well as for an increasingly obese population. The leading competitors are Zimmer Biomet, DePuy, and Stryker, with significant share held by Smith & Nephew. Competition is primarily based on innovative design, improved implant materials, and differentiated products such as gender solutions and a range of high-flex knees. With improvements to materials and procedures, younger patients are also increasingly choosing early surgical intervention. Competitors are able to avoid price competition and, instead, focus on differentiation that allows premium pricing.

Competition in the knee replacement industry is primarily based on innovative design, improved implant materials, and differentiated products.
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In contrast, rivalry among competitors becomes fierce during slow or even negative industry growth. Price discounts, frequent new product releases with minor modifications, intense promotional campaigns, and fast retaliation by rivals are all tactics indicative of an industry with slow or negative growth. Competition is fierce because rivals can gain only at the expense of others; therefore, companies are focused on taking business away from one another. Demand for traditional fast food providers such as McDonald's, Burger King, and Wendy's has been declining in recent years. Consumers have become more health-conscious and demand has shifted to alternative restaurants such as Subway, Chick-fil-A, and Chipotle. Attempts by McDonald's, Burger King, and Wendy's to steal customers from one another include frequent discounting tactics such as dollar menus. Such competitive tactics are indicative of cut-throat competition and a low profit potential in the traditional hamburger fast food industry.

Competitive rivalry based solely on cutting prices is especially destructive to profitability because it transfers most, if not all, of the value created in the industry to the customers—leaving little, if anything, for the firms in the industry. While this may appear attractive to customers, firms that are not profitable are not able to make the investments necessary to upgrade their product offerings or services to provide higher value, and they eventually leave the industry. Destructive price competition can lead to limited choices, lower product quality, and higher prices for consumers in the long run if only a few large firms survive.

STRATEGIC COMMITMENTS. If firms make strategic commitments to compete in an industry, rivalry among competitors is likely to be more intense. We defined *strategic commitments* (in Chapter 2) as firm actions that are costly, long-term oriented, and difficult to reverse. Strategic commitments to a specific industry can stem from large, fixed cost requirements, but also from non-economic considerations.[32]

For example, significant strategic commitments are required to compete in the airline industry when using a hub-and-spoke system to provide not only domestic but also international coverage. U.S. airlines Delta, United, and American have large fixed costs to maintain their network of routes that affords global coverage, frequently in conjunction with foreign partner airlines. These fixed costs in terms of aircraft, gate leases, hangars, maintenance facilities, baggage facilities, and ground transportation all accrue before the airlines sell any tickets. High fixed costs create tremendous pressure to fill empty seats. An airline seat on a specific flight is perishable, just like hotel rooms not filled. Empty airline seats are often filled through price-cutting. Given similar high fixed costs, other airlines respond in kind. Eventually, a vicious cycle of price-cutting ensues, driving average industry profitability to zero, or even negative numbers (where the companies are losing money). To make matters worse, given their strategic commitments, airlines are unlikely to exit an industry. Excess capacity remains, further depressing industry profitability.

In other cases, strategic commitments to a specific industry may be the result of more political than economic considerations. Airbus, for example, was created by a number of European governments through direct subsidies to provide a countervailing power to Boeing. The European Union in turn claims that Boeing is subsidized by the U.S. government indirectly via defense contracts. Given these political considerations and large-scale strategic commitments, neither Airbus nor Boeing is likely to exit the aircraft manufacturing industry even if industry profit potential falls to zero.

EXIT BARRIERS. The rivalry among existing competitors is also a function of an industry's **exit barriers,** the obstacles that determine how easily a firm can leave that industry. Exit barriers comprise both economic and social factors. They include fixed costs that must be paid regardless of whether the company is operating in the industry or not. A company exiting an industry may still have contractual obligations to suppliers, such as employee health care, retirement benefits, and severance pay. Social factors include elements such as emotional attachments to certain geographic locations. In Michigan, entire communities still depend on GM, Ford, and Chrysler. If any of those carmakers were to exit the industry, communities would suffer. Other social and economic factors include ripple effects through the supply chain. When one major player in an industry shuts down, its suppliers are adversely impacted as well.

exit barriers
Obstacles that determine how easily a firm can leave an industry.

An industry with low exit barriers is more attractive because it allows underperforming firms to exit more easily. Such exits reduce competitive pressure on the remaining firms because excess capacity is removed. In contrast, an industry with high exit barriers reduces its profit potential because excess capacity still remains. All of the large airlines featured in Strategy Highlight 3.2 (American, Delta, and United) have filed for bankruptcy at one point. Due to a unique feature of U.S. Chapter 11 bankruptcy law, however, companies may continue to operate and reorganize while being temporarily shielded from their creditors and other obligations until renegotiated. This implies that excess capacity is not removed from the industry, and by putting pressure on prices further reduces industry profit potential.

To summarize our discussion of the five forces model, Exhibit 3.4 provides a checklist that you can apply to any industry when assessing the underlying competitive forces that

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EXHIBIT 3.4

The Five Forces Competitive Analysis Checklist

The threat of entry is high when:

- √ The minimum efficient scale to compete in an industry is low.
- √ Network effects are not present.
- √ Customer switching costs are low.
- √ Capital requirements are low.
- √ Incumbents do not possess:
  - Brand loyalty.
  - Proprietary technology.
  - Preferential access to raw materials.
  - Preferential access to distribution channels.
  - Favorable geographic locations.
  - Cumulative learning and experience effects.
- √ Restrictive government regulations do not exist.
- √ New entrants expect that incumbents will not or cannot retaliate.

The power of suppliers is high when:

- √ Suppliers' industry is more concentrated than the industry it sells to.
- √ Suppliers do not depend heavily on the industry for their revenues.
- √ Incumbent firms face significant switching costs when changing suppliers.
- √ Suppliers offer products that are differentiated.
- √ There are no readily available substitutes for the products or services that the suppliers offer.
- √ Suppliers can credibly threaten to forward-integrate into the industry.

The power of buyers is high when:

- √ There are a few buyers and each buyer purchases large quantities relative to the size of a single seller.
- √ The industry's products are standardized or undifferentiated commodities.
- √ Buyers face low or no switching costs.
- √ Buyers can credibly threaten to backwardly integrate into the industry.

The threat of substitutes is high when:

- √ The substitute offers an attractive price–performance trade-off.
- √ The buyers' cost of switching to the substitute is low.

The rivalry among existing competitors is high when:

- √ There are many competitors in the industry.
- √ The competitors are roughly of equal size.
- √ Industry growth is slow, zero, or even negative.
- √ Exit barriers are high.
- √ Incumbent firms are highly committed to the business.
- √ Incumbent firms cannot read or understand each other's strategies well.
- √ Products and services are direct substitutes.
- √ Fixed costs are high and marginal costs are low.
- √ Excess capacity exists in the industry.
- √ The product or service is perishable.

Source: Adapted from Porter, M.E. (2008). "The five competitive forces that shape strategy." *Harvard Business Review*, January.

shape strategy. The key take-away from the five forces model is that the stronger the forces, the lower the industry's ability to earn above-average profits, and correspondingly, the lower the firm's ability to gain and sustain a competitive advantage. Conversely, the weaker the forces, the greater the industry's ability to earn above-average profits, and correspondingly, the greater the firm's ability to gain and sustain competitive advantage. Therefore, managers need to craft a strategic position for their company that leverages weak forces into opportunities and mitigates strong forces because they are potential threats to the firm's ability to gain and sustain a competitive advantage.

A SIXTH FORCE: THE STRATEGIC ROLE OF COMPLEMENTS

LO 3-4

Describe the strategic role of complements in creating positive-sum co-opetition.

As valuable as the five forces model is for explaining the profit potential and attractiveness of industries, the value of Porter's five forces model can be further enhanced if one also considers the availability of complements.[33]

A **complement** is a product, service, or competency that adds value to the original product offering when the two are used in tandem.[34] Complements increase demand for the primary product, thereby enhancing the profit potential for the industry and the firm. A company is a **complementor** to your company if customers value your product or service offering more when they are able to combine it with the other company's product or service.[35] Firms may choose to provide the complements themselves or work with another company to accomplish this.

complement
A product, service, or competency that adds value to the original product offering when the two are used in tandem.

complementor
A company that provides a good or service that leads customers to value your firm's offering more when the two are combined.

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

For example, in the smartphone industry, Google complements Samsung. The Korean high-tech company's smartphones are more valuable when they come with Google's Android system installed. At the same time, Google and Samsung are increasingly becoming competitors. With Google's acquisition of Motorola Mobility, the online search company is planning to launch its own line of smartphones and Chromebooks. This development illustrates the process of **co-opetition**, which is cooperation by competitors to achieve a strategic objective. Samsung and Google cooperate as complementors to compete against Apple's strong position in the mobile device industry, while at the same time Samsung and Google are increasingly becoming competitive with one another.

3.3 Changes over Time: Industry Dynamics

LO 3-5

Appraise the role of industry dynamics and industry convergence in shaping the firm's external environment.

Although the five-forces-plus-complements model is useful in understanding an industry's profit potential, it provides only a point-in-time snapshot of a moving target. With this model (as with other static models), one cannot determine the changing speed of an industry or the rate of innovation. This drawback implies that managers must repeat their analysis over time in order to create a more accurate picture of their industry. It is therefore important that managers consider industry dynamics.

Industry structures are not stable over time. Rather, they are dynamic. Since a consolidated industry tends to be more profitable than a fragmented one (see Exhibit 3.3), firms have a tendency to change the industry structure in their favor, making it more consolidated through horizontal mergers and acquisitions. Having fewer competitors generally equates to higher industry profitability. Industry incumbents, therefore, have an incentive to reduce the number of competitors in the industry. With fewer but larger competitors, incumbent firms can mitigate the threat of strong competitive forces such as supplier or buyer power more effectively.

The U.S. domestic airline industry (featured in Strategy Highlight 3.2) has witnessed several large, horizontal mergers between competitors, including Delta and Northwest,

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United and Continental, Southwest and AirTran, as well as American and U.S. Airways. These moves allow the remaining carriers to enjoy a more benign industry structure. It also allows them to retire some of the excess capacity in the industry as the merged airlines consolidate their networks of routes. The merger activity in the airline industry provides one example of how firms can proactively reshape industry structure in their favor. A more consolidated airline industry is likely to lead to higher ticket prices and fewer choices for customers, but also more profitable airlines.

In contrast, consolidated industry structures may also break up and become more fragmented. This generally happens when there are external shocks to an industry such as deregulation, new legislation, technological innovation, or globalization. For example, the emergence of the Internet moved the stock brokerage business from an oligopoly controlled by full-service firms such as Merrill Lynch and Morgan Stanley to monopolistic competition with many generic online brokers such as Ameritrade, E*TRADE, and Scottrade.

industry convergence A process whereby formerly unrelated industries begin to satisfy the same customer need.

Another dynamic to be considered is **industry convergence**, a process whereby formerly unrelated industries begin to satisfy the same customer need. Industry convergence is often brought on by technological advances. For years, many players in the media industries have been converging due to technological progress in IT, telecommunications, and digital media. Media convergence unites computing, communications, and content, thereby causing significant upheaval across previously distinct industries. Content providers in industries such as newspapers, magazines, TV, movies, radio, and music are all scrambling to adapt. Many standalone print newspapers are closing up shop, while others are trying to figure out how to offer online news content for which consumers are willing to pay.[36] Internet companies such as Google, Facebook, Instagram, LinkedIn, Snapchat, Pinterest, and Twitter are changing the industry structure by constantly morphing their capabilities and forcing old-line media companies such as News Corp., Time Warner, and Disney to adapt. Amazon's Kindle, Apple's iPad, Google's Chromebook, and Samsung's Galaxy Tab provide a new form of content delivery that has the potential to make print media obsolete.

LO 3-6

Generate a strategic group model to reveal performance differences between clusters of firms in the same industry.

3.4 Performance Differences within the Same Industry: Strategic Groups

In further analyzing the firm's external environment to explain performance differences, we now move to firms *within the same industry*. As noted earlier in the chapter, a firm occupies a place within a **strategic group**, a set of companies that pursue a similar strategy within a specific industry in their quest for competitive advantage (see Exhibit 3.1).[37] Strategic groups differ from one another along important dimensions such as expenditures on research and development, technology, product differentiation, product and service offerings, pricing, market segments, distribution channels, and customer service.

strategic group The set of companies that pursue a similar strategy within a specific industry.

strategic group model A framework that explains differences in firm performance within the same industry.

To explain differences in firm performance within the same industry, the **strategic group model** clusters different firms into groups based on a few key strategic dimensions.[38] Even within the same industry, firm performances differ depending on strategic group membership. Some strategic groups tend to be more profitable than others. This difference implies that firm performance is determined not only by the industry to which the firm belongs, but also by its strategic group membership.

The distinct differences across strategic groups reflect the business strategies that firms pursue. Firms in the same strategic group tend to follow a similar strategy. Companies in the same strategic group, therefore, are direct competitors. The rivalry among firms

within the same strategic group is generally more intense than the rivalry *among* strategic groups: *intra-group rivalry exceeds inter-group rivalry*. The number of different business strategies pursued within an industry determines the number of strategic groups in that industry. In most industries, strategic groups can be identified along a fairly small number of dimensions. In many instances, two strategic groups are in an industry based on two different business strategies: one that pursues a low-cost strategy and a second that pursues a differentiation strategy (see Exhibit 3.5). We'll discuss each of these generic business strategies in detail in Chapter 6.

THE STRATEGIC GROUP MODEL

To understand competitive behavior and performance within an industry, we can map the industry competitors into strategic groups. We do this as shown:

- Identify the most important strategic dimensions such as expenditures on research and development, technology, product differentiation, product and service offerings, pricing, market segments, distribution channels, and customer service.
- Choose two key dimensions for the horizontal and vertical axes, which expose important differences among the competitors. The dimensions chosen for the axes should *not* be highly correlated.
- Graph the firms in the strategic group, indicating each firm's market share by the size of the bubble with which it is represented.[39]

The U.S. domestic airline industry (featured in Strategy Highlight 3.2) provides an illustrative example. Exhibit 3.5 maps companies active in this industry. The two strategic dimensions on the axes are prices and routes. As a result of this mapping, two strategic groups become apparent, as indicated by the dashed circles: Group A, low-cost, point-to-point airlines (Virgin Atlantic, Alaska Airlines, JetBlue, and Southwest Airlines) and Group B, differentiated airlines using a hub-and-spoke system (American, Delta, and United). The low-cost, point-to-point airlines are clustered in the lower-left corner because they tend to offer lower ticket prices but generally serve fewer routes due to their point-to-point operating system.

The differentiated airlines in Group B, offering full services using a hub-and-spoke route system, comprise the so-called legacy carriers. They are clustered in the upper-right corner because their frequently higher ticket prices reflect frequently higher cost structures. They usually offer many more routes than the point-to-point low-cost carriers, made possible by use of the hub-and-spoke system, and thus offer many different destinations. For example, Delta's main hub is in Atlanta, Georgia.[40] If you were to fly from Seattle, Washington, to Miami, Florida, you would stop to change planes in Delta's Atlanta hub on your way.

The strategic group mapping in Exhibit 3.5 provides some additional insights:

- **Competitive rivalry is strongest between firms that are within the same strategic group.** The closer firms are on the strategic group map, the more directly and intensely they are in competition with one another. After a wave of mergers, the remaining mega-airlines—American, Delta, and United—are competing head-to-head, not only in the U.S. domestic market but also globally. They tend to monitor one another's strategic actions closely. While Delta faces secondary competition from low-cost carriers such as Southwest Airlines (SWA) on some domestic routes, its primary competitive rivals remain the other legacy carriers. This is because they compete more on providing seamless global services within their respective airline alliances (SkyTeam for Delta, Oneworld for American, and Star Alliance for United) than on low-cost airfares for

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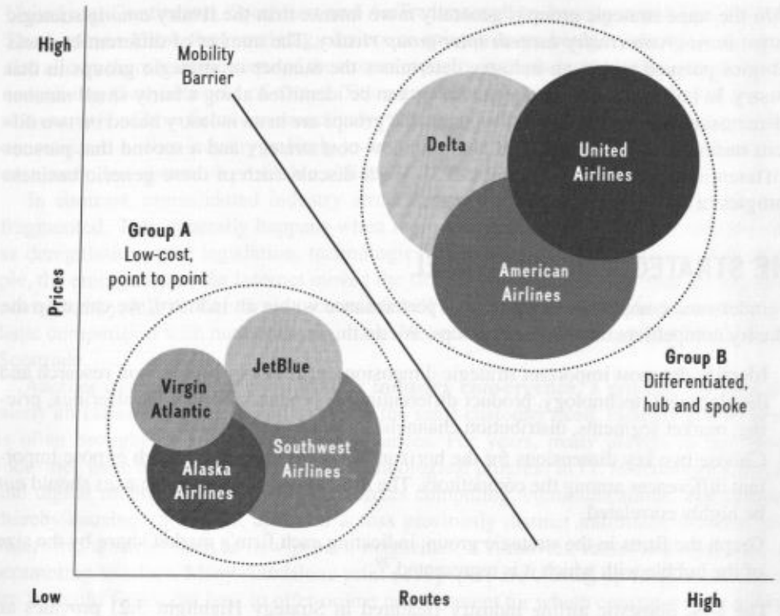
EXHIBIT 3.5

Strategic Groups and the Mobility Barrier in the U.S. Domestic Airline Industry



particular city pairs in the United States. Nonetheless, when Delta is faced with direct competition from SWA on a particular domestic route (say from Atlanta to Chicago), both tend to offer similar low-cost fares.

- **The external environment affects strategic groups differently.** During times of economic downturn, for example, the low-cost airlines tend to take market share away from the legacy carriers. Moreover, given their generally higher cost structure, the legacy carriers are often unable to stay profitable during recessions, at least on domestic routes. This implies that external factors such as recessions or high oil prices favor the companies in the low-cost strategic group. On the other hand, given a number of governmental restrictions on international air travel, the few airlines that are able to compete globally usually make a tidy profit in this specific industry segment.
- **The five competitive forces affect strategic groups differently.** *Barriers to entry,* for example, are higher in the hub-and-spoke (differentiated) airline group than in the point-to-point (low-cost) airline group. Following deregulation, many airlines entered the industry, but all of these new players used the point-to-point system. Since hub-and-spoke airlines can offer worldwide service and are protected from foreign competition by regulation to some extent, they often face weaker *buyer power,* especially from business travelers. While the hub-and-spoke airlines compete head-on with the point-to-point airlines when they are flying the same or similar routes, the *threat of substitutes* is stronger for the point-to-point airlines. This is because they tend to be regionally focused and compete with the viable substitutes of car, train, or bus travel. The threat of *supplier power* tends to be stronger for the airlines in the point-to-point, low-cost strategic group because they are much smaller and thus have weaker negotiation power when acquiring new aircraft, for example. To get around this, these airlines frequently purchase used aircraft from

legacy carriers. This brief application of the five forces model leads us to conclude that rivalry among existing competitors in the low-cost, point-to-point strategic group is likely to be more intense than within the differentiated, hub-and-spoke strategic group.

- **Some strategic groups are more profitable than others.** Historically, airlines clustered in the lower-left corner tend to be more profitable when considering the U.S. domestic market only. Why? Because they create similar, or even higher, value for their customers in terms of on-time departure and arrival, safety, and fewer bags lost, while keeping ticket costs below those of the legacy carriers. The point-to-point airlines have generally lower costs than the legacy carriers because they are faster in turning their airplanes around, keep them flying longer, use fewer and older airplane models, focus on high-yield city pairs, and tie pay to company performance, among many other activities that all support their low-cost business model. The point-to-point airlines, therefore, are able to offer their services at a lower cost and a higher perceived value, thus creating the basis for a competitive advantage.

MOBILITY BARRIERS

Although some strategic groups tend to be more profitable and therefore more attractive than others, **mobility barriers** restrict movement between groups. These are industry-specific factors that separate one strategic group from another.[41]

mobility barriers Industry-specific factors that separate one strategic group from another.

The two groups identified in Exhibit 3.5 are separated by the fact that offering international routes necessitates the hub-and-spoke model. Frequently, the international routes tend to be the remaining profitable routes left for the legacy carriers; albeit the up-and-coming Persian Gulf region carriers, in particular Emirates, Etihad Airways, and Qatar Airways, are beginning to threaten this profit sanctuary.[42]

This economic reality implies that if carriers in the lower-left cluster, such as SWA or JetBlue, would like to compete globally, they would likely need to change their point-to-point operating model to a hub-and-spoke model. Or, they could select a few profitable international routes and service them with long-range aircrafts such as Boeing 787s or Airbus A-380s. Adding international service to the low-cost model, however, would require significant capital investments and a likely departure from a well-functioning business model. Additional regulatory hurdles reinforce these mobility barriers, such as the difficulty of securing landing slots at international airports around the world.

Despite using its point-to-point operating system, SWA experienced these and many other challenges when it began offering international flights to selected resort destinations such as Aruba, Cabo San Lucas, Cancun, the Bahamas, and Jamaica: changes to its reservation system, securing passports for crew members, cultural-awareness training, learning instructions in foreign languages, and performing drills in swimming pools on how to evacuate passengers onto life rafts.[43]

3.5 ◂▸ Implications for the Strategist

At the start of the strategic management process, it is critical for managers to conduct a thorough analysis of the firm's external environment to identify threats and opportunities. The initial step is to apply a PESTEL analysis to scan, monitor, and evaluate changes and trends in the firm's macroenvironment. This versatile framework allows managers to track important trends and developments based on the *source* of the external factors: political, economic, sociocultural, technological, ecological, and legal. When applying a PESTEL analysis, the guiding consideration for managers should be the question of how the external factors identified affect the firm's industry environment.

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Exhibit 3.1 delineates external factors based on the *proximity* of these external factors by gradually moving from the general to the task environment. The next layer for managers to understand is the industry. Applying Porter's five forces model allows managers to understand the profit potential of an industry and to obtain clues on how to carve out a strategic position that makes gaining and sustaining a competitive advantage more likely. Follow these steps to apply the five forces model:[44]

1. **Define the relevant industry.** In the five forces model, industry boundaries are drawn by identifying a group of incumbent companies that face more or less the same suppliers and buyers. This group of competitors is likely to be an industry if it also has the same entry barriers and a similar threat from substitutes. In this model, therefore, an industry is defined by commonality and overlap in the five competitive forces that shape competition.
2. **Identify the key players in each of the five forces and attempt to group them into different categories.** This step aids in assessing the relative strength of each force. For example, while makers of jet engines (GE, Rolls-Royce, Pratt & Whitney) and local catering services are all suppliers to airlines, their strengths vary widely. Segmenting different players within each force allows you to assess each force at a fine-grained level.
3. **Identify the underlying drivers of each force.** Which forces are strong, and which are weak? And why? Keeping with the airline example, why is the supplier power of jet engine manufacturers strong? Because they are supplying a mission-critical, highly differentiated product for airlines. Moreover, there are only a few suppliers of jet engines worldwide and no viable substitutes.
4. **Assess the overall industry structure.** What is the industry's profit potential? Here you need to identify forces that directly influence industry profit potential, because not all forces are likely to have an equal effect. Focus on the most important forces that drive industry profitability.

The final step in industry analysis is to draw a strategic group map. This exercise allows you to unearth and explain *performance differences within the same industry.* When analyzing a firm's external environment, it is critical to apply the three frameworks introduced in this chapter (PESTEL, Porter's five forces, and strategic group mapping). Taken together, the external environment can determine up to roughly one-half of the performance differences across firms (see Exhibit 1.1).

Although the different models discussed in this chapter are an important step in the strategic management process, they are not without shortcomings. First, all of the models presented are *static.* They provide a snapshot of what is actually a moving target and do not allow for consideration of industry dynamics. However, changes in the external environment can appear suddenly, for example, through black swan events. Industries can be revolutionized by innovation. Strategic groups can be made obsolete through deregulation or technological progress. To overcome this important shortcoming, managers must conduct external analyses at different points in time to gain a sense of the underlying *dynamics.* The frequency with which these tools need to be applied is a function of the rate of change in the industry. The mobile app industry is changing extremely fast, while the railroad industry experiences a less volatile environment.

Second, the models presented in this chapter do not allow managers to fully understand *why* there are performance differences among firms in the *same* industry or strategic group. To better understand differences in firm performance, we must look *inside the firm* to study its resources, capabilities, and core competencies. We do this in the next chapter by moving from external to internal analysis.

CHAPTERCASE 3 / Consider This...

ALTHOUGH TESLA MOTORS has successfully entered the U.S. automotive market using innovative new technology, its continued success will depend on other firm and industry factors. While industry forces have been favorable for a long time in the U.S. automotive industry, recent dynamics have lowered the profit potential of competing in this industry and thus reduced its attractiveness. Now that Tesla Motors has demonstrated how new technology can be used to circumvent entry barriers, other new ventures may soon follow. There are also nontraditional competitors entering the electric vehicle market. Google, for example, has been working on a self-driving car, unveiling a prototype in 2015. Apple is also investing in an electric car under the code name "Titan." None of these has the performance of a Tesla, but both are firms with established brands and credibility and significant financial resources. In addition, the old-line car companies are also adopting the new technology by introducing hybrid or all-electric cars, further increasing rivalry in the industry. The Nissan Leaf, with a sticker price of about $30,000 before tax incentives, is the world's best-selling all-electric vehicle worldwide, with more than 200,000 vehicles sold.

One of the biggest PESTEL factors impacting the all-electric car market, however, is that the price for crude oil declined steeply from over $110 per barrel in the summer of 2014 to about $40 by spring 2015. With it, prices for a gallon of regular gas in the United States fell from over $4 in the summer of 2008 to less than $2 by 2015. With low gas prices, Americans prefer to buy large SUVs and trucks, which benefits GM, Ford, and Chrysler. In addition, several states are reducing or phasing out tax credits for alternative-fuel vehicles.

Another external industry force that Tesla Motors currently addresses is the bargaining power of suppliers. Lithium-ion battery packs are not only in short supply but also the single most-expensive component for Tesla's electric engines. These critical inputs are supplied by only a few technology firms, including Panasonic in Japan. Given that these sources are few, the bargaining power of suppliers in the electric car segment is quite high, further limiting the industry's profit potential. To mitigate the strong bargaining power of key suppliers, however, Tesla has committed to building a 980-acre facility near Reno, Nevada, to produce its own lithium-ion batteries to supply its automobile assembly plant in Fremont, California. The new battery plant is slated to begin production in 2017 and requires a $5 billion investment to place the plant near sources of lithium and power it with renewable energy. Questions remain whether lithium-ion batteries will be able to provide the needed performance for battery life and recharging time, or whether a new technology will emerge, making this a large gamble.

Tesla Motors completed its IPO on June 29, 2010, the first IPO by an American automaker since Ford in 1956. On the first day of trading, Tesla's shares closed at $23.89 and generated $226.1 million for the company. By fall 2014, Tesla's stock had risen to over $285 per share before starting to slide below $200 in spring 2015. Nonetheless, Tesla's market capitalization is almost one-half that of GM, although Tesla revenues were a little over $3 billion in 2014, while GM's were $155 billion.[45]

Questions

1. Which PESTEL factors are the most salient for the electric vehicle segment of the car industry? Do you see a future for electric vehicles in the United States? Why or why not?
2. Looking at Porter's five forces of competition, how would you assess the profit potential of the U.S. car industry?
3. Using the five forces model, what implications can we derive for how Tesla Motors should compete in the U.S. car industry? What would be your top three recommendations for Elon Musk? Support your arguments.
4. Draw a strategic group map for the U.S. automotive industry. What are your conclusions?
5. Why do you think that Tesla's market capitalization (Share price × Number of outstanding shares) is roughly 50 percent that of GM, while GM's revenues are more than 50 times larger than that of Tesla Motors?

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TAKE-AWAY CONCEPTS

This chapter demonstrated various approaches to analyzing the firm's *external environment,* as summarized by the following learning objectives and related take-away concepts.

LO 3-1 / Generate a PESTEL analysis to evaluate the impact of external forces on the firm.

- A firm's macroenvironment consists of a wide range of political, economic, sociocultural, technological, ecological, and legal (PESTEL) factors that can affect industry and firm performance. These external factors have both domestic and global aspects.
- Political factors describe the influence government bodies can have on firms.
- Economic factors to be considered are growth rates, interest rates, levels of employment, price stability (inflation and deflation), and currency exchange rates.
- Sociocultural factors capture a society's cultures, norms, and values.
- Technological factors capture the application of knowledge to create new processes and products.
- Ecological factors concern a firm's regard for environmental issues such as the natural environment, global warming, and sustainable economic growth.
- Legal factors capture the official outcomes of the political processes that manifest themselves in laws, mandates, regulations, and court decisions.

LO 3-2 / Apply Porter's five competitive forces to explain the profit potential of different industries.

- Competition must be viewed more broadly to encompass not only direct rivals but also a set of other forces in an industry: buyers, suppliers, the potential new entry of other firms, and the threat of substitutes.
- The profit potential of an industry is a function of the five forces that shape competition: (1) threat of entry, (2) power of suppliers, (3) power of buyers, (4) threat of substitutes, and (5) rivalry among existing competitors.
- The stronger a competitive force, the greater the threat it represents. The weaker the competitive force, the greater the opportunity it presents.
- A firm can shape an industry's structure in its favor through its strategy.

LO 3-3 / Explain how competitive industry structure shapes rivalry among competitors.

- The competitive structure of an industry is largely captured by the number and size of competitors in an industry, whether the firms possess some degree of pricing power, the type of product or service the industry offers (commodity or differentiated product), and the height of entry barriers.
- A perfectly competitive industry is characterized by many small firms, a commodity product, low entry barriers, and no pricing power for individual firms.
- A monopolistic industry is characterized by many firms, a differentiated product, medium entry barriers, and some pricing power.
- An oligopolistic industry is characterized by few (large) firms, a differentiated product, high entry barriers, and some degree of pricing power.
- A monopoly exists when there is only one (large) firm supplying the market. In such instances, the firm may offer a unique product, the barriers to entry may be high, and the monopolist usually has considerable pricing power.

LO 3-4 / Describe the strategic role of complements in creating positive-sum co-opetition.

- Co-opetition (co-operation among competitors) can create a positive-sum game, resulting in a larger pie for everyone involved.
- Complements increase demand for the primary product, enhancing the profit potential for the industry and the firm.
- Attractive industries for co-opetition are characterized by high entry barriers, low exit barriers, low buyer and supplier power, a low threat of substitutes, and the availability of complements.

LO 3-5 / Appraise the role of industry dynamics and industry convergence in shaping the firm's external environment.

- Industries are dynamic—they change over time.
- Different conditions prevail in different industries, directly affecting the firms competing in these industries and their profitability.
- In industry convergence, formerly unrelated industries begin to satisfy the same customer need. Such convergence is often brought on by technological advances.

LO 3-6 / Generate a strategic group model to reveal performance differences between clusters of firms in the same industry.

- A strategic group is a set of firms within a specific industry that pursue a similar strategy in their quest for competitive advantage.
- Generally, there are two strategic groups in an industry based on two different business strategies: one that pursues a low-cost strategy and a second that pursues a differentiation strategy.
- Rivalry among firms of the same strategic group is more intense than the rivalry between strategic groups: intra-group rivalry exceeds inter-group rivalry.
- Strategic groups are affected differently by the external environment and the five competitive forces.
- Some strategic groups are more profitable than others.
- Movement between strategic groups is restricted by mobility barriers—industry-specific factors that separate one strategic group from another.

KEY TERMS

Competitive industry structure *(p. 83)*
Complement *(p. 89)*
Complementor *(p. 89)*
Co-opetition *(p. 89)*
Entry barriers *(p. 76)*
Exit barriers *(p. 87)*
Five forces model *(p. 73)*
Industry *(p. 72)*
Industry analysis *(p. 73)*
Industry convergence *(p. 90)*
Mobility barriers *(p. 93)*
Network effects *(p. 76)*
PESTEL model *(p. 67)*
Strategic group *(p. 90)*
Strategic group model *(p. 90)*
Strategic position *(p. 73)*
Threat of entry *(p. 75)*

DISCUSSION QUESTIONS

1. Why is it important for any organization (firms, nonprofits, etc.) to study and understand its external environment?
2. How do the five competitive forces in Porter's model affect the average profitability of the industry? For example, in what way might weak forces increase industry profits, and in what way do strong forces reduce industry profits? Identify an industry in which many of the competitors seem to be having financial performance problems. Which of the five forces seems to be strongest?
3. What is a strategic group? How can studying such groups be useful in industry analysis?
4. How do mobility barriers affect the structure of an industry? How do they help us explain firm differences in performance?

ETHICAL/SOCIAL ISSUES

1. UBS, a venerable Swiss banking institution with global business activities, experienced the significant implications that political factors can have on the bottom line. The U.S. government alleged that by advertising its "tax savings" advantages to U.S. clients, UBS aided wealthy Americans in siphoning off billions of dollars to a safe haven that the IRS cannot touch. The government requested from UBS the names of 52,000 U.S. citizens who it suspected were tax evaders. Initially, UBS declined to release names, citing Swiss banking laws and regulations that

Chapter 4

Internal Analysis: Resources, Capabilities, and Core Competencies

Chapter Outline

4.1 Core Competencies

4.2 The Resource-Based View
Two Critical Assumptions
The VRIO Framework
Isolating Mechanisms: How to Sustain a Competitive Advantage

4.3 The Dynamic Capabilities Perspective

4.4 The Value Chain Analysis

4.5 Implications for the Strategist
Using SWOT Analysis to Generate Insights from External and Internal Analysis

Learning Objectives

LO 4-1 Differentiate among a firm's core competencies, resources, capabilities, and activities.

LO 4-2 Compare and contrast tangible and intangible resources.

LO 4-3 Evaluate the two critical assumptions behind the resource-based view.

LO 4-4 Apply the VRIO framework to assess the competitive implications of a firm's resources.

LO 4-5 Evaluate different conditions that allow a firm to sustain a competitive advantage.

LO 4-6 Outline how dynamic capabilities can enable a firm to sustain a competitive advantage.

LO 4-7 Apply a value chain analysis to understand which of the firm's activities in the process of transforming inputs into outputs generate differentiation and which drive costs.

LO 4-8 Conduct a SWOT analysis to generate insights from external and internal analysis and derive strategic implications.

CHAPTERCASE 4

Dr. Dre's Core Competency: Coolness Factor

IN 2014, DR. DRE—whose real name is Andre Young—became the first hip-hop billionaire after Apple acquired Beats Electronics for $3 billion. Dr. Dre has a long track record as a successful music producer, rapper, and entrepreneur. Known for his strong work ethic, he expects nothing less than perfection from the people he works with—similar to some of the personality attributes ascribed to the late Steve Jobs, co-founder and long-time CEO of Apple.

Dr. Dre, right, and Jimmy Iovine, center, cofounders of Beats Electronics, with Luke Wood, president, on left.
© Kevin Mazur/Getty Images

Although Dr. Dre created and subsequently sold several successful music record labels, as an entrepreneur he is best known as co-founder of Beats Electronics with Jimmy Iovine, also an entrepreneur and record and film producer. Both are considered to be some of the best-connected businesspeople in the music industry, with personal networks spanning hundreds of both famous and up-and-coming artists. Founded in 2008, Beats Electronics is known globally for its premium consumer headphones, Beats by Dr. Dre, which he claims allows the listeners to "hear all the music." Since early 2014, the company also offers the streaming music subscription service Beats Music. Beats' vision is to "bring the energy, emotion, and excitement of playback in the recording studio to the listening experience and introduce an entirely new generation to the possibilities of premium sound entertainment."[1] Many acoustics experts maintain, however, that playback of digitally compressed MP3 audio files is inferior in comparison to high fidelity. Moreover, the sound quality of Beats headphones is considered poor in comparison to other premium-brand headphones such as those by Bose, JBL, Sennheiser, and others.

Why then would Apple pay $3 billion to acquire Beats Electronics? This was by far the largest acquisition in Apple's history. Two main reasons: First, Apple is hoping that some of Beats' coolness will spill over to its brand, which has become somewhat stale. Apple's iPhones, for example, have become a standardized commodity given the successful imitation by Samsung, Xiaomi, and others. Second, although Apple is the world's largest music vendor with 800 million accounts on iTunes Store, the industry is being disrupted. Content delivery, especially in music but also video (think Netflix), is moving rapidly from ownership via downloads to streaming on demand. As a consequence, music downloads have been declining in the past few years.

BEATS COOLNESS FACTOR

Beats by Dr. Dre achieved an unprecedented coolness factor with celebrity endorsements not only from music icons but also athletes, actors, and other stars. Prior to Beats, no musician endorsed audio headphones in the same way as a basketball player such as Michael Jordan endorsed his line of Nike shoes, Air Jordan. Dr. Dre was the first legendary music producer to endorse premium headphones. In addition, he created custom Beats for stars such as Justin Bieber, Lady Gaga, and Nicki Minaj. Other music celebrities including Skrillex, Lil Wayne, and will.i.am endorsed Beats by wearing them in their music videos and at live events and mentioning them on social media. But Beats did not stop at musicians. Famous athletes—basketball superstars LeBron James and Kobe Bryant, tennis player Serena Williams, and soccer stars Cristiano Ronaldo and Neymar Jr.—are all wearing Beats by Dr. Dre in public and endorse the brand in advertisements.

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DISRUPTION IN CONTENT DELIVERY

Content delivery is rapidly moving from ownership through downloads to renting via online streaming. This disruption in the business model is most visible in movies as the success of Netflix demonstrates, but is also gaining steam in music. Apple is a laggard in music streaming when compared to leaders such as Pandora with 250 million users and Spotify with 60 million users. Apple's attempt at online music streaming service, iTunes Radio created in 2013, has been falling flat. After disrupting the music download space with iTunes in 2003, Apple is now being disrupted by others that lead in music streaming. It is hoping that by acquiring Beats Music it can become a leader in the music streaming space.[2]

You will learn more about Beats Electronics by reading this chapter; related questions appear on page 132.

ONE OF THE KEY messages of this chapter is that a firm's ability to gain and sustain competitive advantage is partly driven by *core competencies*—unique strengths that are embedded deep within a firm. 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. So what are core competencies of Beats by Dr. Dre? Beats succeeds not because it provides the best possible acoustic experience, but because it functions as a fashion statement that communicates coolness.[3] The iconic headphones are worn by celebrities from music, movies, and sports. Even fashion designer Marc Jacobs had models wear Beats headphones during runway shows. The extent to which Beats succeeds at product placements with celebrities across the world is unprecedented. The genius behind Beats is creating a perception that if you want to be as cool as one of your heroes, you need to shell out hundreds of dollars to wear plastic headphones in public.

Beats' unique strengths in establishing a brand that communicates coolness is built upon Dr. Dre's intuition and feel for music and cultural trends; Dr. Dre is one of music's savviest marketing minds. Although the sound quality of Beats headphones is good enough, they mainly sell as a fashion accessory for their coolness factor and brand image. Dr. Dre relies on gut instinct in making decisions, while shunning market research. This approach is quite similar to Apple's late co-founder Steve Jobs who made no secret of his disdain for market research because he believed that consumers don't really know what they want until someone else shows it to them.

Beats' core competency in marketing allows the company to differentiate its products from rival offerings because it is able to create higher perceived value for its customers. In turn, Beats' core competency affords the firm a competitive advantage. It is hugely successful: Beats holds some 65 percent market share in the premium headphone market, priced at $100 and up. Beats' competitive advantage was rewarded with a $3 billion acquisition by Apple.

In this chapter, we study analytical tools to explain why differences in firm performance exist even within the *same* industry. For example, why does Beats Electronics outperform Audio-Technica, Bose, JBL, Skullcandy, Sennheiser, and Sony in the high-end, premium headphone market? Since these companies compete in the same industry and face similar external opportunities and threats, the source for some of the observable performance difference must be found *inside the firm.* When discussing industry, firm, and other effects in explaining superior performance, we noted that up to 55 percent of the overall performance differences is explained by firm-specific effects (see Exhibit 1.1). Looking inside the firm to analyze its resources, capabilities, and core competencies allows us to understand the firm's strengths and weaknesses. Linking these insights from a firm's internal analysis to the ones derived in Chapter 3 on external analysis allows managers to determine their

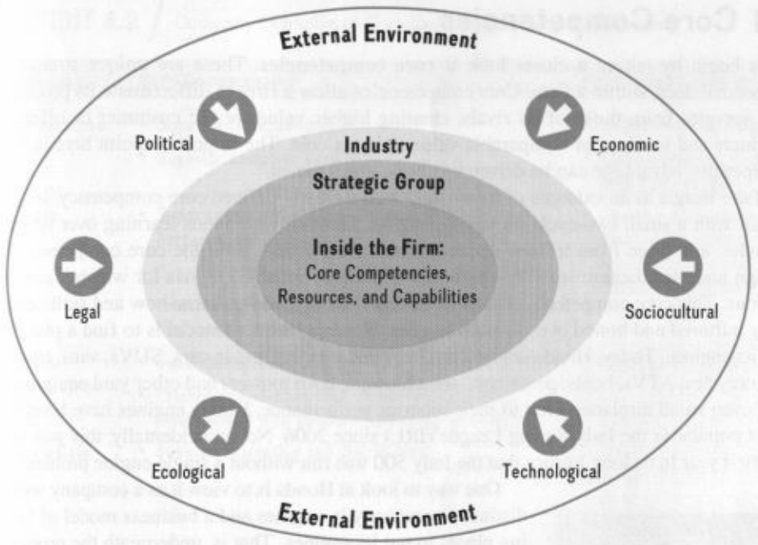

EXHIBIT 4.1 Inside the Firm: Competitive Advantage based on Core Competencies, Resources, and Capabilities

strategic options. Ideally, firms want to leverage their internal strengths to exploit external opportunities, and to mitigate internal weaknesses and external threats.

Exhibit 4.1 depicts how and why we move from the firm's external environment to its internal environment. To formulate and implement a strategy that enhances the firm's chances of gaining and sustaining competitive advantage, the firm must have certain types of resources and capabilities that combine to form core competencies. The best firms conscientiously identify their core competencies, resources, and capabilities to survive and succeed. Firms then determine how to manage and develop internal strengths to respond to the challenges and opportunities in their external environment. In particular, firms conduct the evaluation and development of internal strengths in the context of external PESTEL forces and competition within its industry and strategic group.

The firm's response is dynamic. Rather than creating a onetime and thus a static fit, the firm's internal strengths need to change with its external environment in a *dynamic* fashion. At each point the goal should be to develop resources, capabilities, and competencies that create a *strategic fit* with the firm's environment. The forward motion of those environmental forces must also be considered. The chapter will provide a deeper understanding of the *sources* of competitive advantage that reside within a firm.

To gain a better understanding of why and how firm differences explain competitive advantage, we begin this chapter by taking a closer look at *core competencies.* Next, we introduce the *resource-based view* of the firm to provide an analytical model that allows us to assess resources, capabilities, and competencies and their potential for creating a sustainable competitive advantage. We discuss the *dynamic capabilities perspective,* a model that emphasizes a firm's ability to modify and leverage its resource base to gain and sustain a competitive advantage in a constantly changing environment. We then turn our attention to the *value chain analysis* to gain a deeper understanding of the internal activities a firm engages in when transforming inputs into outputs. We conclude with "Implications for the Strategist," with a particular focus on how to use the *SWOT analysis* to obtain strategic insights from combining external and internal analysis.

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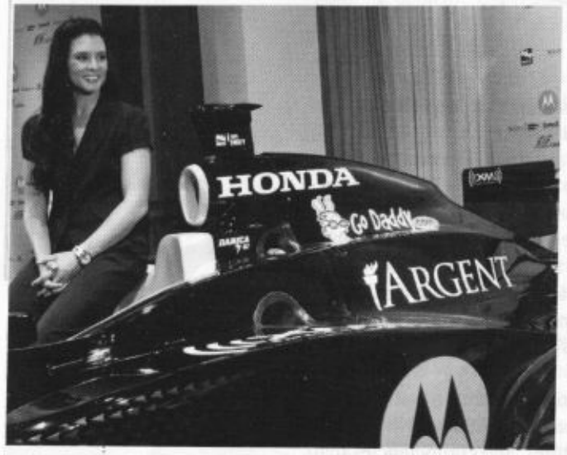
LO 4-1

Differentiate among a firm's resources, capabilities, core competencies, and activities.

4.1 Core Competencies

Let's begin by taking a closer look at **core competencies**. These are unique strengths, embedded deep within a firm. 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. The important point here is that competitive advantage can be driven by core competencies.[4]

Take Honda as an example of a company with a clearly defined core competency. Its life began with a small two-cycle motorbike engine. Through continuous learning over several decades, and often from lessons learned from failure, Honda built the core competency to design and manufacture small but powerful and highly reliable engines for which it now is famous. This core competency results from superior engineering know-how and skills carefully nurtured and honed over several decades. Honda's business model is to find a place to put its engines. Today, Honda engines can be found everywhere: in cars, SUVs, vans, trucks, motorcycles, ATVs, boats, generators, snowblowers, lawn mowers and other yard equipment, and even small airplanes. Due to their superior performance, Honda engines have been the most popular in the Indy Racing League (IRL) since 2006. Not coincidentally, this was also the first year in its long history that the Indy 500 was run without a single engine problem.



Honda promotes its expertise with engines by sponsoring racecar driver Danica Patrick.
© AP Photo/Julio Cortez

One way to look at Honda is to view it as a company with a distinct competency in engines and a business model of finding places to put its engines. That is, underneath the products and services that make up the *visible* side of competition lies a diverse set of *invisible* competencies that make this happen. These invisible core competencies reside deep within the firm. Companies, therefore, compete as much in the product and service markets as they do in developing and leveraging core competencies. Although invisible by themselves, core competencies find their expression in superior products and services. Exhibit 4.2 identifies the core competencies of a number of companies, with application examples.

Since core competencies are critical to gaining and sustaining competitive advantage, it is important to understand how they are created. Companies develop core competencies through the interplay of resources and capabilities. Exhibit 4.3 shows this relationship. **Resources** are any assets such as cash, buildings, machinery, or intellectual property that a firm can draw on when crafting and executing a strategy. Resources can be either tangible or intangible. **Capabilities** are the organizational and managerial skills necessary to orchestrate a diverse set of resources and to deploy them strategically. Capabilities are by nature intangible. They find their expression in a company's structure, routines, and culture.

As shown in Exhibit 4.3, such competencies are demonstrated in the company's activities, which can lead to competitive advantage, resulting in superior firm performance. **Activities** are distinct and fine-grained business processes such as order taking,

core competencies
Unique strengths, embedded deep within a firm, that are critical to gaining and sustaining competitive advantage.

resources
Any assets that a firm can draw on when formulating and implementing a strategy.

capabilities
Organizational and managerial skills necessary to orchestrate a diverse set of resources and deploy them strategically.

activities
Distinct and fine-grained business processes that enable firms to add incremental value by transforming inputs into goods and services.

EXHIBIT 4.2 / Company Examples of Core Competencies and Applications

Company	Core Competencies	Application Examples
Amazon.com	• Superior IT capabilities. • Superior customer service.	• Online retailing: Largest selection of items online. • Cloud computing: Largest provider through Amazon Web Services (AWS).
Apple	• Superior industrial design in integration of hardware and software. • Superior marketing and retailing experience. • Establishing an ecosystem of products and services that reinforce one another in a virtuous fashion.	• Creation of innovative and category-defining mobile devices and software services that take the user's experience to a new level (e.g., iMac, iPod, iTunes, iPhone, iPad, Apple Pay, and Apple Watch.)
Beats Electronics	• Superior marketing: creating a perception of coolness. • Establishing an ecosystem, combining hardware (headphones) with software (streaming service).	• Beats by Dr. Dre and Beats Music.
Coca-Cola	• Superior marketing and distribution.	• Leveraging one of the world's most recognized brands (based on its original "secret formula") into a diverse lineup of soft drinks. • Global availability of products.
ExxonMobil	• Superior at discovering and exploring fossil-fuel–based energy sources globally.	• Focus on oil and gas (fossil fuels only, not renewables).
Facebook	• Superior IT capabilities to provide reliable social network services globally on a large scale. • Superior algorithms to offer targeted online ads.	• Connecting 1.5 billion social media users worldwide. • News feed, timeline, and graph search.
General Electric	• Superior expertise in industrial engineering, designing and implementing efficient management processes, and developing and training leaders.	• Providing products and services to solve tough engineering problems in energy, health care, and aerospace, among other sectors.
Google	• Superior in creating proprietary algorithms based on large amounts of data collected online.	• Software products and services for the Internet and mobile computing, including some mobile devices (Chromebook). • Online search, Android mobile operating system, Chrome OS, Chrome web browser, Google Play, AdWords, AdSense, Google docs, Gmail, etc.
Honda	• Superior engineering of small but powerful and highly reliable internal combustion engines.	• Motorcycles, cars, ATVs, sporting boats, snowmobiles, lawn mowers, small aircraft, etc.
IKEA	• Superior in designing modern functional home furnishings at low cost. • Superior retail experience.	• Fully furnished room setups, practical tools for all rooms, do-it-yourself.
McKinsey	• Superior in developing practice-relevant knowledge, insights, and frameworks in strategy.	• Management consulting; in particular, strategy consulting provided to company and government leaders.
Netflix	• Superior in creating proprietary algorithms-based individual customer preferences.	• DVD-by-mail rentals, streaming media (including proprietary) content, connection to game consoles.
Tesla Motors	• Superior engineering expertise in designing high-performance battery-powered motors and power trains.	• Tesla Model S, Tesla Model X, and Tesla Model 3.
Uber	• Superior mobile-app–based transportation and logistics expertise focused on cities, but on global scale.	• Uber, UberX, UberBlack, UberLUX, UberSUV, etc.

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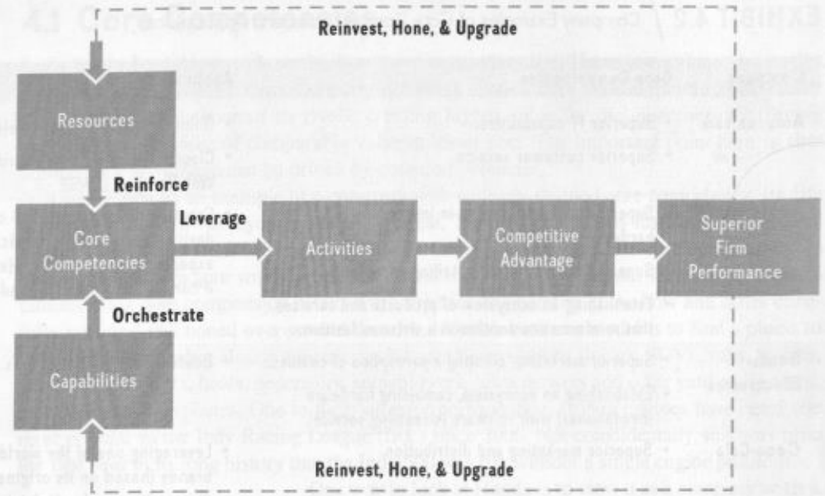
EXHIBIT 4.3 / Linking Core Competencies, Resources, Capabilities, and Activities to Competitive Advantage and Superior Firm Performance



the physical delivery of products, or invoicing customers. Each distinct activity enables firms to add incremental value by transforming inputs into goods and services. In the interplay of resources and capabilities, resources reinforce core competencies, while capabilities allow managers to orchestrate their core competencies. Strategic choices find their expression in a set of specific firm activities, which leverage core competencies for competitive advantage. The arrows leading back from performance to resources and capabilities indicate that superior performance in the marketplace generates profits that can be reinvested into the firm (retained earnings) to further hone and upgrade a firm's resources and capabilities in its pursuit of achieving and maintaining a strategic fit within a dynamic environment.

We should make two more observations about Exhibit 4.3 before moving on. First, core competencies that are not continuously nourished will eventually lose their ability to yield a competitive advantage. And second, in analyzing a company's success in the market, it can be too easy to focus on the more *visible* elements or facets of core competencies such as superior products or services. While these are the outward manifestation of core competencies, what is even more important is to understand the *invisible* part of core competencies. As to the first point, we consider the consumer electronics industry. For some years, Best Buy outperformed Circuit City based on its strengths in customer-centricity (segmenting customers based on demographic, attitudinal, and value tiers, and configuring stores to serve the needs of the customer segments in that region), employee development, and exclusive branding. Although Best Buy outperformed Circuit City (which filed for bankruptcy in 2009), more recently Best Buy did not hone and upgrade its core competencies sufficiently to compete effectively against Amazon.com, the world's largest online retailer. Amazon does not have the overhead expenses associated with maintaining buildings or human sales forces; therefore, it can undercut in-store retailers on price. When a firm does not invest in continual upgrading or improving core competencies, its competitors are more likely to develop equivalent or superior skills, as did Amazon. This insight will allow us to explain differences between firms in the same industry, as well as competitive dynamics, over time. It also will help us identify the strategy

with which firms gain and sustain a competitive advantage and weather an adverse external environment.

As to the second point, we will soon introduce tools to help bring more opaque aspects of a firm's core competencies into the daylight to be seen with clarity. We start by looking at both tangible and intangible resources.

4.2 The Resource-Based View

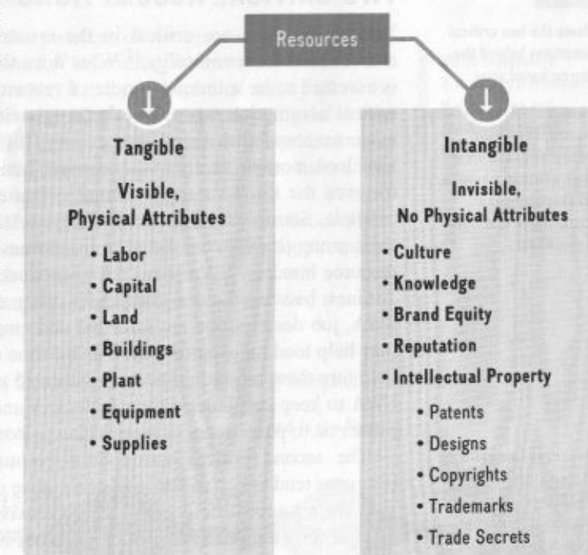
LO 4-2
Compare and contrast tangible and intangible resources.

To gain a deeper understanding of how the interplay between resources and capabilities creates core competencies that drive firm activities leading to competitive advantage, we turn to the **resource-based view** of the firm. This model systematically aids in identifying core competencies.[5] As the name suggests, this model sees resources as key to superior firm performance. As Exhibit 4.4 illustrates, resources fall broadly into two categories: tangible and intangible. **Tangible resources** have physical attributes and are visible. Examples of tangible resources are labor, capital, land, buildings, plant, equipment, and supplies. **Intangible resources** have no physical attributes and thus are invisible. Examples of intangible resources are a firm's culture, its knowledge, brand equity, reputation, and intellectual property.

Consider Google. Its tangible resources, valued at $16 billion, include its headquarters (The Googleplex)[6] in Mountain View, California, and numerous server farms (clusters of computer servers) across the globe.[7] The Google brand, an intangible resource, is valued at roughly $160 billion (number one worldwide)—10 times higher than the value of its tangible assets.[8]

Google's headquarters provides examples of both tangible and intangible resources. The Googleplex is a piece of land with a futuristic building, and thus a tangible resource. The *location* of the company in the heart of Silicon Valley is an *intangible resource* that provides access to a valuable network of contacts and gives the company several benefits. It allows Google to tap into a large and computer-savvy work force and access graduates and knowledge spillovers from a large number of universities, including San Francisco State University, San Jose State University, Santa Clara University, Stanford, and the University of California, Berkeley, among others, which

EXHIBIT 4.4 / Tangible and Intangible Resources



resource-based view
A model that sees certain types of resources as key to superior firm performance.

tangible resources
Resources that have physical attributes and thus are visible.

intangible resources
Resources that do not have physical attributes and thus are invisible.

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adds to Google's technical and managerial capabilities.[9] Another benefit stems from Silicon Valley's designation as having the largest concentration of venture capital in the United States. This proximity benefits Google because venture capitalists tend to prefer local investments to ensure closer monitoring.[10] Google received initial funding from the well-known venture capital firms Kleiner Perkins Caufield & Byers and Sequoia Capital, both located in Silicon Valley.

Competitive advantage is more likely to spring from intangible rather than tangible resources. Tangible assets, such as buildings or computer servers, can be bought on the open market by any comers who have the necessary cash. However, a brand name must be built, often over long periods of time. Google (founded in 1998) and Amazon .com (founded in 1994) accomplished their enormous brand valuation fairly quickly due to a ubiquitous Internet presence, while the other companies in the global top-10 most valuable brands—Apple, IBM, Microsoft, McDonald's, Coca-Cola, Visa, AT&T, and Marlboro—took much longer to build value and have it recognized in the marketplace.[11]

Note that the resource-based view of the firm uses the term *resource* much more broadly than previously defined. In the resource-based view of the firm, a resource includes any assets as well as any capabilities and competencies that a firm can draw upon when formulating and implementing strategy. In addition, the usefulness of the resource-based view to explain and predict competitive advantage rests upon two critical assumptions about the nature of resources, to which we turn next.

LO 4-3

Evaluate the two critical assumptions behind the resource-based view.

TWO CRITICAL ASSUMPTIONS

resource heterogeneity Assumption in the resource-based view that a firm is a bundle of resources and capabilities that differ across firms.

Two assumptions are critical in the resource-based model: (1) *resource heterogeneity* and (2) *resource immobility*.[12] What does this mean? In the resource-based view, a firm is assumed to be a unique bundle of resources, capabilities, and competencies. The first critical assumption—**resource heterogeneity**—comes from the insight that bundles of resources, capabilities, and competencies differ across firms. This insight ensures that analysts look more critically at the resource bundles of firms competing in the *same* industry (or even the same strategic group), because each bundle is unique to some extent. For example, Southwest Airlines (SWA) and Alaska Airlines both compete in the same strategic group (low-cost, point-to-point airlines, see Exhibit 3.5). But they draw on different resource bundles. SWA's employee productivity tends to be higher than that of Alaska Airlines, because the two companies differ along human and organizational resources. At SWA, job descriptions are informal and employees pitch in to "get the job done." Pilots may help load luggage to ensure an on-time departure; flight attendants clean airplanes to help turn them around at the gate within 15 minutes from arrival to departure. This allows SWA to keep its planes flying for longer and lowers its cost structure, savings that SWA passes on to passengers in lower ticket prices.

resource immobility Assumption in the resource-based view that a firm has resources that tend to be "sticky" and that do not move easily from firm to firm.

The second critical assumption—**resource immobility**—describes the insight that resources tend to be "sticky" and don't move easily from firm to firm. Because of that stickiness, the resource differences that exist between firms are difficult to replicate and, therefore, can last for a long time. For example, SWA has enjoyed a sustained competitive advantage, allowing it to outperform its competitors over several decades. That resource difference is not due to a lack of imitation attempts, though. Continental and Delta both attempted to copy SWA, with Continental Lite and Song airline offerings, respectively. Neither airline, however, was able to successfully imitate the resource bundles and firm capabilities that make SWA unique. Combined, these insights tell us that resource bundles differ across firms, and such differences can persist for long periods. These two assumptions about resources are critical to explaining superior firm performance in the resource-based model.

Note, by the way, that the critical assumptions of the resource-based model are fundamentally different from the way in which a firm is viewed in the perfectly competitive industry structure introduced in Chapter 3. In perfect competition, all firms have access to the *same* resources and capabilities, ensuring that any advantage that one firm has will be short-lived. That is, when resources are freely available and mobile, competitors can move quickly to acquire resources that are utilized by the current market leader. Although some commodity markets approach this situation, most other markets include firms whose resource endowments differ. The resource-based view, therefore, delivers useful insights to managers about how to formulate a strategy that will enhance the chances of gaining a competitive advantage.

THE VRIO FRAMEWORK

LO 4-4

Apply the VRIO framework to assess the competitive implications of a firm's resources.

Our tool for evaluating a firm's resource endowments is a framework that answers the question of what resource attributes underpin competitive advantage. This framework is implied in the resource-based model, identifying certain *types of resources* as key to superior firm performance.[13] For a resource to be the basis of a competitive advantage, it must be

Valuable

Rare

Icostly to **I**mitate.

And finally, the firm itself must be

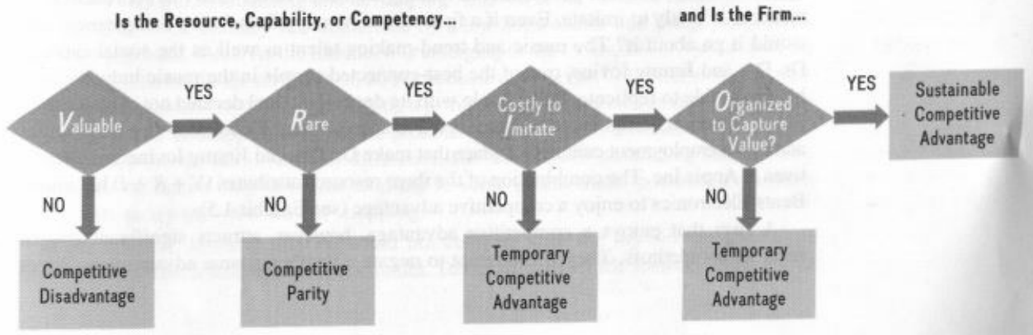
Organized to capture the value of the resource.

Following the lead of Jay Barney, one of the pioneers of the resource-based view of the firm, we call this model the **VRIO framework**.[14] According to this model, a firm can gain and sustain a competitive advantage only when it has resources that satisfy all of the VRIO criteria. Keep in mind that resources in the VRIO framework are broadly defined to include any assets *as well as* any capabilities and competencies that a firm can draw upon when formulating and implementing strategy. So to some degree, this presentation of the VRIO model summarizes all of our discussion in the chapter so far.

VRIO framework A theoretical framework that explains and predicts firm-level competitive advantage.

Exhibit 4.5 captures the VRIO framework. You can use this decision tree to decide if the resource, capability, or competency under consideration fulfills the VRIO requirements. As you study the following discussion of each of the VRIO attributes, you will see that the attributes accumulate. Only if a firm's managers are able to answer "yes" four times to

EXHIBIT 4.5 / Applying the Resource-Based View: A Decision Tree Revealing Competitive Implications



the attributes listed in the decision tree is the resource in question a core competency that underpins a firm's sustainable competitive advantage.

valuable resource
One of the four key criteria in the VRIO framework. A resource is valuable if it helps a firm exploit an external opportunity or offset an external threat.

VALUABLE. A **valuable resource** is one that enables the firm to exploit an external opportunity or offset an external threat. This has a positive effect on a firm's competitive advantage. In particular, a valuable resource enables a firm to increase its economic value creation ($V - C$). Revenues rise if a firm is able to increase the perceived value of its product or service in the eyes of consumers by offering superior design and adding attractive features (assuming costs are not increasing). Production costs, for example, fall if the firm is able to put an efficient manufacturing process and tight supply chain management in place (assuming perceived value is not decreasing). Beats Electronics' ability to design and market premium headphones that bestow a certain air of coolness upon wearers is a valuable resource. The profit margins for Beats designer headphones are astronomical: The production cost for its headphones is estimated to be no more than $15, while they retail for $150 to $450, with some special editions over $1,000. Thus, Beats' competency in designing and marketing premium headphones is a valuable resource in the VRIO framework.

rare resource
One of the four key criteria in the VRIO framework. A resource is rare if the number of firms that possess it is less than the number of firms it would require to reach a state of perfect competition.

RARE. A resource is **rare** if only one or a few firms possess it. If the resource is common, it will result in perfect competition where no firm is able to maintain a competitive advantage (see discussion in Chapter 3). A resource that is valuable but not rare can lead to competitive parity at best. A firm is on the path to competitive *advantage* only if it possesses a valuable resource that is also rare. Beats Electronics' ability and reach in product placement and celebrity endorsements that build its coolness factor are certainly rare. No other brand in the world, not even Apple or Nike, has such a large number of celebrities from music, movies, and sports using its product in public. Thus, this resource is not only valuable but also rare.

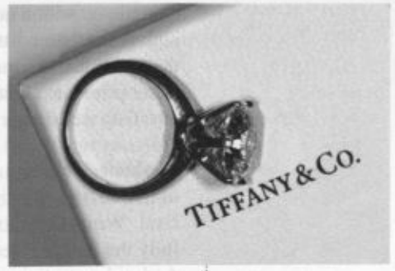
costly-to-imitate resource
One of the four key criteria in the VRIO framework. A resource is costly to imitate if firms that do not possess the resource are unable to develop or buy the resource at a comparable cost.

COSTLY TO IMITATE. A resource is **costly to imitate** if firms that do not possess the resource are unable to develop or buy the resource at a reasonable price. If the resource in question is valuable, rare, and costly to imitate, then it is an internal strength and a core competency. If the firm's competitors fail to duplicate the strategy based on the valuable, rare, and costly-to-imitate resource, then the firm can achieve a temporary competitive advantage.

Beats' core competency in establishing a brand that communicates coolness is built upon the intuition and feel for music and cultural trends of Dr. Dre, one of music's savviest marketing minds. Although the sound quality of Beats headphones is good enough, they mainly sell as a fashion accessory for their coolness factor and brand image. Because its creator Dr. Dre relies on gut instinct in making decisions rather than market research, this resource is costly to imitate. Even if a firm wanted to copy Beats' core competency—how would it go about it? The music and trend-making talent as well as the social capital of Dr. Dre and Jimmy Iovine, two of the best-connected people in the music industry, might be impossible to replicate. Even Apple with its deep talent pool decided not to build its own line of premium headphones but rather opted to acquire Beats Electronics' line for $3 billion, and to put employment contracts in place that make Dr. Dre and Jimmy Iovine senior executives at Apple Inc. The combination of the three resource attributes ($V + R + I$) has allowed Beats Electronics to enjoy a competitive advantage (see Exhibit 4.5).

A firm that enjoys a competitive advantage, however, attracts significant attention from its competitors. They will attempt to negate a firm's resource advantage by directly

imitating the resource in question *(direct imitation)* or through working around it to provide a comparable product or service *(substitution)*.



Tiffany & Co. has developed a core competency—elegant jewelry design and craftsmanship delivered through a superior customer experience—that is valuable, rare, and costly for competitors to imitate. The company vigorously protects its trademarks, including its Tiffany Blue Box, but it never trademarked the so-called "tiffany setting" for diamond rings, used now by many jewelers. The term has been co-opted for advertising by other retailers (including Costco), which now maintain it is a generic term commonly used in the jewelry industry.
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Direct Imitation. We usually see direct imitation, as a way to copy or imitate a valuable and rare resource, when firms have difficulty protecting their advantage. (We discuss barriers to imitation shortly.) Direct imitation is swift if the firm is successful and intellectual property (IP) protection such as patents or trademarks, for example, can be easily circumvented.

Crocs, the maker of the iconic plastic clog, fell victim to direct imitation. Launched in 2002 as a spa shoe at the Fort Lauderdale, Florida, boat show, Crocs experienced explosive growth, selling millions of pairs each year and reaching over $650 million in revenue in 2008. Crocs are worn by people in every age group and walk of life, including celebrities Sergey Brin, Matt Damon, Heidi Klum, Adam Sandler, and even Kate Middleton, the Duchess of Cambridge. To protect its unique shoe design, the firm owns several patents. Given Crocs' explosive growth, however, numerous cheap imitators have sprung up to copy the colorful and comfortable plastic clog. Despite the patents and celebrity endorsements, other firms were able to copy the shoe, taking a big bite into Crocs' profits. Indeed, Crocs' share price plunged from a high of almost $75 to less than $1 in less than 13 months.[15]

This example illustrates that competitive advantage cannot be sustained if the underlying capability can easily be replicated and can thus be *directly imitated*. Competitors simply created molds to imitate the shape, look, and feel of the original Crocs shoe. Any competitive advantage in a fashion-driven industry, moreover, is notoriously short-lived if the company fails to continuously innovate or build such brand recognition that imitators won't gain a foothold in the market. Crocs was more or less a "one-trick pony." Beats Electronics, on the other hand, created an ecosystem of hardware (Beats by Dr. Dre) and software (Beats Music) that positively reinforce one another. Beats by Dr. Dre are the installed base that drives demand for Beats Music. As Beats Music's music streaming and celebrity-curated playlists become more popular, demand for Beats headphones further increases. With increasing demand, Beats Music services also become more valuable as its proprietary algorithms have more data to work with. Continuous innovation by churning out new headphone designs combined with the unique coolness factor of Dr. Dre make direct imitation attempts more or less futile.

Substitution. The second avenue of imitation for a firm's valuable and rare resource is through *substitution*. This is often accomplished through *strategic equivalence*. Take the example of Jeff Bezos launching and developing Amazon.com.[16] Before Amazon's inception, the retail book industry was dominated by a few large chains and many independent mom-and-pop bookstores. As the Internet was emerging in the 1990s, Bezos was looking for options in online retail. He zeroed in on books because of their non-differentiated commodity nature and easiness to ship. In purchasing a printed book online, customers knew exactly what they would be shipped, because the products were identical, whether sold online or in a brick-and-mortar store. The only difference was the mode of transacting and delivery. Taking out the uncertainty of online retailing to some extent made potential customers more likely to try this new way of shopping.

Bezos realized, however, that he could not compete with the big-box book retailers directly and needed a different business model. The emergence of the Internet allowed him

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to come up with a new distribution system that negated the need for retail stores and thus high real-estate costs. Bezos' new business model of ecommerce not only substituted for the traditional fragmented supply chain in book retailing, but also allowed Amazon to offer lower prices due to its lower operating costs. Amazon uses a strategic equivalent substitute to satisfy a customer need previously met by brick-and-mortar retail stores.

Combining Imitation and Substitution. In some instances, firms are able to combine direct imitation and substitution when attempting to mitigate the competitive advantage of a rival. With its Galaxy line of smartphones, Samsung has been able to imitate successfully the look and feel of Apple's iPhones. Samsung's Galaxy smartphones use Google's Android operating system and apps from Google Play as an alternative to Apple's iOS and iTunes Store. Samsung achieved this through a combination of *direct imitation* (look and feel) and *substitution* (using Google's mobile operating system and app store).[17]

More recently, both Apple and Samsung are feeling the pressure from low-end disruptor Xiaomi, a Chinese smartphone company.[18] As a result of its explosive growth, Xiaomi is now the world's third-largest maker of smartphones. Xiaomi has been spectacularly successful in its Chinese home market where it is selling more smartphones than Apple or even Samsung.[19] Xiaomi also uses Google's Android system on its low-priced models that mimic the look and feel of both the Apple iPhone as well as the Samsung Galaxy line of phones.

ORGANIZED TO CAPTURE VALUE. The final criterion of whether a rare, valuable, and costly-to-imitate resource can form the basis of a sustainable competitive advantage depends on the firm's internal structure. To fully exploit the competitive potential of its resources, capabilities, and competencies, a firm must be **organized to capture value**—that is, it must have in place an effective organizational structure and coordinating systems. (We will study organizational design in detail in Chapter 11.) Before Apple or Microsoft had any significant share of the personal computer market, Xerox's Palo Alto Research Center (PARC) invented and developed an early word-processing application, the graphical user interface (GUI), the Ethernet, the mouse as a pointing device, and even the first personal computer. These technology breakthroughs laid the foundation of the desktop-computing industry.[20] Xerox's invention competency built through a unique combination of resources and capabilities was clearly valuable, rare, and costly to imitate with the potential to create a competitive advantage.

organized to capture value
One of the four key criteria in the VRIO framework. The characteristic of having in place an effective organizational structure, processes, and systems to fully exploit the competitive potential of the firm's resources, capabilities, and competencies.

Due to a lack of appropriate organization, however, Xerox failed to appreciate and exploit the many breakthroughs made by PARC in computing software and hardware. Why? Because the innovations did not fit within the Xerox business focus at the time. Under pressure in its core business from Japanese low-cost competitors, Xerox's top management was busy pursuing innovations in the photocopier business. Xerox was not organized to appreciate the competitive potential of the valuable, rare, and inimitable resources generated at PARC, if not in the photocopier field. Such organizational problems were exacerbated by geography: Xerox headquarters is on the East Coast in Norwalk, Connecticut, across the country from PARC on the West Coast in Palo Alto, California.[21] Nor did it help that development engineers at Xerox headquarters had a disdain for the scientists engaging in basic research at PARC. In the meantime, both Apple and Microsoft developed operating systems, graphical user interfaces, and application software.

If a firm is not effectively organized to exploit the competitive potential of a valuable, rare, and costly-to-imitate (VRI) resource, the best-case scenario is a temporary competitive

advantage (see Exhibit 4.5). In the case of Xerox, where management was not supportive of the resource, even a temporary competitive advantage would not be realized even though the resource meets the VRI requirements.

In summary, for a firm to gain and sustain a competitive advantage, its resources and capabilities need to interact in such a way as to create unique core competencies (see Exhibit 4.3). Ultimately, though, only a few competencies may turn out to be those *specific* core competencies that fulfill the VRIO requirements.[23] A company cannot do everything equally well and must carve out a unique strategic position for itself, making necessary trade-offs.[24] Strategy Highlight 4.1 demonstrates application of the VRIO framework.

Strategy Highlight 4.1

Applying VRIO: The Rise and Fall of Groupon

After graduating with a degree in music from Northwestern University, Andrew Mason spent a couple of years as a web designer. In 2008, the then 27-year-old founded Groupon, a daily-deal website that connects local retailers and other merchants to consumers by offering goods and services at a discount. Groupon creates marketplaces by bringing the brick-and-mortar world of local commerce onto the Internet. The company basically offers a "group-coupon." If more than a predetermined number of Groupon users sign up for the offer, the deal is extended to all Groupon users. For example, a local spa may offer a massage for $40 instead of the regular $80. If more than say 10 people sign up, the deal becomes reality. The users prepay $40 for the coupon, which Groupon splits 50-50 with the local merchant. Inspired by how Amazon.com has become the global leader in ecommerce, Mason's strategic vision for Groupon was *to be the global leader in local commerce.*

Measured by its explosive growth, Groupon became one of the most successful recent Internet startups, with over 260 million subscribers and serving over 500,000 merchants in the United States and some 50 countries. Indeed, Groupon's success attracted a $6 billion buyout offer by Google in early 2011, which Mason declined. In November 2011, Groupon held a successful initial public offering (IPO), valued at more than $16 billion with a share price of over $26. But a year later, Groupon's share price had fallen 90 percent to just $2.63, resulting in a market cap of less than $1.8 billion In early 2013, Mason posted a letter for Groupon employees on the web, arguing that it would leak anyway, stating, "After four and a half intense and wonderful years as CEO of Groupon, I've decided that I'd like to spend more time with my family. Just kidding—I was fired today."

Although Groupon is still in business, it is just one competitor among many, and not a market leader. What went wrong? The implosion of Groupon's market value can be explained using the VRIO framework. Its competency to drum up more business for local retailers by offering lower prices for its users was certainly *valuable*. Before Groupon, local merchants used online and classified ads, direct mail, yellow pages, and other venues to reach customers. Rather than using one-way communication, Groupon facilitates the meeting of supply and demand in local markets. When Groupon launched, such local market-making competency was also *rare*. Groupon, with its first-mover advantage, seemed able to use technology in a way so valuable and rare it prompted Google's buyout offer. But was it costly to imitate? Not so much.

The multibillion-dollar Google offer spurred potential competitors to reproduce Groupon's business model. They discovered that Groupon was more of a sales company than a tech venture, despite perceptions to the contrary. To target and fine-tune its local deals, Groupon relies heavily on human labor to do the selling. Barriers to entry in this type of business are nonexistent because Groupon's competency is built more on a tangible resource (labor) than on an intangible one (proprietary technology). Given that Groupon's valuable and rare competency was *not hard to imitate*, hundreds of new ventures (so-called Groupon clones) rushed in to take advantage of this opportunity. Existing online giants such as Google, Amazon (via LivingSocial), and Facebook also moved in. The spurned Google almost immediately created its own daily-deal version with Google Offers.

Also, note that the ability to imitate a rare and valuable resource is directly linked to barriers of entry, which is one of the key elements in Porter's five forces model *(threat of new entrants)*. This relationship allows linking internal analysis using the resource-based view to external analysis

(continued)

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with the five forces model, which also would have predicted low industry profit potential given low or no barriers to entry.

To make matters worse, these Groupon clones are often able to better serve the needs of local markets and specific population groups. Some daily-deal sites focus only on a specific geographic area. As an example, Conejo Deals meets the needs of customers and retailers in Southern California's Conejo Valley, a cluster of suburban communities. These hyper-local sites tend to have much deeper relationships and expertise with merchants in their specific areas. Since they are mostly matching local customers with local businesses, moreover, they tend to foster more repeat business than the one-off bargain hunters that use Groupon (based in Chicago). In addition, some daily-deal sites often target specific groups. They have greater expertise in matching their users with local retailers (e.g., Daily Pride serving LGBT communities; Black Biz Hookup serving African-American business owners and operators; Jdeal, a Jewish group-buying site in New York City; and so on).

"Finding your specific group" or "going hyper local" allows these startups to increase the perceived value added for their users over and above what Groupon can offer. Although Groupon aspires to be the *global leader*, there is really no advantage to global scale in serving local markets. This is because daily-deal sites are best suited to market *experience goods*, such as haircuts at a local barber shop or a meal in a specific Thai restaurant. The quality of these goods and services cannot be judged unless they are consumed. Creation of experience goods and their consumption happens in the *same geographic space*.

Once imitated, Groupon's competency to facilitate local commerce using an Internet platform was neither valuable nor rare. As an application of the VRIO model would have predicted, Groupon's competitive advantage as a first mover would only be temporary at best (see Exhibit 4.5).[22]

LO 4-5

Evaluate different conditions that allow a firm to sustain a competitive advantage.

ISOLATING MECHANISMS: HOW TO SUSTAIN A COMPETITIVE ADVANTAGE

Although VRIO resources can lay the foundation of a sustainable competitive advantage, no competitive advantage can be sustained indefinitely. Several conditions, however, can offer some protection to a successful firm by making it more difficult for competitors to imitate the resources, capabilities, or competencies that underlie its competitive advantage:[25]

- Better expectations of future resource value.
- Path dependence.
- Causal ambiguity.
- Social complexity.
- Intellectual property (IP) protection.

isolating mechanisms Barriers to imitation that prevent rivals from competing away the advantage a firm may enjoy.

These *barriers to imitation* are important examples of **isolating mechanisms** because they prevent rivals from competing away the advantage a firm may enjoy.[26] This link ties isolating mechanisms directly to one of the criteria in the resource-based view to assess the basis of competitive advantage: costly to imitate. If one, or any combination, of these isolating mechanisms is present, a firm may strengthen its basis for competitive advantage, increasing its chance to be sustainable over a longer period of time.

BETTER EXPECTATIONS OF FUTURE RESOURCE VALUE. Sometimes firms can acquire resources at a low cost, which lays the foundation for a competitive advantage later when expectations about the future of the resource turn out to be more accurate.

A real estate developer illustrates the role that the future value of a resource can play. She must decide when and where to buy land for future development. Her firm may gain a competitive advantage if she buys a parcel of land for a low cost in an

undeveloped rural area 40 miles north of San Antonio, Texas—in anticipation that it will increase in value with shifting demographics. Let's assume, several years later, that an interstate highway is built near her firm's land. With the highway, suburban growth explodes as many new neighborhoods and shopping malls are built. Her firm is now able to develop this particular piece of property to build high-end office or apartment buildings. The value creation far exceeds the cost, and her firm gains a competitive advantage. The resource has suddenly become valuable, rare, and costly to imitate, gaining the developer's firm a competitive advantage. Other developers could have bought the land, but once the highway was announced, the cost of the developer's land and that of adjacent land would have risen drastically, reflecting the new reality and thus negating any potential for competitive advantage. The developer had better expectations than her competitors of the future value of the resource, in this case the land she purchased. If this developer can repeat such "better expectations" over time, she will have a sustainable competitive advantage. If she cannot, she was simply lucky. Although luck can play a role in gaining an initial competitive advantage, it is not a basis for a sustainable competitive advantage.

path dependence A situation in which the options one faces in the current situation are limited by decisions made in the past.

PATH DEPENDENCE. **Path dependence** describes a process in which the options one faces in a current situation are limited by decisions made in the past.[27] Often, early events—sometimes even random ones—have a significant effect on final outcomes. The U.S. carpet industry provides an example of path dependence.[28] Roughly 85 percent of all carpets sold in the United States and almost one-half of all carpets sold worldwide come from carpet mills located within 65 miles of one city: Dalton, Georgia. While the U.S. manufacturing sector has suffered in recent decades, the carpet industry has flourished. Companies not clustered near Dalton face a disadvantage because they cannot readily access the required know-how, skilled labor, suppliers, low-cost infrastructure, and so on needed to be competitive.

But why Dalton? Two somewhat random events combined. First, the boom after World War II drew many manufacturers South to escape restrictions placed upon them in the North, such as higher taxation or the demands of unionized labor. Second, technological progress allowed industrial-scale production of tufted textiles to be used *as substitutes for the more expensive wool*. This innovation emerged in and near Dalton. Thus historical accident explains why today almost all U.S. carpet mills are located in a relatively small region, including world leaders Shaw Industries and Mohawk Industries.

Path dependence also rests on the notion that time cannot be compressed at will. While management can compress resources such as labor and R&D into a shorter period, the push will not be as effective as when a firm spreads out its effort and investments over a longer period. Trying to achieve the same outcome in less time, even with higher investments, tends to lead to inferior results, due to *time compression diseconomies*.[29]

Consider GM's problems in providing a competitive alternative to the highly successful Toyota Prius, a hybrid electric vehicle. Its problems highlight path dependence and time compression issues. The California Air Resource Board (CARB) in 1990 passed a mandate for introducing zero-emissions cars, which stipulated that 10 percent of new vehicles sold by carmakers in the state must have zero emissions by 2003. This mandate not only accelerated research in alternative energy sources for cars, but also led to the development of the first fully electric production car, GM's EV1. GM launched the car in California and Arizona in 1996. Competitive models followed, with the Toyota RAV EV and the Honda EV. In this case, regulations in the legal environment fostered innovation in the automobile industry (see discussion of PESTEL forces in Chapter 3).

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Companies not only feel the nudge of forces in their environment but can also push back. The California mandate on zero emissions, for example, did not stand.[30] Several stakeholders, including the car and oil companies, fought it through lawsuits and other actions. CARB ultimately gave in to the pressure and abandoned its zero-emissions mandate. When the mandate was revoked, GM recalled and destroyed its EV1 electric vehicles and terminated its electric-vehicle program. This decision turned out to be a strategic error that would haunt GM a decade or so later. Although GM was the leader among car companies in electric vehicles in the mid-1990s, it did not have a competitive model to counter the Toyota Prius when its sales took off in the early 2000s. The Chevy Volt (a plug-in hybrid), GM's first major competition to the Prius, was delayed by over a decade because GM had to start its electric-vehicle program basically from scratch. Not having an adequate product lineup during the early 2000s, GM's U.S. market share dropped below 20 percent in 2009 (from over 50 percent a few decades earlier), the year it filed for bankruptcy. GM subsequently reorganized under Chapter 11 of the U.S. bankruptcy code, and relisted on the New York Stock Exchange in 2010.

While GM sold about 40,000 Chevy Volts worldwide, Toyota sold over 3.5 million Prius cars. Moreover, Nissan introduced its all-electric Leaf in 2010; GM did not have an all-electric vehicle in its lineup. In the meantime, Nissan sold over 200,000 Leafs worldwide, while GM is hoping to introduce its first all-electric vehicle, the Chevy Bolt, in the 2017 model year. Once the train of new capability development has left the station, it is hard to jump back on because of path dependence. Moreover, firms cannot compress time at will; indeed, learning and improvements must take place over time, and existing competencies must constantly be nourished and upgraded.

Strategic decisions generate long-term consequences due to path dependence and time-compression diseconomies; they are not easily reversible. A competitor cannot imitate or create core competencies quickly, nor can one buy a reputation for quality or innovation on the open market. These types of valuable, rare, and costly-to-imitate resources, capabilities, and competencies must be built and organized effectively over time, often through a painstaking process that frequently includes learning from failure.

causal ambiguity
A situation in which the cause and effect of a phenomenon are not readily apparent.

CAUSAL AMBIGUITY. **Causal ambiguity** describes a situation in which the cause and effect of a phenomenon are not readily apparent. To formulate and implement a strategy that enhances a firm's chances of gaining and sustaining a competitive advantage, managers need to have a hypothesis or theory of how to compete. This implies that managers need to have some kind of understanding about what causes superior or inferior performance. Understanding the underlying reasons of observed phenomena is far from trivial, however. Everyone can see that Apple has had several hugely successful innovative products such as the iMac, iPod, iPhone, and iPad, combined with its hugely popular iTunes services. These successes stem from Apple's set of *V, R, I,* and *O* core competencies that supports its ability to continue to offer a variety of innovative products and to create an ecosystem of products and services.

A deep understanding, however, of exactly *why* Apple has been so successful is very difficult. Even Apple's managers may not be able to clearly pinpoint the sources of their success. Is it the visionary role that the late Steve Jobs played? Is it the rare skills of Apple's uniquely talented design team around Jonathan Ive? Is it the timing of the company's product introductions? Is it Apple CEO Tim Cook who adds superior organizational skills and puts all the pieces together when running the day-to-day operations? Or is it a combination of these factors? If the link between cause and effect is ambiguous for Apple's managers, it is that much more difficult for others seeking to copy a valuable resource, capability, or competency.

social complexity
A situation in which different social and business systems interact with one another.

SOCIAL COMPLEXITY. **Social complexity** describes situations in which different social and business systems interact. There is frequently no causal ambiguity as to how the *individual* systems such as supply chain management or new product development work in isolation. They are often managed through standardized business processes such as Six Sigma or ISO 9000. Social complexity, however, emerges when two or more such systems are *combined.* Copying the emerging complex social systems is difficult for competitors because neither direct imitation nor substitution is a valid approach. The interactions between different systems create too many possible permutations for a system to be understood with any accuracy. The resulting social complexity makes copying these systems difficult, if not impossible, resulting in a valuable, rare, and costly-to-imitate resource that the firm is organized to exploit.

Look at it this way. A group of three people has three relationships, connecting every person directly with one another. Adding a fourth person to this group *doubles* the number of direct relationships to six. Introducing a fifth person increases the number of relationships to 10.[31] This gives you some idea of how complexity might increase when we combine different systems with many different parts.

In reality, firms may manage thousands of employees from all walks of life. Their interactions within the firm's processes, procedures, and norms make up its culture. Although an observer may conclude that Zappos' culture, with its focus on autonomous teams in a flat hierarchy to provide superior customer service, might be the basis for its competitive advantage, engaging in reverse social engineering to crack Zappos' code of success might be much more difficult. Moreover, an organizational culture that works for online retailer Zappos, led by CEO and chief happiness officer Tony Hsieh, might seed havoc for an aerospace and defense company such as Lockheed Martin, led by CEO Marillyn Hewson. This implies that one must understand competitive advantage within its organizational and industry context. Looking at individual elements of success without taking social complexity into account is a recipe for inferior performance, or worse.

intellectual property (IP) protection
A critical intangible resource that can provide a strong isolating mechanism, and thus help to sustain a competitive advantage.

INTELLECTUAL PROPERTY PROTECTION. **Intellectual property (IP) protection** is a critical intangible resource that can also help sustain a competitive advance. Consider the five major forms of IP protection: patents, designs, copyrights, trademarks, and trade secrets.[32]

The intent of IP protection is to prevent others from copying legally protected products or services. In many knowledge-intensive industries that are characterized by high research and development (R&D) costs, for example smartphones and pharmaceuticals, IP protection provides not only an incentive to make these risky and often large-scale investments in the first place, but also affords a strong isolating mechanism that is critical to a firm's ability to capture the returns to investment. Although the initial investments to create the first version of a new product or service is quite high in many knowledge-intensive industries, the *marginal cost* (i.e., the cost to produce the next unit) after initial invention is quite low. For example, Microsoft spends billions of dollars to develop a new version of its Windows operating system; once completed, the cost of the next "copy" is close to zero because it is just software code distributed online in digital form. In a similar fashion, the costs of developing a new prescription drug, a process often taking more than a decade, are estimated to be over $2.5 billion.[33] Rewards to IP-protected products or services, however, can be high. During a little over 14 years on the market, Pfizer's Lipitor, the world's best-selling drug, accumulated over $125 billion in sales.[34]

IP protection can make direct imitation attempts difficult, if not outright illegal. A U.S. court, for example, has found that Samsung infringed in some of its older models

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on Apple's patents and awarded some $600 million in damages.[35] In a similar fashion, Dr. Dre attracted significant attention and support from other artists in the music industry when he sued Napster, an early online music file-sharing service, and helped shut it down in 2001 because of copyright infringements.

IP protection does not last forever, however. Once the protection has expired the invention can be used by others. Patents, for example, usually expire 20 years after a patent is filed with the U.S. Patent and Trademark Office. In the next few years, patents protecting roughly $100 billion in sales of proprietary drugs in the pharmaceutical industry are set to expire. Once this happens, producers of generics (drugs that contain the same active ingredients as the original patent-protected formulation) such as Teva Pharmaceutical Industries of Israel enter the market, and prices fall drastically. Pfizer's patent on Lipitor expired in 2011. Just one year later, of the 55 million Lipitor prescriptions, 45 million (or more than 80 percent) were generics.[36] Drug prices fall by 20 to 80 percent once generic formulations become available.[37]

Taken together, each of the five isolating mechanisms discussed here (or combinations thereof) allow a firm to extend its competitive advantage. Although no competitive advantage lasts forever, a firm may be able to protect its competitive advantage (even for long periods of time) when it has consistently better expectations about the future value of resources, when it has accumulated a resource advantage that can be imitated only over long periods of time, when the source of its competitive advantage is causally ambiguous or socially complex, or when the firm possesses strong intellectual property protection.

LO 4-6

Outline how dynamic capabilities can enable a firm to sustain a competitive advantage.

4.3 The Dynamic Capabilities Perspective

A firm's external environment is rarely stable (as discussed in Chapter 3). Rather, in many industries, change is fast and ferocious. Firms that fail to adapt their core competencies to a changing external environment not only lose a competitive advantage but also may go out of business.

We've seen the merciless pace of change in consumer electronics retailing in the United States. Once a market leader, Circuit City's core competencies in efficient logistics and superior customer service lost value because the firm neglected to upgrade and hone them over time. As a consequence, Circuit City was outflanked by Best Buy and online retailer Amazon, and went bankrupt. Earlier in the chapter we saw how Best Buy encountered the same difficulties competing against Amazon just a few years later. Core competencies might form the basis for a competitive advantage at one point, but as the environment changes, the very same core competencies might later turn into *core rigidities*, retarding the firm's ability to change.[38] A core competency can turn into a **core rigidity** if a firm relies too long on the competency without honing, refining, and upgrading as the environment changes.[39] Over time, the original core competency is no longer a good fit with the external environment, and it turns from an asset into a liability.

core rigidity
A former core competency that turned into a liability because the firm failed to hone, refine, and upgrade the competency as the environment changed.

This is the reason reinvesting, honing, and upgrading resources and capabilities are so crucial to sustaining any competitive advantage (see Exhibit 4.3). This ability lies at the heart of the dynamic capabilities perspective. At the beginning of this chapter, we defined *capabilities* as the organizational and managerial skills necessary to orchestrate a diverse set of resources and to deploy them strategically. Capabilities are by nature intangible. They find their expression in a company's structure, routines, and culture.

dynamic capabilities
A firm's ability to create, deploy, modify, reconfigure, upgrade, or leverage its resources in its quest for competitive advantage.

The dynamic capabilities perspective adds, as the name suggests, a *dynamic* or time element. In particular, **dynamic capabilities** describe a firm's ability to create, deploy, modify, reconfigure, upgrade, or leverage its resources over time in its quest for competitive advantage.[40] Dynamic capabilities are essential to move beyond a short-lived advantage and create a sustained competitive advantage. For a firm to sustain its advantage, any fit between its internal strengths and the external environment must be dynamic. That is, the firm must be able to change its internal resource base as the external environment changes. The goal should be to develop resources, capabilities, and competencies that create a *strategic fit* with the firm's environment. Rather than creating a static fit, the firm's internal strengths should change with its external environment in a *dynamic* fashion.

Not only do dynamic capabilities allow firms to adapt to changing market conditions, but they also enable firms to *create market changes* that can strengthen their strategic position. These market changes implemented by proactive firms introduce altered circumstances, to which more reactive rivals might be forced to respond. Apple's dynamic capabilities allowed it to redefine the markets for mobile devices and computing, in particular in music, smartphones, and media content. For the portable music market through its iPod and iTunes store, Apple generated environmental change to which Sony and others had to respond. With its iPhone, Apple redefined the market for smartphones, again creating environmental change to which competitors such as Samsung, BlackBerry, Google (with its Motorola Mobility unit), or Microsoft (with its Nokia unit) must respond. Apple's introduction of the iPad redefined the media and tablet computing market, forcing competitors such as Amazon and Microsoft to respond. With the introduction of the Apple Watch it is attempting to shape the market for computer wearables in its favor. Dynamic capabilities are especially relevant for surviving and competing in markets that shift quickly and constantly, such as the high-tech space in which firms such as Apple, Google, Microsoft, and Amazon compete. Strategy Highlight 4.2 shows how IBM developed dynamic capabilities to transform itself from a hardware company focused on mainframe computers to a global services company addressing major disruptions in the business world.

Strategy Highlight 4.2

Dynamic Capabilities at IBM

Virginia Rometty, CEO of IBM

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At its core, IBM is a solutions company. It solves data-based problems for its business clients, but the technology and problems both change over time. As an example, IBM helped kick-start the PC revolution in 1981 by setting an open standard in the computer industry with the introduction of the IBM PC running on an Intel 8088 chip and a Microsoft operating system (MS-DOS). Ironically, in the years following, IBM nearly vanished after experiencing the full force of that revolution, because its executives believed that the future of computing lay in mainframes and minicomputers that would be produced by fully integrated companies. However, with an open standard in personal computing, the entire industry value chain disintegrated, and many new firms entered its different stages. This led to a strategic misfit for IBM, which resulted in a competitive disadvantage.

Rather than breaking up IBM into independent businesses, newly installed CEO Lou Gerstner refocused the company on satisfying market needs, which demanded sophisticated IT services. Keeping IBM together as one entity allowed

(continued)

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Gerstner to integrate hardware, software, and services to provide sophisticated solutions to customers' IT challenges. IBM was quick to capitalize on the emergence of the Internet to add further value to its business solutions. The company also moved quickly to sell its PC business when substitution from tablet computers was just beginning to impact demand. More recently, IBM also sold its server business, further shedding its legacy in hardware.

Exhibit 4.6 shows IBM's dynamic capability to successfully transform itself multiple times over its more than 100-year history—a history with periods of major disruptions in the data information industry, from mechanical calculators to the Internet. In contrast to IBM, note how at the bottom of Exhibit 4.6, strong competitors in one period drop from significance when a new wave of technology emerges.

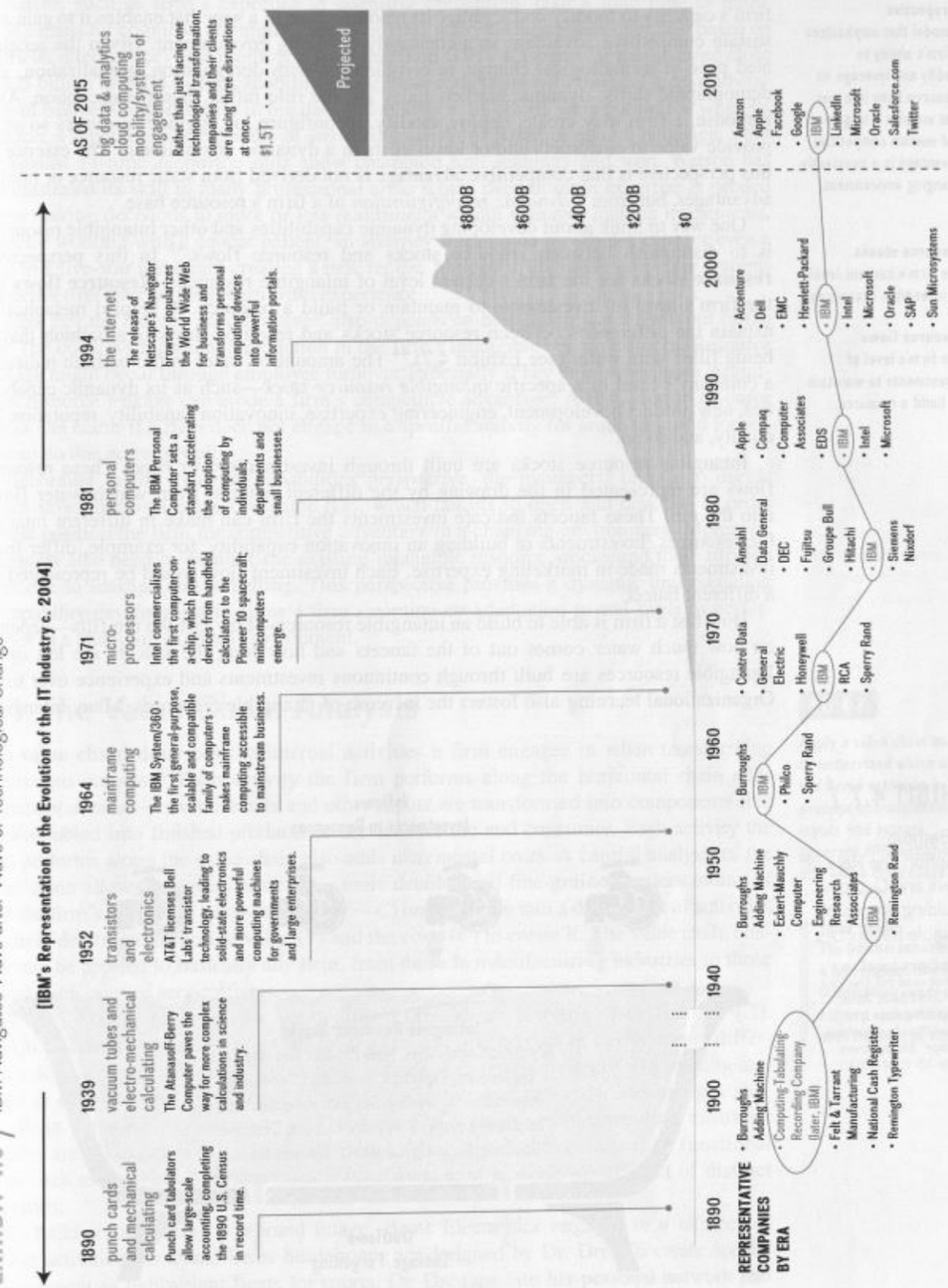
Led by CEO Virginia Rometty, the IBM of today is an agile and nimble IT services company.[41] Rometty was promoted to CEO in 2012 from her position as senior vice president of sales, marketing, and strategy. Rather than just facing one technological transformation, IBM and its clients are currently facing three disruptions at once:

1. *Cloud computing:* By providing convenient, on-demand network access to shared computing resources such as networks, servers, storage, applications, and services, IBM attempts to put itself at the front of a trend now readily apparent in services that include Google Drive, Dropbox, or Microsoft 365. Increasingly, businesses are renting computer services rather than owning hardware and software and running their own networks. One of the largest cloud computing providers for businesses is Amazon Web Services (AWS), which beat out IBM in winning a high-profile CIA contract. This was seen as a major embarrassment given IBM's long history of federal contracts.
2. *Systems of engagement:* IBM now helps businesses with their systems of engagement, a term the company uses broadly to cover the transition from enterprise systems to decentralized systems or mobility. IBM identifies the traditional enterprise system as a "system of record" that passively provides information to the enterprise's knowledge workers. It contrasts that with systems of engagement that provide mobile computing platforms, often including social media apps such as Facebook or Twitter, that promote rapid and active collaboration. To drive adoption of mobile computing for business, IBM partnered with Apple to provide business productivity apps on Apple devices.
3. *Big data and analytics:* IBM now offers smarter analytics solutions that focus on how to acquire, process, store, manage, analyze, and visualize data arriving at high volume, velocity, and variety. Prime applications are in finance, medicine, law, and many other professional fields relying on deep domain expertise within fast-moving environments. IBM partnered with Twitter to provide IBM's business clients big data and analytics solutions in real time based on the vast amount of data produced on Twitter.

Critics of this strategic approach point out that IBM was slow to take advantage of these mega-opportunities, and they continue to watch IBM's stock performance with skepticism. The critics grew louder when Rometty received a pay increase and a $3.6 million bonus for her 2014 performance, during which revenue dropped about 6 percent and net income 27 percent. Overall, IBM's market cap plummeted by more than 60 percent: from a high of $240 billion in the spring of 2013 to some $150 billion early in 2015. And revenues for IBM have fallen for three straight years, from a high of $107 billion when Rometty became CEO to $93 billion by early 2015. During the same period, IBM's stock price fell by almost 10 percent, while the S&P 500 index rose by 67 percent.

Rometty, however, stays committed to IBM's new strategic focus and argues that she is transforming IBM for the long run. She views the most recent waves of technology disruptions as creating major business opportunities and has made sure that IBM invests heavily to take advantage of them. IBM has trained all of its consultants—over 100,000—in these three areas to help its business clients with their own transformation. If history is any guide, IBM is likely to master this three-pronged tech transformation also.[42]

EXHIBIT 4.6 / IBM Navigates Wave after Wave of Technological Change



Source: IBM Prospectus (2004), 'Evolution of the IT industry'; *Understanding Our Company*; 5. Vertical axis shows total industry revenues. IBM relied on industry growth data from IDC (2004), *40 Years of IT: Looking Back, Looking Ahead. An IDC Special Edition Executive Whitepaper*; John Gantz, chief research officer, and IBM's own records. Information in the last column to the right derives (research and depiction of 2015 wave) from author's analysis and estimate of industry growth from various industry sources. Red lines added to emphasize IBM's ongoing competitive standing.

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dynamic capabilities perspective
A model that emphasizes a firm's ability to modify and leverage its resource base in a way that enables it to gain and sustain competitive advantage in a constantly changing environment.

In the **dynamic capabilities perspective,** competitive advantage is the outflow of a firm's capacity to modify and leverage its resource base in a way that enables it to gain and sustain competitive advantage in a constantly changing environment. Given the accelerated pace of technological change, in combination with deregulation, globalization, and demographic shifts, dynamic markets today are the rule rather than the exception. As a response, a firm may create, deploy, modify, reconfigure, or upgrade resources so as to provide value to customers and/or lower costs in a dynamic environment. The essence of this perspective is that competitive advantage is not derived from static resource or market advantages, but from a *dynamic reconfiguration* of a firm's resource base.

resource stocks
The firm's current level of intangible resources.

resource flows
The firm's level of investments to maintain or build a resource.

One way to think about developing dynamic capabilities and other intangible resources is to distinguish between resource stocks and resource flows.[43] In this perspective, **resource stocks** are the firm's current level of intangible resources. **Resource flows** are the firm's level of investments to maintain or build a resource. A helpful metaphor to explain the differences between resource stocks and resource flows is a bathtub that is being filled with water (see Exhibit 4.7).[44] The amount of water in the bathtub indicates a company's level of a specific *intangible resource stock*—such as its dynamic capabilities, new product development, engineering expertise, innovation capability, reputation for quality, and so on.[45]

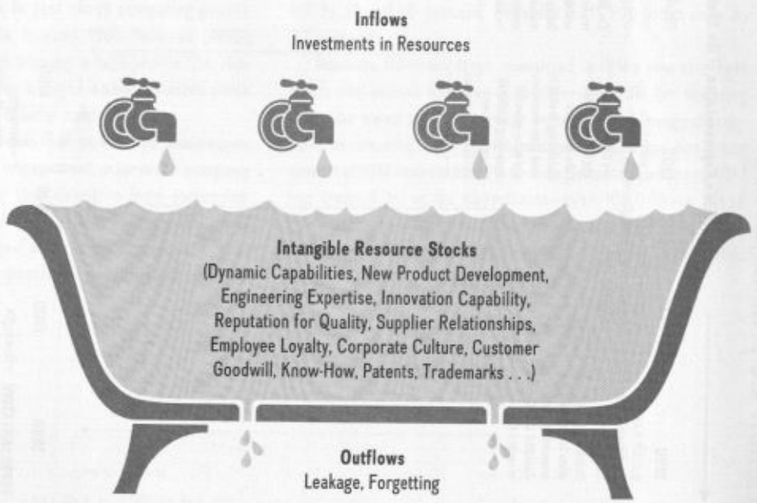
Intangible resource stocks are built through investments over time. These resource flows are represented in the drawing by the different faucets, from which water flows into the tub. These faucets indicate investments the firm can make in different intangible resources. Investments in building an innovation capability, for example, differ from investments made in marketing expertise. Each investment flow would be represented by a different faucet.

How fast a firm is able to build an intangible resource—how fast the tub fills—depends on how much water comes out of the faucets and how long the faucets are left open. Intangible resources are built through continuous investments and experience over time. Organizational learning also fosters the increase of intangible resources. Many intangible

EXHIBIT 4.7

The Bathtub Metaphor: The Role of Inflows and Outflows in Building Stocks of Intangible Resources

Source: Figure based on metaphor used in I. Dierickx and K. Cool (1989), "Asset stock accumulation and sustainability of competitive advantage," *Management Science* 35: 1504–1513.



resources, such as IBM's expertise in cognitive computing, take a long time to build. IBM's quest for cognitive computing began in 1997 after its Deep Blue computer (based on artificial intelligence) beat reigning chess champion Garry Kasparov. It has invested close to $25 billion to build a deep capability in cognitive computing with the goal to take advantage of business opportunities in big data and analytics. Its efforts were publicized when its Watson, a supercomputer capable of answering questions posed in natural language, went up against 74-time *Jeopardy!* quiz show champion Ken Jennings and won. Watson has demonstrated its skill in many professional areas where deep domain expertise is needed when making decisions in more or less real time: a wealth manager making investments, a doctor working with a cancer patient, an attorney working on a complex case, or even a chef in a five-star restaurant creating a new recipe. Moreover, cognitive computer systems get better over time as they learn from experience.

How fast the bathtub fills, however, also depends on how much water leaks out of the tub. The outflows represent a reduction in the firm's intangible resource stocks. Resource leakage might occur through employee turnover, especially if key employees leave. Significant resource leakage can erode a firm's competitive advantage. A reduction in resource stocks can occur if a firm does not engage in a specific activity for some time and forgets how to do this activity well.

According to the dynamic capabilities perspective, the managers' task is to decide which investments to make over time (i.e., which faucets to open and how far) in order to best position the firm for competitive advantage in a changing environment. Moreover, managers also need to monitor the existing intangible resource stocks and their attrition rates due to leakage and forgetting. This perspective provides a dynamic understanding of capability development to allow a firm's continuous adaptation to and superior performance in a changing external environment.

4.4 The Value Chain Analysis

LO 4-7

Apply a value chain analysis to understand which of the firm's activities in the process of transforming inputs into outputs generate differentiation and which drive costs.

The **value chain** describes the internal activities a firm engages in when transforming inputs into outputs.[46] Each activity the firm performs along the horizontal chain adds incremental value—raw materials and other inputs are transformed into components that are assembled into finished products or services for the end consumer. Each activity the firm performs along the value chain also adds incremental costs. A careful analysis of the value chain allows managers to obtain a more detailed and fine-grained understanding of how the firm's *economic value creation* ($V - C$) breaks down into a distinct set of activities that help determine perceived value (V) and the costs (C) to create it. The value chain concept can be applied to basically any firm, from those in manufacturing industries to those in high-tech ones or service firms.

value chain
The internal activities a firm engages in when transforming inputs into outputs; each activity adds incremental value.

A firm's core competencies are deployed through its activities (see Exhibit 4.3). A firm's activities, therefore, are one of the key internal drivers of performance differences across firms. *Activities* are distinct actions that enable firms to add incremental value at each step by transforming inputs into goods and services. Managing a supply chain, running the company's IT system and websites, and providing customer support are all examples of distinct activities. Activities are narrower than functional areas such as marketing, because each functional area is made up of a set of distinct activities.

To build its uniquely cool brand image, Beats Electronics engages in a number of distinct activities. Its iconic Beats headphones are designed by Dr. Dre. To create special editions such as lightweight Beats for sports, Dr. Dre taps into his personal network and

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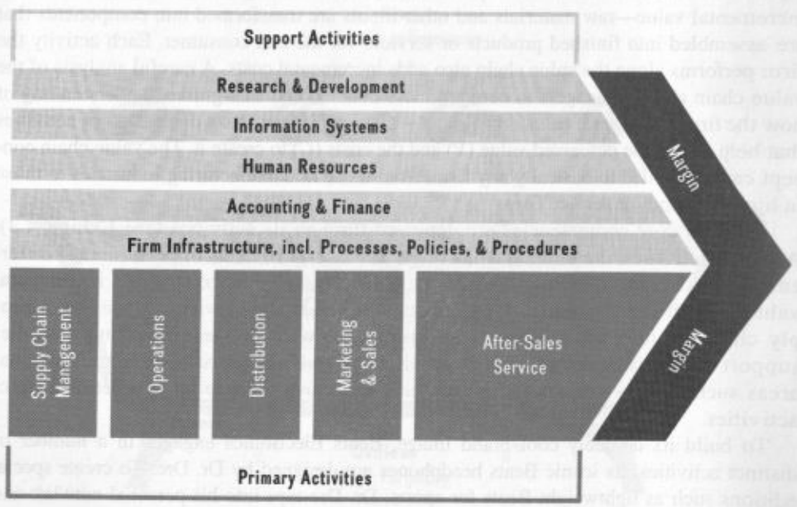
works with basketball stars such as Kobe Bryant. Once designed, Beats manufactures its high-end headphones (before the Apple acquisition, that was done in conjunction with Monster Cable Products, a California-based company). Other distinct activities concern the marketing and sales of its products. Beats is not only marketing savvy in product placement and branding with a large number of celebrities across different fields, but it also focuses on other distinct activities such as packaging and product presentation to create a premium unboxing experience and superb displays in retail outlets, and now especially in Apple stores. In addition, Dr. Dre also works with celebrity musicians to have them curate playlists for the Beats Music streaming service. In sum, a number of distinct activities along the value chain are performed to create Beats by Dr. Dre, from initial design to a unique sales experience and after-sales service.

As shown in the generic value chain in Exhibit 4.8, the transformation process from inputs to outputs is composed of a set of distinct activities. When a firm's distinct activities generate value greater than the costs to create them, the firm obtains a profit margin (see Exhibit 4.8), assuming the market price the firm is able to command exceeds the costs of value creation. A generic value chain needs to be modified to capture the activities of a specific business. Retail chain American Eagle Outfitters, for example, needs to identify suitable store locations, either build or rent stores, purchase goods and supplies, manage distribution and store inventories, operate stores both in the brick-and-mortar world and online, hire and motivate a sales force, create payment and IT systems or partner with vendors, engage in promotions, and ensure after-sales services including returns. A maker of semiconductor chips such as Intel, on the other hand, needs to engage in R&D, design and engineer semiconductor chips and their production processes, purchase silicon and other ingredients, set up and staff chip fabrication plants, control quality and throughput, engage in marketing and sales, and provide after-sales customer support.

primary activities
Firm activities that add value directly by transforming inputs into outputs as the firm moves a product or service horizontally along the internal value chain.

As shown in Exhibit 4.8, the value chain is divided into primary and support activities. The **primary activities** add value directly as the firm transforms inputs into outputs—from

EXHIBIT 4.8
A Generic Value Chain: Primary and Support Activities



raw materials through production phases to sales and marketing and finally customer service, specifically

- Supply chain management.
- Operations.
- Distribution.
- Marketing and sales.
- After-sales service.

Other activities, called **support activities**, add value indirectly. These activities include

support activities
Firm activities that add value indirectly, but are necessary to sustain primary activities.

- Research and development (R&D).
- Information systems.
- Human resources.
- Accounting and finance.
- Firm infrastructure including processes, policies, and procedures.

To help a firm achieve a competitive advantage, each distinct activity performed needs to either add incremental value to the product or service offering or lower its relative cost. Discrete and specific firm activities are the basic units with which to understand competitive advantage because they are the drivers of the firm's relative costs and level of differentiation the firm can provide to its customers. Although the resource-based view of the firm helps identify the integrated set of resources and capabilities that are the building blocks of core competencies, the value chain perspective enables managers to see how competitive advantage flows from the firm's distinct set of activities. This is because a firm's core competency is generally found in a network linking different but distinct activities, each contributing to the firm's strategic position as either low-cost leader or differentiator.

Let's consider The Vanguard Group, one of the world's largest investment companies, with $3 trillion of assets under management.[47] It serves individual investors, financial professionals, and institutional investors such as state retirement funds. Vanguard's mission is *to help clients reach their financial goals by being their highest-value provider of investment products and services.*[48] It therefore emphasizes low-cost investing and quality service for its clients. Vanguard's average expense ratio (fees as a percentage of total net assets paid by investors) is generally the lowest in the industry.[49] Vanguard's core competency of low-cost investing while providing quality service for its clients is accomplished through a unique set of interconnected primary and support activities including strict cost control, direct distribution, low expenses with savings passed on to clients, a broad array of mutual funds, an efficient investment management approach, and straightforward client communication and education.

4.5 Implications for the Strategist

We've now reached a significant point: We can combine external analysis from Chapter 3 with the internal analysis just introduced. Together the two allow you to begin formulating a strategy that matches your firm's internal resources and capabilities to the demands of

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the external industry environment. Ideally, managers want to leverage their firm's internal strengths to exploit external opportunities, while mitigating internal weaknesses and external threats. Both types of analysis in tandem allow managers to formulate a strategy that is tailored to their company, creating a unique fit between the company's internal resources and the external environment. A *strategic fit* increases the likelihood that a firm is able to gain a competitive advantage. If a firm achieves a *dynamic* strategic fit, it is likely to be able to *sustain* its advantage over time.

LO 4-8

Conduct a SWOT analysis to generate insights from external and internal analysis and derive strategic implications.

USING SWOT ANALYSIS TO GENERATE INSIGHTS FROM EXTERNAL AND INTERNAL ANALYSIS

SWOT analysis
A framework that allows managers to synthesize insights obtained from an internal analysis of the company's strengths and weaknesses (S and W) with those from an analysis of external opportunities and threats (O and T) to derive strategic implications.

We synthesize insights from an internal analysis of the company's *strengths* and *weaknesses* with those from an analysis of external *opportunities* and *threats* using the **SWOT analysis**. Internal strengths (S) and weaknesses (W) concern resources, capabilities, and competencies. Whether they are strengths or weaknesses can be determined by applying the VRIO framework. A resource is a weakness if it is not valuable. In this case, the resource does not allow the firm to exploit an external opportunity or offset an external threat. A resource, however, is a strength and a core competency if it is valuable, rare, costly to imitate, and the firm is organized to capture at least part of the economic value created.

External opportunities (O) and threats (T) are in the firm's general environment and can be captured by PESTEL and Porter's five forces analyses (discussed in the previous chapter). An attractive industry as determined by Porter's five forces, for example, presents an external opportunity for firms not yet active in this industry. On the other hand, stricter regulation for financial institutions, for example, might represent an external threat to banks.

A SWOT analysis allows the strategist to evaluate a firm's current situation and future prospects by simultaneously considering internal and external factors. The SWOT analysis encourages managers to scan the internal and external environments, looking for any relevant factors that might affect the firm's current or future competitive advantage. The focus is on internal and external factors that can affect—in a positive or negative way—the firm's ability to gain and sustain a competitive advantage. To facilitate a SWOT analysis, managers use a set of strategic questions that link the firm's internal environment to its external environment, as shown in Exhibit 4.9, to derive strategic implications. In this SWOT matrix, the horizontal axis is divided into factors that are *external to the firm* (the focus of Chapter 3) and the vertical axis into factors that are *internal to the firm* (the focus of this chapter).

In a first step, managers gather information for a SWOT analysis in order to link internal factors *(Strengths* and *Weaknesses)* to external factors *(Opportunities* and *Threats)*. Next, managers use the SWOT matrix shown in Exhibit 4.9 to develop *strategic alternatives* for the firm using a four-step process:

1. Focus on the *Strengths–Opportunities* quadrant (top left) to derive "offensive" alternatives by using an internal strength in order to exploit an external opportunity.
2. Focus on the *Weaknesses–Threats* quadrant (bottom right) to derive "defensive" alternatives by eliminating or minimizing an internal weakness in order to mitigate an external threat.

EXHIBIT 4.9

Strategic Questions within the SWOT Matrix

		External to Firm	
	Strategic Questions	**Opportunities**	**Threats**
Internal to Firm	**Strengths**	*How can the firm use internal strengths to take advantage of external opportunities?*	*How can the firm use internal strengths to reduce the likelihood and impact of external threats?*
	Weaknesses	*How can the firm overcome internal weaknesses that prevent the firm from taking advantage of external opportunities?*	*How can the firm overcome internal weaknesses that will make external threats a reality?*

3. Focus on the *Strengths–Threats* quadrant (top right) to use an internal strength to minimize the effect of an external threat.
4. Focus on the *Weaknesses–Opportunities* quadrant (bottom left) to shore up an internal weakness to improve its ability to take advantage of an external opportunity.

In a final step, the strategist needs to carefully evaluate the pros and cons of each strategic alternative to select one or more alternatives to implement. Managers need to carefully explain their decision rationale, including why other strategic alternatives were rejected.

Although the SWOT analysis is a widely used management framework, however, a word of caution is in order. A problem with this framework is that a strength can also be a weakness and an opportunity can also simultaneously be a threat. Earlier in this chapter, we discussed the location of Google's headquarters in Silicon Valley and near several universities as a key resource for the firm. Most people would consider this a strength for the firm. However, California has a high cost of living and is routinely ranked among the worst of the U.S. states in terms of "ease of doing business." In addition, this area of California is along major earthquake fault lines and is more prone to natural disasters than many other parts of the country. So is the location a strength or a weakness? The answer is "it depends." In a similar fashion, is global warming an opportunity or threat for car manufacturers? If governments enact higher gasoline taxes and make driving more expensive, it can be a threat. If, however, carmakers respond to government regulations by increased innovation through developing more fuel-efficient cars as well as low- or zero-emission engines such as hybrid or electric vehicles, it may create more demand for new cars and lead to higher sales.

To make the SWOT analysis an effective management tool, the strategist must first conduct a thorough external and internal analysis, as laid out in Chapters 3 and 4. This sequential process enables the strategist to ground the analysis in rigorous theoretical frameworks before using SWOT to synthesize the results from the external and internal analyses in order to derive a set of strategic options.

You have now acquired the toolkit with which to conduct a complete strategic analysis of a firm's internal and external environments. In the next chapter, we consider various ways to assess and measure competitive advantage. That chapter will complete Part 1, on strategy analysis, in the AFI framework (see Exhibit 1.5).

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CHAPTERCASE 4 / Consider This...

ALTHOUGH MANY OBSERVERS are convinced that Apple purchased Beats Electronics for the coolness of its brand and to gain a stronger position in the music industry, others are suggesting that what Apple is really buying are the talents that Beats co-founder Jimmy Iovine and Dr. Dre bring to the table. Since the death of Steve Jobs, Apple's visionary leader, the company has been lacking the kind of inspired personality it needs to remain a cultural icon. The critics argue that what Apple really needs is someone with a creative vision combined with a wide-reaching industry network and the ability to close a deal, especially in music where the personalities of its celebrities are known to be idiosyncratic. In music jargon, Apple is in need of a "front man." With the acquisition of Beats, it got two of the greatest creative talents in the music industry, with a long successful track record and deep and far-reaching networks.

Indeed, Iovine is of the opinion that Beats had always belonged with Apple. Iovine and Dr. Dre set out to model Beats Electronics after Apple's unique ability to marry culture and technology. Intriguingly, both Iovine and Dr. Dre are taking on senior positions at Apple. This indicates how much Apple's culture has changed under CEO Cook, because Iovine and Dr. Dre were not the first cool superstars from flashy industries he brought to Apple. In 2013, Apple hired former Burberry CEO Angela Ahrendts to head its retail operations. Bringing in superstars from the flashy industries of music or fashion to Apple, let alone into senior executive roles, would have been unthinkable under Jobs. Under his top-down leadership, only Apple products introduced to the public by himself in well-rehearsed theatrical launches were allowed to shine.

Questions

1. The ChapterCase argues that Beats Electronics' core competency lies in its marketing savvy and in Dr. Dre's coolness factor. Do you agree with this assessment? Why or why not?
2. If you believe that Apple bought Beats Electronics to bring Jimmy Iovine and Dr. Dre into Apple, what are the potential downsides of this multibillion-dollar "acqui-hire" (an acquisition to hire key personnel)?
3. If Beats Electronics' core competencies are indeed intangibles, such as coolness and marketing savvy, do you think these competencies will remain as valuable under Apple's ownership? Why or why not?
4. The ChapterCase provides at least three theories why Apple purchased Beats Electronics. Which of those do you believe are most accurate, and why?

TAKE-AWAY CONCEPTS

This chapter demonstrated various approaches to analyzing the firm's *internal environment,* as summarized by the following learning objectives and related take-away concepts.

LO 4-1 / Differentiate among a firm's core competencies, resources, capabilities, and activities.

- *Core competencies* are unique, deeply embedded, firm-specific strengths that allow companies to differentiate their products and services and thus create more value for customers than their rivals, or offer products and services of acceptable value at lower cost.
- *Resources* are any assets that a company can draw on when crafting and executing strategy.
- *Capabilities* are the organizational and managerial skills necessary to orchestrate a diverse set of resources to deploy them strategically.
- *Activities* are distinct and fine-grained business processes that enable firms to add incremental value by transforming inputs into goods and services.

LO 4-2 / Compare and contrast tangible and intangible resources.

- *Tangible resources* have physical attributes and are visible.
- *Intangible resources* have no physical attributes and are invisible.
- Competitive advantage is more likely to be based on intangible resources.

LO 4-3 / Evaluate the two critical assumptions behind the resource-based view.

- The first critical assumption—*resource heterogeneity*—is that bundles of resources, capabilities, and competencies differ across firms. The resource bundles of firms competing in the same industry (or even the same strategic group) are unique to some extent and thus differ from one another.
- The second critical assumption—*resource immobility*—is that resources tend to be "sticky" and don't move easily from firm to firm. Because of that stickiness, the resource differences that exist between firms are difficult to replicate and, therefore, can last for a long time.

LO 4-4 / Apply the VRIO framework to assess the competitive implications of a firm's resources.

- For a firm's resource to be the basis of a competitive advantage, it must have VRIO attributes: *valuable (V), rare (R),* and *costly to imitate (I).* The firm must also be able to *organize (O) in order to capture the value of the resource.*
- A resource is valuable (V) if it allows the firm to take advantage of an external opportunity and/or neutralize an external threat. A valuable resource enables a firm to increase its economic value creation ($V - C$).
- A resource is rare (R) if the number of firms that possess it is less than the number of firms it would require to reach a state of perfect competition.
- A resource is costly to imitate (I) if firms that do not possess the resource are unable to develop or buy the resource at a comparable cost.
- The firm is organized (O) to capture the value of the resource if it has an effective organizational structure, processes, and systems in place to fully exploit the competitive potential.

LO 4-5 / Evaluate different conditions that allow a firm to sustain a competitive advantage.

- Several conditions make it costly for competitors to imitate the resources, capabilities, or competencies that underlie a firm's competitive advantage: (1) *better expectations of future resource value,* (2) *path dependence,* (3) *causal ambiguity,* (4) *social complexity,* and (5) *intellectual property (IP) protection.*
- These *barriers to imitation* are isolating mechanisms because they prevent rivals from competing away the advantage a firm may enjoy.

LO 4-6 / Outline how dynamic capabilities can enable a firm to sustain a competitive advantage.

- To sustain a competitive advantage, any fit between a firm's internal strengths and the external environment must be dynamic.
- *Dynamic capabilities* allow a firm to create, deploy, modify, reconfigure, or upgrade its resource base to gain and sustain competitive advantage in a constantly changing environment.

LO 4-7 / Apply a value chain analysis to understand which of the firm's activities in the process of transforming inputs into outputs generate differentiation and which drive costs.

- The value chain describes the internal activities a firm engages in when transforming inputs into outputs.
- Each activity the firm performs along the horizontal chain adds incremental value and incremental costs.
- A careful analysis of the value chain allows managers to obtain a more detailed and fine-grained understanding of how the firm's economic value creation breaks down into a distinct set of activities that helps determine perceived value and the costs to create it.
- When a firm's set of distinct activities is able to generate value greater than the costs to create it, the firm obtains a profit margin (assuming the market price the firm is able to command exceeds the costs of value creation).

LO 4-8 / Conduct a SWOT analysis to generate insights from external and internal analysis and derive strategic implications.

- Formulating a strategy that increases the chances of gaining and sustaining a competitive advantage is based on synthesizing insights obtained

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Chapter 5

Competitive Advantage, Firm Performance, and Business Models

Chapter Outline

5.1 Competitive Advantage and Firm Performance
Accounting Profitability
Shareholder Value Creation
Economic Value Creation
The Balanced Scorecard
The Triple Bottom Line

5.2 Business Models: Putting Strategy into Action
Popular Business Models
Dynamic Nature of Business Models

5.3 Implications for the Strategist

Learning Objectives

LO 5-1 Conduct a firm profitability analysis using accounting data to assess and evaluate competitive advantage.

LO 5-2 Apply shareholder value creation to assess and evaluate competitive advantage.

LO 5-3 Explain economic value creation and different sources of competitive advantage.

LO 5-4 Apply a balanced scorecard to assess and evaluate competitive advantage.

LO 5-5 Apply a triple bottom line to assess and evaluate competitive advantage.

LO 5-6 Outline how business models put strategy into action.

The Quest for Competitive Advantage: Apple vs. Microsoft*

Apple and Microsoft have been fierce rivals since their arrival in the mid-1970s. Although Apple has been dominating more recently, in the early decades of the PC revolution, Microsoft was the undisputed leader. With its Windows operating system, Microsoft set the standard in the world of personal computers. Some 90 percent of all PCs run Windows. Once users are locked into a Microsoft operating system, which generally comes preloaded with the computer they purchased, they then want to buy applications that run seamlessly with the operating system. The obvious choice for users is Microsoft's Office Suite (containing Word, Excel, PowerPoint, OneNote, Outlook, Publisher, and Access), but they need to shell out several hundred dollars for the latest version. Microsoft's business model was to create a large installed base of users for its PC operating system and then make money from selling application software such as its ubiquitous Office Suite.

Steve Jobs and Bill Gates at All Things Digital 5 in 2007.
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Microsoft then went on to replicate with its corporate customers this hugely successful business model of setting the standard in operating systems combined with bundling discounted application suites. Once servers became ubiquitous in corporations, Microsoft offered IT departments e-mail systems, databases, and other business applications that were tightly integrated with Windows. As a consequence, some 80 percent of Microsoft's revenues were either tied directly or indirectly to its Windows franchise. Microsoft's strategy of focusing on setting the industry standard allowed it to create a favorable (monopoly) market position and thus to extract high profits for many years. For example, its bundling strategy with Microsoft Office, combining different application services that run seamlessly in one discounted product offering, allowed Microsoft to overtake IBM, once the most valuable tech company. By 2000, Microsoft was the most valuable company globally with some $510 billion in market capitalization.

In contrast, at roughly the same time, Apple was struggling to survive with less than 5 percent market share in the PC market. Near bankruptcy in 1997, Apple's revitalization took off in the fall of 2001 when it introduced the iPod, a portable digital music player. Eighteen months later, the Cupertino, California, company soared even higher when it opened the online store iTunes, quickly followed by its first retail stores. Apple's stores earn the highest sales per square foot of any retail outlets, including luxury stores such as jeweler Tiffany & Co. or LVMH, purveyor of fine handbags and other luxury goods.

Apple didn't stop there. In 2007, the company revolutionized the smartphone market with the introduction of the iPhone. Just three years later, Apple created the tablet computer industry by introducing the iPad, thus beginning to reshape the publishing and media industries. Further, for each of its iPod, iPhone, and iPad lines of businesses, Apple followed up with incremental product innovations extending each product category. By the fall of 2012, Apple had become the most valuable company in the world with some $620 billion market capitalization.

Two years later, in the fall of 2014, Apple introduced the hugely popular iPhone 6 and the iPhone 6 Plus, offering larger screens with higher resolution. In the spring of 2015, the high-tech company introduced Apple Watch, a watch that is fully integrated with the iOS Apple operating system, thus running basically all the apps available for the

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iPhone. Apple Watch also incorporates new fitness tracking and other health-oriented capabilities. At the same time, Apple's market capitalization had further risen to almost $740 billion.

The comparison of Microsoft and Apple over time shows that competitive advantage is clearly transitory. Given the rough-and-tumble competition combined with relentless technological progress and innovation, it is hard to gain a competitive advantage in the first place, and it is even harder to sustain it.

You will learn more about Microsoft and Apple by reading the chapter; related questions appear on page 167.[1]

*** A strategic financial analysis exercise related to this ChapterCase is available in Connect.**

GAINING AND SUSTAINING competitive advantage is the defining goal of strategic management. Competitive advantage leads to superior firm performance. To explain differences in firm performance and to derive strategic implications—including new strategic initiatives—we must understand how to measure and assess competitive advantage. We devote this chapter to studying how to measure and assess firm performance. In particular, we introduce three frameworks to capture the multifaceted nature of competitive advantage. The three traditional frameworks to measure and assess firm performance are

- Accounting profitability.
- Shareholder value creation.
- Economic value creation.

We then will introduce two integrative frameworks, combining quantitative data with qualitative assessments:

- The balanced scorecard.
- The triple bottom line.

Next, we take a closer look at *business models* to understand more deeply how firms put their strategy into action in order to make money. We conclude the chapter with practical "Implications for the Strategist."

5.1 Competitive Advantage and Firm Performance

It is easy to compare two firms and identify the better performer as having competitive advantage. But simple comparisons have their limitations. How can we understand how and why a firm has competitive advantage? How can we measure it? How can we understand that advantage within the bigger picture of an entire industry and the ever-changing external environment? And what strategic implications for managerial actions do we derive from our assessments? These apparently simple questions do not have simple answers. Strategic management researchers have debated them intensely for at least 30 years.[2]

To address these key questions, we will develop a *multidimensional perspective* for assessing competitive advantage. Let's begin by focusing on the three standard performance dimensions:[3]

1. What is the firm's *accounting profitability*?
2. How much *shareholder value* does the firm create?
3. How much *economic value* does the firm generate?

These three performance dimensions tend to be correlated, particularly over time. Accounting profitability and economic value creation tend to be reflected in the firm's stock price, which in turn determines in part the stock's market valuation.

ACCOUNTING PROFITABILITY

LO 5-1
Conduct a firm profitability analysis using accounting data to assess and evaluate competitive advantage.

As we discussed in Chapter 1, *strategy* is a set of goal-directed actions a firm takes to gain and sustain competitive advantage. Using accounting data to assess competitive advantage and firm performance is standard managerial practice. When assessing competitive advantage by measuring accounting profitability, we use financial data and ratios derived from publicly available accounting data such as income statements and balance sheets.[4] Since *competitive advantage* is defined as superior performance *relative* to other competitors in the same industry or the industry average, a firm's managers must be able to accomplish two critical tasks:

1. Accurately assess the performance of their firm.
2. Compare and benchmark their firm's performance to other competitors in the same industry or against the industry average.

Standardized financial metrics, derived from such publicly available accounting data as income statements and balance sheets, fulfill both these conditions. Public companies are required by law to release these data, in compliance with generally accepted accounting principles (GAAP) set by the Financial Accounting Standards Board (FASB), and as audited by certified public accountants. Publicly traded firms are required to file a Form 10-K (or 10-K report) annually with the U.S. Securities and Exchange Commission (SEC), a federal regulatory agency. The 10-K reports are the primary source of companies' accounting data available to the public. In the wake of the Sarbanes–Oxley Act of 2002, accounting data released to the public had to comply with even more stringent requirements. This in turn enhances the data's usefulness for comparative analysis.

Accounting data enable us to conduct direct performance comparisons between different companies. Some of the profitability ratios most commonly used in strategic management are *return on invested capital (ROIC), return on equity (ROE), return on assets (ROA),* and *return on revenue (ROR).* In the "How to Conduct a Case Analysis" module (at the end of Part 4, following the MiniCases), you will find a complete presentation of accounting measures and financial ratios, how they are calculated, and a brief description of their strategic characteristics.

One of the most commonly used metrics in assessing firm financial performance is *return on invested capital (ROIC),* where ROIC = (Net profits / Invested capital).[5] ROIC is a popular metric because it is a good proxy for *firm profitability.* In particular, the ratio measures how effectively a company uses its *total invested capital,* which consists of two components: (1) *shareholders' equity* through the selling of shares to the public, and (2) *interest-bearing debt* through borrowing from financial institutions and bondholders.

As a rule of thumb, if a firm's ROIC is greater than its cost of capital, it generates value; if it is less than the cost of capital, the firm destroys value. The *cost of capital* represents a firm's cost of financing operations from both equity through issuing stock and debt through issuing bonds. To be more precise and to be able to derive strategic implications, however, managers must compare their ROIC to other competitors.

APPLE VS. MICROSOFT To demonstrate the usefulness of accounting data in assessing competitive advantage and to derive strategic implications, let's revisit the comparison between Apple and Microsoft that we began in ChapterCase 5, and investigate the sources of performance differences in more detail. Exhibit 5.1 shows the ROIC for Apple and Microsoft (as of fiscal year 2014).[6] It further breaks down ROIC into its constituent

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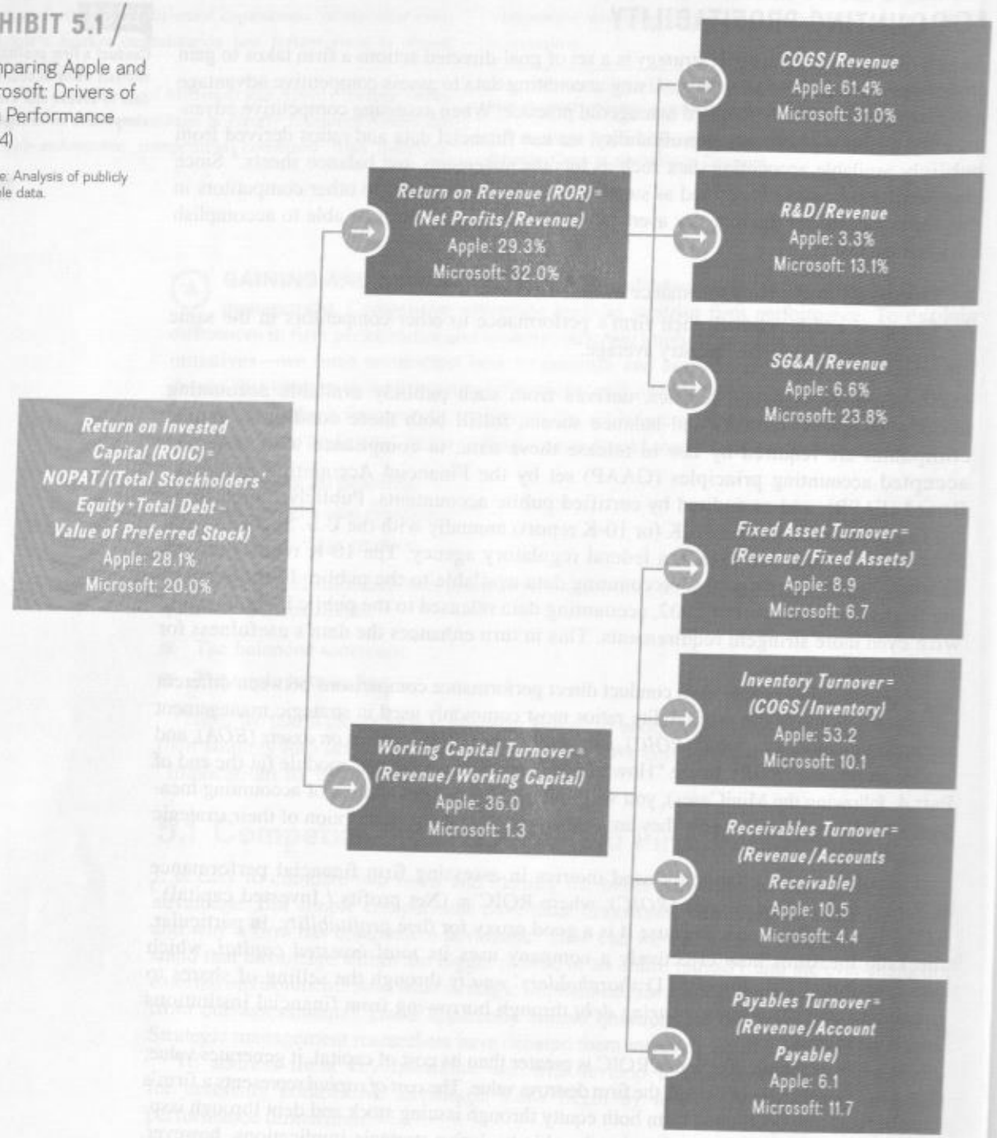
EXHIBIT 5.1

Comparing Apple and Microsoft: Drivers of Firm Performance (2014)

Source: Analysis of publicly available data.



components. This provides important clues for managers on which areas to focus when attempting to improve firm performance relative to their competitors.

Apple's ROIC was 28.1 percent, which was more than 8 percentage points higher than Microsoft's (20.0 percent). This means that for every $1.00 invested in Apple, the company returned almost $1.28, while for every $1.00 invested in the company, Microsoft returned

$1.20. Since Apple was 40 percent more efficient than Microsoft at generating a return on invested capital, Apple had a clear competitive advantage over Microsoft. Although this is an important piece of information, managers need to know the underlying factors driving differences in firm profitability. Why is the ROIC for these two companies so different?

Much like detectives, managers look for clues to solve that mystery: They break down ROIC into its constituents (as shown in Exhibit 5.1)—*return on revenue* and *working capital turnover*—to discover the underlying drivers of the marked difference in firm profitability.

We start with the first component of ROIC. *Return on revenue (ROR)* indicates how much of the firm's sales is converted into profits. Apple's ROR was 29.3 percent, while Microsoft's ROR was 32 percent. For every $100 in revenues, Apple earns $29.30 in profit, while Microsoft earns $32 in profit. On this metric, Microsoft had a slight edge over Apple. Keep in mind, however, that Apple's 2014 revenues were $183 billion, while Microsoft's were $83 billion. Thus, Apple is 2.2 times larger than Microsoft in terms of annual sales. As we investigate the differences in ROIC further, we will also discover that Microsoft has a higher cost structure than Apple, and that Apple is able to charge a much higher margin for its products and services than Microsoft.

To explore further drivers of this difference, we break down return on revenue into three additional financial ratios:

- Cost of goods sold (COGS) / Revenue.
- Research & development (R&D) expense / Revenue.
- Selling, general, & administrative (SG&A) expense / Revenue.

The first of these three ratios, *COGS / Revenue,* indicates how efficiently a company can produce a good. On this metric, Microsoft turns out to be much more efficient than Apple, with a difference of over 30 percentage points (see Exhibit 5.1). This is because Microsoft's vast majority of revenues (87 percent) came from software and online services, with little cost attached to such digitally delivered products and services. In contrast, Apple's revenues were mostly from mobile devices, combining both hardware and software. In particular, the iPhone made up two-thirds (or over $120 billion) of Apple's total revenues (in 2014).

Even though Apple is more than two times as large as Microsoft in terms of revenues, it spends much less on research and development or on marketing and sales. Both of these help drive down Apple's cost structure. In particular, the next ratio, *R&D / Revenue,* indicates how much of each dollar that the firm earns in sales is invested to conduct research and development. A higher percentage is generally an indicator of a stronger focus on innovation to improve current products and services, and to come up with new ones.

Interestingly, Apple's R&D is much less intense than Microsoft's. Apple spent 3.3 percent on R&D for every dollar of revenue, while Microsoft spent almost four times as much (13.1 percent R&D). Even considering the fact that Microsoft's revenues were $83 billion versus Apple's $183 billion, Microsoft ($11 billion) spent more on R&D in absolute dollars than Apple ($6 billion). For every $100 earned in revenues Microsoft spent $13.10 on R&D, while Apple only spent $3.30. For more than a decade now, Microsoft generally spends the most on R&D in absolute terms among all technology firms.

In contrast, Apple has spent much less on research and development than other firms in the high-tech industry, in both absolute and relative terms. Apple's co-founder and long-time CEO, the late Steve Jobs, defined Apple's R&D philosophy as follows: "Innovation has nothing to do with how many R&D dollars you have. When Apple came up with the Mac, IBM was spending at least 100 times more on R&D. It's not about money. It's about the people you have, how you're led, and how much you get it."[7]

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The third ratio in breaking down return on revenue, *SG&A / Revenue,* indicates how much of each dollar that the firm earns in sales is invested in sales, general, and administrative (SG&A) expenses. Generally, this ratio is an indicator of the firm's focus on marketing and sales to promote its products and services. Again, Microsoft ($20 billion) not only outspent Apple ($18.3 billion) in absolute terms in marketing and sales expenses, but its SG&A intensity was more than 3.5 times as high as Apple's. For every $100 earned in revenues Microsoft spent $23.80 on sales and marketing, while Apple spent $6.60.

The second component of ROIC is *working capital turnover* (see Exhibit 5.1), which is a measure of how effectively capital is being used to generate revenue. This is where Apple outperforms Microsoft by a wide margin (36.0 vs. 1.3). For every dollar that Apple puts to work, it realizes a whopping $36.00 of sales; this rate is more than 28 times higher than the conversion rate for Microsoft, which only realizes $1.30 in sales for each dollar invested.

This huge difference provides an important clue for Microsoft's managers to dig deeper to find the underlying drivers in working capital turnover. This enables managers to uncover which levers to pull in order to improve firm financial performance. In a next step, therefore, managers break down working capital turnover into other ratios, including *fixed asset turnover, inventory turnover, receivables turnover,* and *payables turnover.* Each of these metrics is a measure of how effective a particular item on the balance sheet is contributing to revenue.

Fixed asset turnover (Revenue / Fixed assets) measures how well a company leverages its fixed assets, particularly property, plant, and equipment (PPE). Microsoft's fixed assets contribute $6.70 of revenue for every dollar spent on PPE, while each dollar of Apple's fixed assets generates $8.90. This ratio indicates how much of a firm's capital is tied up in its fixed assets. Higher fixed assets often go along with lower firm valuations (more on this in the section "Shareholder Value Creation" later in this chapter).

The performance difference between Apple and Microsoft in regard to *inventory turnover (COGS / Inventory)* is even more striking. Cost of goods sold (COGS) captures the firm's production cost of merchandise it *has sold.* Inventory is the cost of the firm's merchandise *to be* sold. This ratio indicates how much of a firm's capital is tied up in its inventory. Apple turned over its inventory more than 53 times during 2014, which implies that the company had very little capital tied up in its inventory. Apple benefited from strong demand for its products, as well as an effective management of its global supply chain. The vast majority of Apple's manufacturing is done in China by low-cost producer Foxconn, which employs over 1.2 million people.

In stark contrast, Microsoft turned over its inventory only about 10 times during the year. The firm's cost of hardware products to be sold was very high, because Microsoft acquired Nokia's mobile phone business for over $7 billion to more effectively compete against Apple. With the Nokia purchase, however, came a huge pile of unsold Lumia phones, added to Microsoft's inventory of unsold Surface tablet computers, tying up billions of dollars. In addition, Microsoft has likely higher production costs than Apple. Rather than outsourcing manufacturing to Foxconn or other original equipment manufacturers (OEMs), Microsoft owns and operates its manufacturing facilities. They are also located in countries with a generally higher cost structure (e.g., Brazil and Mexico, among others) than China. In comparison to Microsoft, Apple turned over its inventory more than five times faster! This big difference can be explained by disappointing demand for Lumia phones and Surface tablet computers and the lack of any exciting new product launches. Consumers continued to migrate to Apple iPhones, especially its popular iPhone 6, which launched in 2014.

The final set of financial ratios displayed in Exhibit 5.1 concerns the effectiveness of a company's receivables and payables. These are part of a company's cash flow management; they indicate the company's efficiency in extending credit, as well as collecting debts.

Higher ratios of *receivables turnover (Revenue / Accounts receivable)* imply more efficient management in collecting accounts receivable and shorter durations of interest-free loans to customers (i.e., time until payments are due). In contrast, *payables turnover (Revenue / Accounts payable)* indicates how fast the firm is paying its creditors and how much it benefits from interest-free loans extended by its suppliers. A lower ratio indicates more efficient management in paying creditors and generating interest-free loans from suppliers.

Satya Nadella, CEO Microsoft
© Brian Smale/ Microsoft/Getty Images

In the two dimensions of cash flow management, Apple displays a clear advantage over Microsoft. *Apple is paid much faster than Microsoft.* This might be explained by the fact that Apple's customers are mainly individual consumers who tend to pay with cash or credit cards at the time of purchase, while Microsoft's most important customers are other businesses, in particular, OEMs that make PCs and corporate IT departments and governments (who request to be invoiced, and thus pay later). On the other hand, *Apple takes quite a bit longer to pay its creditors.* Due to its stronger negotiating power, Apple might also be able to extend its payment periods, while Microsoft may be required to pay its creditors more quickly.

A deeper understanding of the fundamental drivers for differences in firm profitability allows managers to develop strategic approaches. For example, Satya Nadella, Microsoft's CEO since 2014, could rework Microsoft's cost structure, in particular, its very high R&D and SG&A spending. Perhaps, R&D dollars could be spent more effectively? Apple generates a much higher return to its R&D spending. Microsoft's sales and marketing expenses also seem to be quite high, but may be needed to rebuild Microsoft's brand image with a new focus on mobile and cloud computing. One of the biggest drains on operating profits for Microsoft is the multibillion-dollar Nokia handset acquisition, resulting in low *working capital turnover* and *inventory turnover* ratios.

LIMITATIONS OF ACCOUNTING DATA Although accounting data tend to be readily available and we can easily transform them into financial ratios to assess and evaluate competitive performance, they also exhibit some important limitations:

- *All accounting data are historical and thus backward-looking.* Accounting profitability ratios show us only the outcomes from past decisions, and the past is no guarantee of future performance. There is also a significant time delay before accounting data become publicly available. Some strategists liken making decisions using accounting data to driving a car by looking in the rearview mirror.[8] While financial strength certainly helps, past performance is no guarantee that a company is prepared for market disruption. Rather, as we saw in Chapter 4, IBM survived over the last century only by complete transformation of its capabilities multiple times in response to radical technological innovations.
- *Accounting data do not consider off–balance sheet items.* Off–balance sheet items, such as pension obligations (quite large in some U.S. companies) or operating leases in the retail industry, can be significant factors. For example, one retailer may own all its stores, which would properly be included in the firm's assets; a second retailer may lease all its stores, which would *not be* listed as assets. All else being equal, the second retailer's return on assets (ROA) would be higher. Strategists address this shortcoming by adjusting accounting data to obtain an *equivalent* economic capital base, so that they can compare companies with different capital structures.
- *Accounting data focus mainly on tangible assets, which are no longer the most important.*[9] This limitation of accounting data is nicely captured in the adage: *Not everything that can be counted counts. Not everything that counts can be counted.*[10] Although accounting data capture some intangible assets, such as the value of intellectual property

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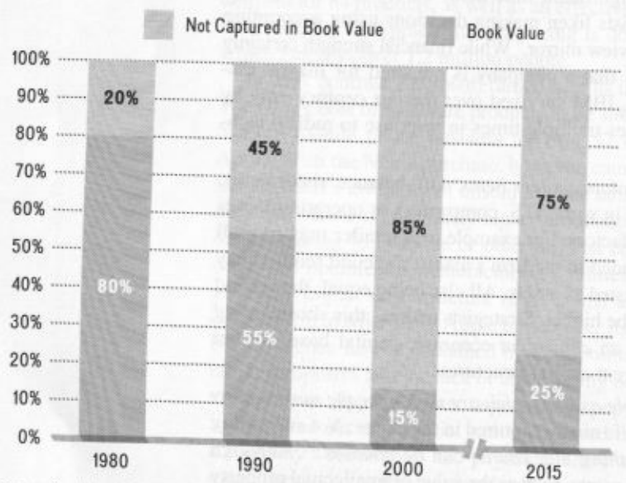
(patents, trademarks, and so on) and customer goodwill, many key intangible assets are not captured. Today, the most competitively important assets tend to be intangibles such as innovation, quality, and customer experience, which are not included in a firm's balance sheets. For example, Tesla's core competency in designing high-performance all-electric vehicles is not a balance sheet item, but nonetheless a critical foundation in its quest for competitive advantage.

INTANGIBLES AND THE VALUE OF FIRMS Intangible assets that are not captured in accounting data have become much more important in firms' stock market valuations over the last few decades. Exhibit 5.2 shows the firm's book value (accounting data capturing the firm's actual costs of assets minus depreciation) as part of a firm's total stock market valuation (number of outstanding shares times share price). The firm's book value captures the historical cost of a firm's assets, whereas market valuation is based on future expectations for a firm's growth potential and performance. For the firms in the S&P 500 (the 500 largest publicly traded companies by market capitalization in the U.S. stock market, as determined by Standard & Poor's, a rating agency), the importance of a firm's book value has declined dramatically over time. This decline mirrors a commensurate increase in the importance of intangibles that contribute to growth potential and yet are not captured in a firm's accounting data.

In 1980, about 80 percent of a firm's stock market valuation was based on its book value with 20 percent based on the market's expectations concerning the firm's future performance. This almost reversed by 2000 (at the height of the Internet bubble), when firm valuations were based only 15 percent on assets captured by accounting data. The important take-away is that intangibles not captured in firms' accounting data have become much more important to a firm's competitive advantage. By 2015, about 75 percent of a firm's market valuation was determined by its intangibles. This explains why Google ($365 billion) is valued over six times more than GM ($59 billion), or why Facebook ($234 billion) is valued more than twice as much as Boeing ($110 billion).

EXHIBIT 5.2 / The Declining Importance of Book Value in a Firm's Stock Market Valuation, 1980–2015



Source: Analysis and depiction of data from Compustat, 1980–2015.

So what have we learned about accounting profitability? Key financial ratios based on accounting data give us an important tool with which to assess competitive advantage. In particular, they help us measure *relative* profitability, which is useful when comparing firms of different sizes over time. While not perfect, these ratios are an important starting point when analyzing the competitive performance of firms (and thus are a critical tool for case analysis). Again, see the "How to Conduct a Case Analysis" module (at the end of Part 4). We next turn to *shareholder value creation* as a second traditional way to measure and assess competitive advantage, attempting to overcome the shortcomings of a backward-looking internal focus on mostly tangible assets inherent in accounting profitability.

SHAREHOLDER VALUE CREATION

LO 5-2

Apply shareholder value creation to assess and evaluate competitive advantage.

Shareholders—individuals or organizations that own one or more shares of stock in a public company—are the legal owners of public companies. From the shareholders' perspective, the measure of competitive advantage that matters most is the return on their **risk capital**,[11] which is the money they provide in return for an equity share, money that they cannot recover if the firm goes bankrupt. In September 2008, the shareholders of Lehman Brothers, a global financial services firm, lost their entire investment of about $40 billion when the firm declared bankruptcy.

shareholders Individuals or organizations that own one or more shares of stock in a public company.

risk capital The money provided by shareholders in exchange for an equity share in a company; it cannot be recovered if the firm goes bankrupt.

Investors are primarily interested in a company's **total return to shareholders**, which is the return on risk capital, including stock price appreciation plus dividends received over a specific period. Unlike accounting data, total return to shareholders is an *external* and *forward-looking* performance metric. It essentially indicates how the stock market views all available public information about a firm's past, current state, and expected future performance, with most of the weight on future growth expectations. The idea that all available information about a firm's past, current state, and expected future performance is embedded in the market price of the firm's stock is called the *efficient-market hypothesis*.[12] In this perspective, a firm's share price provides an objective performance indicator. When assessing and evaluating competitive advantage, a comparison of rival firms' share price development or market capitalization provides a helpful yardstick when used over the *long term*. **Market capitalization** (or market cap) captures the total dollar market value of a company's total outstanding shares at any given point in time (*Market cap = Number of outstanding shares × Share price*). If a company has 50 million shares outstanding, and each share is traded at $200, the market capitalization is $10 billion (50,000,000 × $200 = $10,000,000,000, or $10 billion).[13]

total return to shareholders Return on risk capital that includes stock price appreciation plus dividends received over a specific period.

market capitalization A firm performance metric that captures the total dollar market value of a company's total outstanding shares at any given point in time.

All public companies in the United States are required to report total return to shareholders annually in the statements they file with the Securities and Exchange Commission (SEC). In addition, companies must also provide benchmarks, usually one comparison to the industry average and another to a broader market index that is relevant for more diversified firms.[14] Since competitive advantage is defined in relative terms, these benchmarks allow us to assess whether a firm has a competitive advantage. In its annual reports, Microsoft, for example, compares its performance to two stock indices: the NASDAQ computer index and the S&P 500. The computer index includes over 400 high-tech companies traded on the NASDAQ, including Apple, Adobe, Google, Intel, and Oracle. It provides a comparison of Microsoft to the computer industry—broadly defined. The S&P 500 offers a comparison to the wider stock market beyond the computer industry. In its 2014 annual report, Microsoft shows that it *underperformed* in comparison to both, the NASDAQ computer index and the S&P 500 since 2009, with the gap widening over time.[15] This is one reason Satya Nadella was appointed Microsoft's CEO in early 2014, following Steve Ballmer, who had served as CEO since 2000.

Effective strategies to grow the business can increase a firm's profitability and thus its stock price.[16] Indeed, investors and Wall Street analysts expect continuous growth. A firm's stock price generally increases only if the firm's rate of growth exceeds investors' expectations. This is because investors discount into the present value of the firm's stock price whatever growth rate they foresee in the future. If a low-growth business like Comcast (in cable TV) is expected to grow 2 percent each year but realizes 4 percent growth, its stock price will appreciate. In contrast, if a fast-growing business like Apple in mobile computing is expected to grow by 10 percent annually but delivers "only" 8 percent growth, its stock price will fall.

Investors also adjust their expectations over time. Since the business in the slow-growth industry surprised them by delivering higher than expected growth, they adjust their

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expectations upward. The next year, they expect this firm to again deliver 4 percent growth. On the other hand, if the industry average is 10 percent a year in the high-tech business, the firm that delivered 8 percent growth will again be expected to deliver at least the industry average growth rate; otherwise, its stock will be further discounted.

In ChapterCase 5, we noted that Apple was the most valuable company on the planet. In early 2015, Apple's market cap was a whopping $727 billion, twice as high as the second most valuable company worldwide, Exxon Mobil with $360 billion in market cap. Considering stock market valuations (*Share price × Number of outstanding shares*) over the long term provides a useful metric to assess competitive advantage. Exhibit 5.3 shows the stock market valuations for Apple and Microsoft from 1990 until early 2015. Microsoft was once the most valuable company worldwide (in December 1999 with close to $600 billion in market cap), but since then its market valuation has dropped more than 40 percent. The valuation declined because investors now have lower expectations concerning Microsoft's ability to deliver profitable growth in the future. In particular, Microsoft struggles with the transition from desktop to mobile computing. CEO Satya Nadella vows to move Microsoft away from its Windows-only business model to compete more effectively in a "mobile-first, cloud-first world."[17] It appears that investors view this strategic shift in a positive way because they believe it will put Microsoft on a future growth trajectory. Since a low in Microsoft's market cap of about $220 billion in early 2013, it has grown by more than 50 percent to over $340 billion by spring 2015. Nonetheless, Microsoft remains well below Apple, as Exhibit 5.3 clearly shows using market cap as its metric. This shows again that it is difficult to gain a competitive advantage, and even harder to sustain it over a prolonged period of time. *Competitive advantage is transitory!*

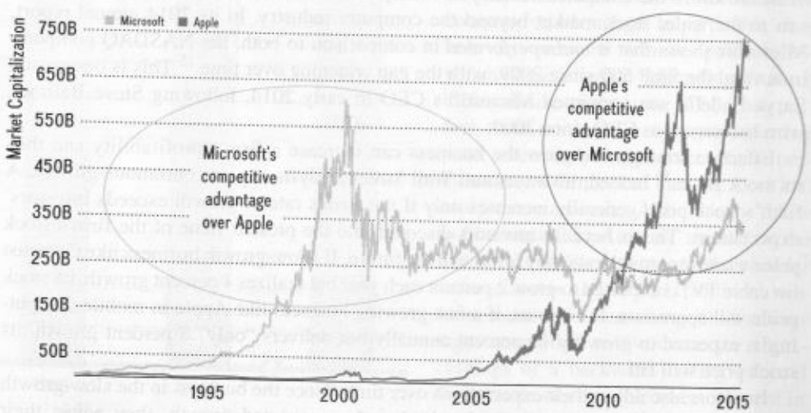
LIMITATIONS OF SHAREHOLDER VALUE CREATION Although measuring firm performance through total return to shareholders and firm market capitalization has many advantages, just as with accounting profitability, it has its shortcomings:

- *Stock prices can be highly volatile, making it difficult to assess firm performance, particularly in the short term.* This volatility implies that *total return to shareholders* is a better measure of firm performance and competitive advantage over the long term, because of the "noise" introduced by market volatility, external factors, and investor sentiment.

EXHIBIT 5.3

Stock Market Valuations of Apple and Microsoft, 1990–2015

Source: Depiction of publicly available data using YCHARTS; www.ycharts.com.



- *Overall macroeconomic factors such as economic growth or contraction, the unemployment rate, and interest and exchange rates all have a direct bearing on stock prices.* It can be difficult to ascertain the extent to which a stock price is influenced more by external macroeconomic factors (as discussed in Chapter 3) than by the firm's strategy (see also Exhibit 1.1 highlighting firm, industry, and other effects in overall firm performance).
- *Stock prices frequently reflect the psychological mood of investors, which can at times be irrational.* Stock prices can overshoot expectations based on economic fundamentals amid periods like the Internet boom, during which former Federal Reserve Chairman Alan Greenspan famously described investors' buoyant sentiments as "irrational exuberance."[18] Similarly, stock prices can undershoot expectations during busts like the 2008–2009 global financial crisis, during which investors' sentiment was described as "irrational gloom."[19]

ECONOMIC VALUE CREATION

LO 5-3

Explain economic value creation and different sources of competitive advantage.

The relationship between *economic value creation* and competitive advantage is fundamental in strategic management. It provides the foundation upon which to formulate a firm's competitive strategy for cost leadership or differentiation (discussed in detail in the next chapter). For now, it is important to note that a firm has a competitive advantage when it creates more *economic value* than rival firms. What does that mean?

economic value created Difference between value (V) and cost (C), or ($V - C$).

reservation price The maximum price a consumer is willing to pay for a product or service based on the total perceived consumer benefits.

Economic value created is the difference between a buyer's willingness to pay for a product or service and the firm's total cost to produce it. Let's assume you consider buying a laptop computer and you have a budget of $1,200. You have narrowed your search to two models, one offered by Firm A, the other by Firm B. Your subjective assessment of the benefits derived from owning Firm A's laptop is $1,000—this is the absolute maximum you'd be willing to pay for it, or the **reservation price**. For example, this could be a more or less generic, run-of-the-mill Dell laptop. In contrast, you value Firm B's laptop model at $1,200 because it has somewhat higher performance, is more user-friendly, and definitely has a higher "coolness-factor." Think of Apple's MacBook Pro with Retina display. Given that you value Firm B's laptop by $200 more than Firm A's model, you will purchase a laptop from Firm B (and, in this case, end up paying as much as your reservation price allows).

Let's move now from your individual considerations to the overall market for laptop computers in order to derive implications for firm-level competitive advantage. To simplify this illustration, only Firm A and Firm B are competing in the market for laptops. Assuming that both Firm A and Firm B have the same total unit cost of producing the particular laptop models under consideration ($400) and the market at large has preferences similar to yours, then Firm B will have a competitive advantage. This is because Firm B creates more economic value than Firm A (by $200), but has the same total cost, depicted in Exhibit 5.4. The amount of *total perceived consumer benefits* equals the *maximum willingness to pay*, or the *reservation price*. This amount is then split into economic value creation and the firm's total unit cost. Firm A and Firm B have identical total unit cost, $400 per laptop. However, Firm B's laptop (e.g., Apple's MacBook Pro) is perceived to provide more utility than Firm A's laptop (e.g., Dell's generic laptop), which implies that Firm B creates more economic value ($1,200 − $400 = $800) than Firm A ($1,000 − $400 = $600). Taken together, Firm B has a competitive advantage over Firm A because Firm B creates more economic value. This is because Firm B's offering has greater total perceived consumer benefits than Firm A's, while the firms have the same total cost. In short, Firm B's advantage is based on superior *differentiation* leading to higher perceived value. Further, the competitive advantage can be quantified: It is $200 (or, $1,200 − $1,000) per laptop sold for Firm B over Firm A (see Exhibit 5.4).

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EXHIBIT 5.4 / Firm B's Competitive Advantage: Same Cost as Firm A but Firm B Creates More Economic Value

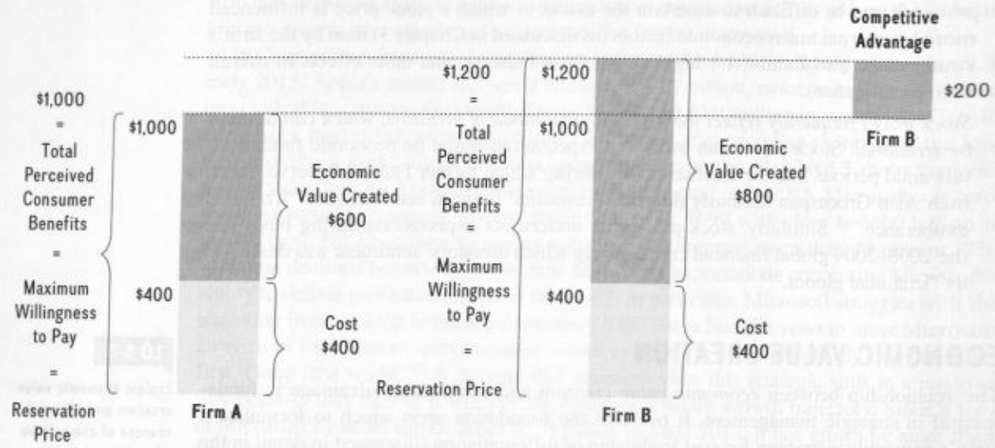
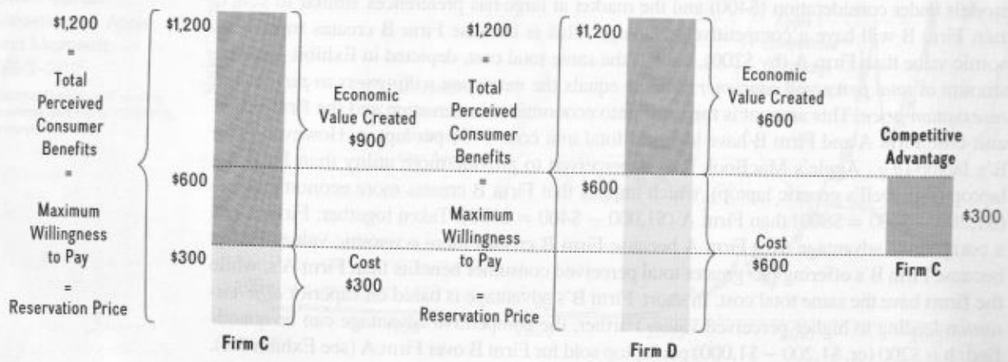


Exhibit 5.4 shows that Firm B's competitive advantage is based on greater economic value creation because of superior product differentiation. In addition, a firm can achieve competitive advantage through a second avenue. In particular, competitive advantage can also result from a relative *cost advantage* over rivals, assuming both firms can create the same total perceived consumer benefits.

As shown in Exhibit 5.5, two different laptop makers each offer a model that has the same perceived consumer benefits ($1,200). Firm C, however, creates economic value greater ($900, or $1,200 – $300) than that of Firm B ($600, or $1,200 – $600). This is because Firm C's total unit cost ($300) is lower than Firm D's ($600). Firm C has a relative cost advantage over Firm D, while both products provide identical total perceived consumer benefits ($1,200). In this example, Firm C could be Lenovo with lower cost structure than Firm D, which could be HP, but both firms offer the same value. As Exhibit 5.5 shows,

EXHIBIT 5.5 / Firm C's Competitive Advantage: Same Total Perceived Consumer Benefits as Firm D but Firm C Creates More Economic Value



Firm C has a competitive advantage over Firm D because it has lower costs. Firm C's competitive advantage over Firm D is in the amount of $300 for each laptop sold. Here, the source of the competitive advantage is a relative cost advantage over its rival.

So far we have looked at situations in which products are priced at the maximum a consumer might be willing to pay. But markets generally don't work like that. More often, the economic value created is shared among the producer and the consumer. That is, most of the time consumers are able to purchase the product at a price point below the maximum they are willing to spend. Both the seller and the buyer benefit.

For ease in calculating competitive advantage, three components are needed. These will help us to further explain *total perceived consumer benefits* and *economic value created* in more detail:

1. Value (V)
2. Price (P)
3. Cost (C)

Value denotes the dollar amount (V) a consumer attaches to a good or service. Value captures a consumer's willingness to pay and is determined by the perceived benefits a good or service provides to the buyer. The cost (C) to produce the good or service matters little to the consumer, but it matters a great deal to the producer (supplier) of the good or service since it has a direct bearing on the profit margin.

value
The dollar amount (V) a consumer attaches to a good or service; the consumer's maximum willingness to pay; also called *reservation price*.

Let's return to our laptop example from Exhibit 5.4, in which two firms sold their laptops at different prices ($1,000 for Firm A and $1,200 for Firm B), even though the costs were the same ($400). In each case, the price matched the consumer's maximum willingness to pay for the particular offering. Subtracting the costs, we found that Firm A created an economic value of $600 while Firm B created an economic value of $800, thus achieving a competitive advantage. In most market transactions, however, some of the economic value created benefits the consumer as well.

Again, let's revisit the example depicted in Exhibit 5.4. The consumer's preference was to buy the laptop from Firm B, which she would have done because it matched her reservation price. Let's assume Firm B's laptop is actually on sale for $1,000 (everything else remains constant). Assume the consumer again chose to purchase the laptop of Firm B rather than the one offered by Firm A (which she considered inferior). In this case, some of the economic value created by Firm B goes to the consumer. On a formula basis, total perceived value of Firm B's laptop ($1,200) splits into *economic value created* ($V - C = \$800$) plus *total unit cost* ($C = \$400$), or: $V = (V - C) + C$.

The difference between the price charged (P) and the cost to produce (C) is the **profit**, or **producer surplus**. In the laptop example in Exhibit 5.6, if the price charged is $1,000, the profit is $P - C = \$1{,}000 - \$400 = \$600$. The firm captures this amount as profit per unit sold. As the consumer, you capture the difference between what you would have been willing to pay (V) and what you paid (P), called **consumer surplus**. In our example, the consumer surplus is $V - P = \$1{,}200 - \$1{,}000$, or $200. *Economic value creation* therefore equals *consumer surplus* plus *firm profit*, or $(V - C) = (V - P) + (P - C)$. In the laptop example:

profit
Difference between price charged (P) and the cost to produce (C), or ($P - C$); also called *producer surplus*.

producer surplus
Another term for profit, the difference between price charged (P) and the cost to produce (C), or ($P - C$); also called *profit*.

consumer surplus
Difference between the value a consumer attaches to a good or service (V) and what he or she paid for it (P), or ($V - P$).

Economic Value Created ($1,200 – $400) = Consumer Surplus ($1,200 – $1,000) + Producer surplus ($1,000 – $400) = $200 + $600 = $800.

The relationship between consumer and producer surplus is the reason trade happens: Both transacting parties capture *some* of the overall value created. Note, though, that the distribution of the value created between parties need not be equal to make trade worthwhile. In the example above (illustrated in Exhibit 5.6), the consumer surplus was $200, while profit per unit sold was $600.

In some cases, where firms offer highly innovative products or services, the relationship can be even more skewed. The entry-level model of the Apple Watch retailed for $349

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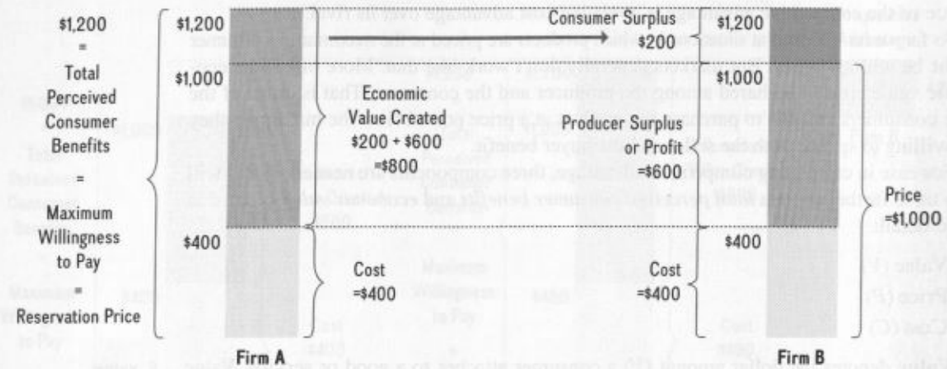
EXHIBIT 5.6 / The Role of Consumer Surplus and Producer Surplus (Profit)



(in 2015), and the high-tech firm is predicted to sell millions of it. An analysis by an independent engineering team, however, revealed that the firm's total cost in terms of materials and labor for the Apple Watch is no more than $84.[20] Thus, Apple's profit for each watch sold is an estimated $265, with a profit margin of 315 percent.

The economic value creation framework shows that strategy is about

1. Creating economic value.
2. Capturing as much of it as possible.

In contrast to Apple, consider Amazon as a counter-example: It is creating a large amount of value for its customers, but it is not capturing much, if any, of it. Amazon has had several years of negative net income as it attempts to build a stronger position in a variety of businesses. Its cloud computing service offering, Amazon Web Services (AWS), for example, is creating huge value for the businesses that run its computing needs on AWS, businesses including Airbnb, Condé Nast, Comcast, Foursquare, HTC, NASA, Nokia, and Pfizer, but Amazon's "profit" margin is a negative 1 to 2 percent.[21] In this case, Amazon's customers are capturing the value that Amazon is creating.

Exhibit 5.7 illustrates how the components of economic value creation fit together conceptually. On the left side of the graph, V represents the total perceived consumer benefits, as captured in the consumer's maximum willingness to pay. In the lower part of the center bar, C is the cost to produce the product or service (the unit cost). It follows that the difference between the consumers' maximum willingness to pay and the firm's cost $(V - C)$ is the economic value created. The price of the product or service (P) is indicated in the dashed line. The economic value created $(V - C)$, as shown in Exhibit 5.7, is split between producer and consumer: $(V - P)$ is the value the consumer captures *(consumer surplus)*, and $(P - C)$ is the value the producer captures *(producer surplus,* or *profit)*.

Competitive advantage goes to the firm that achieves the largest economic value created, which is the difference between V, the consumer's willingness to pay, and C, the cost to produce the good or service. The reason is that a large difference between V and C gives the firm two distinct pricing options: (1) It can charge higher prices to reflect the higher value and thus increase its profitability, or (2) it can charge the same price as competitors and thus gain market share. Given this, the strategic objective is to maximize $(V - C)$, or the economic value created.

Applying the notion of *economic value creation* also has direct implications for firm financial performance. Revenues are a function of the value created for consumers and the

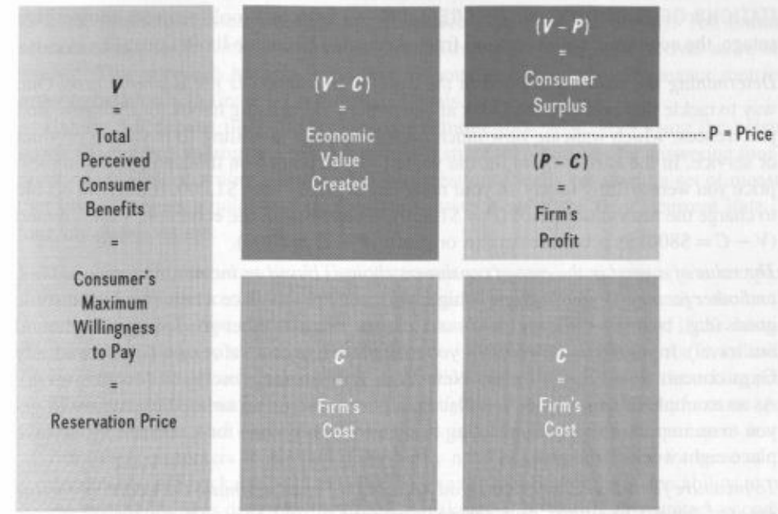


EXHIBIT 5.7 / Competitive Advantage and Economic Value Created: The Role of Value, Cost, and Price

price of the good or service, which together drive the volume of goods sold. In this perspective, profit (Π) is defined as total revenues (TR) minus total costs (TC):

$$\Pi = TR - TC, \text{ where } TR = P \times Q, \text{ or price times quantity sold}$$

Total costs include both fixed and variable costs. *Fixed costs* are independent of consumer demand—for example, the cost of capital to build computer manufacturing plants or an online retail presence to take direct orders. *Variable costs* change with the level of consumer demand—for instance, components such as different types of display screens, microprocessors, hard drives, and keyboards.

Rather than merely relying on historical costs, as done when taking the perspective of *accounting profitability* (introduced earlier), in the *economic value creation* perspective, *all costs,* including *opportunity costs,* must be considered. **Opportunity costs** capture the value of the best forgone alternative use of the resources employed.

opportunity costs The value of the best forgone alternative use of the resources employed.

An entrepreneur, for example, faces two types of opportunity costs: (1) forgone wages she could be earning if she was employed elsewhere and (2) the cost of capital she invested in her business, which could instead be invested in, say, the stock market or U.S. Treasury bonds. At the end of the year, the entrepreneur considers her business over the last 12 months. She made an *accounting profit* of $70,000, calculated as total revenues minus expenses, which include all historical costs but not opportunity costs. But she also realizes she has forgone $60,000 in salary she could have earned as an employee at another firm. In addition, she knows she could have earned $15,000 in interest if she had bought U.S. Treasury bills with a 2 percent return instead of investing $750,000 in her business. The opportunity cost of being an entrepreneur was $75,000 ($60,000 + $15,000). Therefore, when considering all costs, including opportunity costs, she actually experienced an economic loss of $5,000 ($75,000 – $70,000). When considering her future options, she should stay in business only if she values her independence as an entrepreneur more than $5,000 per year, or thinks business will be better next year.

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LIMITATIONS OF ECONOMIC VALUE CREATION As with any tool to assess competitive advantage, the economic value creation framework also has some limitations:

- *Determining the value of a good in the eyes of consumers is not a simple task.* One way to tackle this problem is to look at consumers' purchasing habits for their revealed preferences, which indicate how much each consumer is willing to pay for a product or service. In the earlier example, the value (V) you placed on the laptop—the highest price you were willing to pay, or your reservation price—was $1,200. If the firm is able to charge the reservation price ($P = \$1{,}200$), it captures all the economic value created ($V - C = \$800$) as producer surplus or profit ($P - C = \$800$).
- *The value of a good in the eyes of consumers changes based on income, preferences, time, and other factors.* If your income is high, you are likely to place a higher value on some goods (e.g., business-class air travel) and a lower value on other goods (e.g., Greyhound bus travel). In regard to preferences, you may place a higher value on a ticket for a Lady Gaga concert than on one for the New York Philharmonic orchestra (or vice versa). As an example of time value, you place a higher value on an airline ticket that will get you to an important business meeting tomorrow than on one for a planned trip to take place eight weeks from now.
- *To measure firm-level competitive advantage, we must estimate the economic value created for all products and services offered by the firm.* This estimation may be a relatively easy task if the firm offers only a few products or services. However, it becomes much more complicated for diversified firms such as General Electric or the Tata Group that may offer hundreds or even thousands of different products and services across many industries and geographies. Although the performance of individual strategic business units (SBUs) can be assessed along the dimensions described here, it becomes more difficult to make this assessment at the corporate level (more on this in our discussion of diversification strategy in Chapter 8).

The economic value creation perspective gives us one useful way to assess competitive advantage. This approach is conceptually quite powerful, and it lies at the center of many strategic management frameworks such as the generic business strategies (which we discuss in the next chapter). However, it falls somewhat short when managers are called upon to operationalize competitive advantage. When the need for "hard numbers" arises, managers and analysts frequently rely on firm financials such as *accounting profitability* or *shareholder value creation* to measure firm performance.

We've now completed our consideration of the three standard dimensions for measuring competitive advantage—accounting profitability, shareholder value, and economic value. Although each provides unique insights for assessing competitive advantage, one drawback is that they are more or less one-dimensional metrics. Focusing on just one performance metric when assessing competitive advantage, however, can lead to significant problems, because each metric has its shortcomings, as listed earlier. We now turn to two more conceptual and qualitative frameworks—the balanced scorecard and the triple bottom line—that attempt to provide a more holistic perspective on firm performance.

LO 5-4

Apply a balanced scorecard to assess and evaluate competitive advantage.

THE BALANCED SCORECARD

Just as airplane pilots rely on a number of instruments to provide constant information about key variables—such as altitude, airspeed, fuel, position of other aircraft in the vicinity, and destination—to ensure a safe flight, so should managers rely on multiple yardsticks

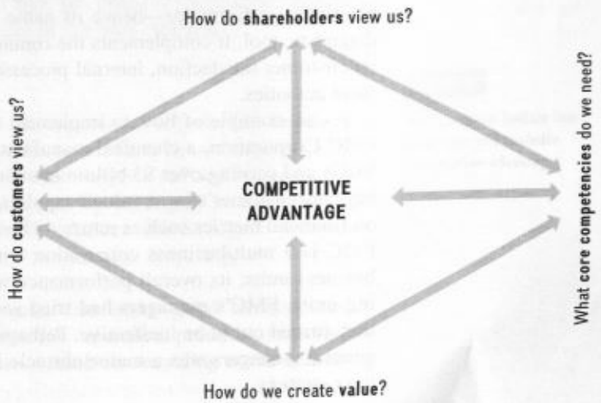
to more accurately assess company performance in an integrative way. The **balanced scorecard** is a framework to help managers achieve their strategic objectives more effectively.[22] This approach harnesses multiple internal and external performance metrics in order to balance both financial and strategic goals.

balanced scorecard Strategy implementation tool that harnesses multiple internal and external performance metrics in order to balance financial and strategic goals.

Exhibit 5.8 depicts the balanced-scorecard framework. Managers using the balanced scorecard develop appropriate metrics to assess strategic objectives by answering four key questions.[23] Brainstorming answers to these questions ideally results in a set of measures that give managers a quick but also comprehensive view of the firm's current state. The four key questions are:

1. *How do customers view us?* The customer's perspective concerning the company's products and services links directly to its revenues and profits. Consumers decide their reservation price for a product or service based on how they view it. If the customer views the company's offering favorably, she is willing to pay more for it, enhancing its competitive advantage (assuming production costs are well below the asking price). Managers track customer perception to identify areas to improve, with a focus on speed, quality, service, and cost. In the air-express industry, for example, managers learned from their customers that many don't really need next-day delivery for most of their documents and packages; rather what they really cared about was the ability to track the shipments. This discovery led to the development of steeply discounted second-day delivery by UPS and FedEx, combined with sophisticated real-time tracking tools online.
2. *How do we create value?* Answering this question challenges managers to develop strategic objectives that ensure future competitiveness, innovation, and organizational learning. The answer focuses on the business processes and structures that allow a firm to create economic value. One useful metric is the percentage of revenues obtained from new product introductions. For example, 3M requires that 30 percent of revenues must come from products introduced within the last four years.[24] A second metric, aimed at assessing a firm's external learning and collaboration capability, is to stipulate that a certain percentage of new products must originate from outside the firm's boundaries.[25] Through its Connect + Develop program, the consumer products company Procter & Gamble has raised the percentage of new products that originated (at least partly) from outside P&G, from 15 to 35 percent.[26]
3. *What core competencies do we need?* This question focuses managers internally, to identify the core competencies needed to achieve their objectives and the accompanying business processes that support, hone, and leverage those competencies. As mentioned in the last chapter, Honda's core competency is to design and manufacture small but powerful and highly reliable engines. Its business model is to find places to put its engines. Beginning with motorcycles in 1948, Honda nurtured this core competency over many decades and is leveraging it to reach stretch goals in the design, development, and manufacture of small airplanes.

EXHIBIT 5.8 / Balanced-Scorecard Approach to Creating and Sustaining Competitive Advantage



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Today, consumers still value reliable, gas-powered engines made by Honda. If consumers start to value electric motors more because of zero emissions, lower maintenance costs, and higher performance metrics, among other possible reasons, the value of Honda's engine competency will decrease. If this happens, then Tesla's core competency in designing and building high-powered battery packs and electric drivetrains will become more valuable. In turn, Tesla might then be able to leverage this core competency into a strong strategic position in the emerging all-electric car and mobility industry.

4. *How do shareholders view us?* The final perspective in the balanced scorecard is the shareholders' view of financial performance (as discussed in the prior section). Some of the measures in this area rely on accounting data such as cash flow, operating income, ROIC, ROE, and, of course, total returns to shareholders. Understanding the shareholders' view of value creation leads managers to a more future-oriented evaluation.

By relying on both an internal and an external view of the firm, the balanced scorecard combines the strengths provided by the individual approaches to assessing competitive advantage discussed earlier: accounting profitability, shareholder value creation, and economic value creation.

ADVANTAGES OF THE BALANCED SCORECARD The balanced-scorecard approach is popular in managerial practice because it has several advantages. In particular, the balanced scorecard allows managers to:

- Communicate and link the strategic vision to responsible parties within the organization.
- Translate the vision into measurable operational goals.
- Design and plan business processes.
- Implement feedback and organizational learning to modify and adapt strategic goals when indicated.

The balanced scorecard can accommodate both short- and long-term performance metrics. It provides a concise report that tracks chosen metrics and measures and compares them to target values. This approach allows managers to assess past performance, identify areas for improvement, and position the company for future growth. Including a broader perspective than financials allows managers and executives a more balanced view of organizational performance—hence its name. In a sense, the balanced scorecard is a broad diagnostic tool. It complements the common financial metrics with operational measures on customer satisfaction, internal processes, and the company's innovation and improvement activities.

As an example of how to implement the balanced-scorecard approach, let's look at FMC Corporation, a chemical manufacturer employing some 5,000 people in different SBUs and earning over $3 billion in annual revenues.[27] To achieve its vision of becoming "the customer's most valued supplier," FMC's managers initially had focused solely on financial metrics such as return on invested capital (ROIC) as performance measures. FMC is a multibusiness corporation with several standalone profit-and-loss strategic business units; its overall performance was the result of both over- and underperforming units. FMC's managers had tried several approaches to enhance performance, but they turned out to be ineffective. Perhaps even more significant, short-term thinking by general managers was a major obstacle in the attempt to implement an effective business strategy.

Searching for improved performance, FMC's CEO decided to adopt a balanced-scorecard approach. It enabled the managers to view FMC's challenges and shortcomings from a holistic, company perspective, which was especially helpful to the general managers of different business units. In particular, the balanced scorecard allowed general managers to focus on market position, customer service, and new product introductions that could generate long-term value. Using the framework depicted in Exhibit 5.7, general managers had to answer tough follow-up questions such as: How do we become the customer's most valued supplier, and how can my division create this value for the customer? How do we become more externally focused? What are my division's core competencies and contributions to the company goals? What are my division's weaknesses?

Implementing a balanced scorecard allowed FMC's managers to align their different perspectives to create a more focused corporation overall. General managers now review progress along the chosen metrics every month, and corporate executives do so on a quarterly basis. Implementing a balanced-scorecard approach is not a onetime effort, but requires continuous tracking of metrics and updating of strategic objectives, if needed. It is a continuous process, feeding performance back into the strategy process to assess its effectiveness (see Chapter 2).

DISADVANTAGES OF THE BALANCED SCORECARD Though widely implemented by many businesses, the balanced scorecard is not without its critics.[28] It is important to note that the balanced scorecard is a tool for strategy *implementation,* not for strategy *formulation.* It is up to a firm's managers to formulate a strategy that will enhance the chances of gaining and sustaining a competitive advantage. In addition, the balanced-scorecard approach provides only limited guidance about which metrics to choose. Different situations call for different metrics. All of the three approaches to measuring competitive advantage—accounting profitability, shareholder value creation, and economic value creation—in addition to other quantitative and qualitative measures can be helpful when using a balanced-scorecard approach.

When implementing a balanced scorecard, managers need to be aware that a failure to achieve competitive advantage is not so much a reflection of a poor framework but of a strategic failure. The balanced scorecard is only as good as the skills of the managers who use it: They first must devise a strategy that enhances the odds of achieving competitive advantage. Second, they must accurately translate the strategy into objectives that they can measure and manage within the balanced-scorecard approach.[29]

Once the metrics have been selected, the balanced scorecard tracks chosen metrics and measures and compares them to target values. It does not, however, provide much insight into how metrics that deviate from the set goals can be put back on track.[30]

THE TRIPLE BOTTOM LINE

LO 5-5

Apply a triple bottom line to assess and evaluate competitive advantage.

Today, managers are frequently asked to maintain and improve not only the firm's economic performance but also its social and ecological performance. CEO Indra Nooyi responded by declaring PepsiCo's vision to be *Performance with Purpose* defined by goals in the social dimension (*human sustainability* to combat obesity by making its products healthier, and the *whole person at work* to achieve work/life balance) and ecological dimension (*environmental sustainability* in regard to clean water, energy, recycling, and so on), in addition to firm financial performance.

Being proactive along noneconomic dimensions can make good business sense. In anticipation of coming industry requirements for "extended producer responsibility," which requires the seller of a product to take it back for recycling at the end of its

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life, the German carmaker BMW was proactive. It not only lined up the leading car-recycling companies but also started to redesign its cars using a modular approach. The modular parts allow for quick car disassembly and reuse of components in the after-sales market (so-called refurbished or rebuilt auto parts).[31] Three dimensions—*economic, social, and ecological*—make up the **triple bottom line**, which is fundamental to a sustainable strategy. These three dimensions are also called the three Ps: profits, people, and planet:

triple bottom line Combination of economic, social, and ecological concerns—*or profits, people, and planet*—that can lead to a sustainable strategy.

- **Profits.** The *economic dimension* captures the necessity of businesses to be profitable to survive.
- **People.** The *social dimension* emphasizes the people aspect, such as PepsiCo's initiative of the *whole person at work*.
- **Planet.** The *ecological dimension* emphasizes the relationship between business and the natural environment.

sustainable strategy A strategy along the economic, social, and ecological dimensions that can be pursued over time without detrimental effects on people or the planet.

As the intersection of the three ovals (*profits, people,* and *planet*) in Exhibit 5.9 suggests, achieving positive results in all three areas can lead to a **sustainable strategy**. Rather than emphasizing sustaining a competitive advantage over time, *sustainable strategy* means a strategy that can be pursued over time without detrimental effects on people or the planet. Using renewable energy sources such as wind or solar power, for example, is sustainable over time. It can also be good for profits, or simply put "green is green," as Jeffrey Immelt, GE's CEO, is fond of saying. GE's renewable energy business brought in more than $6 billion in revenues in 2014 and made up roughly one quarter of GE's total business in its power and water division.[32]

business model A firm's plan that details how it intends to make money.

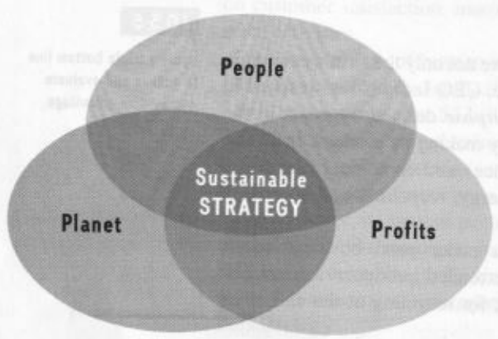
Like the balanced scorecard, the triple bottom line takes a more integrative and holistic view in assessing a company's performance.[33] Using a triple-bottom-line approach, managers audit their company's fulfillment of its social and ecological obligations to stakeholders such as employees, customers, suppliers, and communities as conscientiously as they track its financial performance.[34] In this sense, the triple-bottom-line framework is related to *stakeholder theory*, an approach to understanding a firm as embedded in a network of internal and external constituencies that each make contributions and expect consideration in return (see the discussion in Chapter 1). For an example of how Interface, a global leader in the carpet industry, uses a triple-bottom-line approach to gain and sustain a competitive advantage, read Strategy Highlight 5.1.

LO 5-6

Outline how business models put strategy into action.

EXHIBIT 5.9 / Sustainable Strategy: A Focus on the Triple Bottom Line

The simultaneous pursuit of performance along social, economic, and ecological dimensions provides a basis for a triple-bottom-line strategy.



5.2 Business Models: Putting Strategy into Action

Strategy is a set of goal-directed actions a firm takes to gain and sustain superior performance relative to competitors or the industry average. The translation of strategy into action takes place in the firm's **business model**, which details the firm's competitive tactics and initiatives. Simply put, the firm's business model explains *how the firm intends to make money*. The business model stipulates how the firm conducts its business with its buyers, suppliers, and partners.[37]

How companies do business can sometimes be as important to gaining and sustaining competitive advantage as what they do. This also implies that *business model innovation* might be as important as product or process innovation.

Strategy Highlight 5.1

Interface: The World's First Sustainable Company

The Atlanta-based Interface Inc. is the world's largest manufacturer of modular carpet with annual sales of roughly $1 billion. What makes the company unique is its strategic intent to become the world's first *fully sustainable* company. In 1994, founder Ray Anderson set a goal for the company to be "off oil" entirely by 2020. That included not using any petroleum-based raw materials or oil-related energy to fuel the manufacturing plants.

According to Collins and Porras in *Built to Last*, their classic study of high-performing companies over long periods of time, this is a "BHAG—a big hairy audacious goal." BHAGs are bold missions declared by visionary companies and are a "powerful mechanism to stimulate progress."[35] Weaning Interface off oil by 2020 is indeed a BHAG. Many see the carpet industry as an extension of the petrochemical industry, given its heavy reliance on fossil fuels and chemicals in the manufacturing, shipping, and installation of its products.

Today, Interface is not only the global leader in modular carpet but also in sustainability. The company estimates that between 1996 and 2008, it saved over $400 million due to its energy efficiency and use of recycled materials. Its business model is changing the carpet industry. Speaking of sustainability as a business model, Mr. Anderson concluded:

> Sustainability has given my company a competitive edge in more ways than one. It has proven to be the most powerful marketplace differentiator I have known in my long career. Our costs are down, our profits are up, and our products are the best they have ever been. Sustainable design has provided an unexpected wellspring of innovation, people are galvanized around a shared higher purpose, better people are applying, the best people are staying and working with a purpose, the goodwill in the marketplace generated by our focus on sustainability far exceeds that which any amount of advertising or marketing expenditure could have generated—this company believes it has found a better way to a bigger and more legitimate profit—a better business model.[36]

Consider Netflix, the video-streaming service that allows people to watch movies and TV shows on almost any Internet-enabled device, such as a tablet, PC, TV, or smartphone. Netflix's business model is to grow its global user base as large as possible and then to monetize it via monthly subscription fees. The cost of establishing a large library of streaming content is more or less fixed, but the per unit cost falls drastically as more users join. Netflix has been hugely successful in attracting new users; as of spring 2015 it had more than 61 million subscribers worldwide. Yet, while providing a large selection of high quality online streaming is a necessity of the Netflix business model, this element can and has been easily duplicated by Amazon, Hulu, and premium services on YouTube.

To lock in its large installed base of users, however, Netflix has begun producing and distributing original content such as the hugely popular shows *House of Cards* and *Orange Is the New Black*. Netflix also releases all episodes of a new season of a series at once, allowing subscribers to watch what they want, when they want. This has given rise to the practice of "binge watching," where subscribers will dedicate a weekend to watching all episodes, rather than making a regular weekly time commitment to watch a particular show. This demonstrates that for a business model to be successful, it might need to consist of several reinforcing activities. Netflix remains a moving target for its competition, which allows it to monetize its large user base with monthly subscription fees. This has allowed Netflix to grow to over $5 billion in annual revenues and $35 billion in market cap, while producing a positive net income. The expectations are high that Netflix can further drive this business model to continue its success across the world.

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To come up with an effective business model, a firm's managers first transform their strategy of how to compete into a blueprint of actions and initiatives that support the overarching goals. In a second step, managers implement this blueprint through structures, processes, culture, and procedures. If the company fails to translate a strategy into a profitable business model, the firm will run into trouble.

Take Zipcar, a member-based car-sharing company.[38] Zipcar came up with a new business model: It allowed its members to rent a vehicle online that was already in their vicinity for a few hours or a day. Users were charged for the duration of the use of the car, and gas and insurance are included in the rental fees. Zipcar appealed to urban dwellers and Millennials who prefer not to own a vehicle but need a car on occasion. The Zipcar member just paid for the service of access to a car as needed. The downside of Zipcar's business model is that it required a large amount of up-front investment to build the rental car fleet. Although Zipcar excelled in customer experience and technology, it was unable to obtain the capital necessary to scale its operation to be profitable. Given low barriers to imitation, numerous competitors have sprung up. The first competitors to Zipcar included traditional car rental companies and others that created Zipcar clones such as Hertz on Demand, Enterprise's WeCar, U-Haul's U Car Share, Avis On Location, and Daimler's Car2Go. Regional competitors also entered the industry, including City CarShare in the San Francisco Bay Area, I-GO in Chicago, and Mint in New York and Boston. Perhaps the most powerful competitors to Zipcar, however, were those that required no capital investment by the provider—ride-sharing services Uber, Lyft, and Sidecar. As a consequence, Zipcar's stock price fell rapidly. Zipcar was eventually acquired by rental car company Avis, which planned to combine its vast rental fleet with Zipcar's mobile technology and customer experience.

Often business model innovation combines new ideas with information technology. The sharing economy, for example, leverages information technology and Internet connectivity to offer peer-to-peer rental services such as ride sharing (Uber or Lyft), car rental (RelayRides), house cleaning (Handy), or someone running errands for you (TaskRabbit). Strategy Highlight 5.2 shows how Airbnb's business model revolutionized the hospitality and travel business.

Strategy Highlight 5.2

Airbnb: Tapping the Value of Unused Space

In 2007, the then unemployed Brian Chesky and Joe Gebbia became roommates in San Francisco. They could not afford their rent payments and had extra space and some inflatable mattresses in their loft. They decided to try renting out space on the mattresses and serving guests breakfast. After they got a few paying guests, they brought on web architect Nathan Blecharczyk to create a smooth web interface. They named the website "Air Bed and Breakfast," later shortened to Airbnb. The launch of their startup was timed to take advantage of the anticipated shortage of hotel rooms in Denver, Colorado, the site of the Democratic Party national convention in the summer of 2008.

After struggling initially, the Airbnb founders quickly realized that attractive photographs were the key to spaces being rented. The founders created a system whereby a professional photographer would take high-quality photographs of the location at no cost to the owner. Airbnb also streamlined the payment process between hosts and guests, profiting from a fee on the transaction. As a first mover in the peer-to-peer rental industry, Airbnb grew quickly. It also garnered fame and rave reviews for its unique accommodation offerings, including an airplane fuselage in Costa Rica, a chateau in France, a tree house in California, a cave in Spain, a windmill in Greece, and even a private island in Fiji.

Airbnb has allowed spaces that previously would have been unused to generate revenue, while also dramatically increasing the potential amount of accommodation space in the 191 countries (including Afghanistan, Cuba, and Iraq) where it has listings. As a result of a unique business model innovation, by spring 2015 Airbnb was valued at $20 billion.[39]

POPULAR BUSINESS MODELS

Given their critical importance to achieving competitive advantage, business models are constantly evolving. Below we will discuss the some of the more popular business models:[40]

- Razor-razorblades
- Subscription
- Pay as you go
- Freemium
- Wholesale
- Agency
- Bundling

Understanding the more popular business models today will increase the tools in your strategy toolkit.

- **Razor-razorblades**. The initial product is often sold at a loss or given away for free in order to drive demand for complementary goods. The company makes its money on the replacement part needed. As you might guess, it was invented by Gillette, which gave away its razors and sold the replacement cartridges for relatively high prices. The razor-razorblade model is found in many business applications today. For example, HP charges little for its laser printers but imposes high prices for its replacement toner cartridges.
- **Subscription**. The subscription model has been traditionally used for (print) magazines and newspapers. Users pay for access to a product or service whether they use the product or service during the payment term or not. Industries that use this model presently are cable television, cellular service providers, satellite radio, Internet service providers, and health clubs. Above we discussed Netflix, which uses a subscription model.
- **Pay as you go**. In the *pay-as-you-go business model*, users pay for only the services they consume. The pay-as-you-go model is most widely used by utilities providing power and water and cell phone service plans, but it is gaining momentum in other areas such as rental cars (e.g., Zipcar) and cloud computing. News providers such as *The New York Times* and *The Wall Street Journal* have created "pay walls" as a pay-as-you-go option.
- **Freemium.** The *freemium (free + premium) business model* provides the basic features of a product or service *free* of charge, but charges the user for *premium* services such as advanced features or add-ons.[41] For example, companies may provide a minimally supported version of their software as a trial (e.g., business application or video game) to give users the chance to try the product. Users later have the option of purchasing a supported version of software, which includes a full set of product features and product support.
- **Wholesale.** The traditional model in retail is called a wholesale model. Let's look at the book publishing industry as an example. Under the wholesale model, book publishers would sell books to retailers at a fixed price (usually 50 percent below the recommended retail price). Retailers, however, were free to set their own price on any book and profit from the difference between their selling price and the cost to buy the book from the publisher (or wholesaler).
- **Agency.** In this model the producer relies on an agent or retailer to sell the product, at a predetermined percentage commission. Sometimes the producer will also control the retail price. The agency model was long used in the entertainment industry, where agents place artists or artistic properties and then take their commission. More recently we see this approach at work in a number of online sales venues, as in Apple's pricing of book products or its app sales. (See further discussion following.)

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- **Bundling.** The bundling business model sells products or services for which demand is negatively correlated *at a discount*. Demand for two products is negatively correlated if a user values one product more than another. In the Microsoft Office Suite, a user might value Word more than Excel and vice versa. Instead of selling both products for $120 each, Microsoft bundles them in a suite and sells them combined at a discount, say $180. This bundling strategy allowed Microsoft to become the number-one provider of all major application software packages such as word processing, spreadsheets, slide show presentation, and so on. Before its bundling strategy, Microsoft faced strong competition in each segment. Indeed, Word Perfect was outselling Word, Lotus 1-2-3 was outselling Excel, and Harvard Graphics was outselling PowerPoint. The problem for Microsoft's competitors was that they did not control the operating system (Windows), which made their programs less seamless on this operating system. In addition, the competitor products to Microsoft were offered by three independent companies, so they lacked the option to bundle them at a discount.

DYNAMIC NATURE OF BUSINESS MODELS

Business models evolve dynamically, and we can see many combinations and permutations. Sometimes business models are tweaked to respond to disruptions in the market, efforts that can conflict with fair trade practices and may even prompt government intervention.

COMBINATION. Telecommunications companies such as AT&T or Verizon, to take one industry, combine the *razor-razorblade* model with the *subscription* model. They provide a basic cell phone at no charge, or significantly subsidize a high-end smartphone, when you sign up for a two-year wireless service plan. Telecom providers recoup the subsidy provided for the smartphone by requiring customers to sign up for lengthy service plans. This is why it is so critical for telecom providers to keep their *churn rate*—the proportion of subscribers that leave, especially before the end of the contractual term—as low as possible.

EVOLUTION. The freemium business model can be seen as an evolutionary variation on the razor-razorblade model. The base product is provided free, and the producer finds other ways to monetize the usage. The freemium model is used extensively by open-source software companies (e.g., Red Hat), mobile app companies, and other Internet businesses. Many of the free versions of applications include advertisements to make up for the cost of supporting nonpaying users. In addition, the paying premium users subsidize the free users. The freemium model is often used to build a consumer base when the marginal cost of adding another user is low or even zero (such as in software sales). Many online video games, including massive multiplayer online games and app-based mobile games, follow a variation of this model, allowing basic access to the game for free, but charging for power-ups, customizations, special objects, and similar things that enhance the game experience for users.

DISRUPTION. When introducing the agency model, we mentioned Apple and book publishing, and you may already know how severely Amazon disrupted the traditional wholesale model for publishers. Amazon took advantage of the pricing flexibility inherent in the wholesale model and offered many books (especially e-books) below the cost that other retailers had to pay to publishers. In particular, Amazon would offer newly released bestsellers, such as Dan Brown's novels, for $9.99 to promote its Kindle e-reader. Publishers and other retailers strongly objected because Amazon's retail price was lower than the wholesale price paid by retailers competing with Amazon. Moreover, the $9.99 e-book offer by Amazon made it untenable for other retailers to continue to charge $28.95 for newly released hardcover books (for which they had to pay $14 to $15 to the publishers). With its aggressive pricing, Amazon not only devalued the printed book, but also lost money on every book it sold. It did this to increase the number of users of its Kindle e-readers and tablets.

RESPONSE TO DISRUPTION. The market is dynamic, and in the above example, book publishers looked for another model. Many book publishers worked with Apple on an agency approach, in which the publishers would set the price for Apple and receive 70 percent of the revenue, while Apple received 30 percent. The approach is similar to the Apple App Store pricing model for iOS applications in which developers set a price for applications and Apple retains a percentage of the revenue.

Use of the agency model was intended to give publishers the leverage to raise e-book prices for retailers. Under the agency model, publishers could increase their e-book profits and price e-book more closely to prices of print books. Publishers inked their deals with Apple, but how could they get Amazon to play ball? For leverage, publishers withheld new releases from Amazon. This forced Amazon to raise prices on newly released e-books in line with the agency model to around $14.95.

LEGAL CONFLICTS. The rapid development of business models, especially in response to disruption, can lead producers to breach existing rules of commerce. In the above example, the publishers' response prompted an antitrust investigation. In 2012 the Department of Justice determined that Apple and major publishers had conspired to raise prices of e-books. To settle the legal action, each publisher involved negotiated new deals with retailers, including Amazon. A year later, Apple was found guilty of colluding with several major book publishers to fix prices on e-books and had to change its agency model.[42]

5.3 ◂▸ Implications for the Strategist

In this chapter, we discussed how to measure and assess competitive advantage using three traditional approaches: accounting profitability, shareholder value creation, and economic value creation. We then introduced two conceptual frameworks to help us understand competitive advantage in a more holistic fashion: the balanced scorecard and the triple bottom line. Exhibit 5.10 summarizes the concepts discussed.

Several managerial implications emerged from our discussion of competitive advantage and firm performance:

- No *best* strategy exists—only *better* ones (better in comparison with others). We must interpret any performance metric relative to those of competitors and the industry average. True performance can be judged only in comparison to other contenders in the field or the industry average, not on an absolute basis.
- The goal of strategic management is to integrate and align each business function and activity to obtain superior performance at the business unit and corporate levels. Therefore, competitive advantage is best measured by criteria that reflect *overall business unit performance* rather than the performance of specific departments. For example, although the functional managers in the marketing department may (and should) care greatly about the success or failure of their recent ad campaign, the *general* manager cares most about the performance implications of the ad campaign at the business unit level for which she has profit-and-loss responsibility. Metrics that aggregate upward and reflect overall firm and corporate performance are most useful to assess the effectiveness of a firm's competitive strategy.
- Both *quantitative and qualitative* performance dimensions matter in judging the effectiveness of a firm's strategy. Those who focus on only one metric will risk being blindsided by poor performance on another. Rather, managers need to rely on a more holistic perspective when assessing firm performance, measuring different dimensions over different time periods.
- A firm's business model is critical to achieving a competitive advantage. How a firm does business is as important as what it does.

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This concludes our discussion of competitive advantage, firm performance, and business models, and completes Part 1—strategy analysis—of the AFI framework. In Part 2, we turn our attention to the next steps in the AFI framework—strategy formulation. In Chapters 6 and 7, we focus on business strategy: *How should the firm compete (cost leadership, differentiation, or value innovation)?* In Chapters 8 and 9, we study corporate strategy: *Where should the firm compete (industry, markets, and geography)?* Chapter 10 looks at global strategy: *How and where (local, regional, national, and international) should the firm compete around the world?*

EXHIBIT 5.10 / How Do We Measure and Assess Competitive Advantage?

Competitive advantage is reflected in superior firm performance.

- We always assess competitive advantage *relative* to a benchmark, either using competitors or the industry average.
- Competitive advantage is a multifaceted concept.
- We can assess competitive advantage by measuring accounting profit, shareholder value, or economic value.
- The balanced-scorecard approach harnesses multiple internal and external performance dimensions to balance a firm's financial and strategic goals.
- More recently, competitive advantage has been linked to a firm's triple bottom line, the ability to maintain performance in the economic, social, and ecological contexts (profits, people, planet) to achieve a sustainable strategy.

CHAPTERCASE 5 / Consider This...*

GIVEN MICROSOFT'S LACKLUSTER performance since 2000, the once dominant company is now in turnaround mode. Over time, its competitive advantage turned into a competitive disadvantage, lagging behind Apple by a wide margin. Satya Nadella's strategic focus is to move Microsoft away from its Windows-only business model to compete more effectively in a "mobile-first, cloud-first world," the mantra he used in his appointment e-mail as CEO. Under his leadership, Microsoft made the Office Suite available on Apple iOS and Android mobile devices. Office 365, its cloud-based software offering, is now available as a subscription service starting at $6.99 per month for personal use and $69.99 for business use. Software applications can be accessed on any device, any time, with online storage, combined with Skype's global calling feature. Yet, Nadella needs to work hard to ensure Microsoft's future viability since Windows and Office were cash cows for so long. They are still generating almost half of revenues and some 60 percent of profits, but both continue to decline. The problem he faces is that the gross margin of "classic" PC-based Office is an astronomical 90 percent (due to Microsoft's "monopoly" position), while the gross margin for Office 365 is only around 50 percent. The cloud computing space with Google, Amazon, Apple, IBM, and others is fiercely competitive.[43]

Questions

1. Why is it so hard to gain a competitive advantage? Why is it even harder to sustain a competitive advantage?
2. Looking at the different ways to assess competitive advantage discussed in this chapter, does Apple have a competitive advantage over Microsoft using any of the approaches? Why or why not? In which approach is Microsoft looking "the best"? Explain.
3. Microsoft's new CEO, Satya Nadella, has made drastic changes to Microsoft's strategy. What was Microsoft's strategy before Nadella was appointed CEO? What is it now under his leadership? Do you agree that Nadella has formulated a promising strategy? Why or why not?
4. How much longer do you think Apple can sustain its competitive advantage (not just over Microsoft, but in general)? Explain.

***A strategic financial analysis exercise related to this ChapterCase is available in Connect.**

TAKE-AWAY CONCEPTS

This chapter demonstrated three traditional approaches for assessing and measuring firm performance and competitive advantage, as well as two conceptual frameworks designed to provide a more holistic, albeit more qualitative, perspective on firm performance. We also discussed the role of business models in translating a firm's strategy into actions.

LO 5-1 / Conduct a firm profitability analysis using accounting data to assess and evaluate competitive advantage.

- To measure competitive advantage, we must be able to (1) accurately assess firm performance, and (2) compare and benchmark the focal firm's performance to other competitors in the same industry or the industry average.
- To measure accounting profitability, we use standard metrics derived from publicly available accounting data.
- Commonly used profitability metrics in strategic management are *return on assets (ROA), return on equity (ROE), return on invested capital (ROIC),* and *return on revenue (ROR).* See the key financial ratios in five tables in the "How to Conduct a Case Analysis" guide.
- All accounting data are historical and thus backward-looking. They focus mainly on tangible assets and do not consider intangibles that are hard or impossible to measure and quantify, such as an innovation competency.

LO 5-2 / Apply shareholder value creation to assess and evaluate competitive advantage.

- Investors are primarily interested in total return to shareholders, which includes stock price appreciation plus dividends received over a specific period.
- Total return to shareholders is an external performance metric; it indicates how the market views all publicly available information about a firm's past, current state, and expected future performance.
- Applying a shareholders' perspective, key metrics to measure and assess competitive advantage are the return on (risk) capital and market capitalization.
- Stock prices can be highly volatile, which makes it difficult to assess firm performance. Overall macroeconomic factors have a direct bearing on stock prices. Also, stock prices frequently reflect the psychological mood of the investors, which can at times be irrational.
- Shareholder value creation is a better measure of competitive advantage over the *long term* due to the "noise" introduced by market volatility, external factors, and investor sentiment.

LO 5-3 / Explain economic value creation and different sources of competitive advantage.

- The relationship between economic value creation and competitive advantage is fundamental in strategic management. It provides the foundation upon which to formulate a firm's competitive strategy of cost leadership or differentiation.
- Three components are critical to evaluating any good or service: value (V), price (P), and cost (C). In this perspective, cost includes opportunity costs.
- Economic value created is the difference between a buyer's willingness to pay for a good or service and the firm's cost to produce it ($V - C$).
- A firm has a competitive advantage when it is able to create more economic value than its rivals. The source of competitive advantage can stem from higher perceived value creation (assuming equal cost) or lower cost (assuming equal value creation).

LO 5-4 / Apply a balanced scorecard to assess and evaluate competitive advantage.

- The balanced-scorecard approach attempts to provide a more integrative view of competitive advantage.
- Its goal is to harness multiple internal and external performance dimensions to balance financial and strategic goals.
- Managers develop strategic objectives for the balanced scorecard by answering four key questions: (1) How do customers view us? (2) How do we create value? (3) What core competencies do we need? (4) How do shareholders view us?

LO 5-5 / Apply a triple bottom line to assess and evaluate competitive advantage.

- Noneconomic factors can have a significant impact on a firm's financial performance, not to mention its reputation and customer goodwill.

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- Managers are frequently asked to maintain and improve not only the firm's economic performance but also its social and ecological performance.
- Three dimensions—economic, social, and ecological, also known as *profits, people,* and *planet*—make up the triple bottom line. Achieving positive results in all three areas can lead to a sustainable strategy—a strategy that can endure over time.
- A sustainable strategy produces not only positive financial results, but also positive results along the social and ecological dimensions.
- Using a triple-bottom-line approach, managers audit their company's fulfillment of its social and ecological obligations to stakeholders such as employees, customers, suppliers, and communities in as serious a way as they track its financial performance.
- The triple-bottom-line framework is related to stakeholder theory, an approach to understanding a firm as embedded in a network of internal and external constituencies that each make contributions and expect consideration in return.

LO 5-6 / Outline how business models put strategy into action.

- The translation of a firm's strategy *(where and how to compete for competitive advantage)* into action takes place in the firm's business model *(how to make money).*
- A business model details how the firm conducts its business with its buyers, suppliers, and partners.
- How companies do business is as important to gaining and sustaining competitive advantage as what they do.
- Some important business models include *razor-razorblade, subscription, pay as you go,* and *freemium.*

KEY TERMS

Balanced scorecard *(p. 157)*
Business model *(p. 160)*
Consumer surplus *(p. 153)*
Economic value created *(p. 151)*
Market capitalization *(p. 149)*
Opportunity costs *(p. 155)*
Producer surplus *(p. 153)*
Profit *(p. 153)*
Reservation price *(p. 151)*
Risk capital *(p. 149)*
Shareholders *(p. 149)*
Sustainable strategy *(p. 160)*
Total return to shareholders *(p. 149)*
Triple bottom line *(p. 160)*
Value *(p. 153)*

DISCUSSION QUESTIONS

1. Domino's Pizza has been in business over 50 years and claimed to be "#1 Worldwide in Pizza Delivery" in 2013. Visit the company's business-related website (www.dominosbiz.com) and read the company profile under the "Investors" tab. Does the firm focus on the accounting, shareholder, or economic perspective in describing its competitive advantage in the profile?
2. For many people, the shareholder perspective is perhaps the most familiar measure of competitive advantage for publicly traded firms. What are some of the disadvantages of using shareholder value as the sole point of view for defining competitive advantage?
3. Interface, Inc., is discussed in Strategy Highlight 5.1. It may seem unusual for a business-to-business carpet company to be using a triple-bottom-line approach for its strategy. What other industries do you think could productively use this approach? How would it change customers' perceptions if it did?
4. The chapter highlights several firms that are developing business models around a "sharing economy." The idea being that assets not currently in use by their owners (cars, car seats, homes, rooms, etc.) can be rented to (shared with) others. What other industries can you think of that can be disrupted by this new business model? Where do you see "excess" space or other assets that could perhaps be utilized more efficiently?

ETHICAL/SOCIAL ISSUES

1. You work as a supervisor in a manufacturing firm. The company has implemented a balanced-scorecard performance-appraisal system and a financial bonus for exceeding goals. A major customer order for 1,000 units needs to ship to a destination across the country by the end of the quarter, which is two days away from its close. This shipment, if it goes well, will have a major impact on both your customer-satisfaction goals and your financial goals.

   With 990 units built, a machine breaks. It will take two days to get the parts and repair the machine. You realize there is an opportunity to load the finished units on a truck tomorrow with paperwork for the completed order of 1,000 units. You can have an employee fly out with the 10 remaining parts and meet the truck at the destination city once the machinery has been repaired. The 10 units can be added to the pallet and delivered as a complete shipment of 1,000 pieces, matching the customer's order and your paperwork. What do you do?
2. The chapter mentions that accounting data do not consider off–balance sheet items. A retailer that owns its stores will list the value of that property as an asset, for example, while a firm that leases its stores will not. What are some of the accounting and shareholder advantages of leasing compared to owning retail locations?
3. How do the perspectives on competitive advantage differ when comparing brick-and-mortar stores to online businesses (e.g., Best Buy vs. Amazon, Barnes & Noble vs. Amazon, The Gap vs. Threadless (noted in Strategy Highlight 1.1), Nordstrom vs. Zappos, and so on)? Make recommendations to brick-and-mortar stores as to how they can compete more effectively with online firms. What conclusions do you draw?

SMALL GROUP EXERCISES

//// Small Group Exercise 1

As discussed in the chapter, a balanced scorecard views the performance of an organization through four lenses: customer, innovation and learning, internal business, and financial. According to surveys from Bain & Company (a consulting firm), in recent years about 60 percent of firms in both public and private sectors have used a balanced scorecard for performance measures.[44]

With your group, create a balanced scorecard for the business school at your university. You might start by looking at your school's web page for a mission or vision statement. Then divide up the four perspectives among the team members to develop key elements for each one. It may be helpful to remember the four key balanced-scorecard questions from the chapter:

1. How do customers view us? (Hint: First discuss the following: Who are the customers? The students? The companies that hire students? Others?)
2. How do we create value?
3. What core competencies do we need?
4. How do shareholders view us? (For public universities, the shareholders are the taxpayers who invest their taxes into the university. For private universities, the shareholders are the people or organizations that endow the university.)

//// Small Group Exercise 2

At the next big family gathering, you want to impress your grandparents with the innovative ideas you have learned in business school. They have decades of experience in investing in the stock market and, from their college days, believe that economic profitability is a business's primary responsibility. You would like to convince them that a triple-bottom-line approach is the modern path to stronger economic performance. With your group members, prepare a casual yet informative speech that you can use to persuade them. They probably will not listen for more than two minutes, so you know you have to be clear and concise with interesting examples. You may want to reinforce your argument by consulting "The Bottom Line of Corporate Good," published in *Forbes.*[45] Present your speech in whatever way your instructor requests—to your group, the entire class, or post a video on YouTube.

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Chapter 6

Business Strategy: Differentiation, Cost Leadership, and Blue Oceans

Chapter Outline

6.1 Business-Level Strategy: How to Compete for Advantage
Strategic Position
Generic Business Strategies

6.2 Differentiation Strategy: Understanding Value Drivers
Product Features
Customer Service
Complements

6.3 Cost-Leadership Strategy: Understanding Cost Drivers
Cost of Input Factors
Economies of Scale
Learning Curve
Experience Curve

6.4 Business-Level Strategy and the Five Forces: Benefits and Risks
Differentiation Strategy: Benefits and Risks
Cost-Leadership Strategy: Benefits and Risks

6.5 Blue Ocean Strategy: Combining Differentiation and Cost Leadership
Value Innovation
Blue Ocean Strategy Gone Bad: "Stuck in the Middle"

6.6 Implications for the Strategist

Learning Objectives

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

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

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

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

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

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

CHAPTERCASE 6

JetBlue: "Stuck in the Middle"?

ENTREPRENEUR DAVID NEELEMAN, at the age of 25, co-founded Morris Air, a charter air service that in 1993 was purchased by Southwest Airlines (SWA). Morris Air was a low-fare airline that pioneered many cost-saving practices that later became standard in the industry, such as e-ticketing. After working as an airline executive for SWA, Neeleman founded another airline, JetBlue Airways, in 1998. When Neeleman established JetBlue, his strategy was to provide air travel at even lower costs than SWA. At the same time, he wanted to offer better service and more amenities.

Among high-profile incidents affecting JetBlue's overall reputation as a quality airline was the 2014 emergency landing at Long Beach Airport, after instruments identified a potentially overheated engine. Four passengers were injured in the evacuation.
© AP Photo/KABC-TV

JetBlue copied and improved upon many of SWA's cost-reducing activities. For example, it started by using just one type of airplane (the Airbus A320) to lower the costs of aircraft maintenance and pilot training. It also chose to fly point to point, directly connecting highly trafficked city pairs. In contrast, legacy airlines such as Delta, United, and American use a hub-and-spoke system; such systems connect many different locations via layovers at airport hubs. The point-to-point business model focuses on directly connecting fewer but more highly trafficked city pairs. This operating system lowers costs by not offering baggage transfers and schedule coordination with other airlines. In addition, JetBlue flew longer distances and transported more passengers per flight than SWA, further driving down its costs. Initially, JetBlue enjoyed the lowest cost per available seat-mile (an important performance metric in the airline industry) in the United States.

At the same time, JetBlue also attempted to enhance its differential appeal by driving up its perceived value. Its intent was to combine high-touch—to enhance the customer experience—and high-tech—to drive down costs. Some of JetBlue's value-enhancing features include high-end 100-seat Embraer regional jets with leather seats, free movie and television programming via DirecTV, XM Satellite Radio, along with friendly and attentive on-board service. Other amenities include its recently added Mint class, which offers personal check-in and early boarding, free bag checking and priority bag retrieval after flight, and complimentary gourmet food and alcoholic beverages in flight. It also features small private suites with a lie-flat bed up to 6 feet 8 inches long, a 15-inch high-resolution personal screen, and free in-flight high-speed Wi-Fi ("Fly-Fi"). JetBlue is also adding the newer Airbus 321 to its fleet, which scores significantly higher in customer satisfaction surveys than the older Airbus 320.

Also, because roughly one-third of customers prefer speaking to a live reservation agent, despite a highly functional website for reservations and other travel-related services, JetBlue decided to employ stay-at-home parents in the United States instead of following industry best practice by outsourcing its reservation system to India. The company suggests this "home sourcing" is more productive than outsourcing; it also says that customers' appreciation of the reservation experience more than makes up for the wage differential between the United States and India. To sum it up, JetBlue's "Customer Bill of Rights" declares its dedication to "bringing humanity back to air travel."

Several high-profile incidents, however, damaged JetBlue's outstanding customer service record. In early 2007, JetBlue's reputation took a major hit: Several flights were delayed due to a snowstorm in which the airline kept passengers on board the aircraft; some sat on the tarmac for up to nine hours. Many wondered whether JetBlue was losing its magic touch. A few months later, David

Neeleman left JetBlue.[1] Another reputation-damaging incident for JetBlue occurred in 2010 when a flight attendant, upset because a passenger refused to apologize after striking him with luggage when disembarking the plane, allegedly used the airplane's PA system to hurl obscenities at passengers. Then, he grabbed a couple of cold beers from the galley, deployed and slid down the emergency escape chute, before disappearing in a terminal at New York's JFK airport and proceeding to drive home (where he was later arrested). In 2012, a JetBlue flight to Las Vegas was diverted to Texas because of the pilot's erratic behavior during the flight. Among other bizarre behavior, the mentally unstable pilot told the co-pilot that "we need to take a leap of faith," and that "we're not going to Vegas." The co-pilot locked the pilot out of the cockpit and diverted the flight to Texas, where it landed safely. The issue of pilot mental health and the responsibilities of an airline have taken on new urgency in light of the 2015 deliberate crash into the French Alps of a Germanwings flight with 150 people on board by a co-pilot suffering from documented mental health issues.

For JetBlue, trying to combine a cost-leadership position with a differentiation strategy has meant that despite early years of competitive advantage, it is now struggling. As a consequence of several high-profile mishaps combined with the difficulty in resolving the trade-offs inherent in driving costs down while providing superior customer service and in-flight amenities, JetBlue has experienced a sustained competitive disadvantage since 2007.[2]

You will learn more about JetBlue by reading the chapter; related questions appear on page 200.

THE CHAPTERCASE illustrates how JetBlue ran into trouble by trying to combine two different business strategies at the same time—a *cost-leadership* strategy, focused on low cost, and a *differentiation* strategy, focused on delivering unique features and service. Although the idea of combining different business strategies seems appealing, it is quite difficult to execute a cost-leadership and differentiation position at the same time. This is because cost leadership and differentiation are distinct strategic positions. Pursuing them simultaneously results in trade-offs that work against each other. For instance, higher perceived customer value (e.g., providing leather seats throughout the entire aircraft and free Wi-Fi) comes with higher costs.

JetBlue attempts to be both a cost leader and differentiator. Many firms that attempt to combine cost-leadership and differentiation strategies end up being *stuck in the middle,* that is, the managers have failed to carve out a clear *strategic position.* In their attempt to be everything to everybody, these firms end up being neither a low-cost leader nor a differentiator. This common strategic failure contributed to JetBlue's sustained competitive disadvantage in recent years. Managers need to be aware to not end up being *stuck in the middle* between distinct strategic positions. A clear strategic position—either as differentiator or low-cost leader—can form the basis for competitive advantage.

This chapter, the first in Part 2 on strategy *formulation,* takes a close look at business-level strategy. It deals with *how* to compete for advantage. Based on the analysis of the external and internal environments (presented in Part 1), the second step in the *AFI Strategy Framework* (see page 175) is to formulate a business strategy that enhances the firm's chances of achieving a competitive advantage.

We begin our discussion of strategy formulation by defining *business-level strategy, strategic position,* and *generic business strategies.* We then look at two key generic business strategies: *differentiation* and *cost leadership.* We pay special attention to value and cost drivers that managers can use to carve out a clear strategic profile. Next, we relate the two business-level strategies to the external environment, in particular, to the five forces in order to highlight their respective benefits and risks. We then introduce the notion of *blue ocean strategy*—using *value innovation* to combine a differentiation and cost-leadership

strategic position. We also look at changes in competitive positioning over time before concluding with practical "Implications for the Strategist."

6.1 Business-Level Strategy: How to Compete for Advantage

LO 6-1

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

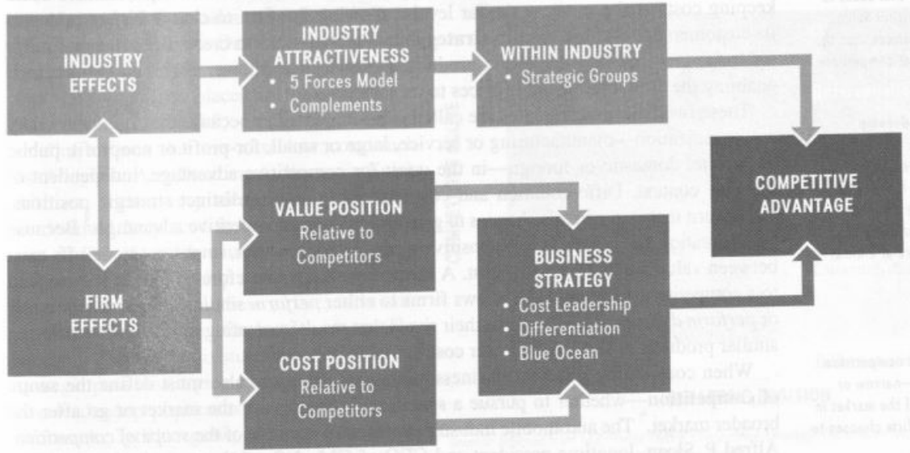
Business-level strategy details the goal-directed actions managers take in their quest for competitive advantage when competing in a single product market.[3] It may involve a single product or a group of similar products that use the same distribution channel. It concerns the broad question, "How should we compete?" To formulate an appropriate business-level strategy, managers must answer the who, what, why, and how questions of competition:

- *Who*—which customer segments will we serve?
- *What* customer needs, wishes, and desires will we satisfy?
- *Why* do we want to satisfy them?
- *How* will we satisfy our customers' needs?[4]

business-level strategy The goal-directed actions managers take in their quest for competitive advantage when competing in a single product market.

To formulate an effective business strategy, managers need to keep in mind that competitive advantage is determined jointly by *industry* and *firm* effects. As shown in Exhibit 6.1, one route to competitive advantage is shaped by *industry effects,* while a second route is determined by *firm effects.* As discussed in Chapter 3, an industry's profit potential can be assessed using the five forces framework plus the availability of complements. Managers need to be certain that the business strategy is aligned with the five forces that shape competition. They can evaluate performance differences among clusters of firms in the same industry by conducting a strategic-group analysis. The concepts introduced in Chapter 4 are key in understanding firm effects because they allow us to look inside firms and explain why they differ based on their resources, capabilities, and competencies. It is also important to note

EXHIBIT 6.1 / Industry and Firm Effects Jointly Determine Competitive Advantage



that industry and firm effects are not independent, but rather they are *interdependent,* as shown by the two-pointed arrow connecting industry effects and firm effects in Exhibit 6.1. At the firm level, performance is determined by value and cost positions *relative* to competitors. This is the firm's *strategic position,* to which we turn next.

STRATEGIC POSITION

We noted in Chapter 5 that competitive advantage is based on the difference between the *perceived value* a firm is able to create for consumers (V), captured by how much consumers are willing to pay for a product or service, and the total cost (C) the firm incurs to create that value. The greater the *economic value created* ($V - C$), the greater is a firm's potential for competitive advantage. To answer the business-level strategy question of how to compete, managers have two primary competitive levers at their disposal: value (V) and cost (C).

A firm's business-level strategy determines its *strategic position*—its strategic profile based on value creation and cost—in a specific product market. A firm attempts to stake out a valuable and unique position that meets customer needs while simultaneously creating as large a gap as possible between the value the firm's product creates and the cost required to produce it. Higher value creation tends to require higher cost. To achieve a desired strategic position, managers must make **strategic trade-offs**—choices between a cost *or* value position. Managers must address the tension between value creation and the pressure to keep cost in check so as not to erode the firm's economic value creation and profit margin. As shown in the ChapterCase, JetBlue experienced a competitive disadvantage because it was unable to effectively address the strategic trade-offs inherent in pursuing a cost-leadership *and* differentiation strategy at the same time. A business strategy is more likely to lead to a competitive advantage if a firm has a clear strategic profile, either as differentiator *or* a low-cost leader.

strategic trade-offs
Choices between a cost *or* value position. Such choices are necessary because higher value creation tends to generate higher cost.

GENERIC BUSINESS STRATEGIES

There are two fundamentally different generic business strategies—*differentiation* and *cost leadership.* A **differentiation strategy** seeks to create higher value for customers than the value that competitors create, by delivering products or services with unique features while keeping costs at the same or similar levels, allowing the firm to charge higher prices to its customers. A **cost-leadership strategy**, in contrast, seeks to create the same or similar value for customers by delivering products or services at a lower cost than competitors, enabling the firm to offer lower prices to its customers.

differentiation strategy
Generic business strategy that seeks to create higher value for customers than the value that competitors create.

cost-leadership strategy
Generic business strategy that seeks to create the same or similar value for customers at a lower cost.

These two business strategies are called *generic strategies* because they can be used by any organization—manufacturing or service, large or small, for-profit or nonprofit, public or private, domestic or foreign—in the quest for competitive advantage, independent of industry context. Differentiation and cost leadership require distinct strategic positions, and in turn increase a firm's chances to gain and sustain a competitive advantage.[5] Because value creation and cost tend to be positively correlated, however, important trade-offs exist between value creation and low cost. A business strategy, therefore, is more likely to lead to a competitive advantage if it allows firms to either *perform similar activities differently* or *perform different activities* than their rivals that result in creating more value or offering similar products or services at lower cost.[6]

When considering different business strategies, managers also must define the **scope of competition**—whether to pursue a specific, narrow part of the market or go after the broader market.[7] The automobile industry provides an example of the *scope of competition.* Alfred P. Sloan, longtime president and CEO of GM, defined the carmaker's mission as

scope of competition
The size—narrow or broad—of the market in which a firm chooses to compete.

providing *a car for every purse and purpose.* GM was one of the first to implement a multidivisional structure in order to separate the brands into strategic business units, allowing each brand to create its unique strategic position (and profit and loss responsibility) within the broad automotive market. For example, GM's product lineup ranges from the low-cost-positioned Chevy brand to the differentiated Cadillac brand. In this case, Chevy is pursuing a broad cost-leadership strategy, while Cadillac is pursuing a broad differentiation strategy. The two different business strategies are integrated at the corporate level at GM (more on *corporate strategy* in Chapters 8 and 9). On the other hand, Tesla Motors, the maker of all-electric cars (featured in ChapterCase 3), offers a highly differentiated product and pursues only a small market segment. At this point, it uses a *focused differentiation strategy.* In particular, Tesla focuses on environmentally conscious consumers who are willing to pay a premium price. Taken together, GM's competitive scope is broad—with a focus on the mass automotive market—while Tesla's competitive scope is narrow—with a focus on high-end (all-electric) luxury cars.

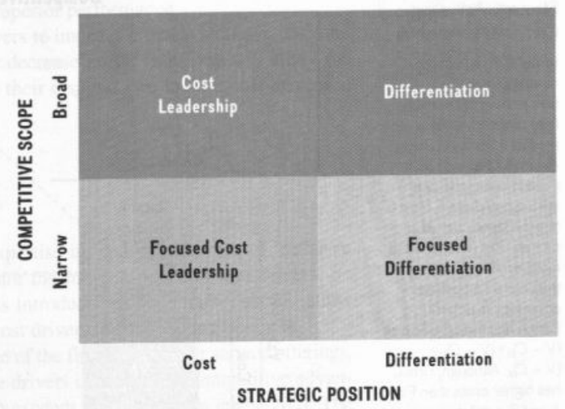
Now we can combine the dimensions describing a firm's strategic position (*differentiation vs. cost*) with the scope of competition (*narrow vs. broad*). As shown in Exhibit 6.2, by doing so we get the two major broad business strategies (*cost leadership* and *differentiation*), shown as the top two boxes in the matrix, and the *focused* version of each (shown as the bottom two boxes in the matrix). The focused versions of the two business strategies—**focused cost-leadership strategy** and **focused differentiation strategy**—are essentially the same as the broad generic strategies *except* that the competitive scope is narrower. For example, the manufacturing company BIC pursues a focused cost-leadership strategy, designing and producing disposable pens and cigarette lighters at a low cost, while Mont Blanc pursues a focused differentiation strategy, offering exquisite pens—what it calls "writing instruments"—priced at several hundred dollars.

focused cost-leadership strategy
Same as the cost-leadership strategy except with a narrow focus on a niche market.

focused differentiation strategy
Same as the differentiation strategy except with a narrow focus on a niche market.

As discussed in ChapterCase 6, JetBlue attempted to combine a focused cost-leadership position with a focused differentiation position. Although initially successful, JetBlue has been consistently outperformed for the past few years by airlines that do not attempt to straddle different strategic positions, but rather have a clear strategic profile. For example, Southwest Airlines competes clearly as a broad cost leader (and would be placed squarely in the upper-left quadrant of Exhibit 6.2). The legacy carriers—Delta, American, and United—all compete as broad differentiators (and would be placed in the upper-right quadrant of Exhibit 6.2). Regionally, we find smaller airlines that are ultra low cost, such as Allegiant Air, Frontier Airlines, or Spirit Airlines, with a very clear strategic position (and would be placed in the lower-left quadrant of Exhibit 6.2 because they are pursuing a focused cost-leadership strategy). Based on a clear strategic position, these airlines have outperformed JetBlue over the last few years. The reason is that JetBlue is stuck between different strategic positions, trying to combine a focused cost-leadership position with focused differentiation. As JetBlue grew, the problems inherent in an attempt to straddle different strategic

EXHIBIT 6.2 / Strategic Position and Competitive Scope: Generic Business Strategies



Source: Adapted from M.E. Porter (1980). *Competitive Strategy: Techniques for Analyzing Industries and Competitors* (New York: Free Press).

positions grew more severe because JetBlue now attempts to also straddle the (broad) cost-leadership position with the (broad) differentiation position, thus trying to be everything to everybody. Being *stuck in the middle* of different strategic positions is a recipe for inferior performance and competitive disadvantage—and this is exactly what JetBlue has experienced since the mid-2000s.

LO 6-2

Examine the relationship between value drivers and differentiation strategy.

6.2 Differentiation Strategy: Understanding Value Drivers

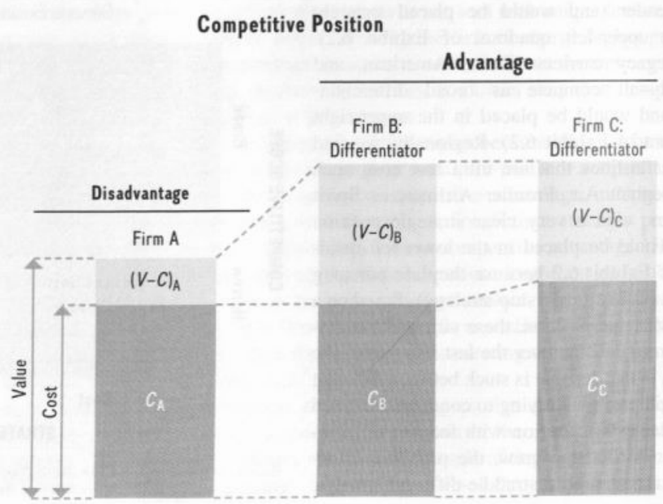
The goal of a differentiation strategy is to add unique features that will increase the perceived value of goods and services in the minds of consumers so they are willing to pay a higher price. Ideally, a firm following a differentiation strategy aims to achieve in the minds of consumers a level of value creation that its competitors cannot easily match. The focus of competition in a differentiation strategy tends to be on unique product features, service, and new product launches, or on marketing and promotion rather than price. For example, the carpet company Interface is a leader in sustainability and offers innovative products such as its Cool Carpet, the world's first carbon-neutral floor covering. Interface's customers reward it with a willingness to pay a higher price for its environmentally friendly products.[8]

A company that uses a differentiation strategy can achieve a competitive advantage as long as its economic value created $(V - C)$ is greater than that of its competitors. Firm A in Exhibit 6.3 produces a generic commodity. Firm B and Firm C represent two efforts at differentiation. Firm B not only offers greater value than Firm A, but also maintains *cost parity,* meaning it has the same costs as Firm A. However, even if a firm fails to achieve cost parity (which is often the case because higher value creation tends to go along with higher costs in terms of higher-quality raw materials, research and development, employee training to provide superior customer service, and so on), it can still gain a competitive advantage if its economic value creation exceeds that of its competitors. Firm C represents just such a competitive advantage. For the approach shown *either* in Firm B or Firm C,

EXHIBIT 6.3

Differentiation Strategy: Achieving Competitive Advantage

Under a differentiation strategy, firms that successfully differentiate their products enjoy a competitive advantage. Firm A's product is seen as a generic commodity with no unique brand value. Firm B has the same cost structure as Firm A but creates more economic value, and thus has a competitive advantage over both Firm A and Firm C because $(V - C)_B > (V - C)_C > (V - C)_A$. Although, Firm C has higher costs than Firm A and B, it still generates a significantly higher economic value than Firm A.



economic value creation, $(V - C)_B$ or $(V - C)_C$, is greater than that of Firm A $(V - C)_A$. Either Firm B or C, therefore, achieves a competitive advantage because it has a higher value gap over Firm A $[(V - C)_B > (V - C)_A$, or $(V - C)_C > (V - C)_A]$, which allows it to charge a premium price, reflecting its higher value creation. To complete the relative comparison, although both companies pursue a differentiation strategy, Firm B also has a competitive advantage over Firm C because although both offer identical value, Firm B has lower cost, thus $(V - C)_B > (V - C)_C$.

Although increased value creation is a defining feature of a differentiation strategy, managers must also control costs. Rising costs reduce economic value created and erode profit margins. Indeed, if cost rises too much as the firm attempts to create more perceived value for customers, its value gap shrinks, negating any differentiation advantage. One reason JetBlue could not maintain an initial competitive advantage was because it was unable to keep its costs down sufficiently. JetBlue's new management team immediately put measures in place to lower the airline's cost structure such as charging fees for checked bags and reducing leg space to increase passenger capacity on each of its planes. These cost-saving initiatives should increase its economic value creation.

Although a differentiation strategy is generally associated with premium pricing, managers have an important second pricing option. When a firm is able to offer a differentiated product or service and can control its costs at the same time, it is able to gain market share from other firms in the industry by charging a similar price but offering more perceived value. By leveraging its differentiated appeal of superior customer service and quality, for example, Marriott offers a line of different hotels: its flagship Marriott full-service business hotel equipped to host large conferences; Residence Inn for extended stay; Marriott Courtyard for business travelers; and Marriott Fairfield Inn for inexpensive leisure and family travel.[9] Although these hotels are roughly comparable to competitors in price, they generally offer a higher perceived value. With this line of different hotels, Marriott can benefit from economies of scale and scope, and thus keep its cost structure in check. *Economies of scale* denote decreases in cost per unit as output increases (more in the next section when we discuss cost-leadership strategy). **Economies of scope** describe the savings that come from producing two (or more) outputs at less cost than producing each output individually, even though using the same resources and technology. This larger difference between cost and value allows Marriott to achieve greater economic value than its competitors, and thus to gain market share and post superior performance.

economies of scope Savings that come from producing two (or more) outputs at less cost than producing each output individually, despite using the same resources and technology.

Managers can adjust a number of different levers to improve a firm's strategic position. These levers either increase perceived value or decrease costs. Here, we will study the most salient *value drivers* that managers have at their disposal (we look at cost drivers in the next section).[10] They are:

- Product features
- Customer service
- Complements

These value drivers are related to a firm's expertise in, and organization of, different internal value chain activities. Although these are the most important value drivers, no such list can be complete. Applying the concepts introduced in this chapter should allow managers to identify other important value and cost drivers unique to their business.

When attempting to increase the perceived value of the firm's product or service offerings, managers must remember that the different value drivers contribute to competitive advantage *only if* their increase in value creation (ΔV) exceeds the increase in costs (ΔC). The condition of $\Delta V > \Delta C$ must be fulfilled if a differentiation strategy is to strengthen a firm's strategic position and thus enhance its competitive advantage.

Trader Joe's is a chain of more than 400 stores, half of which are in California and the rest in another 38 states plus Washington, D.C. The chain is known for good products, value for money, clerks in Hawaiian shirts—and great customer service. As just one example, stores happily stock local products as requested by their communities.[14]
© Karsten Moran/Aurora Photos/Alamy

PRODUCT FEATURES

One of the obvious but most important levers that managers can adjust is product features, thereby increasing the perceived value of the product or service offering. Adding unique product attributes allows firms to turn commodity products into differentiated products commanding a premium price. Strong R&D capabilities are often needed to create superior product features. In the kitchen-utensil industry, OXO follows a differentiation strategy, highlighting product features. By adhering to its "philosophy of making products that are easy to use for the widest spectrum of possible users,"[11] OXO differentiates its kitchen utensils through its patent-protected ergonomically designed soft black rubber grips.

CUSTOMER SERVICE

Managers can increase the perceived value of their firms' product or service offerings by focusing on customer service. For example, the online retailer Zappos earned a reputation for superior customer service by offering free shipping both ways: to the customer and for returns.[12] Zappos' managers didn't view this as an additional expense but rather as part of their marketing budget. Moreover, Zappos does not outsource its customer service, and its associates do not use predetermined scripts. They are instead encouraged to build a relationship of trust with each individual customer. There seemed to be a good return on investment as word spread through the online shopping community. Competitors took notice, too; Amazon bought Zappos for over $1 billion.[13]

COMPLEMENTS

When studying industry analysis in Chapter 3, we identified the availability of complements as an important force determining the profit potential of an industry. Complements add value to a product or service when they are consumed in tandem. Finding complements, therefore, is an important task for managers in their quest to enhance the value of their offerings.

The introduction of AT&T U-verse is an example of leveraging complements to increase the perceived value of a service offering.[15] AT&T's U-verse service bundles high-speed Internet access, phone, and TV services. Service bundles can be further enhanced by DVR capabilities that allow users to pause live TV, to record live TV shows, and to access video on demand. A DVR by itself is not very valuable, but included as a "free" add-on to subscribers, it turns into a complement that significantly enhances the perceived value of the service bundle. Leveraging complementary products allowed AT&T to break into the highly competitive television services market, significantly enhancing the value of its service offerings.

As you have just seen, the differentiation strategy covers a great deal of ground, so let's summarize what we have learned. By choosing the differentiation strategy as the strategic position for a product, managers focus their attention on adding value to the product through its unique features that respond to customer preferences, customer service during and after the sale, or effective marketing that communicates the value of the product's features. Although this positioning involves increased costs (for example, higher-quality inputs or innovative research and development activities), customers will be willing to pay a premium price for the product or service that satisfies their needs and preferences. In the next section, we will discuss how managers formulate a cost-leadership strategy.

6.3 Cost-Leadership Strategy: Understanding Cost Drivers

LO 6-3

Examine the relationship between cost drivers and the cost-leadership strategy.

The goal of a cost-leadership strategy is to reduce the firm's cost below that of its competitors while offering adequate value. The *cost leader*, as the name implies, focuses its attention and resources on reducing the cost to manufacture a product or deliver a service in order to offer lower prices to its customers. The cost leader attempts to optimize all of its value chain activities to achieve a low-cost position. Although staking out the lowest-cost position in the industry is the overriding strategic objective, a cost leader still needs to offer products and services of acceptable value. As an example, GM and Korean car manufacturer Kia offer some models that compete directly with one another, yet Kia's cars tend to be produced at lower cost, while providing a similar value proposition.

A cost leader can achieve a competitive advantage as long as its economic value created $(V - C)$ is greater than that of its competitors. Firm A in Exhibit 6.4 produces a product with a cost structure vulnerable to competition. Firms B and C show two different approaches to cost leadership. Firm B achieves a competitive advantage over Firm A because Firm B not only has lower cost than Firm A, but also achieves *differentiation parity* (meaning it creates the same value as Firm A). As a result, Firm B's economic value creation, $(V - C)_B$, is greater than that of Firm A, $(V - C)_A$. For example, as the low-cost leader, Walmart took market share from Kmart, which subsequently filed for bankruptcy.

What if a firm fails to create differentiation parity? Such parity is often hard to achieve because value creation tends to go along with higher costs, and Firm B's strategy is aimed at lower costs. A firm can still gain a competitive advantage as long as its economic value creation exceeds that of its competitors. Firm C represents this approach to cost leadership. Even with lower value (no differentiation parity) but lower cost, Firm C's economic value creation, $(V - C)_C$, still is greater than that of Firm A, $(V - C)_A$.

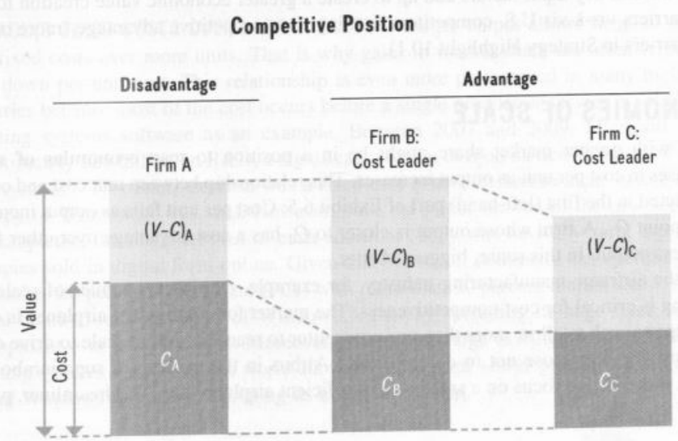


EXHIBIT 6.4

Cost-Leadership Strategy: Achieving Competitive Advantage

Under a cost-leadership strategy, firms that can keep their cost at the lowest point in the industry while offering acceptable value are able to gain a competitive advantage. Firm A has not managed to take advantage of possible cost savings, and thus experiences a competitive disadvantage. The offering from Firm B has the same perceived value as Firm A but through more effective cost containment creates more economic value (over both Firm A and Firm C because $(V - C)_B > (V - C)_C > (V - C)_A$. The offering from Firm C has a lower perceived value than that of Firm A or B and has the same reduced product cost as with Firm B; as a result, Firm C still generates higher economic value than Firm A.

In both approaches to cost leadership in Exhibit 6.4, Firm B's economic value creation is greater than that of Firm A and Firm C. Yet, both firms B and C achieve a competitive advantage over Firm A. Either one can charge prices similar to its competitors and benefit from a greater profit margin per unit, or it can charge lower prices than its competition and gain higher profits from higher volume. Both variations of a cost-leadership strategy can result in competitive advantage. Although Firm B has a competitive advantage over both Firms A and C, Firm C has a competitive advantage in comparison to Firm A.

Although companies successful at cost leadership must excel at controlling costs, this doesn't mean that they can neglect value creation. Kia signals the quality of its cars with a five-year, 60,000-mile warranty, one of the more generous warranties in the industry. Walmart offers products of acceptable quality, including many brand-name products.

The most important *cost drivers* that managers can manipulate to keep their costs low are:

- Cost of input factors.
- Economies of scale.
- Learning-curve effects.
- Experience-curve effects.

However, this list is only a starting point; managers may consider other cost drivers, depending on the situation.

COST OF INPUT FACTORS

One of the most basic advantages a firm can have over its rivals is access to lower-cost input factors such as raw materials, capital, labor, and IT services. In the market for international long-distance travel, the greatest competitive threat facing U.S. legacy carriers—American, Delta, and United—comes from three fast-growing airlines located in the Persian Gulf states—Emirates, Etihad, and Qatar. These airlines achieve a competitive advantage over their U.S. counterparts thanks to lower-cost inputs—raw materials (access to cheaper fuel), capital (interest-free government loans), labor—and fewer regulations (for example, regarding nighttime takeoffs and landings, or in adding new runways and building luxury airports with swimming pools, among other amenities).[16] To benefit from lower-cost IT services, the gulf carriers also outsource some value chain activities such as booking and online customer service to India. Together, these distinct cost advantages across several key input factors add up to create a greater economic value creation for the gulf carriers vis-à-vis U.S. competitors, leading to a competitive advantage (more on the gulf carriers in Strategy Highlight 10.1).

ECONOMIES OF SCALE

economies of scale Decreases in cost per unit as output increases.

Firms with greater market share might be in a position to reap **economies of scale**, decreases in cost per unit as output increases. This relationship between unit cost and output is depicted in the first (left-hand) part of Exhibit 6.5: Cost per unit falls as output increases up to point Q_1. A firm whose output is closer to Q_1 has a cost advantage over other firms with less output. In this sense, bigger is better.

In the airframe-manufacturing industry, for example, reaping economies of scale and learning is critical for cost-competitiveness. The market for commercial airplanes is often not large enough to allow more than one competitor to reach sufficient scale to drive down unit cost. Boeing chose not to compete with Airbus in the market for superjumbo jets; rather, it decided to focus on a smaller, fuel-efficient airplane (the 787 Dreamliner, priced

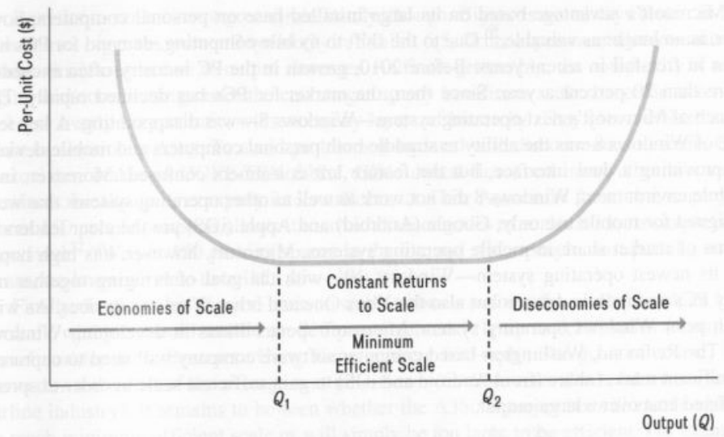


EXHIBIT 6.5 Economies of Scale, Minimum Efficient Scale, and Diseconomies of Scale

at roughly $250 million) that allows for long-distance, point-to-point connections. By 2015, it had built over 250 Dreamliners with more than 1,000 orders for the new airplane.[17] Boeing can expect to reap significant economies of scale and learning, which will lower per-unit cost. At the same time, Airbus had delivered over 150 A380 superjumbos (sticker price: $430 million) with more than 310 orders on its books.[18] If both companies would have chosen to compete head-on in each market segment, the resulting per-unit cost for each airplane would have been much higher because neither could have achieved significant economies of scale (overall their market share split is roughly 50–50).

What causes per-unit cost to drop as output increases (up to point Q_1)? Economies of scale allow firms to:

- Spread their fixed costs over a larger output.
- Employ specialized systems and equipment.
- Take advantage of certain physical properties.

SPREADING FIXED COSTS OVER LARGER OUTPUT. Larger output allows firms to spread their fixed costs over more units. That is why gains in market share are often critical to drive down per-unit cost. This relationship is even more pronounced in many high-tech industries because most of the cost occurs before a single product or service is sold. Take operating systems software as an example. Between 2007 and 2009, Microsoft spent approximately $25 billion on R&D, a significant portion of it on its new Windows 7 operating system.[19] This R&D expense was a fixed cost Microsoft had to incur before a single copy of Windows 7 was sold. However, once the initial version of the new software was completed, the marginal cost of each additional copy was basically zero, especially for copies sold in digital form online. Given that Microsoft dominates the operating system market for personal computers (PCs) with more than 90 percent market share, it sold several hundred million copies of Windows 7, thereby spreading its huge fixed cost of development over a large output. Moreover, Microsoft's large installed base of Windows operating systems throughout the world allowed it to capture a large profit margin for each copy of Windows sold, after recouping its initial investment.

Microsoft's advantage based on its large installed base on personal computers, however, is no longer as valuable.[20] Due to the shift to mobile computing, demand for PCs has been in free-fall in recent years. Before 2010, growth in the PC industry often exceeded more than 20 percent a year. Since then, the market for PCs has declined rapidly. The launch of Microsoft's next operating system—Windows 8—was disappointing. A key feature of Windows 8 was the ability to straddle both personal computers and mobile devices by providing a dual interface, but the feature left consumers confused. Moreover, in a mobile environment, Windows 8 did not work as well as other operating systems that were designed for mobile use only; Google (Android) and Apple (iOS) are the clear leaders in terms of market share in mobile operating systems. Microsoft, however, has high hopes for its newest operating system—Windows 10—with the goal of bringing together not only PCs and mobile devices but also the Xbox One and other Windows devices. As with each prior Windows operating system, Microsoft spent billions in developing Windows 10. The Redmond, Washington-based computer software company will need to capture a significant market share (from Android and iOS) to gain sufficient scale in order to spread its fixed cost over a large output.

EMPLOYING SPECIALIZED SYSTEMS AND EQUIPMENT. Larger output also allows firms to invest in more specialized systems and equipment, such as enterprise resource planning (ERP) software or manufacturing robots. As discussed in ChapterCase 3, Tesla's strong demand for its Model S sedan allowed it to employ cutting-edge robotics in its Fremont, California, manufacturing plant to produce cars of the highest quality at large scale.

TAKING ADVANTAGE OF CERTAIN PHYSICAL PROPERTIES. Economies of scale also occur because of certain physical properties. One such property is known as the *cube-square rule:* The volume of a body such as a pipe or a tank increases disproportionately more than its surface. This same principle makes big-box retail stores such as Walmart, Best Buy, The Home Depot, and Toys "R" Us cheaper to build and run. They can also stock much more merchandise and handle inventory more efficiently. Their huge size makes it difficult for department stores or small retailers to compete on cost and selection.

minimum efficient scale (MES) Output range needed to bring down the cost per unit as much as possible, allowing a firm to stake out the lowest-cost position that is achievable through economies of scale.

Look again at Exhibit 6.5. The output range between Q_1 and Q_2 in the figure is considered the **minimum efficient scale (MES)** in order to be cost-competitive. Between Q_1 and Q_2, the returns to scale are constant. It is the output range needed to bring the cost per unit down as much as possible, allowing a firm to stake out the lowest-cost position achievable through economies of scale. If the firm's output range is less than Q_1 or more than Q_2, the firm is at a cost disadvantage.

With more than 6 million Prius cars sold since its introduction in 1997, Toyota has been able to reach the minimum efficient scale part of the per-unit cost curve. This allows the company to offer the car at a relatively low price and still make a profit.

The concept of minimum efficient scale applies not only to manufacturing processes but also to managerial tasks such as how to organize work. Due to investments in specialized technology and equipment (e.g., electric arc furnaces), Nucor is able to reach MES with much smaller batches of steel than larger, fully vertically integrated steel companies using older technology. Nucor's optimal plant size is about 500 people, which is much smaller than at larger integrated steelmakers such as U.S. Steel (which often employs thousands of workers per plant).[21] Of course, minimum efficient scale depends on the specific industry: The average per-unit cost curve, depicted conceptually in Exhibit 6.5, is a reflection of the underlying production function, which is determined by technology and other input factors.

diseconomies of scale Increases in cost per unit when output increases.

Benefits to scale cannot go on indefinitely, though. Bigger is not always better; in fact, sometimes bigger is worse. Beyond Q_2 in Exhibit 6.5, firms experience **diseconomies of scale**—increases in cost as output increases. As firms get too big, the complexity of managing and coordinating raises the cost, negating any benefits to scale. Large firms tend to become overly bureaucratic, with too many layers of hierarchy. They grow inflexible and slow in decision making. To avoid problems associated with diseconomies of scale, Gore Associates, maker of GORE-TEX fabric, Glide dental floss, and many other innovative products, breaks up its company into smaller units. Gore Associates found that employing about 150 people per plant allows it to avoid diseconomies of scale. It uses a simple decision rule:[22] "We put 150 parking spaces in the lot, and when people start parking on the grass, we know it's time to build a new plant."[23]

Finally, there are also physical limits to scale. Airbus is pushing the envelope with its A380 aircraft, which can hold more than 850 passengers and fly up to 8,200 miles (enough to travel nonstop from Boston to Hong Kong at about 600 mph). The goal, of course, is to drive down the cost of the average seat-mile flown (CASM, a standard cost metric in the airline industry). It remains to be seen whether the A380 superjumbo will enable airlines to reach minimum efficient scale or will simply be too large to be efficient. For example, boarding and embarking procedures must be streamlined to accommodate more than 850 people in a timely and safe manner. Many airports around the world will need to be retrofitted with longer and wider runways to allow the superjumbo to take off and land.

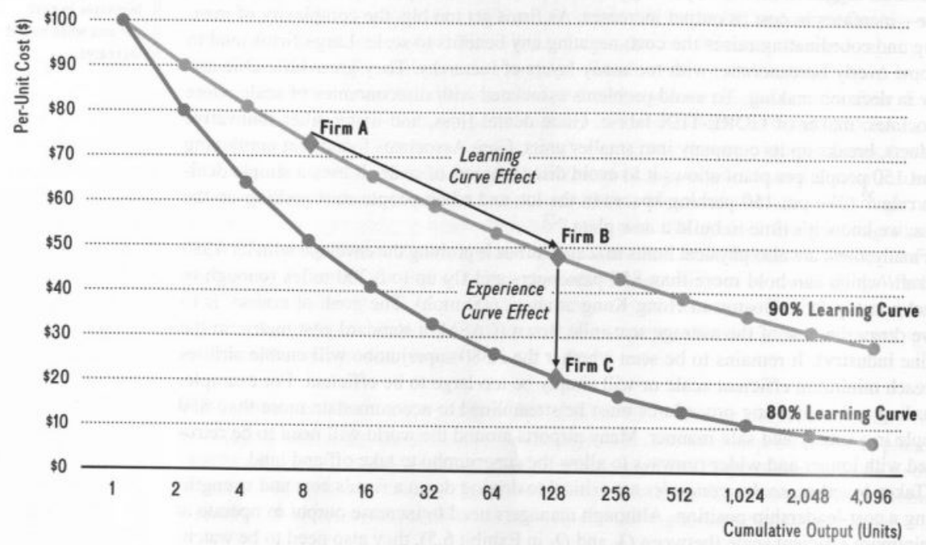
Taken together, *scale economies* are critical to driving down a firm's cost and strengthening a cost-leadership position. Although managers need to increase output to operate at a minimum efficient scale (between Q_1 and Q_2 in Exhibit 6.5), they also need to be watchful not to drive scale beyond Q_2, where they would encounter diseconomies. Monitoring the firm's cost structure closely over different output ranges allows managers to fine-tune operations and benefit from economies of scale.

LEARNING CURVE

Do learning curves go up or down? Looking at the challenge of learning, many people tend to see it as an uphill battle, and assume the learning curve goes up. But if we consider our productivity, learning curves go down, as it takes less and less time to produce the same output as we learn how to be more efficient—learning by doing drives down cost. As individuals and teams engage repeatedly in an activity, whether writing computer code, developing new medicines, or building submarines, they learn from their cumulative experience.[24] *Learning curves* were first documented in aircraft manufacturing as the United States ramped up production in the 1930s, prior to its entry into World War II.[25] Every time production was doubled, the per-unit cost dropped by a predictable and constant rate (approximately 20 percent).[26] This important relationship is captured in Exhibit 6.6, where we see two different learning curves. The steeper the learning curve, the more learning has taken place. As cumulative output increases, firms move down the learning curve, reaching lower per-unit costs.

In particular, Exhibit 6.6 depicts a 90 percent and an 80 percent learning curve. In a 90 percent learning curve, per-unit cost drops 10 percent every time output is doubled. The steeper 80 percent learning curve indicates a 20 percent drop every time output is doubled (this was the case in the aircraft manufacturing example above). It is important to note that the learning-curve effect is driven by increasing cumulative output within the existing technology over time. That implies that the only difference between two points on the same learning curve is the size of the cumulative output. The underlying technology remains the same. The speed of learning determines the slope of the learning curve, or how steep the learning curve is (e.g., 80 percent is steeper than a 90 percent learning curve, because costs decrease by 20 percent versus a mere 10 percent each time output doubles). In this

EXHIBIT 6.6 / Gaining Competitive Advantage through Leveraging Learning- and Experience-Curve Effects



perspective, economies of learning allow movement down a *given* learning curve based on current production technology.

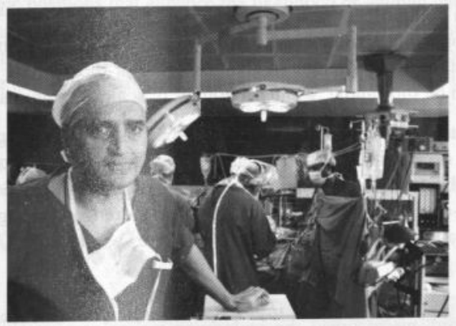
By moving further down a given learning curve than competitors, a firm can gain a competitive advantage. For example, Exhibit 6.6 shows that Firm B is further down the 90 percent learning curve than Firm A. Firm B leverages economies of learning due to larger cumulative output to gain an advantage over Firm A. The only variable that has changed is cumulative output; the technology underlying the 90 percent learning curve remained the same. Let's continue with the example of manufacturing airframes. To be more precise, as shown in Exhibit 6.6, Firm A produces eight aircraft and reaches a per-unit cost of $73 million per aircraft.[27] Firm B produces 128 aircraft using the same technology as Firm A (because both firms are on the same [90 percent] learning curve), but given a much larger cumulative output, its per unit-cost falls to only $48 million. Thus, Firm B has a clear competitive advantage over Firm A (assuming similar or identical quality in output). (We will discuss Firm C when we formally introduce the impact of changes in technology and process innovation.)

It is not surprising that a learning curve was first observed in aircraft manufacturing. Highly complex, a modern commercial aircraft can contain more than 5 million parts, compared with a few thousand for a car. The more complex the underlying process to manufacture a product or deliver a service, the more learning effects we can expect. As cumulative output increases, managers learn how to optimize the process, and workers improve their performance through repetition.

Learning curves are a robust phenomenon that have been observed in many industries, not only in manufacturing processes but also in alliance management, franchising, and health care.[28] For example, physicians who perform only a small number of cardiac surgeries per year can have a patient mortality rate five times higher than physicians who perform the same surgery more frequently.[29] Strategy Highlight 6.1 features Dr. Devi Shetty of India who reaped huge benefits by applying learning-curve principles to open-heart surgery, driving down cost while improving quality at the same time!

Strategy Highlight 6.1

Dr. Shetty: "The Henry Ford of Heart Surgery"



Dr. Devi Shetty
© Namas Bhojani

Open-heart surgeries are complex medical procedures, and loaded with risk. While well-trained surgeons using high-tech equipment are able to reduce mortality rates, costs for cardiac surgeries in the United States have climbed. Difficult heart surgeries can cost $100,000 or more. A heart surgeon in India has driven the costs down to an average of $2,000 per heart surgery, while delivering equal or better outcomes in terms of quality.

Dr. Devi Shetty's goal is to be "the Henry Ford of heart surgery." Just like the great American industrialist who applied the learning curve to drive down the cost of an automobile to make it affordable, so Dr. Shetty is reducing the costs of health care and making some of the most complex medical procedures affordable to the world's poorest. A native of Mangalore, India, Dr. Shetty was trained as a heart surgeon at Guy's Hospital in London, one of Europe's best medical facilities. He first came to fame in the 1990s when he successfully conducted an open-heart bypass surgery on Mother Teresa, after she suffered a heart attack.

Dr. Shetty believes that the key to driving down costs in health care is not product innovation, but process innovation. He is able to drive down the cost of complex medical procedures from $100,000 to $2,000 not by doing one big thing, but rather by focusing on doing 1,000 small things. Dr. Shetty is applying the concept of the learning curve to make a complex procedure routine and comparatively inexpensive. Part of the Narayana Health group, Dr. Shetty's hospital in Bangalore, India, performs so many cardiac procedures per year that doctors are able to get a great deal of experience quickly, which allows them to specialize in one or two complex procedures. The Narayana surgeons perform two or three procedures a day for six days a week, compared to U.S. surgeons who perform one or two procedures a day for five days a week. The difference adds up. Some of Dr. Shetty's surgeons perform more specialized procedures by the time they are in their 30s than their U.S. counterparts will perform throughout their entire careers. This volume of experience allows the cardiac surgeons to move down the learning curve quickly, because the more heart surgeries they perform, the more their skills improve. With this skill level, surgical teams develop robust standard operating procedures and processes, where team members become experts at their specific tasks.

This expertise improves outcomes while the learning-curve effects of performing the same procedures over time also save money (see Exhibit 6.6). Other factors provide more cost savings. At the same time, Dr. Shetty pays his cardiac surgeons the going rate in India, between $110,000 and $250,000 a year, depending on experience. Their U.S. counterparts earn two to three times the average Indian salary.

Dr. Shetty's health group also reduces costs through economies of scale. By performing thousands of heart surgeries a year, high fixed costs such as the purchase of expensive medical equipment can be spread over a much larger volume. The Narayana hospital in Bangalore has 1,000 beds and some 20 operating rooms that stay busy pretty much around the clock, many times larger than the average U.S. hospital with 160 beds. This scale allows the Narayana heart clinic to cost-effectively employ specialized high-tech equipment. Given the large size of Dr. Shetty's hospital, he also has significant buying power, driving down the costs of the latest high-tech equipment from top-notch vendors such as GE. Wherever possible, Dr. Shetty sources lower-cost inputs such as sutures locally, rather than from the more expensive companies such as Johnson & Johnson. Further, the Narayana heart clinic shares common services, such as laboratories and blood bank and more mundane services such as catering, with the 1,400-bed cancer clinic next door. Taken together, all of these small changes result in significant cost savings, and so create a reinforcing system of low-cost value chain activities.

While many worry that high volume compromises quality, the data suggest the opposite: Narayana Health's medical outcomes in terms of mortality rate are equal to or even lower than the best hospitals in the United States. The American College of Cardiology frequently sends surgeons and administrators to visit the Narayana heart clinic. The college concluded that the clinic provides high-tech and high-quality care at low cost. Dr. Shetty now brings top-notch care at low cost to the masses in India. Narayana Health runs a chain of over 30 hospitals in 20 locations throughout India and performs some 100,000 heart surgeries a year.[30]

Learning effects differ from economies of scale (discussed earlier) as shown:

- **Differences in timing.** Learning effects occur *over time* as output accumulates, while economies of scale are captured at *one point in time* when output increases. Although learning can decline or flatten (see Exhibit 6.6), there are no *diseconomies to learning* (unlike *diseconomies to scale* in Exhibit 6.5).
- **Differences in complexity.** In some production processes (e.g., the manufacture of steel rods), effects from economies of scale can be quite significant, while learning effects are minimal. In contrast, in some professions (brain surgery or the practice of estate law), learning effects can be substantial, while economies of scale are minimal.

Managers need to understand such differences to calibrate their business-level strategy. If a firm's cost advantage is due to economies of scale, a manager should worry less about employee turnover (and a potential loss in learning) and more about drops in production runs. In contrast, if the firm's low-cost position is based on complex learning, a manager should be much more concerned if a key employee (e.g., a star researcher) was to leave.

EXPERIENCE CURVE

In the *learning curve* just discussed, we assumed the underlying technology remained constant, while only cumulative output increased. In the *experience curve,* in contrast, we now change the underlying technology while holding cumulative output constant.[31]

In general, technology and production processes do not stay constant. *Process innovation*—a new method or technology to produce an existing product—may initiate a new and steeper curve. Assume that Firm C, on the same learning curve as Firm B, implements a new production process (such as lean manufacturing). In doing so, Firm C initiates an entirely new and steeper learning curve. Exhibit 6.6 shows this *experience-curve effect* based on a process innovation. Firm C jumps down to the 80 percent learning curve, reflecting the new and lower-cost production process. Although Firm B and Firm C produce the same cumulative output (each making 128 aircraft), the per-unit cost differs. Firm B's per-unit cost for each airplane, being positioned on the less-steep 90 percent learning curve is $48 million.[32] In contrast, Firm C's per-unit cost, being positioned on the steeper 80 percent learning curve because of process innovation, is only $21 million per aircraft, and thus less than half of that of Firm B. Clearly, Firm C has a competitive advantage over Firm B based on lower cost per unit (assuming similar quality).

Learning by doing allows a firm to lower its per-unit costs by moving down a given learning curve, while experience-curve effects based on process innovation allow a firm to leapfrog to a steeper learning curve, thereby driving down its per-unit costs.

In Strategy Highlight 6.1, we saw how Dr. Shetty leveraged learning-curve effects to save lives while driving down costs. One could argue that his Narayana Health group not only moved down a given learning curve using best industry practice, but it also jumped down to a new and steeper learning curve through process innovation. Dr. Shetty sums up his business strategy based on cost leadership: "Japanese companies reinvented the process of making cars (by introducing lean manufacturing). That's what we're doing in health care. What health care needs is process innovation, not product innovation."[33]

In a cost-leadership strategy, managers must focus on lowering the costs of production while maintaining a level of quality acceptable to the customer. If firms can share the benefits of lower costs with consumers, cost leaders appeal to the bargain-conscious buyer, whose main criterion is price. By looking to reduce costs in each value chain activity, managers aim for the lowest-cost position in the industry. Thus they strive to offer lower prices than competitors and to attract increased sales. Cost leaders such as Walmart ("Every Day Low Prices"), can profit from this strategic position over time.

6.4 Business-Level Strategy and the Five Forces: Benefits and Risks

LO 6-4

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

The business-level strategies introduced in this chapter allow firms to carve out strong strategic positions that enhance the likelihood of gaining and sustaining competitive advantage. The five forces model introduced in Chapter 3 helps managers assess the forces—threat of entry, power of suppliers, power of buyers, threat of substitutes, and rivalry among existing competitors—that make some industries more attractive than others. With this understanding of industry dynamics, managers use one of the generic business-level strategies to protect themselves against the forces that drive down profitability.[34] Exhibit 6.7 details the relationship between competitive positioning and the five forces. In particular, it highlights the benefits and risks of differentiation and cost-leadership business strategies, which we discuss next.

EXHIBIT 6.7 / Competitive Positioning and the Five Forces: Benefits and Risks of Differentiation and Cost-Leadership Business Strategies

Competitive Force	Differentiation		Cost Leadership	
	Benefits	Risks	Benefits	Risks
Threat of entry	• Protection against entry due to intangible resources such as a reputation for innovation, quality, or customer service	• Erosion of margins • Replacement	• Protection against entry due to economies of scale	• Erosion of margins • Replacement
Power of suppliers	• Protection against increase in input prices, which can be passed on to customers	• Erosion of margins	• Protection against increase in input prices, which can be absorbed	• Erosion of margins
Power of buyers	• Protection against decrease in sales prices, because well-differentiated products or services are not perfect imitations	• Erosion of margins	• Protection against decrease in sales prices, which can be absorbed	• Erosion of margins
Threat of substitutes	• Protection against substitute products due to differential appeal	• Replacement, especially when faced with innovation	• Protection against substitute products through further lowering of prices	• Replacement, especially when faced with innovation
Rivalry among existing competitors	• Protection against competitors if product or service has enough differential appeal to command premium price	• Focus of competition shifts to price • Increasing differentiation of product features that do not create value but raise costs • Increasing differentiation to raise costs above acceptable threshold	• Protection against price wars because lowest-cost firm will win	• Focus of competition shifts to non-price attributes • Lowering costs to drive value creation below acceptable threshold

Source: Based on M.E. Porter (2008), "The five competitive forces that shape strategy," *Harvard Business Review*, January; and M.E. Porter (1980), *Competitive Strategy: Techniques for Analyzing Industries and Competitors* (New York: Free Press).

DIFFERENTIATION STRATEGY: BENEFITS AND RISKS

A differentiation strategy is defined by establishing a strategic position that creates higher perceived value while controlling costs. The successful differentiator stakes out a unique strategic position, where it can benefit from imperfect competition (as discussed in Chapter 3) and command a premium price. A well-executed differentiation strategy reduces rivalry among competitors.

A successful differentiation strategy is likely to be based on unique or specialized features of the product, on an effective marketing campaign, or on intangible resources such as a reputation for innovation, quality, and customer service. A rival would need to improve the product features as well as build a similar or more effective reputation in order to gain market share. The threat of entry is reduced: Competitors will find such intangible advantages time-consuming and costly, and maybe impossible, to imitate. If the source of the differential appeal is intangible rather than tangible (e.g., reputation rather than observable product and service features), a differentiator is even more likely to sustain its advantage.

Moreover, if the differentiator is able to create a significant difference between perceived value and current market prices, the differentiator will not be so threatened by increases in input prices due to powerful suppliers. Although an increase in input factors could erode margins, a differentiator is likely able to pass on price increases to its customersas long as its value creation exceeds the price charged. Since a successful differentiator creates perceived value in the minds of consumers and builds customer loyalty, powerful buyers demanding price decreases are unlikely to emerge. A strong differentiated position also reduces the threat of substitutes, because the unique features of the product have been created to appeal to customer preferences, keeping them loyal to the product. By providing superior quality beverages and other food items combined with a great customer experienceand a global presence, Starbucks has built a strong differentiated appeal. It has cultivated a loyal following of customers who reward it with repeat business.

The viability of a differentiation strategy is severely undermined when the focus of competition shifts to price rather than value-creating features. This can happen when differentiated products become commoditized and an acceptable standard of quality has emerged across rival firms. Although the iPhone was a highly differentiated product when first introduced in 2007, touch-based screens and other once-innovative features are now standard in smartphones. Indeed, Android-based smartphones held more than 80 percent market share in 2015, while Apple's iOS held 15 percent.[35] Several companies including Samsung and low-cost leader Xiaomi of China are attempting to challenge Apple's ability to extract significant profits from the smartphone industry based on its iPhone franchise. A differentiator also needs to be careful not to overshoot its differentiated appeal by adding product features that raise costs but not perceived value in the minds of consumers. For example, any additional increase in screen resolution beyond Apple's retina display cannot be detected by the human eye at a normal viewing distance. Finally, a differentiator needs to be vigilant that its costs of providing uniqueness do not rise above the customer's willingness to pay.

COST-LEADERSHIP STRATEGY: BENEFITS AND RISKS

A cost-leadership strategy is defined by obtaining the lowest-cost position in the industry while offering acceptable value. The cost leader, therefore, is protected

from other competitors because of having the lowest cost. If a price war ensues, the low-cost leader will be the last firm standing; all other firms will be driven out as margins evaporate. Since reaping economies of scale is critical to reaching a low-cost position, the cost leader is likely to have a large market share, which in turn reduces the threat of entry.

A cost leader is also fairly well isolated from threats of powerful suppliers to increase input prices, because it is more able to absorb price increases through accepting lower profit margins. Likewise, a cost leader can absorb price reductions more easily when demanded by powerful buyers. Should substitutes emerge, the low-cost leader can try to fend them off by further lowering its prices to reinstall relative value with the substitute. For example, Walmart tends to be fairly isolated from these threats. Walmart's cost structure combined with its large volume allows it to work with suppliers in keeping prices low, to the extent that suppliers are often the party who experiences a profit margin squeeze.

Although a cost-leadership strategy provides some protection against the five forces, it also carries some risks. If a new entrant with new and relevant expertise enters the market, the low-cost leader's margins may erode due to loss in market share while it attempts to learn new capabilities. For example, Walmart faces challenges to its cost leadership. The Dollar Store has drawn customers who prefer a smaller format than the big box of Walmart. The risk of replacement is particularly pertinent if a potent substitute emerges due to an innovation. Leveraging e-commerce, Amazon has become a potent substitute and thus a powerful threat to many brick-and-mortar retail outlets including Barnes & Noble, Best Buy, The Home Depot, and even Walmart. Powerful suppliers and buyers may be able to reduce margins so much that the low-cost leader could have difficulty covering the cost of capital and lose the potential for a competitive advantage.

The low-cost leader also needs to stay vigilant to keep its cost the lowest in the industry. Over time, competitors can beat the cost leader by implementing the same business strategy, but more effectively. Although keeping its cost the lowest in the industry is imperative, the cost leader must not forget that it needs to create an acceptable level of value. If continuously lowering costs leads to a value proposition that falls below an acceptable threshold, the low-cost leader's market share will evaporate. Finally, the low-cost leader faces significant difficulties when the focus of competition shifts from price to non-price attributes.

We have seen how useful the five forces model can be in industry analysis. None of the business-level strategies depicted in Exhibit 6.2 (cost leadership, differentiation, and focused variations thereof) is inherently superior. The success of each depends on context and relies on two factors:

- How well the strategy leverages the firm's internal strengths while mitigating its weaknesses.
- How well it helps the firm exploit external opportunities while avoiding external threats.

There is no single correct business strategy for a specific industry. The deciding factor is that the chosen business strategy provides a strong position that attempts to maximize economic value creation and is effectively implemented.

6.5 Blue Ocean Strategy: Combining Differentiation and Cost Leadership

So far we've seen that firms can create more economic value and their likelihood of gaining and sustaining competitive advantage in one of two ways—either increasing perceived consumer value (while containing costs) or lowering costs (while offering acceptable value). Should managers try to do both at the same time? To accomplish this, they would need to integrate two different strategic positions: differentiation *and* low cost.[36] In general the answer is *no*. Managers should not pursue this complex strategy because of the inherent trade-offs in different strategic positions, unless they are able to reconcile the conflicting requirements of each generic strategy.

blue ocean strategy Business-level strategy that successfully combines differentiation and cost-leadership activities using value innovation to reconcile the inherent trade-offs.

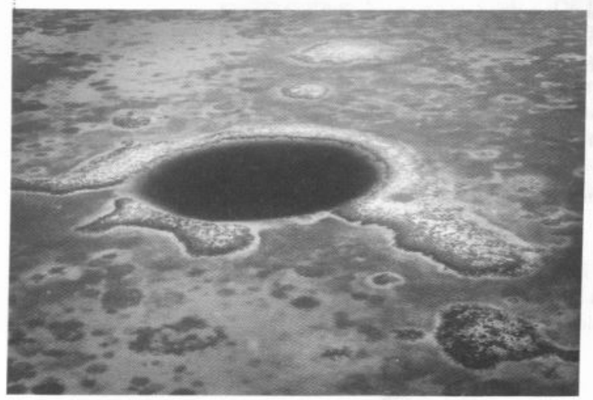
value innovation The simultaneous pursuit of differentiation and low cost in a way that creates a leap in value for both the firm and the consumers; considered a cornerstone of blue ocean strategy.

To meet this challenge, the strategy scholars Kim and Mauborgne advance the notion of a **blue ocean strategy**, which is a business-level strategy that successfully combines differentiation and cost-leadership activities using value innovation to reconcile the inherent trade-offs in those two distinct strategic positions.[37] They use the metaphor of an ocean to denote market spaces. *Blue oceans* represent untapped market space, the creation of additional demand, and the resulting opportunities for highly profitable growth. In contrast, *red oceans* are the known market space of existing industries. In *red oceans* the rivalry among existing firms is cut-throat because the market space is crowded and competition is a zero-sum game. Products become commodities, and competition is focused mainly on price. Any market share gain comes at the expense of other competitors in the same industry, turning the oceans bloody red.

A blue ocean strategy allows a firm to offer a differentiated product or service at low cost. As one example of a blue ocean strategy, consider Trader Joe's, the regional grocer introduced earlier in the chapter. Trader Joe's has much lower costs than Whole Foods for the same market of patrons desiring high value and health-conscious foods, and the chain scores exceptionally well in customer service and other areas. When a blue ocean strategy is successfully formulated and implemented, investments in differentiation and low cost are not substitutes but are complements, providing important positive spill-over effects. A successfully implemented blue ocean strategy allows firms two pricing options: First, the firm can charge a higher price than the cost leader, reflecting its higher value creation and thus generating greater profit margins. Second, the firm can lower its price below that of the differentiator because of its lower-cost structure. If the firm offers lower prices than the differentiator, it can gain market share and make up the loss in margin through increased sales.

Canny managers may use *value innovation* to move to blue oceans, that is, to new and uncontested market spaces. (Shown here is the famous "blue hole" just off Belize.)

© Mlenny/Getty Images RF



VALUE INNOVATION

For a blue ocean strategy to succeed, managers must resolve trade-offs between the two generic strategic positions—low cost and differentiation.[38] This is done through **value innovation**, aligning innovation with total perceived consumer benefits, price and cost (also see the discussion in Chapter 5 on *economic value creation*). Instead of attempting to out-compete your rivals by offering better features or lower costs, successful value innovation makes competition irrelevant by providing a leap in value creation, thereby opening new and uncontested market spaces.

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

Successful value innovation requires that a firm's strategic moves lower its costs and at the same increase the perceived value for buyers (see Exhibit 6.8). Lowering a firm's costs is primarily achieved by eliminating and reducing the taken-for-granted factors that the firm's rivals in their industry compete on. Perceived buyer value is increased by raising existing key success factors and by creating new elements that the industry has not offered previously. To initiate a strategic move that allows a firm to open a new and uncontested market space through value innovation, managers must answer the four key questions below when formulating a blue ocean business strategy.[39] In terms of achieving successful value innovation, note that the first two questions focus on lowering costs, while the other two questions focus on increasing perceived consumer benefits.

Value Innovation—Lower Costs

1. *Eliminate.* Which of the factors that the industry takes for granted should be eliminated?
2. *Reduce.* Which of the factors should be reduced well below the industry's standard?

Value Innovation—Increase Perceived Consumer Benefits

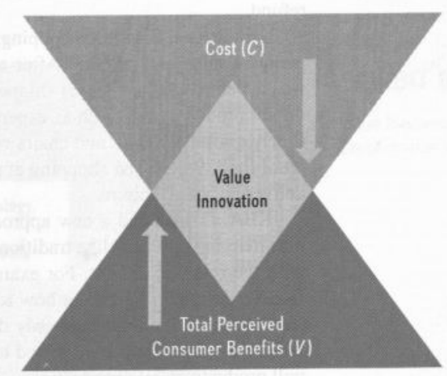
3. *Raise.* Which of the factors should be raised well above the industry's standard?
4. *Create.* Which factors should be created that the industry has never offered?

The international furniture retailer IKEA, for example, has used value innovation based on the *eliminate-reduce-raise-create* framework to initiate its own blue ocean and to achieve a sustainable competitive advantage.[40]

ELIMINATE. IKEA eliminated several taken-for-granted competitive elements: salespeople, expensive but small retail outlets in prime urban locations and shopping malls, long wait after ordering furniture, after-sales service, and other factors. In contrast, IKEA displays its products in a warehouse-like setting, thus reducing inventory cost. Customers serve themselves and then transport the furniture to their homes in IKEA's signature flat-packs for assembly. IKEA also uses the big-box concept of locating super-sized stores near major metropolitan areas.

REDUCE. Because of its do-it-yourself business model from furniture selection, transporting it home, and assembly, IKEA drastically reduced the need for staff in its mega-stores. Strolling through an IKEA store, you encounter few employees. IKEA also reduced several other taken-for-granted competitive elements: 25-year warranties on high-end custom

EXHIBIT 6.8 / Value Innovation Accomplished through Simultaneously Pursuing Differentiation (V ↑) and Low Cost (C ↓)



Source: Adapted from C.W. Kim and R. Mauborgne (2005), *Blue Ocean Strategy: How to Create Uncontested Market Space and Make Competition Irrelevant* (Boston, MA: Harvard Business School Publishing).

Inside IKEA's self-service warehouse
© Alex Segre/Alamy

furniture, high degree of customization in selection of options such as different fabrics and patterns, and use of expensive materials such as leather or hardwoods, among other elements.

RAISE. IKEA raised several competitive elements: It offers tens of thousands of home furnishing items in each of its big-box stores (some 300,000 square feet, roughly five football fields), versus a few hundred at best in traditional furniture stores; it also offers more than furniture, including a range of accessories such as place mats, laptop stands, and much more; each store has hundreds of rooms fully decorated with all sorts of IKEA items, each with a detailed tag explaining the item in detail. Moreover, rather than sourcing its furniture from wholesalers or other furniture makers, IKEA manufactures all of its furniture at fully dedicated suppliers, thus tightly controlling the design, quality, functionality, and cost of each product.

IKEA also raised the customer experience by laying out its stores in such a way that customers see and can touch basically all of IKEA's products, from wineglasses (six for $2.99) to bookshelves (for less than $100).

CREATE. IKEA created a new way for people to shop for furniture. The customer strolls through a predetermined path winding through the fully furnished showrooms. She can compare, test, and touch all the things in the showroom. The price tag on each item contains other important information: type of material, weight, and so on. Once an item is selected, the customer notes the item number (the store provides a pencil and notepad). The tag also indicates the location in the warehouse where the customer can pick up the item. After paying for the items, the customer transports the products in IKEA's signature flat-packs and assembles the furniture. The customer has 90 days to return items for a full refund.

In traditional furniture shopping, the customer visits a small retail outlet where salespeople swarm around him. After a purchase, the customer has to wait generally a few weeks before the furniture is shipped to his house. This is because many furniture makers do not produce items such as expensive leather sofas unless they are paid for in advance. Finely crafted couches and chairs cost thousands of dollars (while IKEA's fabric couches retail for $399). When shopping at a traditional furniture store, the customer also pays for delivery of the furniture.

IKEA also created a new approach to pricing its products. Rather than using a "cost plus margin approach" like traditional furniture stores when pricing its items, IKEA begins with the retail price first. For example, it sets the price for an office chair at $150, and IKEA's designers figure out how to meet this goal. They need to consider the chair from start to finish, including not only design but also raw materials and the way the product will be displayed and transported to meet that goal, including a profit margin. Only then will products go into production.

IKEA also created several other new competitive elements that allow it to offer more value to its customers: It provides on-site child care; it features a restaurant offering delicious food options including Swedish delicatessen such as smoked salmon at low prices;

stores have convenient and ample parking, often in garages under the store, where escalators bring customers directly into the showrooms.

Taken together, with all these steps to eliminate, reduce, raise, and create, IKEA orchestrates different internal value chain activities to reconcile the tension between differentiation and cost leadership in order to create a unique market space. IKEA uses innovation in multiple dimensions—in furniture design, engineering, and store design—to solve the trade-offs between value creation and production cost. An IKEA executive highlights the difficulty as follows: "Designing beautiful-but-expensive products is easy. Designing beautiful products that are inexpensive and functional is a huge challenge."[41] IKEA leverages its deep design and engineering expertise to offer furniture that is stylish and functional and that can be easily assembled by the consumer. In this way, IKEA can pursue a blue ocean strategy based on value innovation to increase the perceived value of its products, while simultaneously lowering its cost and offering competitive prices. It opened up a new market serving a younger demographic than traditional furniture stores. When young people the world over move into their own apartment or house, they frequently furnish it from IKEA.

BLUE OCEAN STRATEGY GONE BAD: "STUCK IN THE MIDDLE"

LO 6-6

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

Although appealing in a theoretical sense, a blue ocean strategy can be quite difficult to translate into reality. The reason is that differentiation and cost leadership are distinct strategic positions that require important trade-offs.[42] A blue ocean strategy is difficult to implement because it requires the reconciliation of fundamentally different strategic positions—differentiation and low cost—which in turn require distinct internal value chain activities (see Chapter 4) so the firm can increase value *and* lower cost at the same time.

Exhibit 6.9 suggests how a successfully formulated blue ocean strategy based on *value innovation* combines both a differentiation and low-cost position. It also shows the consequence of a blue ocean strategy gone bad—the firm ends up being *stuck in the middle,* meaning the firm has neither a clear differentiation nor a clear cost-leadership profile. Being *stuck in the middle* leads to inferior performance and a resulting competitive disadvantage. Strategy Highlight 6.2 illustrates how JCPenney failed at a blue ocean strategy and ended up in the red ocean of cut-throat competition.

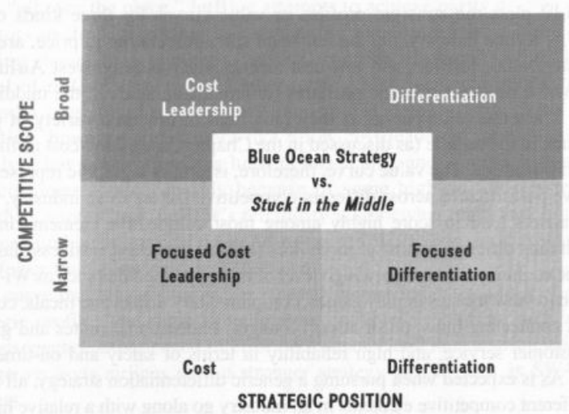


EXHIBIT 6.9 Value Innovation vs. *Stuck in the Middle*

Strategy Highlight 6.2

How JCPenney Sailed Deeper into the Red Ocean

JCPenney under its (former) CEO, Ron Johnson, learned the hard way how difficult it is to change a strategic position. When hired as JCPenney's CEO in 2011, Johnson was hailed as a star executive. He was poached from Apple, where he had created and led Apple's retail stores since 2000. Apple's stores are the most successful retail outlets globally in terms of sales per square foot. No other retail outlet, not even luxury jewelers, achieves more.

Once on board with JCPenney, Johnson immediately began to change the company's strategic position from a cost-leadership to a *blue ocean strategy*, attempting to combine the cost-leadership position with a differentiation position. In particular, he tried to reposition the department store more toward the high end by providing an improved customer experience and more exclusive merchandise through in-store boutiques. CEO Johnson ordered all clearance racks with steeply discounted merchandise, common in JCPenney stores, to be removed. He also did away with JCPenney's long-standing practice of mailing discount coupons to its customers. Rather than following industry best practice by testing the more drastic strategic moves in a small number of selected stores, Johnson implemented them wholesale in all 1,800 stores at once. When one executive raised the issue of pretesting, Johnson bristled and responded: "We didn't test at Apple." Under his leadership, JCPenney also got embroiled in a legal battle with Macy's because of Johnson's attempt to lure away homemaking maven Martha Stewart and her exclusive merchandise collection.

The envisioned blue ocean strategy failed badly, and JCPenney ended up being stuck in the middle. Within 12 months with Johnson at the helm, JCPenney's sales dropped by 25 percent. In a hypercompetitive industry such as retailing where every single percent of market share counts, this was a landslide. In 2013, JCPenney's stock performed so poorly it was dropped from the S&P 500 index. Less than 18 months into his new job, Johnson was fired. Myron Ullman, his predecessor, was brought out of retirement as a replacement.

JCPenney failed at its attempted blue ocean strategy and instead sailed deeper into the *red ocean* of bloody competition. This highlights the perils of attempting a blue ocean strategy because of the inherent trade-offs in the underlying generic business strategies of cost leadership and differentiation. As a result, JCPenney continues to experience a sustained competitive disadvantage as of this writing.[43]

value curve
Horizontal connection of the points of each value on the strategy canvas that helps strategists diagnose and determine courses of action.

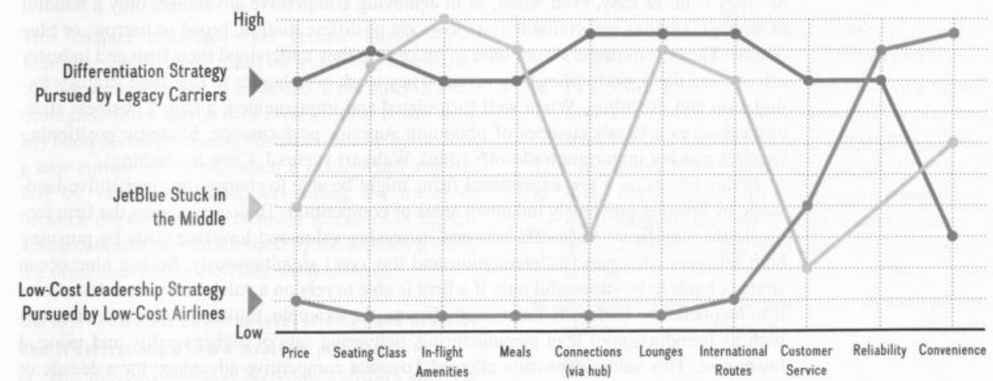
strategy canvas
Graphical depiction of a company's relative performance vis-à-vis its competitors across the industry's key success factors.

The **value curve** is the basic component of the **strategy canvas**. It graphically depicts a company's relative performance across its industry's factors of competition. A strong value curve has focus and divergence, and it can even provide a kind of tagline as to what strategy is being undertaken or should be undertaken.

Exhibit 6.10 plots the strategic profiles or value curves for three kinds of competitors in the U.S. airline industry. On the left-hand side, descending in price, are the legacy carriers (think Delta), JetBlue, and low-cost airlines such as Southwest Airlines (SWA). We also show the different strategic positions (differentiator, stuck in the middle, and low-cost leader). Trace the value curves as they rank high or low on a variety of parameters. JetBlue is stuck in the middle (as discussed in the ChapterCase). Low-cost airlines follow a cost-leadership strategy. The value curve, therefore, is simply a graphic representation of a firm's relative performance across different competitive factors in an industry.

Legacy carriers tend to score highly among most competitive elements in the airline industry, including different seating class choices (such as first class, business class, economy comfort, basic economy, and so on), a high level of in-flight amenities such as Wi-Fi, personal video console to view movies or play games, complimentary drinks and meals, coast-to-coast coverage via connecting hubs, plush airport lounges, international routes and global coverage, high customer service, and high reliability in terms of safety and on-time departures and arrivals. As is expected when pursuing a generic differentiation strategy, all these scores along the different competitive elements in an industry go along with a relative high price.

EXHIBIT 6.10 / Strategy Canvas of JetBlue vs. Low-cost Airlines and Legacy Carriers.



In contrast, the low-cost airlines tend to hover near the bottom of the strategy canvas, indicating low scores along a number of competitive factors in the industry, with no assigned seating, no in-flight amenities, no drinks or meals, no airport lounges, few if any international routes, low to intermediate level of customer service. A relatively low price goes along with a generic low-cost leadership strategy.

This strategy canvas also reveals key strategic insights. Look at the few competitive elements where the value curves of the differentiator and low-cost leader diverge. 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 and is thus "all over the place." 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.

6.7 ◂▸ Implications for the Strategist

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 competitive disadvantage.

CHAPTERCASE 6 / Consider This...

Early in its history JetBlue achieved a competitive advantage based on *value innovation*. In particular, JetBlue was able to drive up perceived costumer 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, it was unable to sustain it over time. Because JetBlue failed in reconciling the strategic trade-offs inherent in combing differentiation and cost leadership, it was unable to continue its blue ocean strategy, despite initial success. Since 2007 JetBlue experienced a sustained competitive disadvantage, at one point in 2014 lagging the S&P 500 index by more than 100 percentage points.

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 decided to start charging $50 per checked bag instead of offering it as a free service. Moreover, it also removed the additional legroom JetBlue was famous for in the industry, adding 10 percent more seats on its airplanes. It remains to be seen if JetBlue's strategic repositioning will be successful.

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."
   - **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, Robin Hayes, put in place? 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 6.10. Why is JetBlue experiencing a competitive advantage? What recommendations would you offer to JetBlue to strengthen its strategic profile? Be specific.

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. *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 the 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 managerscan 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 6.7 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.
- Managers track their opportunities and risks for lowering a firm's costs and increasing perceived value vis-à-vis their competitors by use

Chapter 7

Business Strategy: Innovation and Entrepreneurship

Chapter Outline

7.1 Competition Driven by Innovation
The Innovation Process

7.2 Strategic and Social Entrepreneurship

7.3 Innovation and the Industry Life Cycle
Introduction Stage
Growth Stage
Shakeout Stage
Maturity Stage
Decline Stage
Crossing the Chasm

7.4 Types of Innovation
Incremental vs. Radical Innovation
Architectural vs. Disruptive Innovation
Open Innovation

7.5 Implications for the Strategist

Learning Objectives

LO 7.1 Outline the four-step innovation process from idea to imitation.

LO 7.2 Apply strategic management concepts to entrepreneurship and innovation.

LO 7.3 Describe the competitive implications of different stages in the industry life cycle.

LO 7.4 Derive strategic implications of the crossing-the-chasm framework.

LO 7.5 Categorize different types of innovations in the markets-and-technology framework.

LO 7.6 Compare and contrast closed and open innovation.

CHAPTERCASE 7

Netflix: Disrupting the TV Industry

Just like cable providers disrupted the early broadcast model of television in a wave of innovation, companies streaming video represents the most recent wave of innovation reshaping the television industry.

The disruptive impact of cable played out in the 1980s and 1990s, upsetting a handful of broadcast networks with dozens and then hundreds of channels. The current wave of disruption started in the 2000s and may be reaching its peak. Now, with basically every device from a TV to a PC or laptop and smartphones turning into a TV screen, demand for online streaming is exploding. And Netflix is riding atop the crest of this wave to industry leadership and competitive advantage. During peak hours, Netflix now accounts for more than one-third of all downstream Internet traffic in the United States!

House of Cards, a Netflix original series, starring Kevin Spacey and Robin Wright.
© A-Pix Entertainment/Photofest

How did Netflix turn from an obscure online rental shop for DVDs sent via postal mail to the dominant content provider of on-demand streaming? After being annoyed at having to pay more than $40 in late fees for a Blockbuster video, Reed Hastings started Netflix in 1997 to offer online rentals of DVDs. At the time, the commercial Internet was in its infancy; Amazon had just made its IPO in the same year. Streaming content was only a distant dream in the era of dial-up Internet. Selling products online seemed rather straightforward, but how could a business rent DVDs through the web? In 1999 Netflix rolled out a monthly subscription model, with unlimited rentals for a single monthly rate (and no late fees!). Rental DVDs were sent in distinctive red envelopes, with preprinted return envelopes. New rentals would not be sent until the current rental was returned.

Despite an innovative business model, Netflix got off to a slow start. By 2000, it had only about 300,000 subscribers and was losing money. Hastings approached Blockbuster, at the time the largest brick-and-mortar video rental chain with almost 8,000 stores in the United States. He proposed selling Blockbuster 49 percent of Netflix and rebranding it as Blockbuster.com. Basically the idea was that Netflix would become the online presence for the huge national chain. The dot.com bubble had just burst, and Blockbuster didn't see value in having a presence online. Blockbuster turned Netflix down cold. Netflix, however, survived the dot.com bust, and by 2002, the company was profitable and went public. Blockbuster began online rentals in 2004, but by this time, Netflix had built a subscriber base of almost 4 million and a strong brand identity. Blockbuster lost 75 percent of its market value between 2003 and 2005. From there it went from bad to worse. In 2010, the once mighty Blockbuster filed for bankruptcy.

So Netflix was at the forefront of the current wave of disruption in the TV industry as it began streaming content over the Internet in 2007. And it stayed at the forefront. It adjusted quickly to the new options consumers had to receive content, making streaming available on a large number of devices including mobile phones, tablets, game consoles, and new devices dedicated to Internet content streaming such as Roku, Apple TV, and Google Chromecast. At the same time the market for Internet-connected,

large, high-definition flat-screen TVs began to take off. Within just two years, Netflix subscriptions (then priced at $7.99 per month) jumped to 12 million. Despite the impending wave of disruption, old-line media executives continued to dismiss Netflix as a threat. In 2010, Time Warner CEO Jeff Bewkes snubbed Netflix by saying, "It's a little bit like, is the Albanian army going to take over the world? I don't think so."[1]

Even Reed Hastings called what Netflix provided "rerun TV." But behind their bravado, the broadcast networks were awaking to the threat Netflix posed. They stopped distributing content to Netflix and instead made it available through Hulu.com, an online content website that is jointly owned by several of the major networks. In 2011, Hulu began offering original content that was not available on broadcast or cable television. The lower-cost structure afforded by Hulu's streaming model meant that the networks saw Hulu as a place to test new series ideas with minimal financial risk. In response, Netflix announced a move to create and stream original content online.

Since content streaming was Netflix's main business, it devoted significant resources to produce high-quality content. In 2013, Netflix first released the political drama *House of Cards*, followed by the comedy-drama *Orange Is the New Black*. Both of these shows proved tremendous hits, and both have received many awards including Emmys and Golden Globes.

In 2015, Netflix had more than 60 million subscribers worldwide, with 50 million in the United States. Its revenues were $6 billion, and its market cap was $38 billion. Indeed, over the past decade, Netflix's stock appreciated by over 4,100 percentage points, while the tech-heavy NASDAQ 100 index grew by "only" 193 percentage points over the same period. By innovating on many different dimensions, Netflix was able to not only disrupt the TV industry, but also to gain a competitive advantage.[2]

You will learn more about Netflix by reading the chapter; related questions appear on page 242.

INNOVATION—the successful introduction of a new product, process, or business model—is a powerful driver in the competitive process. The ChapterCase provides an example of how innovations in technology and business models can make existing competitors obsolete, and how they allowed Netflix to gain a competitive advantage.

Continued innovation forms the bedrock of Netflix's business strategy. Using big data analytics, in particular, Netflix introduced a number of early innovations in the video rental business. One of the more ingenious moves by Netflix was to have each user build a queue of movies he or she wanted to watch next. This allowed Netflix to predict future demand for specific movies fairly accurately. Another innovation was to create a "personalized recommendation engine" for each user that would predict what each subscriber might want to watch next based not only on a quick rating survey and the subscriber's viewing history, but also what movies users with a similar profile had watched and enjoyed. Based on Netflix's proprietary learning algorithm, the recommendations would improve over time as the user's preferences become more clear. This also allowed Netflix to steer users away from hit movies (where wait times for DVD rentals were long because the company only had a limited number in its library) to lesser-known titles in its catalog. The ability to bring in the "long tail"[3] of demand delighted not only viewers, as they enjoyed lesser-known, but often critically acclaimed films, but also movie studies, which could now make additional money on movies that would otherwise not be in demand. Moreover, in contrast to other players in the media industry, Netflix was fast to catch the wave of content streaming via the Internet.

Innovation allows firms to redefine the marketplace in their favor and achieve a competitive advantage.[4] That's why we focus on innovation and the related topic of entrepreneurship in this chapter—to celebrate innovation as a powerful competitive weapon for business strategy formulation. We begin this chapter by detailing how competition is a process driven by continuous innovation. Next we discuss strategic and social

entrepreneurship. We then take a deep dive into the industry life cycle. This helps us to formulate a more dynamic business strategy as the industry changes over time. We also introduce the crossing-the-chasm framework, highlighting the difficulties in transitioning through different stages of the industry life cycle. We then move into a detailed discussion of different types of innovation using the markets-and-technology framework. We also present different ways to organize for innovation. As with every chapter, we conclude with practice-oriented "Implications for the Strategist."

7.1 Competition Driven by Innovation

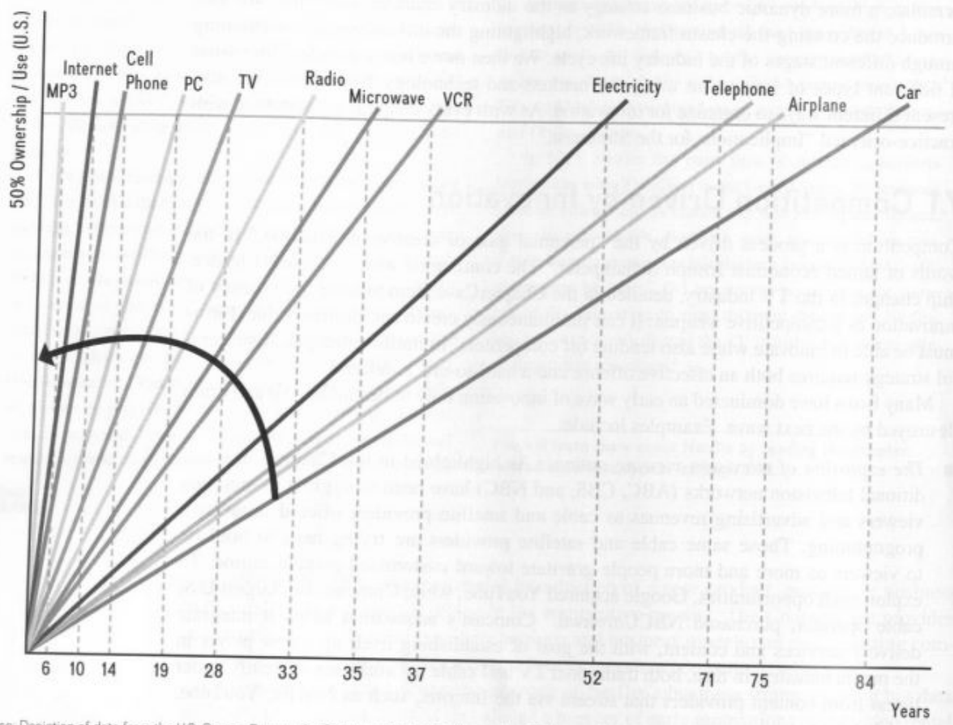
Competition is a process driven by the "perennial gale of creative destruction," in the words of famed economist Joseph Schumpeter.[5] The continuous waves of market leadership changes in the TV industry, detailed in the ChapterCase, demonstrate the potency of innovation as a competitive weapon: It can simultaneously create and destroy value. Firms must be able to innovate while also fending off competitors' imitation attempts. A successful strategy requires both an effective offense and a hard-to-crack defense.

Many firms have dominated an early wave of innovation only to be challenged and often destroyed by the next wave. Examples include:

- *The explosion of television-viewing options:* As highlighted in the ChapterCase, traditional television networks (ABC, CBS, and NBC) have been struggling to maintain viewers and advertising revenues as cable and satellite providers offered innovative programming. Those same cable and satellite providers are trying hard to hold on to viewers as more and more people gravitate toward customized content online. To exploit such opportunities, Google acquired YouTube, while Comcast, the largest U.S. cable operator, purchased NBCUniversal.[6] Comcast's acquisition helps it integrate delivery services and content, with the goal of establishing itself as a new player in the media industry. In turn, both traditional TV and cable networks are currently under threat from content providers that stream via the Internet, such as Netflix, YouTube, and Amazon.
- *The move from typewriters to PCs to mobile devices:* Wang Laboratories, a computer company that led the market for word-processing machines, destroyed typewriter companies such as Smith Corona and Underwood. It then was undone by computer makers such as IBM and Compaq. Today, IBM has exited the personal computer market, selling its PC division to the Chinese technology company Lenovo, and Compaq has been acquired by HP. The computer industry, however, has not been standing still either. Once-successful PC makers such as HP and Dell are now under threat by companies that are innovating in the mobile device space, such as Apple, Samsung, Google, and the Chinese start-up Xiaomi.

As the adage goes, change is the only constant—and the rate of technological change has accelerated dramatically over the past hundred years. Changing technologies spawn new industries, while others die. This makes innovation a powerful strategic weapon in order to gain and sustain competitive advantage. Exhibit 7.1 shows how many years it took for different technological innovations to reach 50 percent of the U.S. population (either through ownership or usage). As an example, it took 84 years for half of the U.S. population to own a car, but only 28 years for half the population to own a TV. The pace of the adoption rate of recent innovations continues to accelerate. It took 19 years for the PC to reach 50 percent ownership, but only 6 years for MP3 players to accomplish the same diffusion rate.

EXHIBIT 7.1 / Accelerating Speed of Technological Change



Source: Depiction of data from the U.S. Census Bureau, the Consumer Electronics Association, *Forbes*, and the National Cable and Telecommunications Association.

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

LO 7-1

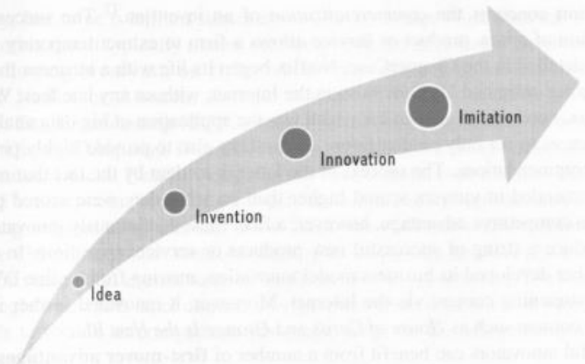
Outline the four-step innovation process from idea to imitation.

THE INNOVATION PROCESS

Broadly viewed, innovation describes the discovery, development, and transformation of new knowledge in a four-step process captured in the *four I's: Idea, Invention, Innovation,* and *Imitation* (see Exhibit 7.2).[7]

EXHIBIT 7.2 /

The Four I's: Idea, Invention, Innovation, and Imitation



The innovation process begins with an *idea.* The idea is often presented in terms of abstract concepts or as findings derived from basic research. Basic research is conducted to discover new knowledge and is often published in academic journals. This may be done to enhance the fundamental understanding of nature, without any commercial application or benefit in mind. In the long run, however, basic research is often transformed into applied research with commercial applications. For example, wireless communication technology today is built upon the fundamental science breakthroughs Albert Einstein accomplished over 100 years ago in his research on the nature of light.[8]

In a next step, **invention** describes the transformation of an idea into a new product or process, or the modification and recombination of existing ones. The practical application of basic knowledge in a particular area frequently results in new technology. If an invention is *useful, novel,* and *non-obvious* as assessed by the U.S. Patent and Trademark Office, it can be patented.[9] A **patent** is a form of *intellectual property,* and gives the inventor exclusive rights to benefit from commercializing a technology for a specified time period in exchange for public disclosure of the underlying idea (see also the discussion on *isolating mechanisms* in Chapter 4). In the United States, the time period for the right to exclude others from the use of the technology is 20 years from the filing date of a patent application. Exclusive rights often translate into a *temporary monopoly position* until the patent expires. For instance, many pharmaceutical drugs are patent protected.

invention
The transformation of an idea into a new product or process, or the modification and recombination of existing ones.

patent
A form of *intellectual property* that gives the inventor exclusive rights to benefit from commercializing a technology for a specified time period in exchange for public disclosure of the underlying idea.

Strategically, however, patents are a *double-edged sword.* On the one hand, patents provide a temporary monopoly as they bestow exclusive rights on the patent owner to use a novel technology for a specific time period. Thus, patents may form the basis for a competitive advantage. Because patents require full disclosure of the underlying technology and know-how so that others can use it freely once the patent protection has expired, however, many firms find it strategically beneficial *not* to patent their technology. Instead they use **trade secrets**, defined as valuable proprietary information that is not in the public domain and where the firm makes every effort to maintain its secrecy. The most famous example of a trade secret is the Coca-Cola recipe, which has been protected for over a century.[10] The same goes for Ferrero's Nutella, whose secret recipe is said to be known by even fewer than the handful of people who have access to the Coca-Cola recipe.[11]

trade secret
Valuable proprietary information that is not in the public domain and where the firm makes every effort to maintain its secrecy.

Avoiding public disclosure and thus making its underlying technology widely known is precisely the reason Netflix does not patent its recommendation algorithm or Google its PageRank algorithm. Netflix has an advantage over competitors because its recommendation algorithm works best; the same goes for Google—its search algorithm is the best available. Disclosing the information how exactly these algorithms work would nullify their advantage.

innovation
The commercialization of any new product or process, or the modification and recombination of existing ones.

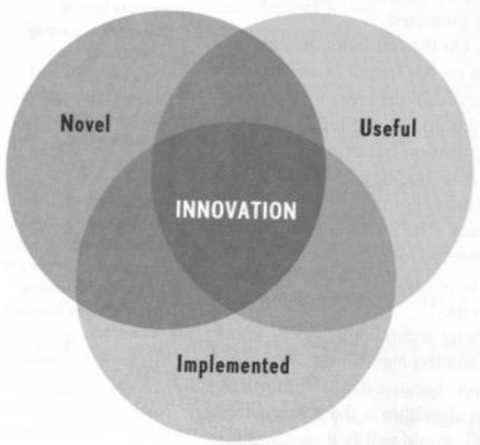
Innovation concerns the *commercialization* of an invention.[12] The successful commercialization of a new product or service allows a firm to extract temporary monopoly profits. As detailed in the ChapterCase, Netflix began its life with a business model innovation, offering unlimited DVD rentals via the Internet, without any late fees. What really aided Netflix, however, to gain an early lead was the application of big data analytics to its user preferences to not only predict future demand but also to provide highly personalized viewing recommendations. The success of the latter is evident by the fact that movies that were recommended to viewers scored higher than on what they were scored previously. To sustain a competitive advantage, however, a firm must continuously innovate—that is, it must produce a string of successful new products or services over time. In this spirit, Netflix further developed its business model innovation, moving from online DVD rentals to directly streaming content via the Internet. Moreover, it innovated further in creating proprietary content such as *House of Cards* and *Orange Is the New Black*.

first-mover advantages
Competitive benefits that accrue to the successful innovator.

Successful innovators can benefit from a number of **first-mover advantages**,[13] including economies of scale as well as experience and learning-curve effects (as discussed in Chapter 6). First movers may also benefit from *network effects* (see discussion of Apple in discussion of the Introduction Stage later in this chapter). Moreover, first movers may hold important intellectual property such as critical patents. They may also be able to lock in key suppliers as well as customers through increasing switching costs. For example, users of Microsoft Word might find the switching costs entailed in moving to a different word-processing software prohibitive. Not only would they need to spend many hours learning the new software, but collaborators would also need to have compatible software installed and be familiar with the program to open and revise shared documents.

Google (by offering Google Docs, a free web-based suite of application software such as word-processing, spreadsheet, and presentation programs) is attempting to minimize switching costs by leveraging *cloud computing*—a real-time network of shared computing resources via the Internet (Google Drive). Rather than requiring each user to have the appropriate software installed on his or her personal computer, the software is maintained and updated in the cloud. Files are also saved in the cloud, which allows collaboration in real time globally wherever one can access an Internet connection.

EXHIBIT 7.3 / Innovation: A Novel and Useful Idea That Is Successfully Implemented



Innovation need not be high-tech in order to be a potent competitive weapon, as P&G's history of innovative new product launches such as the Swiffer line of cleaning products shows. P&G uses the *razor-razorblade business model* (introduced in Chapter 5), where the consumer purchases the handle at a low price, but must pay a premium for replacement refills and pads over time. As shown in Exhibit 7.3, an innovation needs to be novel, useful, and successfully implemented in order to help firms gain and sustain a competitive advantage.

The innovation process ends with *imitation*. If an innovation is successful in the marketplace, competitors will attempt to imitate it. Although Netflix has some 50 million U.S. subscribers, imitators are set to compete its advantage away. Amazon offers its Instant Video service to its estimated 50 million Prime subscribers ($99 a year or $8.25 a month), with selected titles free. In addition, Prime members receive free two-day shipping on Amazon purchases. Hulu Plus ($7.99 a month), a video-on-demand service jointly owned by NBC, Fox, and Disney, has some 6 million subscribers. One advantage Hulu Plus has over Netflix and Amazon is that it typically makes the latest episodes of popular TV shows available the day following broadcast, on Hulu, while often delayed by several months before offered by Netflix or Amazon. A joint venture of NBCUniversal Television Group (Comcast), Fox Broadcasting (21st Century Fox) and Disney—ABC Television Group (The Walt Disney Company), Hulu Plus uses advertisements along with its subscription fees as revenue sources. Finally, Google's YouTube with its over 1 billion users is evolving into a TV ecosystem, benefiting not only from free content uploaded by its users but also creating original programming. As of 2015, the most subscribed channels were by PewDiePie (36 million) and YouTube Spotlight, its official channel (23 million) used to highlight videos and events such as YouTube Music Awards and YouTube Comedy Week. Google's business is, of course, ad supported. Only time will tell whether Netflix will be able to sustain its competitive advantage given the imitation attempts by a number of competitors.

7.2 Strategic and Social Entrepreneurship

LO 7-2
Apply strategic management concepts to entrepreneurship and innovation.

entrepreneurship
The process by which people undertake economic risk to innovate—to create new products, processes, and sometimes new organizations.

Entrepreneurship describes the process by which change agents (entrepreneurs) undertake economic risk to innovate—to create new products, processes, and sometimes new organizations.[14] Entrepreneurs innovate by commercializing ideas and inventions.[15] They seek out or create new business opportunities and then assemble the resources necessary to exploit them.[16] If successful, entrepreneurship not only drives the competitive process, but it also creates value for the individual entrepreneurs and society at large.

Although many new ventures fail, some achieve spectacular success. Examples of successful entrepreneurs are:

- **Reed Hastings,** founder of Netflix featured in the ChapterCase. Hastings grew up in Cambridge, Massachusetts. He obtained an undergraduate degree in math from Bowdoin College, a small liberal arts college. Hastings then volunteered for the Peace Corps for two years, teaching high school math in Swaziland (Africa). Next, he enrolled at Stanford University to pursue a master's degree in computer science, which brought him to Silicon Valley. Reed Hastings declared his love affair with writing computer code, but emphasized, "The big thing that Stanford did for me was to turn me on to the entrepreneurial model."[17] His net worth today is an estimated $1 billion.
- **Jeff Bezos,** the founder of Amazon.com (featured in ChapterCase 8), the world's largest online retailer. The stepson of a Cuban immigrant, Bezos graduated from Princeton and then worked as a financial analyst on Wall Street. In 1994, after reading that the Internet was growing by 2,000 percent a month, he set out to leverage the Internet as a new distribution channel. Listing products that could be sold online, he finally settled on books because that retail market was fairly fragmented, with huge inefficiencies in its distribution system. Perhaps even more important, books represent a perfect commodity, because they are identical regardless of where a consumer buys them. This reduced uncertainty when introducing online shopping to consumers. In a comprehensive research study that evaluated the long-term performance of CEOs globally, Jeff Bezos was ranked number two, just behind the late Steve Jobs (Apple), but ahead of Yun Jong-Yong (Samsung).[18]
- **Oprah Winfrey,** best-known for her self-titled TV talk show, and founder and CEO of Harpo Productions, a multimedia company. Some of Harpo's well-known products include *The Oprah Winfrey Show, Dr. Phil, The Rachael Ray Show, The Dr. Oz Show,*

Oprah Winfrey, a highly successful entrepreneur and business person in many areas including as talk show host, actress, producer, media proprietor, and philanthropist.
© Randall Michelson/ WireImage/Getty Images

Oprah.com, O, The Oprah Magazine, and *O at Home.* In 2011, she launched a new cable TV channel jointly with Discovery Communications: OWN, The Oprah Winfrey Network.[19] A graduate of Tennessee State University, Winfrey used her entrepreneurial talents to rise from poverty and an abusive childhood to become one of the most successful entrepreneurs in the multimedia business, with a net worth of over $2 billion.[20] Also in 2011, Winfrey ended her record-setting talk show to devote her entrepreneurial talents to OWN. To make OWN more successful, she took over the position as CEO in addition to chief creative officer. OWN is now available to some 82 million pay television households in the United States (70 percent of households).

- **Elon Musk,** an engineer and serial entrepreneur with a deep passion to "solve environmental, social, and economic challenges."[21] We featured him in his role as leader of Tesla Motors in ChapterCase 3. Musk left his native South Africa at age 17. He went to Canada and then to the United States, where he completed a bachelor's degree in economics and physics at the University of Pennsylvania. After only two days in a PhD program in applied physics and material sciences at Stanford University, Musk left graduate school to found Zip2, an online provider of content publishing software for news organizations. Four years later, in 1999, computer maker Compaq acquired Zip2 for $341 million (and was in turn acquired by HP in 2002). Elon Musk moved on to co-found PayPal, an online payment processor. When eBay acquired PayPal for $1.5 billion in 2002, Musk had the financial resources to pursue his passion to use science and engineering to solve social and economic challenges. He is leading three new ventures simultaneously: electric cars with Tesla Motors, renewable energy with SolarCity, and space exploration with SpaceX.[22]

entrepreneurs
The agents that introduce change into the competitive system.

Entrepreneurs are the agents who introduce change into the competitive system. They do this not only by figuring out how to use inventions, but also by introducing new products or services, new production processes, and new forms of organization. Entrepreneurs can introduce change by starting new ventures, such as Reed Hastings with Netflix or Mark Zuckerberg with Facebook. Or they can be found within existing firms, such as A.G. Lafley at Procter & Gamble (P&G), who implemented an *open-innovation model* (which we'll discuss later). When innovating within existing companies, change agents are often called *intrapreneurs:* those pursuing *corporate entrepreneurship.*[23]

Entrepreneurs who drive innovation need just as much skill, commitment, and daring as the inventors who are responsible for the process of invention.[24] As an example, the engineer Nikola Tesla invented the alternating-current (AC) electric motor and was granted a patent in 1888 by the U.S. Patent and Trademark Office.[25] Because this breakthrough technology was neglected for much of the 20th century and Tesla did not receive the recognition he deserved in his lifetime, the entrepreneur Elon Musk is not just commercializing Tesla's invention but also honoring Tesla with the name of his company, Tesla Motors, a new venture formed to design and manufacture all-electric automobiles. Tesla Motors launched several all-electric vehicles based on Tesla's original invention.

strategic entrepreneurship
The pursuit of innovation using tools and concepts from strategic management.

Strategic entrepreneurship describes the pursuit of innovation using tools and concepts from strategic management.[26] We can leverage innovation for competitive advantage by applying a strategic management lens to entrepreneurship. The fundamental question of strategic entrepreneurship, therefore, is how to combine entrepreneurial actions, creating new opportunities or exploiting existing ones with strategic actions taken in the pursuit of competitive advantage.[27] This can take place within new ventures such as Tesla Motors or within established firms such as Apple. Apple's continued innovation in mobile devices is an example of strategic entrepreneurship: Apple's managers use strategic analysis, formulation, and implementation when deciding which new type of mobile device to research and develop, when to launch it, and how to implement the necessary organizational changes to support the new product launch. Each new release is an innovation; each is therefore an act of entrepreneurship—planned and executed using strategic management concepts. In 2015, for example, Apple entered the market for computer wearables by introducing the Apple Watch.

social entrepreneurship
The pursuit of social goals while creating a profitable business.

Social entrepreneurship describes the pursuit of social goals while creating profitable businesses. Social entrepreneurs evaluate the performance of their ventures not only by financial metrics but also by ecological and social contribution (*profits, planet,* and *people*). They use a *triple-bottom-line* approach to assess performance (discussed in Chapter 5). Examples of social entrepreneurship ventures include Teach For America (see MiniCase 2), TOMS Shoes (which gives a pair of shoes to an economically disadvantaged child for every pair of shoes it sells), Better World Books (an online bookstore that "harnesses the power of capitalism to bring literacy and opportunity to people around the world"),[28] and Wikipedia (see following and MiniCase 17).

The founder of Wikipedia, Jimmy Wales, typifies social entrepreneurship.[29] Raised in Alabama, Wales was educated by his mother and grandmother who ran a nontraditional school. In 1994, he dropped out of a doctoral program in economics at Indiana University to take a job at a stock brokerage firm in Chicago. In the evenings he wrote computer code for fun and built a web browser. During the late 1990s' Internet boom, Wales was one of the first to grasp the power of an open-source method to provide knowledge on a very large scale. What differentiates Wales from other web entrepreneurs is his idealism: Wikipedia is free for the end user and supports itself solely by donations and not, for example, by online advertising. Wikipedia has 35 million articles in 288 languages, including some 5 million items in English. About 500 million people use Wikipedia each month. Wales' idealism is a form of social entrepreneurship: His vision is to make the entire repository of human knowledge available to anyone anywhere for free.

Since entrepreneurs and the innovations they unleash frequently create entire new industries, we now turn to a discussion of the industry life cycle to derive implications for competitive strategy.

7.3 Innovation and the Industry Life Cycle

LO 7-3
Describe the competitive implications of different stages in the industry life cycle.

Innovations frequently lead to the birth of new industries. Innovative advances in IT and logistics facilitated the creation of the overnight express delivery industry by FedEx and that of big-box retailing by Walmart. The Internet set online retailing in motion, with new companies such as Amazon and eBay taking the lead, and it revolutionized the advertising industry first through Yahoo, and later Google and Facebook. Advances in nanotechnology are revolutionizing many different industries, ranging from medical diagnostics and surgery to lighter and stronger airplane components.[30]

industry life cycle
The five different stages—introduction, growth, shakeout, maturity, and decline—that occur in the evolution of an industry over time.

Industries tend to follow a predictable **industry life cycle**: As an industry evolves over time, we can identify five distinct stages: *introduction, growth, shakeout, maturity,* and *decline.*[31] We will illustrate how the type of innovation and resulting strategic implications change at each stage of the life cycle as well as how innovation can initiate and drive a new life cycle.

The number and size of competitors change as the industry life cycle unfolds, and different types of consumers enter the market at each stage. That is, both the supply and demand sides of the market change as the industry ages. Each stage of the industry life cycle requires different competencies for the firm to perform well and to satisfy that stage's

unique customer group. We first introduce the life cycle model before discussing different customer groups in more depth when introducing the crossing-the-chasm concept later in this chapter.[32]

Exhibit 7.4 depicts a typical industry life cycle, focusing on the smartphone industry in emerging and developed economies. In a stylized industry life cycle model, the horizontal axis shows time (in years) and the vertical axis market size. In Exhibit 7.4, however, we are taking a snapshot of the global smartphone industry in the year 2016. This implies that we are joining two different life cycles (one for emerging economies and one for developed economies) in the same exhibit at one point in time.

The development of most industries follows an S-curve. Initial demand for a new product or service is often slow to take off, then accelerates, before decelerating, and eventually turning to zero, and even becoming negative as a market contracts.

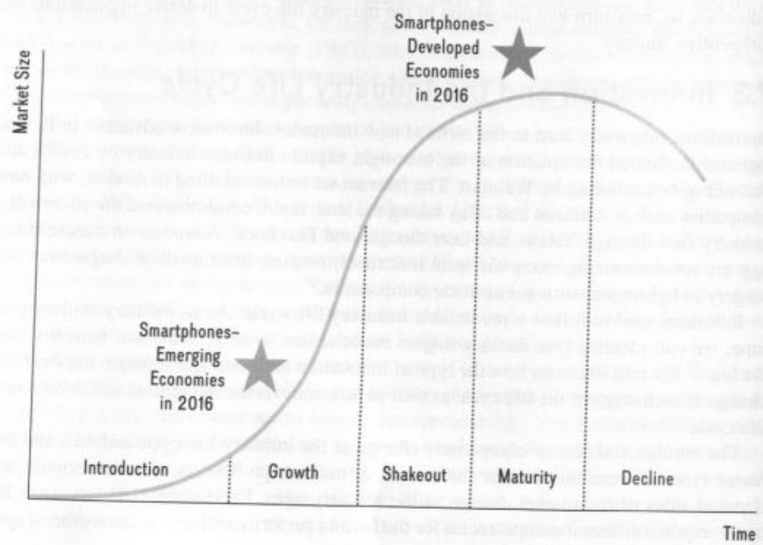
As shown in Exhibit 7.4, in emerging economies such as Argentina, Brazil, China, India, Indonesia, Mexico, and Russia, the smartphone industry is in the growth stage (in 2016). The market for smartphones in these countries is expected to grow rapidly over the next few years. More and more of the consumers in these countries with very large populations are expected to upgrade from a simple mobile phone to a smartphone such as the Apple iPhone, Samsung Galaxy, or Xiaomi's popular Mi2S phone.

In contrast, the market for smartphones is in the maturity stage in 2016 in developed economies such as Australia, Canada, Germany, Japan, South Korea, the United Kingdom, and the United States. This implies that developed economies moved through the prior three stages of the industry life cycle (introductory, growth, and shakeout) some years earlier. Because the smartphone industry is mature in these markets, little or no growth in market size is expected over the next few years because most consumers own smartphones. This implies that any market share gain by one firm comes at the expense of others, as users replace older smartphones with newer models. Competitive intensity is expected to be high.

Each stage of the industry life cycle—introduction, growth, shakeout, maturity, and decline—has different strategic implications for competing firms. We now discuss each stage in detail.

EXHIBIT 7.4

Industry Life Cycle: The Smartphone Industry in Emerging and Developed Economies



INTRODUCTION STAGE

When an individual inventor or company launches a successful innovation, a new industry may emerge. In this introductory stage, the innovator's core competency is R&D, which is necessary to creating a new product category that will attract customers. This is a capital-intensive process, in which the innovator is investing in designing a unique product, trying new ideas to attract customers, and producing small quantities—all of which contribute to a high price when the product is launched. The initial market size is small, and growth is slow.

In this introductory stage, when barriers to entry tend to be high, generally only a few firms are active in the market. In their competitive struggle for market share, they emphasize unique product features and performance rather than price.

Although there are some benefits to being early in the market (as previously discussed), innovators also may encounter *first-mover disadvantages*. They must educate potential customers about the product's intended benefits, find distribution channels and complementary assets, and continue to perfect the fledgling product. Although a core competency in R&D is necessary to create or enter an industry in the introductory stage, some competency in marketing also is helpful in achieving a successful product launch and market acceptance. Competition can be intense, and early winners are well-positioned to stake out a strong position for the future. As one of the main innovators in software for mobile devices, Google's Android operating system for smartphones is enjoying a strong market position and substantial lead over competitors.

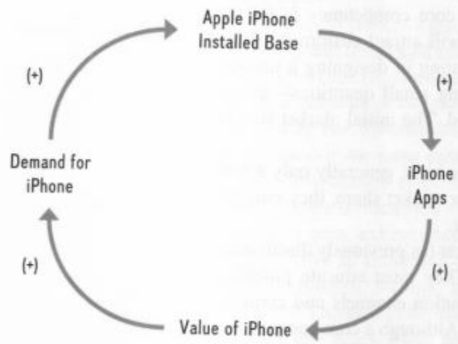
The strategic objective during the introductory stage is to achieve market acceptance and seed future growth. One way to accomplish these objectives is to initiate and leverage **network effects**,[33] the positive effect that one user of a product or service has on the value of that product for other users. Network effects occur when the value of a product or service increases, often exponentially, with the number of users. If successful, network effects propel the industry to the next stage of the life cycle, the growth stage (which we discuss next).

network effects The positive effect (externality) that one user of a product or service has on the value of that product for other users.

Apple effectively leveraged the network effects generated by numerous complementary software applications (apps) available via iTunes to create a tightly integrated ecosystem of hardware, software, and services, which competitors find hard to crack. The consequence has been a competitive advantage for over a decade, beginning with the introduction of the iPod in 2001 and iTunes in 2003. Apple launched its enormously successful iPhone in the summer of 2007. A year later, it followed up with the Apple App Store, which boasts, for almost anything you might need, "there's an app for that." *Apps* are small software programs developed to provide mobile users with inexpensive business and personal services wherever they may be. Popular apps allow iPhone users to access their business contacts via LinkedIn, hail a ride via Uber, call colleagues overseas via Skype, check delivery of their Zappos packages shipped via UPS, get the latest news on Twitter, and engage in customer relationship management using Salesforce.com. You can stream music via Pandora, post photos using Instagram, watch Netflix, access Facebook to check on your friends, or video message using Snapchat.

Even more important is the effect that apps have on the value of an iPhone. Arguably, the explosive growth of the iPhone is due to the fact that the Apple App Store offers the largest selection of apps to its users. The 1.5 million apps available were downloaded 75 billion times as of spring 2015. Moreover, Apple argues that users have a better experience because the apps take advantage of the tight integration of hardware and software provided by the iPhone. The availability of apps, in turn, leads to network effects that increase the value of the iPhone for its users. Exhibit 7.5 shows how. Increased value creation, as we know from Chapter 6, is positively related to demand, which in turn

EXHIBIT 7.5 / Leveraging Network Effects to Drive Demand: Apple's iPhone



increases the installed base, meaning the number of people using an iPhone. As of the spring of 2015, Apple had sold more than 75 million iPhone 6 models, introduced just six months prior. As the installed based of iPhone users further increases, this incentivizes software developers to write even more apps. Making apps widely available strengthened Apple's position in the smartphone industry. Based on positive feedback loops, a virtuous cycle emerges where one factor positively reinforces another. Apple's ecosystem based on integrated hardware, software, and services providing a superior user experience is hard to crack for competitors. Apple now hopes that its vast App Store in combination with a seamless user experience will now also ignite a virtuous cycle of continuous demand based on network effects for its Apple Watch, introduced in early 2015.[34]

GROWTH STAGE

Market growth accelerates in the growth stage of the industry life cycle (see Exhibit 7.4). After the initial innovation has gained some market acceptance, demand increases rapidly as first-time buyers rush to enter the market, convinced by the proof of concept demonstrated in the introductory stage.

standard
An agreed-upon solution about a common set of engineering features and design choices.

As the size of the market expands, a **standard** signals the market's agreement on a common set of engineering features and design choices.[35] Standards can emerge bottom-up through competition in the marketplace or be imposed top-down by government or other standard-setting agencies such as the Institute of Electrical and Electronics Engineers (IEEE) that develops and sets industrial standards in a broad range of industries, including energy, electric power, biomedical and health care technology, IT, telecommunications, consumer electronics, aerospace, and nanotechnology.

An agreed-upon standard, such as the IBM PC, ensures that all components of the system work well together, regardless of who developed them. It also helps legitimize the new technology by reducing uncertainty and confusion. A standard tends to capture a larger market share and can persist for a long time.

In the 1980s, the Wintel standard (a portmanteau of Windows and Intel) marked the beginning of exponential growth in the personal computer industry; it still holds some 90 percent of market share in personal computers. In the 2000s we saw a standards war between the HD-DVD format and the higher-definition rival, the Blu-ray Disc (BD). Blu-ray, backed by an association of electronics companies including Sony, Panasonic, and others, bested the HD-DVD format backed by Toshiba. Some argue that Sony's PlayStation 3 acted as a catalyst for adopting the Blu-ray format. A tipping point in favor of the Blu-ray format may have been the decision in 2008 by Warner Bros. to release discs only in Blu-ray format. Leading retailers such as Walmart and Best Buy began carrying DVDs in Blu-ray format and did not stock as large a selection in the HD-DVD format; Netflix and Blockbuster also fell in line. As a consequence, many companies stopped making HD-DVD players. Barriers to entry fell as technological uncertainties were overcome, and many new and established firms rushed to participate in the growth opportunity. As a side note, Sony and others never reaped the full rewards of this victory. Today the HD-DVD format still prevails, and wars on media formats have been overshadowed by delivery through video on demand (VOD) and streaming.

Government bodies or industry associations can also set standards by making top-down decisions. The European Union determined in the 1980s that GSM (Global System for Mobile Communications) should be the standard for cell phones in Europe. The United States relied instead on a market-based approach, and CDMA (Code Division Multiple Access), a proprietary standard developed by Qualcomm, emerged as an early leader. While North American manufacturers and service providers such as AT&T, Verizon, Motorola, and others were fighting a format war, Scandinavian companies such as Nokia and Ericsson faced no such uncertainty, and they leveraged their early lead into a temporary competitive advantage. Today, about 80 percent of the global mobile market uses the GSM standard.

Since demand is strong during the growth phase, both efficient and inefficient firms thrive; the rising tide lifts all boats. Moreover, prices begin to fall, often rapidly, as standard business processes are put in place and firms begin to reap economies of scale and learning. Distribution channels are expanded, and complementary assets in the form of products and services become widely available.[36]

After a standard is established in an industry, the basis of competition tends to move away from product innovations toward process innovations.[37] **Product innovations**, as the name suggests, are new or recombined knowledge embodied in new products—the jet airplane, electric vehicle, smartphones, and wearable computers. **Process innovations** are new ways to produce existing products or to deliver existing services. Process innovations are made possible through advances such as the Internet, lean manufacturing, Six Sigma, biotechnology, nanotechnology, and so on.

product innovation
New or recombined knowledge embodied in new products.

process innovation
New ways to produce existing products or deliver existing services.

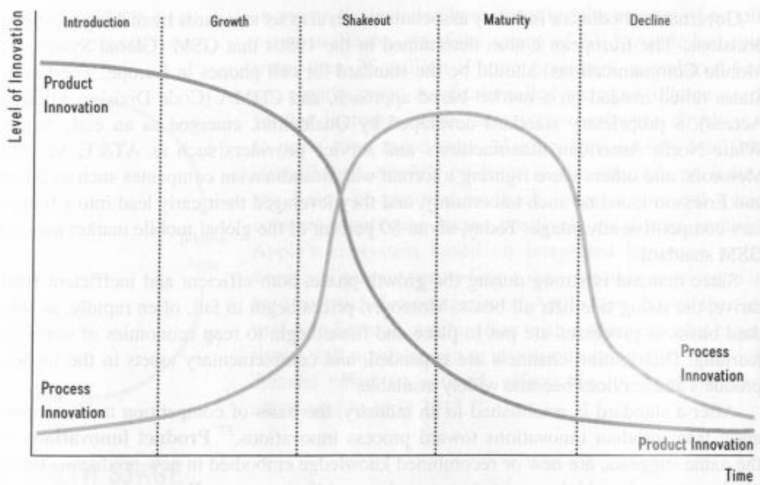
Process innovation must not be high-tech to be impactful, however. The invention of the standardized shipping container, for instance, has transformed global trade.[38] By loading goods into uniform containers that could easily be moved between trucks, rail, and ships, significant savings in cost and time were accomplished. Before containerization was invented some 60 years ago, it cost almost $6 to load a ton of (loose) cargo, and theft was rampant. After containerization, the cost for loading a ton of cargo had plummeted to $0.16 and theft all but disappeared (because containers are sealed at the departing factory). Efficiency gains in terms of labor and time were even more impressive. Before containerization, dock labor could move 1.7 tons per hour onto a cargo ship. After containerization, this had jumped to 30 tons per hour. Ports are now able to accommodate much larger ships, and travel time across the oceans has fallen in half. As a consequence, costs for shipping goods across the globe have fallen rapidly. Moreover, containerization enabled optimization of global supply chains and set the stage for subsequent process innovations such as *just-in-time (JIT) operations management.* Taken together, a set of research studies estimated that containerization alone more than tripled international trade within five years of adopting this critical process innovation.[39]

Exhibit 7.6 shows the level of product and process innovation throughout the entire life cycle.[40] In the introductory stage, the level of *product* innovation is at a maximum because new features increasing perceived consumer value are critical to gaining traction in the market. In contrast, process innovation is at a minimum in the introductory stage because companies produce only a small number of products, often just prototypes or beta versions. The main concern is to commercialize the invention—that is, to demonstrate that the product works and that a market exists.

The relative importance, however, reverses over time. Frequently, a standard emerges during the growth stage of the industry life cycle (see the second column, "Growth," in Exhibit 7.6). At that point, most of the technological and commercial uncertainties about the new product are gone. After the market accepts a new product, and a standard for the new technology has emerged, *process* innovation rapidly becomes more important than

EXHIBIT 7.6

Product and Process Innovation throughout an Industry Life Cycle



product innovation. As market demand increases, economies of scale kick in: Firms establish and optimize standard business processes through applications of lean manufacturing, Six Sigma, and so on. As a consequence, product improvements become incremental, while the level of process innovation rises rapidly.

During the growth stage, process innovation ramps up (at increasing marginal returns) as firms attempt to keep up with rapidly rising demand while attempting to bring down costs at the same time. The core competencies for competitive advantage in the growth stage tend to shift toward manufacturing and marketing capabilities. At the same time, the R& D emphasis tends to shift to process innovation for improved efficiency. Competitive rivalry is somewhat muted because the market is growing fast.

Since market demand is robust in this stage and more competitors have entered the market, there tends to be more strategic variety: Some competitors will continue to follow a *differentiation* strategy, emphasizing unique features, product functionality, and reliability. Other firms employ a *cost-leadership strategy* in order to offer an acceptable level of value but lower prices to consumers. They realize that lower cost is likely a key success factor in the future, because this will allow the firm to lower prices and attract more consumers into the market. When introduced in the spring of 2010, for example, Apple's first-generation iPad was priced at $829 for 64GB with a 3G Wi-Fi connection.[41] Just three years later, in spring 2013, the same model was priced at only one-third of the original price, or $275.[42] Access to efficient and large-scale manufacturing operations (such as those offered by Foxconn in China, the company that assembles most of Apple's products) and effective supply chain capabilities are key success factors when market demand increases rapidly. By 2015, Gazelle, an ecommerce company that allows people to sell their electronic devices and to buy pre-certified used ones, offered $30 for a "flawless" first-generation iPad.

The key objective for firms during the growth phase is to stake out a strong strategic position not easily imitated by rivals. In the fast-growing shapewear industry, start-up company Spanx has staked out a strong position. In 1998, Florida State University graduate Sara Blakely decided to cut the feet off her pantyhose to enhance her looks when wearing pants.[43] Soon after she obtained a patent for her bodyshaping undergarments, and

Spanx began production and retailing of its shapewear in 2000. Sales grew exponentially after Blakely appeared on *The Oprah Winfrey Show*. By 2015, Spanx had grown to 150 employees and sold millions of Spanx "power panties," with revenues exceeding $250 million. To stake out a strong position and to preempt competitors, Spanx now offers over 200 products ranging from slimming apparel and swimsuits to bras and activewear. Moreover, it now designs and manufactures bodyshaping undergarments for men ("Spanx for Men—Manx"). Spanx products are now available in over 50 countries globally via the Internet. Moreover, to strengthen its strategic position and brand image in the United States, Spanx is opening retail stores across the country.

Sara Blakely, founder and long-time CEO of Spanx. World's youngest female billionaire.
© Zuma Press, Inc/Alamy

The shapewear industry's explosive growth has attracted several other players: Flexees by Maidenform, BodyWrap, and Miraclesuit, to name a few. They are all attempting to carve out positions in the new industry. Given Spanx's ability to stake out a strong position during the growth stage of the industry life cycle and the fact that it continues to be a moving target, it might be difficult for competitors to dislodge the company.

Taking the risk paid off for Spanx's founder: After investing an initial $5,000 into her startup, Blakely became the world's youngest self-made female billionaire. Blakely was also listed in the Time 100, the annual list of the most influential people in the world.

SHAKEOUT STAGE

Rapid industry growth and expansion cannot go on indefinitely. As the industry moves into the next stage of the industry life cycle, the rate of growth declines (see Exhibit 7.4). Firms begin to compete directly against one another for market share, rather than trying to capture a share of an increasing pie. As competitive intensity increases, the weaker firms are forced out of the industry. This is the reason this phase of the industry life cycle is called the shakeout stage: Only the strongest competitors survive increasing rivalry as firms begin to cut prices and offer more services, all in an attempt to gain more of a market that grows slowly, it at all. This type of cut-throat competition erodes profitability of all but the most efficient firms in the industry. As a consequence, the industry often consolidates, as the weakest competitors either are acquired by stronger firms or exit through bankruptcy.

The winners in this increasingly competitive environment are often firms that stake out a strong position as cost leaders. Key success factors at this stage are the manufacturing and process engineering capabilities that can be used to drive costs down. The importance of process innovation further increases (albeit at diminishing marginal returns), while the importance of product innovation further declines.

Assuming an acceptable value proposition, price becomes a more important competitive weapon in the shakeout stage, because product features and performance requirements tend to be well-established. A few firms may be able to implement a blue ocean strategy, combining differentiation and low cost, but given the intensity of competition, many weaker firms are forced to exit. Any firm that does not have a clear strategic profile is likely to not survive the shakeout phase.

MATURITY STAGE

After the shakeout is completed and a few firms remain, the industry enters the maturity stage. During the fourth stage of the industry life cycle, the industry structure morphs into an oligopoly with only a few large firms. Most of the demand was largely satisfied in the prior shakeout stage. Any additional market demand in the maturity stage is limited. Demand now consists of replacement or repeat purchases. The market has reached its maximum size, and industry growth is likely to be zero or even negative going forward. This decrease in market demand increases competitive intensity within the industry. In the maturity stage, the level of process innovation reaches its maximum as firms attempt to lower cost as much as possible, while the level of incremental product innovation sinks to its minimum (see Exhibit 7.6).

Generally, the firms that survive the shakeout stage tend to be larger and enjoy economies of scale, as the industry consolidated and most excess capacity was removed. As shown in Exhibit 7.4, the smartphone industry in the United States and other developed economies is in the maturity stage. Competitive intensity is likely to increase even further going forward.

The domestic airline industry has been in the maturity stage for a long time. The large number of bankruptcies as well as the wave of mega-mergers, such as those of Delta and Northwest, United and Continental, and American Airlines and US Airways, are a consequence of low or zero growth in a mature market characterized by significant excess capacity.

DECLINE STAGE

Changes in the external environment (such as those discussed in Chapter 3 when presenting the PESTEL framework) often take industries from maturity to decline. In this final stage of the industry life cycle, the size of the market contracts further as demand falls, often rapidly. At this final phase of the industry life cycle, innovation efforts along both product and process dimensions cease (see Exhibit 7.6). If a technological or business model breakthrough emerges that opens up a *new* industry, however, then this dynamic interplay between product and process innovation starts anew.

If there is any remaining excess industry capacity in the decline stage, this puts strong pressure on prices and can further increase competitive intensity, especially if the industry has high exit barriers. At this final stage of the industry life cycle, managers generally have four strategic options: *exit, harvest, maintain,* or *consolidate:*[44]

- **Exit.** Some firms are forced to *exit* the industry by bankruptcy or liquidation. The U.S. textile industry has experienced a large number of exits over the last few decades, mainly due to low-cost foreign competition.
- **Harvest.** In pursuing a *harvest strategy,* the firm reduces investments in product support and allocates only a minimum of human and other resources. While several companies such as IBM, Brother, Olivetti, and Nakajima still offer typewriters, they don't invest much in future innovation. Instead, they are maximizing cash flow from their existing typewriter product line.
- **Maintain.** Philip Morris, on the other hand, is following a *maintain strategy* with its Marlboro brand, continuing to support marketing efforts at a given level despite the fact that U.S. cigarette consumption has been declining.
- **Consolidate.** Although market size shrinks in a declining industry, some firms may choose to *consolidate* the industry by buying rivals. This allows the consolidating firm to stake out a strong position—possibly approaching monopolistic market power, albeit in a declining industry.

Although chewing tobacco is a declining industry, Swedish Match has pursued a number of acquisitions to consolidate its strategic position in the industry. It acquired, among other firms, the Pinkerton Tobacco Company of Owensboro, Kentucky, maker of the Red Man brand. Red Man is the leading chewing tobacco brand in the United States. Red Man has carved out a strong strategic position built on a superior reputation for a quality product and by past endorsements of Major League Baseball players since 1904. Despite gory product warnings detailing the health risk of chewing tobacco and a federally mandated prohibition on marketing, the Red Man brand has remained not only popular, but also profitable.

CROSSING THE CHASM

LO 7-4
Derive strategic implications of the crossing-the-chasm framework.

The industry life cycle model assumes a more or less smooth transition from one stage to another. This holds true for most continuous innovations that require little or no change in consumer behavior. But not all innovations enjoy such continuity.

In the influential bestseller *Crossing the Chasm*[45] Geoffrey Moore documented that many innovators were unable to successfully transition from one stage of the industry life cycle to the next. Based on empirical observations, Moore's core argument is that *each stage of the industry life cycle is dominated by a different customer group.* Different customer groups with distinctly different preferences enter the industry at each stage of the industry life cycle. Each customer group responds differently to a technological innovation. This is due to differences in the psychological, demographic, and social attributes observed in each unique customer segment. Moore's main contribution is that the significant differences between the *early* customer groups—who enter during the introductory stage of the industry life cycle—and *later* customers—who enter during the growth stage—can make for a difficult transition between the different parts of the industry life cycle. Such differences between customer groups lead to a big gulf or *chasm* into which companies and their innovations frequently fall. Only companies that recognize these differences and are able to apply the appropriate competencies at each stage of the industry life cycle will have a chance to transition successfully from stage to stage.

crossing-the-chasm framework Conceptual model that shows how each stage of the industry life cycle is dominated by a different customer group.

Exhibit 7.7 shows the **crossing-the-chasm framework** and the different customer segments. The industry life cycle model (shown in Exhibit 7.4) follows an S-curve leading up to 100 percent total market potential that can be reached during the maturity

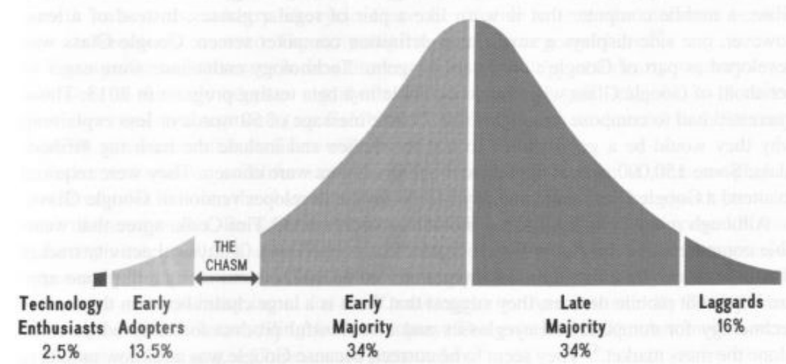


EXHIBIT 7.7
The Crossing-the-Chasm Framework

Source: Adapted from G.A. Moore (1991), *Crossing the Chasm: Marketing and Selling Disruptive Products to Mainstream Customers* (New York: HarperCollins), p. 17.

stage. In contrast, the *chasm framework* breaks down the 100 percent market potential into different customer segments, highlighting the *incremental* contribution each specific segment can bring into the market. This results in the familiar bell curve. Note the big gulf, or *chasm,* separating the early adopters from the early and late majority that make up the mass market. Social network sites have followed a pattern similar to that illustrated in Exhibit 7.7. Friendster was unable to cross the big chasm. MySpace was successful with the early majority, but only Facebook went on to succeed with the late majority and laggards. Each stage customer segment, moreover, is also separated by smaller chasms. Both the large competitive chasm and the smaller ones have strategic implications.

Both new technology ventures and innovations introduced by established firms have a high failure rate. This can be explained as a failure to successfully cross the chasm from the early users to the mass market because the firm does not recognize that the business strategy needs to be fine-tuned for each customer segment. Formulating a business strategy for each segment guided by the *who, what, why, and how* questions of competition (Who to serve? What needs to satisfy? Why and how to satisfy them?), introduced in Chapter 6, the firm will find that the core competencies to satisfy each of the different customer segments are quite different. If not recognized and addressed, this will lead to the demise of the innovation as it crashes into the chasm between life cycle stages.

We first introduce each customer group and map it to the respective stage of the industry life cycle. To illustrate, we then apply the chasm framework to an analysis of the mobile phone industry.

TECHNOLOGY ENTHUSIASTS. The customer segment in the introductory stage of the industry life cycle is called *technology enthusiasts.*[46] The smallest market segment, it makes up some 2.5 percent of total market potential. Technology enthusiasts often have an engineering mind-set and pursue new technology proactively. They frequently seek out new products before the products are officially introduced into the market. Technology enthusiasts enjoy using beta versions of products, tinkering with the product's imperfections and providing (free) feedback and suggestions to companies. For example, many software companies such as Google and Microsoft launch beta versions to accumulate customer feedback to work out bugs before the official launch. Moreover, technology enthusiasts will often pay a premium price to have the latest gadget. The endorsement by technology enthusiasts validates the fact that the new product does in fact work.

A recent example of an innovation that appeals to technology enthusiasts is Google Glass, a mobile computer that is worn like a pair of regular glasses. Instead of a lens, however, one side displays a small, high-definition computer screen. Google Glass was developed as part of Google's wild-card program. Technology enthusiasts were eager to get ahold of Google Glass when made available in a beta testing program in 2013. Those interested had to compose a Google+ or Twitter message of 50 words or less explaining why they would be a good choice to test the device and include the hash tag #ifihadglass. Some 150,000 people applied and 8,000 winners were chosen. They were required to attend a Google Glass event and pay $1,500 for the developer version of Google Glass.

Although many industry leaders, including Apple's CEO Tim Cook, agree that wearable computers like the Apple Watch or the Nike + FuelBand (a physical activity tracker that is worn on the wrist; data are integrated into an online community and phone app) are important mobile devices, they suggest that there is a large chasm between the current technology for computerized eyeglasses and a successful product for early adopters let alone the mass market.[47] They seem to be correct, because Google was until now unable to

cross the chasm between technology enthusiasts and early adopters, even after spending $10 billion on R&D per year.[48]

Google Glass allows the wearer to use the Internet and smartphone-like applications via voice commands (e.g., conduct online search, stream video, and so on). © AP Photo/Google/Rex Features

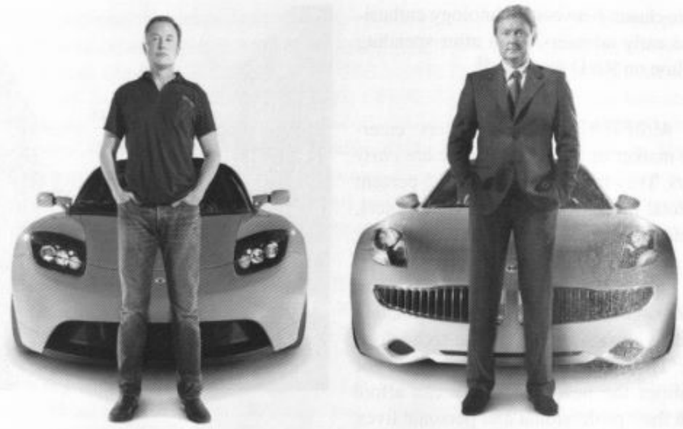
EARLY ADOPTERS. The customers entering the market in the growth stage are *early adopters.* They make up roughly 13.5 percent of the total market potential. Early adopters, as the name suggests, are eager to buy early into a new technology or product concept. Unlike technology enthusiasts, however, their demand is driven by their imagination and creativity rather than by the technology per se. They recognize and appreciate the possibilities the new technology can afford them in their professional and personal lives. Early adopters' demand is fueled more by intuition and vision rather than technology concerns. These are the people that lined up at Apple Stores in the spring of 2015 when it introduced Apple Watch. Since early adopters are not influenced by standard technological performance metrics but by intuition and imagination (What can this new product do for me or my business?), the firm needs to communicate the product's potential applications in a more direct way than when it attracted the initial technology enthusiasts. Attracting the early adopters to the new offering is critical to opening any new high-tech market segment.

EARLY MAJORITY. The customers coming into the market in the shakeout stage are called *early majority.* Their main consideration in deciding whether or not to adopt a new technological innovation is a strong sense of practicality. They are pragmatists and are most concerned with the question of what the new technology can do for them. Before adopting a new product or service, they weigh the benefits and costs carefully. Customers in the early majority are aware that many hyped new product introductions will fade away, so they prefer to wait and see how things shake out. They like to observe how early adopters are using the product. Early majority customers rely on endorsements by others. They seek out reputable references such as reviews in prominent trade journals or in magazines such as *Consumer Reports.*

Because the early majority makes up roughly one-third of the entire market potential, winning them over is critical to the commercial success of the innovation. They are on the cusp of the mass market. Bringing the early majority on board is the key to catching the growth wave of the industry life cycle. Once they decide to enter the market, a *herding effect* is frequently observed: The early majority enters in large numbers.[49]

The significant differences in the attitudes toward technology of the early majority when compared to the early adopters signify the wide competitive gulf—*the chasm*—between these two consumer segments (see Exhibit 7.7). Without adequate demand from the early majority, most innovative products wither away.

Fisker Automotive, a California-based designer and manufacturer of premium plug-in hybrid vehicles, fell into the chasm because it was unable to transition to early adopters, let alone the mass market. Between its founding in 2007 and 2012, Fisker sold some 1,800 of its Karma model, a $100K sports car, to technology enthusiasts. It was unable, however, to follow up with a lower-cost model to attract the early adopters into the market. In addition, technology and reliability issues for the Karma could not be overcome. By 2013, Fisker had crashed into a chasm, filing for bankruptcy. The assets of Fisker Automotive were purchased by Wanxiang, a Chinese auto parts maker.[50]



Tesla Motors CEO Elon Musk, left, in front of a Tesla Roadster; Fisker Automotive CEO Henrik Fisker, right, in front of a Fisker Karma.
© Misha Gravenor

In contrast, Tesla Motors, the maker of all-electric vehicles introduced in ChapterCase 3, and a fierce rival of Fisker at one time, was able to overcome some of the early chasms. The Tesla Roadster was a proof-of-concept car that demonstrated that electric vehicles could achieve an equal or better performance than the very best gasoline-engine sports cars. The 2,400 Roadsters that Tesla built between 2008 and 2012 were purchased by technology enthusiasts. Next, Tesla successfully launched the Model S, a family sedan, sold to early adopters. The Tesla Model S received a strong endorsement as the 2013 *MotorTrend* Car of the Year and the highest test scores ever awarded by *Consumer Reports*. This may help in crossing the chasm to the early majority, because consumers would now feel more comfortable in considering and purchasing a Tesla vehicle. Tesla is hoping to cross the large competitive chasm between early adopters and early majority with its Model X (a minivan, SUV crossover) and its new, lower-priced Model 3, coming out in 2017.

LATE MAJORITY. The next wave of growth comes from buyers in the *late majority* entering the market in the maturity stage. Like the early majority, they are a large customer segment, making up approximately 34 percent of the total market potential. Combined, the early adopters and early majority make up the lion's share of the market potential. Demand coming from just two groups—early and late majority—drives most industry growth and firm profitability.

Members of the early and late majority are also quite similar in their attitudes toward new technology. The late majority shares all the concerns of the early majority. But there are important differences. Although members of the early majority are confident in their ability to master the new technology, the late majority is not. They prefer to wait until standards have emerged and are firmly entrenched, so that uncertainty is much reduced. The late majority also prefers to buy from well-established firms with a strong brand image rather than from unknown new ventures.

LAGGARDS. Finally, *laggards* are the last consumer segment to come into the market, entering in the declining stage of the industry life cycle. These are customers who adopt a new product only if it is absolutely necessary, such as first-time cell phone adopters in the United States today. These customers generally don't want new technology, either for personal or economic reasons. Given their reluctance to adopt new technology, they are generally not considered worth pursuing. Laggards make up no more than 16 percent of

the total market potential. Their demand is far too small to compensate for reduced demand from the early and late majority (jointly almost 70 percent of total market demand), who are moving on to different products and services.

CROSSING THE CHASM: APPLICATION TO THE MOBILE PHONE INDUSTRY. Let's apply the crossing-the-chasm framework to one specific industry. In this model, the transition from stage to stage in the industry life cycle is characterized by different competitive chasms that open up because of important differences between customer groups. Although the large chasm between early adopters and the early majority is the main cause of demise for technological innovations, other smaller mini-chasms open between each stage.

Exhibit 7.8 shows the application of the chasm model to the mobile phone industry. The first victim was Motorola's Iridium, an ill-fated satellite-based telephone system.[51] Development began in 1992 after the spouse of a Motorola engineer complained about being unable to get any data or voice access to check on clients while vacationing on a remote island. Motorola's solution was to launch 66 satellites into low orbit to provide global voice and data coverage. In late 1998, Motorola began offering its satellite phone service, charging $5,000 per handset (which was almost too heavy to carry around) and up to $14 per minute for calls.[52] Problems in consumer adoption beyond the few technology enthusiasts became rapidly apparent. The Iridium phone could not be used inside buildings or in cars. Rather, to receive a satellite signal, the phone needed an unobstructed line of sight to a satellite. Iridium crashed into the first chasm, never moving beyond technology enthusiasts (see Exhibit 7.8). For Motorola, it was a billion-dollar blunder. Iridium was soon displaced by cell phones that relied on Earth-based networks of radio towers. The global satellite telephone industry never moved beyond the introductory stage of the industry life cycle.

The first Treo, a fully functioning smartphone combining voice and data capabilities, was released in 2002 by Handspring. The Treo fell into the main chasm that arises between early adopters and the early majority (see Exhibit 7.8). Technical problems, combined with a lack of apps and an overly rigid contract with Sprint as its sole service provider, prevented the Treo from gaining traction in the market beyond early adopters. For these reasons, the Treo was not an attractive product for the early majority, who rejected it. This caused the Treo to plunge into the chasm. Just a year later, Handspring was folded into Palm, which in turn was acquired by HP for $1 billion in 2010.[53] HP shut down Palm in 2011 and wrote off the acquisition.[54]

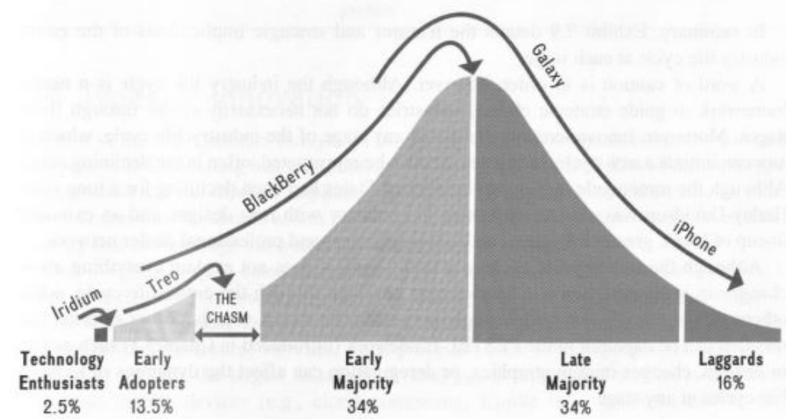


EXHIBIT 7.8 Crossing the Chasm: The Mobile Phone Industry

Research in Motion (RIM)[55] introduced its first fully functioning BlackBerry smartphone in 2000. It was a huge success—especially with two key consumer segments. First, corporate IT managers were early adopters. They became product champions for the BlackBerry because of its encrypted security software and its reliability in always staying connected to a company's network. This allowed users to receive e-mail and other data in real time, anywhere in the world where wireless service was provided. Second, corporate executives were the early majority pulling the BlackBerry over the chasm because it allowed 24/7 access to data and voice. RIM was able to create a beachhead to cross the chasm between the technology enthusiasts and early adopters on one side and the early majority on the other.[56] RIM's managers identified the needs of not only early adopters (e.g., IT managers) but also the early majority (e.g., executives), who pulled the BlackBerry over the chasm. By 2005, the BlackBerry had become a corporate executive status symbol. As a consequence of capturing the first three stages of the industry life cycle, between 2002 and 2007, RIM enjoyed no less than 30 percent year-over-year revenue growth as well as double-digit growth in other financial performance metrics such as return on equity. RIM enjoyed a temporary competitive advantage.

In 2007, RIM's dominance over the smartphone market began to erode quickly. The main reason was Apple's introduction of the iPhone. Although technology enthusiasts and early adopters argue that the iPhone is an inferior product to the BlackBerry based on technological criteria, the iPhone enticed not only the early majority, but also the late majority to enter the market. For the late majority, encrypted software security was much less important than having fun with a device that allowed users to surf the web, take pictures, play games, and send and receive e-mail. Moreover, the Apple iTunes Store soon provided thousands of apps for basically any kind of service. While the BlackBerry couldn't cross the gulf between the early and the late majority, Apple's iPhone captured the mass market rapidly. Moreover, consumers began to bring their personal iPhone to work, which forced corporate IT departments to expand their services beyond the BlackBerry. Apple rode the wave of this success to capture each market segment. Likewise, Samsung with its Galaxy line of phones, having successfully imitated the look-and-feel of an iPhone (as discussed in Chapter 4), is enjoying similar success across the different market segments.

This brief application of the chasm framework to the mobile phone industry shows its usefulness. It provides insightful explanations of why some companies failed, while others succeeded—and thus goes at the core of strategy management.

In summary, Exhibit 7.9 details the features and strategic implications of the entire industry life cycle at each stage.

A word of caution is in order, however: Although the industry life cycle is a useful framework to guide strategic choice, industries do not *necessarily evolve* through these stages. Moreover, innovations can emerge at any stage of the industry life cycle, which in turn can initiate a new cycle. Industries can also be rejuvenated, often in the declining stage. Although the motorcycle industry in the United States had been declining for a long time, Harley-Davidson was able to rejuvenate the industry with new designs and an extended lineup of bikes, greater reliability, and a more efficient and professional dealer network.

Although the industry life cycle is a useful tool, it does not explain everything about changes in industries. Some industries may never go through the entire life cycle, while others are continually renewed through innovation. Be aware, too, that other external factors that can be captured in the PESTEL framework (introduced in Chapter 3) such as fads in fashion, changes in demographics, or deregulation can affect the dynamics of industry life cycles at any stage.

EXHIBIT 7.9 / Features and Strategic Implications of the Industry Life Cycle

	Life Cycle Stages				
	Introduction	**Growth**	**Shakeout**	**Maturity**	**Decline**
Core Competency	R&D, some marketing	R&D, some manufacturing, marketing	Manufacturing, process engineering	Manufacturing, process engineering, marketing	Manufacturing, process engineering, marketing, service
Type and Level of Innovation	Product innovation at a maximum; process innovation at a minimum	Product innovation decreasing; process innovation increasing	After emergence of standard: product innovation decreasing rapidly; process innovation increasing rapidly	Product innovation at a minimum; process innovation at a maximum	Product and process innovation ceased
Market Growth	Slow	High	Moderate and slowing down	None to moderate	Negative
Market Size	Small	Moderate	Large	Largest	Small to moderate
Price	High	Falling	Moderate	Low	Low to high
Number of Competitors	Few, if any	Many	Fewer	Moderate, but large	Few, if any
Mode of Competition	Non-price competition	Non-price competition	Shifting from non-price to price competition	Price	Price or non-price competition
Customer	Technology enthusiasts	Early adopters	Early majority	Late majority	Laggards
Business-Level Strategy	Differentiation	Differentiation	Differentiation or blue ocean	Cost-leadership or blue ocean	Cost-leadership, differentiation, or blue ocean
Strategic Objective	Achieving market acceptance	Staking out a strong strategic position; generating "deep pockets"	Surviving by drawing on "deep pockets"	Maintaining strong strategic position	Exit, harvest, maintain, or consolidate

7.4 Types of Innovation

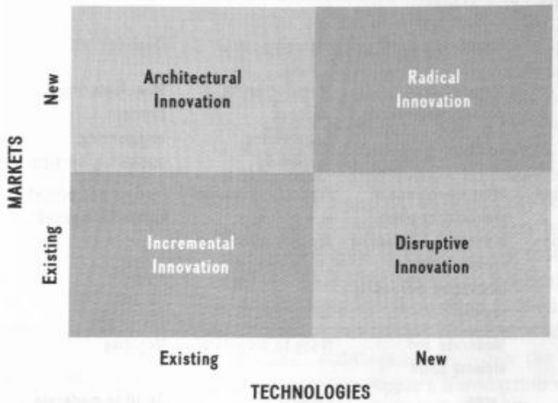
LO 7-5

Categorize different types of innovations in the markets-and-technology framework.

Because of the importance of innovation in shaping competitive dynamics and as a critical component in formulating business strategy, we now turn to a discussion of different types of innovation and the strategic implications of each. We need to know, in particular, along which dimensions we should assess innovations. This will allow us to formulate a business strategy that can leverage innovation for competitive advantage.

One insightful way to categorize innovations is to measure their degree of newness in terms of *technology* and *markets*.[57] Here, *technology* refers to the methods and materials used to achieve a commercial objective.[58] For example, Amazon integrates different types of technologies (hardware, software, microprocessors, the Internet, logistics, and so on) to provide not only the largest selection of retail goods online, but also an array of services and mobile devices (e.g., cloud computing, Kindle tablets, Prime, and so on).

EXHIBIT 7.10 / Types of Innovation: Combining Markets and Technologies



We also want to understand the *market* for an innovation—e.g., whether an innovation is introduced into a new or an existing market—because an invention turns into an innovation only when it is successfully commercialized.[59] Measuring an innovation along these dimensions gives us the **markets-and-technology framework** depicted in Exhibit 7.10. Along the horizontal axis, we ask whether the innovation builds on existing technologies or creates a new one. On the vertical axis, we ask whether the innovation is targeted toward existing or new markets. Four types of innovations emerge: incremental, radical, architectural, and disruptive innovations. As indicated by the color coding in Exhibit 7.10, each diagonal forms a pair: incremental versus radical innovation and architectural versus disruptive innovation.

INCREMENTAL VS. RADICAL INNOVATION

Although radical breakthroughs such as smartphones and magnetic resonance imaging (MRI) radiology capture most of our attention, the vast majority of innovations are actually incremental ones. An **incremental innovation** squarely builds on an established knowledge base and steadily improves an existing product or service offering.[60] It targets existing markets using existing technology.

On the other hand, **radical innovation** draws on novel methods or materials, is derived either from an entirely different knowledge base or from a recombination of existing knowledge bases with a new stream of knowledge. It targets new markets by using new technologies.[61] Well-known examples of radical innovations include the introduction of the mass-produced automobile (the Ford Model T), the X-ray, the airplane, and more recently biotechnology breakthroughs such as genetic engineering and the decoding of the human genome.

Many firms get their start by successfully commercializing radical innovations, some of which, such as the jet-powered airplane, even give birth to new industries. Although the British firm de Havilland first commercialized the jet-powered passenger airplane, Boeing was the company that rode this radical innovation to industry dominance. More recently, Boeing's leadership has been contested by Airbus; each company has approximately half the market. This stalemate is now being challenged by aircraft manufacturers such as Bombardier of Canada and Embraer of Brazil, which are moving up-market by building larger luxury jets that are competing with some of the smaller airplane models offered by Boeing and Airbus.

markets-and-technology framework
A conceptual model to categorize innovations along the market (existing/new) and technology (existing/new) dimensions.

incremental innovation
An innovation that squarely builds on an established knowledge base and steadily improves an existing product or service.

radical innovation
An innovation that draws on novel methods or materials, is derived either from an entirely different knowledge base or from a recombination of the existing knowledge bases with a new stream of knowledge.

A predictable pattern of innovation is that firms (often new ventures) use radical innovation to create a temporary competitive advantage. They then follow up with a string of incremental innovations to sustain that initial lead. Gillette is a prime example for this pattern of strategic innovation. In 1903, entrepreneur King C. Gillette invented and began selling the safety razor with a disposable blade. This *radical innovation* launched the Gillette Company (now a brand of Procter & Gamble). To sustain its competitive advantage, Gillette not only made sure that its razors were inexpensive and widely available by introducing the "razor and razorblade" business model, but also continually improved its blades. In a classic example of a string of *incremental innovations,* Gillette kept adding an additional blade with each new version of its razor until the number had gone from one to six! Though this innovation strategy seems predictable, it worked. Gillette holds some 80 percent of the $15 billion market for razors and blades globally. Gillette's newest razor, the Fusion ProGlide with Flexball technology, a razor handle that features a swiveling ball hinge, costs $11.49 (and $12.59 for a battery-operated one) *per* razor![62]

The example shows how radical innovation created a competitive advantage that the company sustained through follow-up incremental innovation. Such an outcome is not a foregone conclusion, though. In some instances, the innovator is outcompeted by second movers that quickly introduce a similar incremental innovation to continuously improve their own offering. For example, although CNN was the pioneer in 24-hour cable news, today Fox News is the most watched cable news network in the United States (although the entire industry is in decline as viewers now stream much more content directly via mobile devices, as discussed in the Netflix ChapterCase). Once firms have achieved market acceptance of a breakthrough innovation, they tend to follow up with incremental rather than radical innovations. Over time, these companies morph into industry incumbents. Future radical innovations are generally introduced by new entrepreneurial ventures. Why is this so? The reasons concern *economic incentives, organizational inertia,* and the firm's embeddedness in an *innovation ecosystem.*[63]

ECONOMIC INCENTIVES. Economists highlight the role of *incentives* in strategic choice. Once an innovator has become an established incumbent firm (such as Google has today), it has strong incentives to defend its strategic position and market power. An emphasis on incremental innovations strengthens the incumbent firm's position and thus maintains high entry barriers. A focus on incremental innovation is particularly attractive once an industry standard has emerged and technological uncertainty is reduced. Moreover, many markets where network effects are important (such as online search), turn into **winner-take-all markets**, where the market leader captures almost all of the market share. As a near monopolist, the winner in these types of markets is able to extract a significant amount of the value created. In the United States, Google handles some 65 percent of all online queries, while it handles more than 90 percent in Europe. As a result, the incumbent firm uses incremental innovation to extend the time it can extract profits based on a favorable industry structure (see the discussion in Chapter 3). Any potential radical innovation threatens the incumbent firm's dominant position.

winner-take-all markets
Markets where the market leader captures almost all of the market share and is able to extract a significant amount of the value created.

The incentives for entrepreneurial ventures, however, are just the opposite. Successfully commercializing a radical innovation is frequently the only option to enter an industry protected by high entry barriers. One of the first biotech firms, Amgen, used newly discovered drugs based on genetic engineering to overcome entry barriers to the pharmaceutical industry, in which incumbents had enjoyed notoriously high profits for several decades. Because of differential economic incentives, incumbents often push forward with incremental innovations, while new entrants focus on radical innovations.

ORGANIZATIONAL INERTIA. From an organizational perspective, as firms become established and grow, they rely more heavily on formalized business processes and structures. In some cases, the firm may experience *organizational inertia*—resistance to changes in the status quo. Incumbent firms, therefore, tend to favor incremental innovations that reinforce the existing organizational structure and power distribution while avoiding radical innovation that could disturb the existing power distribution. Take, for instance, power distribution between different functional areas, such as R&D and marketing. New entrants, however, do not have formal organizational structures and processes, giving them more freedom to launch an initial breakthrough. We discuss the link between organizational structure and firm strategy in depth in Chapter 11.

INNOVATION ECOSYSTEM. A final reason incumbent firms tend to be a source of incremental rather than radical innovations is that they become embedded in an **innovation ecosystem**: a network of suppliers, buyers, complementors, and so on.[64] They no longer make independent decisions but must consider the ramifications on other parties in their innovation ecosystem. Continuous incremental innovations reinforce this network and keep all its members happy, while radical innovations disrupt it. Again, new entrants don't have to worry about preexisting innovation ecosystems, since they will be building theirs around the radical innovation they are bringing to a new market.

innovation ecosystem
A firm's embeddedness in a complex network of suppliers, buyers, and complementors, which requires interdependent strategic decision making.

ARCHITECTURAL VS. DISRUPTIVE INNOVATION

Firms can also innovate by leveraging *existing technologies* into *new markets*. Doing so generally requires them to reconfigure the components of a technology, meaning they alter the overall *architecture* of the product.[65] An **architectural innovation**, therefore, is a new product in which known components, based on existing technologies, are reconfigured in a novel way to create new markets.

architectural innovation
A new product in which known components, based on existing technologies, are reconfigured in a novel way to attack new markets.

As a radical innovator commercializing the xerography invention, Xerox was long the most dominant copier company worldwide.[66] It produced high-volume, high-quality, and high-priced copying machines that it leased to its customers through a service agreement. Although these machines were ideal for the high end of the market such as Fortune 100 companies, Xerox ignored small and medium-sized businesses. By applying an architectural innovation, the Japanese entry Canon was able to redesign the copier so that it didn't need professional service—reliability was built directly into the machine, and the user could replace parts such as the cartridge. This allowed Canon to apply the *razor–razorblade business model* (introduced in Chapter 5), charging relatively low prices for its copiers but adding a steep markup to its cartridges. Xerox had not envisioned the possibility that the components of the copying machine could be put together in an altogether different way that was more user-friendly. More importantly, Canon addressed a need in a specific consumer segment—small and medium-sized businesses and individual departments or offices in large companies—that Xerox neglected.

Finally, a **disruptive innovation** leverages *new technologies* to attack *existing markets*. It invades an existing market from the bottom up, as shown in Exhibit 7.11.[67] The dashed blue lines represent different market segments, from Segment 1 at the low end to Segment 4 at the high end. Low-end market segments are generally associated with low profit margins, while high-end market segments often have high profit margins. As first demonstrated by Clayton Christensen, the dynamic process of disruptive innovation begins when a firm, frequently a startup, introduces a new product or process based on a new technology to meet existing customer needs. To be a disruptive force, however, this new technology has to have additional characteristics:

disruptive innovation
An innovation that leverages new technologies to attack existing markets from the bottom up.

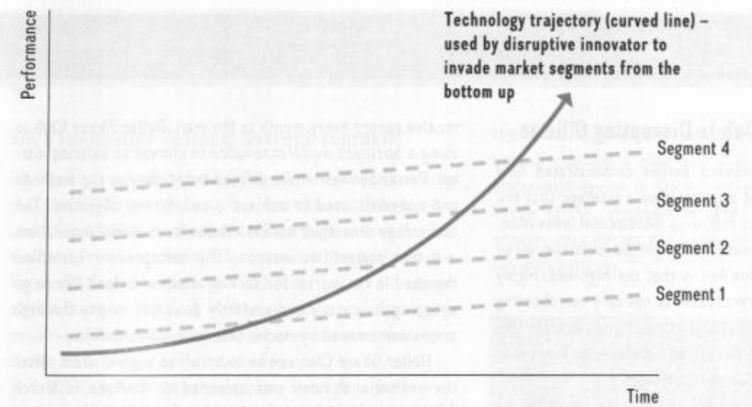


EXHIBIT 7.11 Disruptive Innovation: Riding the Technology Trajectory to Invade Different Market Segments from the Bottom Up

1. It begins as a low-cost solution to an existing problem.
2. Initially, its performance is inferior to the existing technology, but its rate of technological improvement over time is faster than the rate of performance increases required by different market segments. In Exhibit 7.11, the solid curved upward line captures the new technology's trajectory, or rate of improvement over time.

The following examples illustrate disruptive innovations:

- Japanese carmakers successfully followed a strategy of disruptive innovation by first introducing small fuel-efficient cars and then leveraging their low-cost and high-quality advantages into high-end luxury segments, captured by brands such as Lexus, Infiniti, and Acura. More recently, the South Korean carmakers Kia and Hyundai have followed a similar strategy.
- Digital photography improved enough over time to provide higher-definition pictures. As a result, it has been able to replace film photography, even in most professional applications.
- Laptop computers disrupted desktop computers; now tablets and larger-screen smartphones are disrupting laptops.
- Educational organizations such as Coursera and Udacity are disrupting traditional universities by offering *massive open online courses* (MOOCs), using the web to provide large-scale, interactive online courses with open access.

One factor favoring the success of disruptive innovation is that it relies on a stealth attack: It invades the market from the bottom up, by first capturing the low end. Many times, incumbent firms fail to defend (and sometimes are even happy to cede) the low end of the market, because it is frequently a low-margin business. Google, for example, is using its mobile operating system, Android, as a beachhead to challenge Microsoft's dominance in the personal computer industry, where 90 percent of machines run Windows.[68] Google's Android, in contrast, is optimized to run on mobile devices, the fastest-growing segment in computing. To appeal to users who spend most of their time on the web accessing e-mail and other online applications, for instance, it is designed to start up in a few seconds. Moreover, Google provides Android free of charge.[69] In contrast to Microsoft's proprietary Windows operating system, Android is open-source software, accessible to

Strategy Highlight 7.1

How Dollar Shave Club Is Disrupting Gillette

The Gillette example discussed earlier demonstrated how radical innovation created a competitive advantage that the company sustained through follow-up incremental innovation. In some instances, the innovator might be outmaneuvered by low-cost disruption. One key is that the high-end, highly priced offering of the market leader is not only overshooting what the market demands, but also often priced too high. One wonders if a person really does need six blades on one razor, or wants to pay over $10 for one cartridge!

Seeing this opening provided by Gillette's focus on the high-end, high-margin business of the market, Dollar Shave Club is attempting to establish a low-cost alternative to invade Gillette's market from the bottom up (see Exhibit 7.11). With an $8,000 budget and the help of a hilarious promotional video that went viral with over 20 million views,[70] the entrepreneur Michael Dubin launched Dollar Shave Club, an ecommerce startup that delivers razors by mail. It uses a subscription-based business model.[71] As the company's name suggests, its entry-level membership plan delivers a razor and five cartridges a month for just $1 (plus $2 shipping). The member selects an appropriate plan, pays a monthly fee, and will receive razors every month in the mail. Dollar Shave Club is using a *business model innovation* to disrupt an existing market. Remember earlier, we defined *technology* as the methods and materials used to achieve a commercial objective. The technology or method here is the *business model innovation*, a potent competitive weapon. The entrepreneur identified the need in the market for serving those who don't like to go shopping for razors and certainly don't like to pay the high prices commanded by market leaders such as Gillette.

Dollar Shave Club seems to be off to a great start. After the promotional video was uploaded on YouTube in March 2012, some 12,000 people signed up for Dollar Shave membership within the first 48 hours. It also raised over $20 million in venture capital funding from prominent firms such as Kleiner Perkins Caufield & Byers and Andreessen Horowitz, among others. Dollar Shave Club has also begun advertising on regular television in addition to its online campaigns and has expanded its product lines by the introduction of additional personal grooming products. It remains to be seen, however, if Dollar Shave Club can disrupt the $15 billion wet-shaving industry where Procter & Gamble's subsidiary Gillette holds 80 percent of the world market.

anyone for further development and refinement. In this sense, Google is leveraging *crowdsourcing* in its new product development, just as Threadless uses crowdsourcing to design and market T-shirts, and Wikipedia uses the wisdom of the crowds to collectively edit encyclopedia entries. Google's Android holds an 85 percent market share in mobile operating systems, while Apple's iOS has 12 percent, and the remaining 3 percent is held by Microsoft's Windows.[72]

Strategy Highlight 7.1 shows how the upstart Dollar Shave Club is attempting to disrupt the market leader Gillette in the wet-shaving industry.

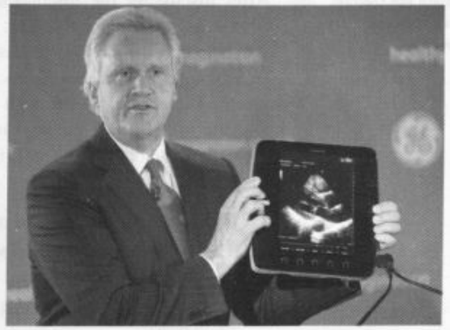
Another factor favoring the success of disruptive innovation is that incumbent firms often are slow to change. Incumbent firms tend to listen closely to their current customers and respond by continuing to invest in the existing technology and in incremental changes to the existing products. When a newer technology matures and proves to be a better solution, those same customers will switch. At that time, however, the incumbent firm does not yet have a competitive product ready that is based on the disruptive technology. Although customer-oriented visions are more likely to guard against firm obsolescence than product-oriented ones (see Chapter 2), they are no guarantee that a firm can hold out in the face of disruptive innovation. One of the counterintuitive findings that Clayton Christensen unearthed in his studies is that it can hurt incumbents to listen too closely to their existing customers. Apple is famous for not soliciting customer feedback because it believes it knows what customers need before they even realize it.

Strategy Highlight 7.2

GE's Innovation Mantra: Disrupt Yourself!

GE Healthcare is a leader in diagnostic devices. Realizing that the likelihood of disruptive innovation increases over time, GE decided to disrupt itself. A high-end ultrasound machine found in cutting-edge research hospitals in the United States or Europe costs $250,000. There is not a large market for these high-end, high-price products in developing countries. Given their large populations, however, there is a strong medical need for ultrasound devices.

In 2002, a GE team in China, through a bottom-up strategic initiative, developed an inexpensive, portable ultrasound device, combining laptop technology with a probe and sophisticated imaging software. This lightweight device (11 pounds) was first used in rural China. In spring 2009, GE unveiled the new medical device under the name Venue 40 in the United States, at a price of less than $30,000. There was also high demand from many American general practitioners, who could not otherwise afford the quarter of a million dollars needed to procure a high-end machine (that weighed about 400 pounds). In the fall of 2009, GE Chairman and CEO Jeff Immelt unveiled the Vscan, an even smaller device that looks like a cross between an early iPod and a flip phone. This wireless ultrasound device is priced around $5,000. GE views the Vscan as the "stethoscope of the 21st century," which a primary care doctor can hang around her neck when visiting with patients.[73]



Jeffrey Immelt, GE CEO and chairman, unveils the Vscan.
© Saul Loeb/AFP/Getty Images

HOW TO RESPOND TO DISRUPTIVE INNOVATION? Although these examples show that disruptive innovations are a serious threat for incumbent firms, some have devised strategic initiatives to counter them:

1. *Continue to innovate in order to stay ahead of the competition.* A moving target is much harder to hit than one that is standing still and resting on existing (innovation) laurels. Apple has done this well, beginning with the iPod in 2001, followed by the iPhone and iPad and more recently the Apple Watch in 2015. Amazon is another example of a company that has continuously morphed through innovation,[74] from a simple online book retailer to the largest ecommerce company. It also offers consumer electronics (Kindle tablets), cloud computing, and content streaming, among other offerings.
2. *Guard against disruptive innovation by protecting the low end of the market* (Segment 1 in Exhibit 7.11) by introducing low-cost innovations to preempt stealth competitors. Intel introduced the Celeron chip, a stripped-down, budget version of its Pentium chip, to prevent low-cost entry into its market space. More recently, Intel followed up with the Atom chip, a new processor that is inexpensive and consumes little battery power, to power low-cost mobile devices.[75] Nonetheless, Intel also listened too closely to its existing personal computer customers such as Dell, HP, Lenovo, and so on, and allowed ARM Holdings, a British semiconductor design company (that supplies its technology to Apple, Samsung, HTC, and others) to take the lead in providing high-performing, low-power-consuming processors for smartphones and other mobile devices.

reverse innovation An innovation that was developed for emerging economies before being introduced in developed economies. Sometimes also called *frugal innovation*.

3. *Disrupt yourself, rather than wait for others to disrupt you.* A firm may develop products specifically for emerging markets such as China and India, and then introduce these innovations into developed markets such as the United States, Japan, or the European Union. This process is called **reverse innovation**,[76] and allows a firm to disrupt itself. Strategy Highlight 7.2 describes how GE Healthcare invented and commercialized a disruptive innovation in China that is now entering the U.S. market, riding the steep technology trajectory of disruptive innovation shown in Exhibit 7.11.

LO 7-6

Compare and contrast closed and open innovation.

OPEN INNOVATION

After discussing the importance of innovation to gaining and sustaining competitive advantage, the question arises: How should firms organize for innovation? During the 20th century, the *closed innovation* approach was the dominant research and development (R&D) approach for most firms: They tended to discover, develop, and commercialize new products internally.[77] Although this approach was costly and time-consuming, it allowed firms to fully capture the returns to their own innovations.

Several factors led to a shift in the knowledge landscape from closed innovation to open innovation. They include:

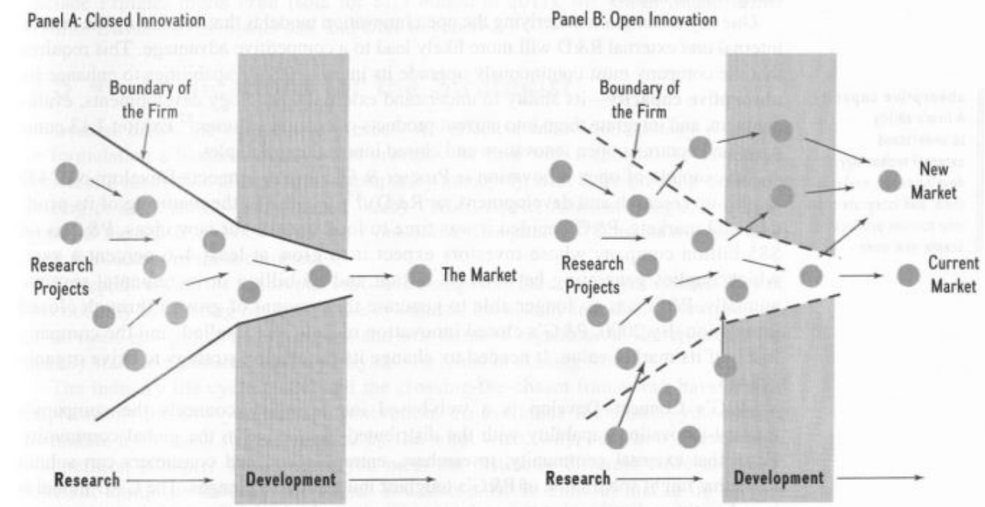
- The increasing supply and mobility of skilled workers.
- The exponential growth of venture capital.
- The increasing availability of external options (such as spinning out new ventures) to commercialize ideas that were previously shelved or insource promising ideas and inventions.
- The increasing capability of external suppliers globally.

open innovation A framework for R&D that proposes permeable firm boundaries to allow a firm to benefit not only from internal ideas and inventions, but also from external ones. The sharing goes both ways: some external ideas and inventions are insourced while others are spun out.

Taken together, these factors have led more and more companies to adopt an open innovation approach to research and development. **Open innovation** is a framework for R&D that proposes permeable firm boundaries to allow a firm to benefit not only from internal ideas and inventions, but also from ideas and innovation from external sources. External sources of knowledge can be customers, suppliers, universities, start-up companies, and even competitors.[78] The sharing goes both ways: Some external R&D is insourced (and further developed in-house) while the firm may spin out internal R&D that does not fit its strategy to allow others to commercialize it. Even the largest companies, such as AT&T, IBM, and GE, are shifting their innovation strategy toward a model that blends internal with external knowledge sourcing via licensing agreements, strategic alliances, joint ventures, and acquisitions.[79]

Exhibit 7.12 depicts the closed and open innovation models. In the closed innovation model (Panel A), the firm is conducting all research and development in-house, using a traditional funnel approach. The boundaries of the firm are impenetrable. Outside ideas and projects cannot enter, nor does the firm allow its own research ideas and development projects to leave the firm. Firms in the closed innovation model are extremely protective of their intellectual property. This not only allows the firm to capture all the benefits from its own R&D, but also prevents competitors from benefiting from it. The mind-set of firms in the closed innovation model is that to profit from R&D, the firm must come up with its own discoveries, develop them on its own, and control the distribution channels. Strength in R&D is equated with a high likelihood of benefiting from first-mover advantages. Firms following the closed innovation model,

EXHIBIT 7.12 / Closed Innovation vs. Open Innovation



Source: Adapted from H. Chesbrough (2003), "The area of open innovation," *MIT Sloan Management Review*, Spring: 35–41.

however, are much more likely to fall prone to the *not-invented-here syndrome*:[80] "If the R&D leading to a discovery and a new development project was not conducted in-house, it cannot be good."

As documented, the pharmaceutical company Merck suffers from the *not-invented-here syndrome*.[81] That is, if a product was not created and developed at Merck, it could not be good enough. Merck's culture and organizational systems perpetuate this logic, which assumes that since the company hired the best people, the smartest people in the industry must work for Merck, and so the best discoveries must be made at Merck. The company leads the industry in terms of R&D spending, because Merck believes that if it is the first to discover and develop a new drug, it would be the first to market. Merck is one of the most successful companies by total number of active R&D projects. Perhaps even more important, Merck's researchers had been awarded several Nobel Prizes for their breakthrough research, a considerable point of pride for Merck's personnel.

In the open innovation model, in contrast, a company attempts to commercialize both its own ideas and research from other firms. It also finds external alternatives such as spin-out ventures or strategic alliances to commercialize its internally developed R&D. The boundary of the firm has become porous (as represented by the dashed lines in the Panel B in Exhibit 7.12), allowing the firm to spin out some R&D projects while insourcing other promising projects. Companies using an open innovation approach realize that great ideas can come from both inside and outside the company. Significant value can be had by commercializing external R&D and letting others commercialize internal R&D that does not fit with the firm's strategy. The focus is on building a more effective

business model to commercialize both internal *and* external R&D, rather than focusing on being first to market.

One key assumption underlying the open innovation model is that combining the best of internal *and* external R&D will more likely lead to a competitive advantage. This requires that the company must continuously upgrade its internal R&D capabilities to enhance its **absorptive capacity**—its ability to understand external technology developments, evaluate them, and integrate them into current products or create new ones.[82] Exhibit 7.13 compares and contrasts open innovation and closed innovation principles.

absorptive capacity A firm's ability to understand external technology developments, evaluate them, and integrate them into current products or create new ones.

An example of open innovation is Procter & Gamble's Connect+Develop, or C+D (a play on research and development, or R&D).[83] Because of the maturing of its products and markets, P&G decided it was time to look outside for new ideas. P&G is an $85 billion company whose investors expect it to grow at least 4–6 percent a year, which implies generating between $3 billion and $5 billion in incremental revenue annually. P&G was no longer able to generate this amount of growth through closed innovation. By 2000, P&G's closed innovation machine had stalled, and the company lost half its market value. It needed to change its innovation strategy to drive organic growth.

P&G's Connect+Develop is a web-based interface that connects the company's internal-innovation capability with the distributed knowledge in the global community. From that external community, researchers, entrepreneurs, and consumers can submit ideas that might solve some of P&G's toughest innovation challenges. The C+D model is based on the realization that innovation was increasingly coming from small entrepreneurial ventures and even from individuals. Universities also became much more proactive in commercializing their inventions. The Internet now enables access to widely distributed knowledge from around the globe.

External collaborations fostered through the worldwide Connect+Develop network now play a role in roughly 50 percent of P&G's new products, up from about 15 percent

EXHIBIT 7.13 / Contrasting Principles of Closed and Open Innovation

Closed Innovation Principles	Open Innovation Principles
The smart people in our field work for us.	Not all the smart people work for us. We need to work with smart people inside *and* outside our company.
To profit from R&D, we must discover it, develop it, and ship it ourselves.	External R&D can create significant value; internal R&D is needed to claim (absorb) some portion of that value.
If we discover it ourselves, we will get it to market first.	We don't have to originate the research to profit from it; we can still be first if we successfully commercialize new research.
The company that gets an innovation to market first will win.	Building a better business model is often more important than getting to market first.
If we create the most and best ideas in the industry, we will win.	If we make the best use of internal *and* external ideas, we will win.
We should control our intellectual property (IP), so that our competitors don't profit from it.	We should profit from others' use of our IP, and we should buy others' IP whenever it advances our own business model.

Source: Adapted from H.W. Chesbrough (2003). *Open Innovation: The New Imperative for Creating and Profiting from Technology* (Boston: Harvard Business School Press).

in 2000. Successful product innovations that resulted from P&G's open innovation model include Pringles meets Print (sold for $1.5 billion in 2011), Mr. Clean Magic Eraser, Swiffer Dusters, Crest SpinBrush, and Olay Regenerist.

7.5 ◄► Implications for the Strategist

Innovation drives the competitive process. An effective innovation strategy is critical in formulating a business strategy that provides the firm with a competitive advantage. Successful innovation affords firms a temporary monopoly, with corresponding monopoly pricing power. *Fast Company* named Warby Parker, Apple, Alibaba, Google, and Instagram as the top five on its *2015 Most Innovative Companies*.[84] Continuous innovation fuels the success of these companies.

Entrepreneurs are the agents that introduce change into the competitive system. They do this not only by figuring out how to use inventions, but also by introducing new products or services, new production processes, and new forms of organization. Entrepreneurs frequently start new ventures, but they may also be found in existing firms.

The industry life cycle model and the crossing-the-chasm framework have critical implications for how you manage innovation. To overcome the chasm, you need to formulate a business strategy guided by the who, what, why, and, how questions of competition (Chapter 6) to ensure you meet the distinctly different customer needs inherent along the industry life cycle. You also must be mindful that to do so, you need to bring different competencies and capabilities to bear at different stages of the industry life cycle.

Many of the more successful companies have either adopted or are moving toward an open innovation model. As a strategist, you must actively manage a firm's internal and external innovation activities. Internally, you can *induce innovation* through a top-down process or motivate innovation through *autonomous behavior*, a bottom-up process.[85] In induced innovation, you need to put a structure and system in place to foster innovation. Consider 3M: "A core belief of 3M is that creativity needs freedom. That's why . . . we've encouraged our employees to spend 15 percent of their working time on their own projects. To take our resources, to build up a unique team, and to follow their own insights in pursuit of problem-solving."[86] We discussed *autonomous behavior* in detail in Chapter 2. To not only motivate innovations through autonomous behavior, but also ensure their possible success, *internal champions* need to be willing to support promising projects. In Strategy Highlight 2.2, we detailed how Howard Behar, at that time a senior executive at Starbucks, was willing to support the bottom-up idea of Frappuccino, which turned out to be a multi-billion-dollar business.

Externally, you must manage innovation through cooperative strategies such as licensing, strategic alliances, joint ventures, and acquisitions. These are the vehicles of *corporate strategy* discussed in the next two chapters.

In conclusion, in this and the previous chapter, we discussed how firms can use *business-level strategy*—differentiation, cost leadership, blue ocean, and innovation—to gain and sustain competitive advantage. We now turn our attention to *corporate-level strategy* to help us understand how executives make decisions about *where to compete* (in terms of industries, value chains, and geography) and how to execute it through strategic alliances as well as mergers and acquisitions. A thorough understanding of business and corporate strategy is necessary to formulate and sustain a winning strategy.

CHAPTERCASE 7 / Consider This . . .

The impact of Netflix's mega success *House of Cards* in reshaping the TV industry cannot be underestimated. The American political TV drama starring Kevin Spacey and Robin Wright was an innovation that fundamentally changed the existing business model of TV viewing on three fronts.

1. Delivery. *House of Cards* was the first time that a major TV drama was streamed online and thus bypassed the established ecosystem of networks and cable operators.
2. Access. *House of Cards* created the phenomenon of binge watching because it allowed Netflix subscribers to view many or all episodes in one sitting, without any advertising interruptions. As of 2015, spending an estimated $200 million, Netflix produced three seasons for a total of 39 episodes each roughly 45 to 60 minutes long.
3. Management. *House of Cards* was the first time original programming had been developed based on Netflix's proprietary data algorithms and not by more traditional methods. When executive producer David Fincher and actor Kevin Spacey brought the proposed show to Netflix, the company approved the project without a pilot or any test-marketing. "Netflix was the only network that said, 'We believe in you, recalls Spacey. We've run our data and it tells us that our audience would watch this series. We don't need you to do a pilot. How many [episodes] do you wanna do?'"[87]

The success of *House of Cards* created a huge buzz, attracted millions of new subscribers to Netflix, and helped its stock climb to new highs.

The power of directly streaming content to users, so that they can watch whenever they want, how much they want to watch at a time, and on whatever Internet-connected device, was also demonstrated in Netflix's reruns of *Breaking Bad*. Netflix streamed the 62-episode crime drama in ultra HD, and it scored much higher than on its previous run on the cable channel AMC. Indeed, the season finale of *Breaking Bad* on Netflix attracted almost 6 million viewers. This is even more impressive given the fact that *Breaking Bad* was a TV rerun.

Despite riding high, there are some serious challenges for Reed Hastings and Netflix on the horizon. First is the issue of how to ensure that Netflix users' have a seamless, uninterrupted viewing experience, without buffering (and seeing the "spinning wheels"). Recall that Netflix is responsible for more than one-third of all downstream Internet traffic in the United States during peak hours. For a long time, Netflix has been a strong support of *net neutrality*, with the goal of preventing broadband operators such as Comcast from slowing content or blocking access to certain websites. Conceivably, Comcast may have an incentive to slow down Netflix's content and favor its own NBC content. This is the reason Netflix—after refusing to do so for a long time—has begun to pay Comcast directly to ensure a smoother streaming experience for its users. Rather than going through the public Internet, in exchange for payment, Netflix will be able to hook up its servers directly to Comcast's broadband network. This so-called *peering* (creating dedicated and direct connections) between a content provider and a broadband provider is the first in the industry. Given its precedent, Netflix is likely to strike similar deals with other broadband providers, such as AT&T, Verizon, and Time Warner, that control access to Netflix customers.

The second issue for Hastings is how to create sustained future growth. The domestic market seems to be maturing, so growth has to come from international expansion. Problems with a lack of available titles and few places with broadband Internet connections hamper its growth. In 2010, Canadian expansion was off to a slow start because of a small number of titles in the Netflix library because of differences in distribution deals. Of the 10 million international users of Netflix (in 2015), 6 million are in Canada. Although the Latin American market has with some 600 million people, roughly twice the population of the United States, because of the *digital divide* (inequality in access to and speed of the Internet) in many Latin American countries, most Internet connections are slow dial-up, which prohibits effective streaming of content. In 2015, Netflix began negotiations to offer its services in China. One of the issues Netflix will face is potential censoring of its content; *House of Cards* has not only explicit content in terms of nudity and violence, but also features a corrupt Chinese businessman meddling in U.S. politics.

Questions

1. Netflix started to pay one broadband provider (Comcast) to ensure fast and seamless access to its end users. As hinted, other broadband providers (AT&T, Verizon, and Time Warner) will want to extract a similar kind of "toll" from Netflix.
   a. Does this violate net neutrality (the rule Internet service providers should treat all data equally, and not charge differentially by user, content, site, etc.)? Why or why not?
   b. Do you favor net neutrality? Explain why.
   c. As Internet service providers will extract more fees from Netflix, the company continues to invest heavily in its proprietary "Open Connect" network, which allows Netflix to connect its servers directly to those of Internet service providers (via peering). Since most users upgrade their Internet connections to faster broadband in order to watch video, are the incentives of broadband providers aligned with Netflix, or will the broadband providers continue to extract significant value from this industry? Apply a five forces analysis.
2. Netflix growth in the United States seems to be maturing. What other services can Netflix offer that might further demand in the United States?
3. International expansion appears to be a major growth opportunity for Netflix. Elaborate on the challenges Netflix faces going beyond the U.S. market. What can Netflix do to address some of the challenges encountered when going internationally?

TAKE-AWAY CONCEPTS

This chapter discussed various aspects of innovation and entrepreneurship as a business-level strategy, as summarized by the following learning objectives and related take-away concepts.

LO 7-1 / Outline the four-step innovation process from idea to imitation.

- Innovation describes the discovery and development of new knowledge in a four-step process captured in the Four I's: *idea, invention, innovation,* and *imitation.*
- The innovation process begins with an idea.
- An invention describes the transformation of an idea into a new product or process, or the modification and recombination of existing ones.
- Innovation concerns the commercialization of an invention by entrepreneurs (within existing companies or new ventures).
- If an innovation is successful in the marketplace, competitors will attempt to imitate it.

LO 7-2 / Apply strategic management concepts to entrepreneurship and innovation.

- Entrepreneurship describes the process by which change agents undertake economic risk to innovate—to create new products, processes, and sometimes new organizations.
- Strategic entrepreneurship describes the pursuit of innovation using tools and concepts from strategic management.
- Social entrepreneurship describes the pursuit of social goals by using entrepreneurship. Social entrepreneurs use a triple-bottom-line approach to assess performance.

LO 7-3 / Describe the competitive implications of different stages in the industry life cycle.

- Innovations frequently lead to the birth of new industries.
- Industries generally follow a predictable industry life cycle, with five distinct stages: introduction, growth, shakeout, maturity, and decline.

Chapter 8

Corporate Strategy: Vertical Integration and Diversification

Chapter Outline

8.1 What Is Corporate Strategy?
Why Firms Need to Grow
Three Dimensions of Corporate Strategy

8.2 The Boundaries of the Firm
Firms vs. Markets: Make or Buy?
Alternatives on the Make-or-Buy Continuum

8.3 Vertical Integration along the Industry Value Chain
Types of Vertical Integration
Benefits and Risks of Vertical Integration
When Does Vertical Integration Make Sense?
Alternatives to Vertical Integration

8.4 Corporate Diversification: Expanding Beyond a Single Market
Types of Corporate Diversification
Leveraging Core Competencies for Corporate Diversification
Corporate Diversification and Firm Performance

8.5 Implications for the Strategist

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.

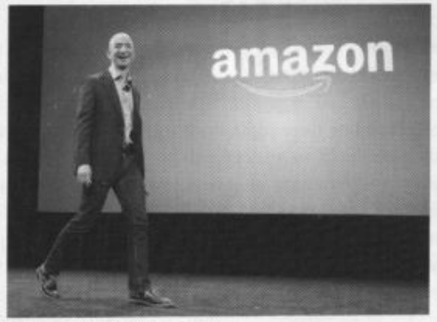
LO 8-9 Explain when a diversification strategy creates a competitive advantage and when it does not.

CHAPTERCASE 8

How Amazon.com Became the Everything Store

TWENTY YEARS AGO JEFF BEZOS STARTED Amazon.com to sell books online from a garage in a Seattle suburb. He furnished his makeshift office with discarded wood doors for desks. Today, Amazon has become the largest online retailer worldwide, with some 230 million items available, 30 times the number sold by Walmart, the world's largest traditional retailer. Yet, wood doors turning into desks remain a staple at Amazon, where strict cost control is paramount to this day.

Amazon.com is also now a widely diversified technology company; see Exhibit 8.1 for Amazon's key strategic initiatives and stock market valuation over the years. Besides offering every imaginable product online, it sells its own line of Kindle e-book readers, Fire tablets, Fire TV, and Fire phone. The Kindle e-reader has transformed the publishing industry. Amazon holds a two-thirds market share in e-books and now sells more e-books than print books.



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Via its Prime Instant Video and Music services, Amazon streams content such as movies, TV shows, and music. Prime members pay an annual $99 fee for unlimited free two-day shipping when buying items on Amazon's site, and they receive the streamed content for free. The estimated 40 million Prime members are Amazon's most loyal customers: They spend roughly $1,300 per year, three times more than non-Prime members. With Amazon Web Services (AWS), the company is now the largest cloud computing service provider globally. It also diversified geographically by establishing country-specific sites not only in the United States, but also in Canada, Brazil, Mexico, Germany, France, Italy, Spain, The Netherlands, the UK, China, India, Japan, and Australia.

Amazon started as an online book retailer but has grown into a massive discount Internet vendor, streaming multimedia from its website, offering cloud computing services, and selling its own technology devices. As technology has evolved, traditional boundaries between hardware and software, products and services, and online and brick-and-mortar stores has become increasingly blurred. As a result, Amazon finds itself engaged in a fierce competitive battle for control of the emerging digital ecosystem, pitted against technology giants such as Apple, Google, and Facebook. Moreover, in general retailing Amazon.com competes with Walmart and the Chinese ecommerce company Alibaba. In data services and cloud computing, it competes with Microsoft, IBM, and others.

Amazon's annual sales total almost $100 billion, making it one of the five largest technology companies in the world (with Apple, Microsoft, Google, and Facebook). Yet, profitability still eludes Amazon.com; in 2014 alone, it lost $250 million. With its ability to diversify into business activities that are not necessarily related to its traditional core competencies, the company faces some of the most formidable competitors. Indeed, Amazon's continued diversification into other areas of the technology industry has been part of a broader convergence of industries previously the sole domain of companies such as Apple, Google, and Facebook.

Despite having yet to deliver any profits, Amazon CEO Jeff Bezos seems undaunted. He has continually emphasized that Amazon's focus is on the long run, and that this requires continued diversification and large scale, requiring billion-dollar outlays. Investors seem to believe that Amazon's future is a bright one. In the last 10 years, Amazon's stock appreciated by more than 1,100 percentage points, while the tech-heavy NASDAQ composite index of 100 companies (including Apple, Amazon, Facebook, Google, Microsoft, Netflix, Tesla Motors, and Yahoo) appreciated by a mere 187 percentage points. In summer 2015, Amazon's market capitalization had surpassed $200 billion, making it one of the most valued tech companies globally.[1]

You will learn more about Amazon.com by reading this chapter; related questions appear on page 283.

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OVER TIME AMAZON.COM has morphed from a mere online book retailer into the "everything store."[2] In the process, it transformed into the world's largest online retailer. From books it 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 a business decide exactly *where to compete*? Answers to this important question—in terms of products and services offered, or of 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 the Strategist," providing a practical application of dynamic corporate strategy at Nike and adidas.

8.1 What Is Corporate Strategy?

LO 8-1

Define corporate strategy and describe the three dimensions along which it is assessed.

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 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. When this happens, managers must formulate a corporate strategy. 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 comprises the decisions that senior management makes and the goal-directed actions it takes 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).

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.

Executives must determine their corporate strategy by answering three questions:

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

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 executives pursue growth for the right reasons and make better decisions for the firm and its stakeholders.

WHY FIRMS NEED TO GROW

LO 8-2

Explain why firms need to grow, and evaluate different growth motives.

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

1. Increase profits.
2. Lower costs.

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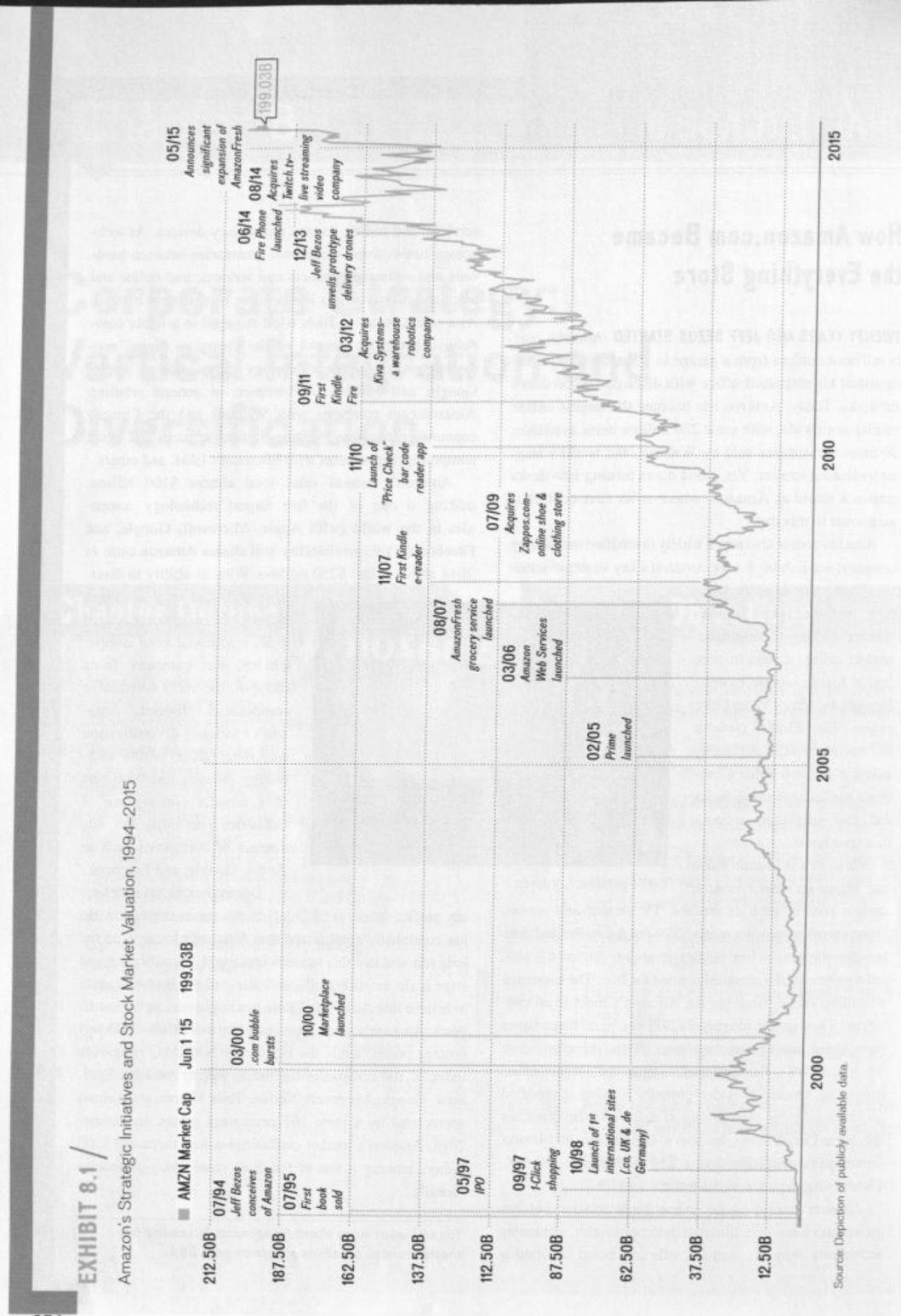

3. Increase market power.
4. Reduce risk.
5. Motivate management.

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. 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).

MANAGERIAL MOTIVES. Research in behavioral economics suggests that firms may grow to achieve goals that benefit its managers more than their 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 more recently groceries, it also moved backward in the industry value chain toward manufacturing and production.

Bezos also chooses *what range of products and services to offer,* and which not (question 2). ChapterCase 8 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., Google's core competency in developing proprietary search algorithms) should be done in-house, while non-core 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, the largest global brewer (producer of brands such as Budweiser, Bud Light, Stella Artois, and Beck's), reaps significant economies of scale. Given its size, it 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. The concept is developed in transaction cost economics, a strategic management framework, and 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.

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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.

LO 8-3

Describe and evaluate different options firms have to organize economic activity.

8.2 The Boundaries of the Firm

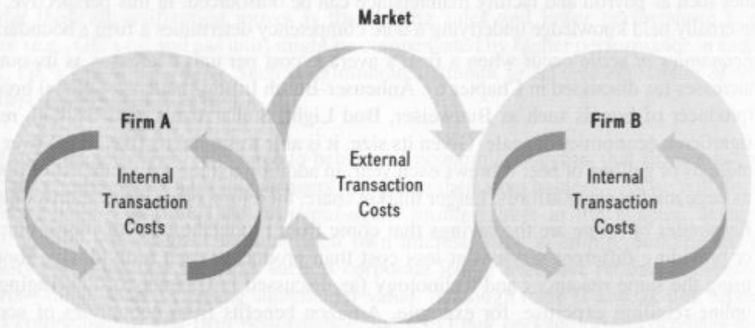
Determining the boundaries of the firm so that it is more likely to gain and sustain a competitive advantage is the critical challenge in corporate strategy.[7] A theoretical framework in strategic management called **transaction cost economics** explains and predicts the boundaries of the firm. Insights gained from transaction cost economics help managers decide what activities to do in-house versus what services and products to obtain from the external market. This stream of research was first 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.[8] 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, 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.

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*.

FIRMS VS. MARKETS: MAKE OR BUY?

Transaction cost economics allows us to explain 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 ($C_{in\text{-}house} < C_{market}$), 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.[9]

For example, rather than contracting in the open market for individual pieces of software code, Google 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).[10] 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.[11]

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.[12] 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.[13] 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.[14]
- *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 non-trivial *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.

Frequently, sellers have better information about products and services than buyers, which creates **information asymmetries**, situations 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.[15] Assume only two types of 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.

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

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 e-commerce (e.g., eBay), mortgage-backed securities, and even collaborative R&D projects.[16]

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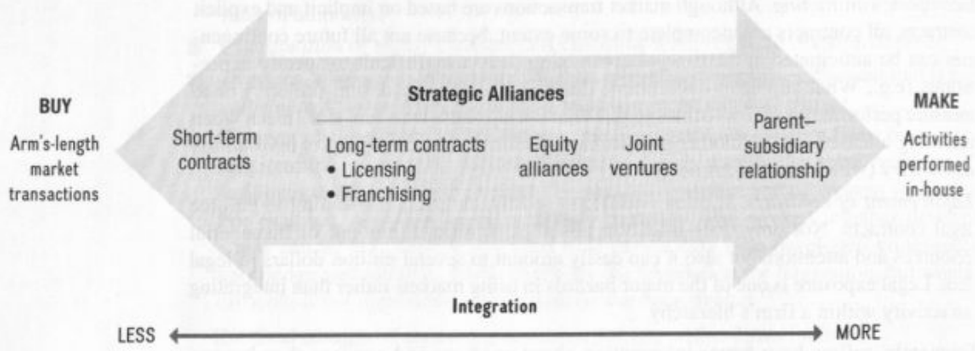
ALTERNATIVES ON THE MAKE-OR-BUY CONTINUUM

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.[17] 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.

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.[18] 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

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



to improve product quality) due to the short duration of the contract. This is exactly what happened in the U.S. automotive 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 their suppliers.[19]

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.[20] 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.

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.

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.

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 formed an equity alliance with energy-drink maker Monster.

Why is the Coca-Cola Co. forming an equity alliance with Monster Beverage Corporation 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).

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

Strategy Highlight 8.1

Is Coke Becoming a Monster?

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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 Corporation, 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.[21]

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 Monster 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, 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.[22] Hulu, which offers web-based streaming video of TV shows and movies, is also a joint venture, owned by NBC, Fox, and Disney-ABC. Logging 5 million users in 2015, Hulu is a smaller competitor to Netflix with some 50 million users in the United States.

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

PARENT–SUBSIDIARY RELATIONSHIP. The *parent–subsidiary relationship* describes the most-integrated alternative to performing an activity within one's own corporate family. 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. For example, although GM owns 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.[23] 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.[24]

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.

8.3 Vertical Integration along the 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.

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?[25] 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

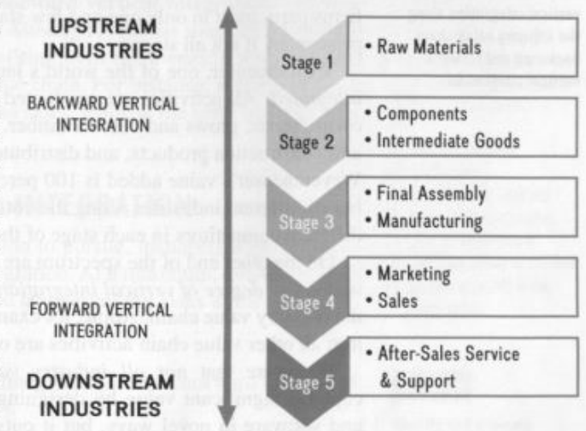


Exhibit 8.5 depicts a generic **industry value chain**. Industry value chains are also called *vertical value chains,* because they depict the transformation of raw materials into finished goods and services along distinct vertical stages. Each stage of the vertical value chain typically represents a 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.

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.

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:

- 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 (U.S.), BASF (Germany), Kyocera (Japan), and ExxonMobil (U.S.).
- *Intermediate goods and components* such as integrated circuits, displays, touchscreens, cameras, and batteries are provided by firms such as ARM Holdings (UK), Jabil Circuit (U.S.), Intel (U.S.), LG Display (Korea), Altek (Taiwan), and BYD (China).
- *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 BlackBerry (Canada), Ericsson (Sweden), Microsoft (U.S., with its acquired Nokia business unit), Samsung (South Korea), and others. If you look closely at an iPhone, for example, you'll notice it says, "Designed by Apple in California. Assembled in China."
- 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 Nexus 6.[26]

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.

LO 8-4

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

TYPES OF VERTICAL INTEGRATION

Along the industry value chain, there are varying degrees of vertical integration. Some firms participate in only one or a few stages of the industry value chain, while others comprise many if not all stages.

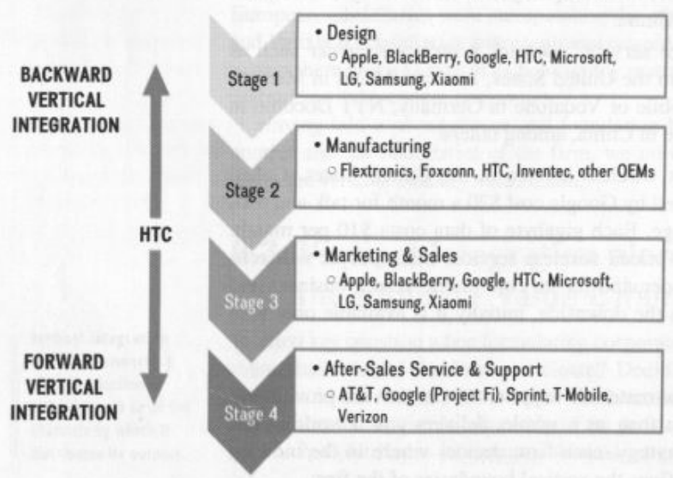
Weyerhaeuser, one of the world's largest paper and pulp companies, is *fully vertically integrated:* All activities are conducted within the boundaries of the firm. Weyerhaeuser owns forests, grows and cuts its timber, mills it, manufactures a variety of different paper and construction products, and distributes them to retail outlets and other large customers. Weyerhaeuser's value added is 100 percent. Weyerhaeuser, 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.

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.

Exhibit 8.6 displays part of the value chain for smartphones. In this figure, note HTC's transformation from a no-name OEM manufacturer in stage 2 of the 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.[27]

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.[28] 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.

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.

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.

BENEFITS AND RISKS OF VERTICAL INTEGRATION

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

LO 8-5

Identify and evaluate benefits and risks of vertical integration.

BENEFITS OF VERTICAL INTEGRATION. Vertical integration, either backward or forward, can have a number of benefits, including[29]

- 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 and telecom service providers AT&T and T-Mobile. It backwardly integrated into smartphone design by acquiring One & Co., a San Francisco–based design firm.[30] 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.

PepsiCo's corporate strategy highlights several benefits to vertical integration. In 2009, PepsiCo forwardly integrated by buying its bottlers in order to obtain more control over its quality, pricing, distribution, and in-store display. This $8 billion purchase reversed a 1999 decision in which PepsiCo sold its bottlers in order to focus on marketing. CEO Indra Nooyi revised PepsiCo's strategic intent to broaden its menu of offerings to include noncarbonated beverages such as flavored water enhanced with vitamins and fruit juices. With an integrated value chain, Nooyi hoped to improve decision making and enhance flexibility to bring these innovative products to market faster, while reducing costs by more than $400 million.[31]

Because of the strategic interdependence of companies in an oligopoly (as studied in Chapter 3), it came as no surprise that only a few months later, in 2010, Pepsi's archrival Coca-Cola responded with its own forward integration move and purchased its bottlers

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for $12 billion. Coca-Cola also indicated that more control of manufacturing and distribution was the key driver behind this deal. Moreover, Coca-Cola pegged the expected cost savings at $350 million. Like PepsiCo, Coca-Cola's forward integration represented a major departure from its decade-old business model of large independent bottlers and distributors.[32]

Vertical integration allows firms to increase operational efficiencies through improved coordination and the fine-tuning of adjacent value chain activities. Keeping the downstream value chain activities independent worked well for PepsiCo and Coca-Cola during the 1980s and 1990s, when consumption of soda beverages was on the rise. However, independent bottlers are cost-effective only when doing large-volume business of a few, limited product offerings. With Pepsi's and Coca-Cola's more diversified portfolio of noncarbonated and healthier drinks, the costs of outsourcing bottling and distribution to independent bottlers increased significantly. Some of the independent bottlers even lacked the specialized equipment needed to produce the niche drinks now in demand. In addition, the independent bottlers' direct store-delivery system adds significant costs. To overcome this problem, the soft drink giants had begun to deliver some of their niche products such as Pepsi's Gatorade and SoBe Lifewater and Coca-Cola's Powerade and Glacéau directly to warehouse retailers such as Sam's Club and Costco. By owning the bottlers, both companies can deliver all products through one channel, thus lowering the overall cost of distribution.

Given the increase in costs of using independent bottlers (or the market), the forward integration of PepsiCo and Coca-Cola is in line with predictions derived from transaction cost economics. Controlling the delivery part of the value chain also enhances the soft drink giants' bargaining power when negotiating product price, placement, and promotion. Looking at Porter's five forces model, PepsiCo and Coca-Cola are reducing the bargaining power of buyers and thus shifting the industry structure in their favor. End consumers are likely to benefit from the forward integration in the form of a wider variety of niche drinks. With all these benefits taken together, vertical integration can increase differentiation and reduce costs, thus strengthening a firm's strategic position as the gap between value creation and costs widens.

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.

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.[33] They can come in several forms:[34]

- *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, such as bottling machinery for Coca-Cola and PepsiCo. Since the bottles have different and often trademarked shapes, they require unique molds. Cans, in contrast, do not require physical-asset specificity because they are generic.
- *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.[35] 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 almost 40 percent of its total operating cost.[36]

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[37]

- 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.[38] 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.[39]

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.[40] The FTC, for example, carefully reviewed PepsiCo's plan to reintegrate its two largest bottlers, which gives the firm full control of about 80 percent of its North American distribution. Before engaging in vertical integration, therefore, managers need to be aware that this corporate strategy can increase the potential for legal repercussions.

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.[41]

In the early days of automobile manufacturing, Ford Motor Company 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 part 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 size of its mega-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 2010, the major soft drink companies purchased bottling plants (as discussed above).

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."[42] 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** 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.[43]

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

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 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. 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.[44] 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.

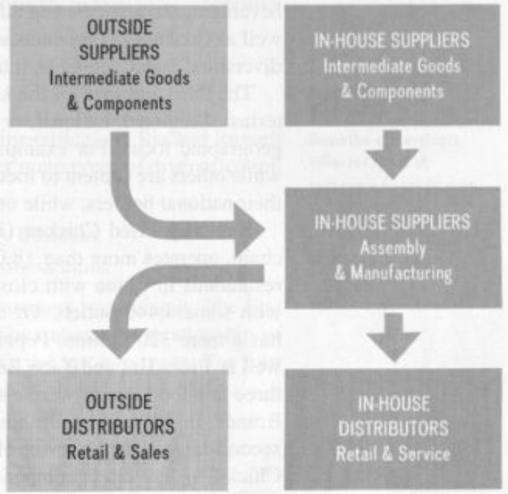
taper integration A way of orchestrating value activities in which a firm is backwardly integrated but also relies on outside-market firms for some of its supplies and/or is forwardly integrated but also relies on outside-market firms for some of its distribution.

Taper integration has several benefits:[45]

- 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.[46]

- 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.

EXHIBIT 8.7 / Taper Integration along the Industry Value Chain



Based on a study of 3,500 product introductions in the computer industry, researchers have provided empirical evidence that taper integration can be beneficial.[47] 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.

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 non-core 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*). By whatever name, it is a *huge* phenomenon. 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 is estimated to be $1.5 trillion and is expected to grow at a compound annual growth rate of 15 percent. Banking and financial services, IT, and health care are the most active sectors in such offshore outsourcing.[48] More recently, U.S. law firms began to offshore low-end legal work, such as drafting standard contracts and background research, to India.[49] 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. *In what stages of the industry value chain should the firm participate?*

Our exploration was primarily in terms of firm boundaries based on the desired extent of vertical integration. We now turn to the second and third questions that determine corporate strategy and the boundaries of the firm:

2. What range of products and services should the firm offer?
3. Where should the firm compete in terms of regional, national, or international markets?

The second question relates to the firm's *degree of 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.

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 geographic focus. 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 more than 18,000 outlets in 115 countries.[50] Interestingly, KFC has more restaurants in China with close to 5,000 outlets than in the United States, its birthplace, with some 4,440 outlets. Of course, China has 1.4 billion people and the United States has a mere 320 million. PepsiCo CEO 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 had annual revenues of $13 billion. Compare the world's second-largest quick-service chicken restaurant, the privately held Chick-fil-A.[51] 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 2014 it had some 2000 locations across 42 states and earned $5 billion in sales.

Why are KFC and Chick-fil-A pursuing different corporate strategies? Although both companies were founded roughly in 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; Chick-fil-A is privately owned. Public companies are often expected by shareholders to achieve profitable growth as fast as possible to result in an appreciation of the stock price and thus an increase in shareholder value (see the discussion in Chapter 5). 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.

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.

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.[52]

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, managers 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.

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 looking at two variables:

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

Just knowing the percentage of revenue of the dominant business immediately, (the first variable), lets us identify the first two types. Asking questions about the relationship of core competencies across business units allows us to identify the last two types. 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* 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. For example, although Google is active in many different businesses, it obtains more than 95 percent of its revenues ($70 billion in 2014) from online advertising.[53]

>95%

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.*

70%-95%
R

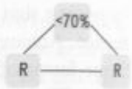
RELATED DIVERSIFICATION. A firm follows a **related diversification strategy** when it derives less than 70 percent of its revenues from a single business activity and obtains revenues from other lines of business linked to the primary business activity. The rationale behind related diversification is 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 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.

* This remaining revenue is by definition less than that of the primary business. Note also that the areas of the boxes in this and following graphics are not scaled to specific percentages.

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.

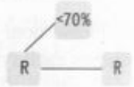
Related-Constrained Diversification. A firm follows a **related-constrained diversification strategy** when it derives less than 70 percent of its revenues from a single business activity and obtains revenues from other lines of business related to the primary business activity. Executives engage in such 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.



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.[54] 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.[55]

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.

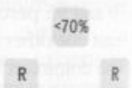
Related-Linked Diversification. If executives consider new business activities that share only a limited number of linkages, the firm is using a **related-linked diversification strategy**. Amazon.com, featured in the ChapterCase, began business by selling only one product: books. Over time, it expanded 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 now also offers its Kindle line of tablet computers and proprietary content, as well as instant video streaming via 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**. Some research evidence suggests that an unrelated diversification strategy can be advantageous in emerging economies.[56]

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.



This 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 LG (representing a uniquely South Korean form of organization, the *chaebol*), 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.

Exhibit 8.8 summarizes the four main types of diversification—single business, dominant business, related diversification (including its subcategories related-constrained and related-linked diversification), and unrelated diversification.

EXHIBIT 8.8 / Four Main Types of Diversification

Revenues from Primary Business	Type of Diversification	Competencies (in products, services, technology or distribution)	Examples	Graphic
>95%	Single Business	Single business leverages its competencies.	Coca-Cola Google Facebook	>95%
70%–95%	Dominant Business	Dominant and minor businesses share competencies.	Harley-Davidson Nestlé UPS	70%-95% R
<70%	Related Diversification			
	Related-Constrained	Businesses generally share competencies.	ExxonMobil Johnson & Johnson Nike	<70% R R
	Related-Linked	Some businesses share competencies.	Amazon Disney GE	<70% R R
	Unrelated Diversification (Conglomerate)	Businesses share few, if any, competencies.	Berkshire Hathaway Yamaha Tata	<70% R R

Note: *R* = Remainder revenue, generally in other strategic business units (SBU) within the firm.

Source: Adapted from R.P. Rumelt (1974), *Strategy, Structure, and Economic Performance* (Boston, MA: Harvard Business School Press).

LEVERAGING CORE COMPETENCIES FOR CORPORATE DIVERSIFICATION

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

In Chapter 4, when looking inside the firm, we introduced the idea that competitive advantage can be based on core competencies. Core competencies are unique strengths embedded deep within a firm. They allow companies to increase the perceived value of their product and service offerings and/or lower the cost to produce them.[58] Examples of core competencies are:

- Walmart's ability to effectively orchestrate a globally distributed supply chain at low cost.
- Infosys' ability to provide high-quality information technology services at a low cost by leveraging its global delivery model. This implies taking work to the location where it makes the best economic sense, based on the available talent and the least amount of acceptable risk and lowest cost.

core competence–market matrix A framework to guide corporate diversification strategy by analyzing possible combinations of existing/new core competencies and existing/new markets.

To survive and prosper, companies need to grow. This mantra holds especially true for publicly owned companies, because they create shareholder value through profitable growth. Managers respond to this relentless growth imperative by leveraging their existing core competencies to find future growth opportunities. Gary Hamel and C.K. Prahalad advanced the **core competence–market matrix**, depicted in Exhibit 8.9, as a way to guide

Strategy Highlight 8.2

The Tata Group: Integration at the Corporate Level

Tata Nano GenX, starting at $3,100
© Sam Panthaky/AFP/Getty Images

Range Rover, starting at $85,000
© Graeme Lamb/Alamy RF

Founded in 1868 as a trading company by then 29-year-old entrepreneur Jamsetji Nusserwanji Tata, the Tata group today has roughly 500,000 employees and $100 billion in annual revenues. A widely diversified multinational conglomerate, headquartered in Mumbai, India, it is active in industries as wide ranging as tea, hospitality, steel, IT, communications, power, and automobiles. Some of its strategic business units are giants in their own right. The Tata group includes Asia's largest software company (TCS) and India's largest steelmaker. It also owns the renowned Taj Hotels Resorts & Palaces.

In 2008, Tata Motors attracted attention in the automotive world when it bought Jaguar and Land Rover from Ford for $2.3 billion. In 2009, Tata Motors attracted even more attention when it unveiled its Tata Nano, the world's lowest-priced car. It accommodates passengers just over 6 feet tall, goes from zero to 60 mph in 30 seconds, and gets 67 mpg, beating the Toyota Prius for fuel consumption. The Tata Nano, clearly a no-frills car, exemplifies a focused low-cost strategy. It lacks a radio, glove compartment, and operable rear hatch, and its top speed is a little over 60 mph. Nonetheless, being about 50 percent cheaper than the next-lowest-cost car, Tata Motors hopes to find tens of millions of customers in the Indian and Chinese markets. Initial sales were disappointing, however. Apparently low cost alone was not sufficient to lure new buyers into the market. The first Nano models might have provided too little along the value dimension. Tata responded in 2015 with the Nano GenX, which has more options and customizability in an attempt to appeal to younger consumers, including an automatic transmission, Bluetooth compatibility and USB ports for the car's audio system, and a special feature designed to allow the car to creep forward with the engine at idle when the brake is released—a valuable feature in countries such as China and India where massive traffic jams are the norm.

The Tata group is attempting to carve out different strategic positions in its different segments of the automotive industry. Moreover, the Tata group hopes to integrate distinctly different business strategies at the corporate level. In particular, the luxury division of Tata Motors, with the Jaguar and Land Rover brands, is pursuing a focused differentiation strategy; the Nano car division is pursuing a focused cost-leadership strategy. Although their respective strategic profiles are basically the opposite of one another (differentiation versus low-cost), both business-level strategies are aimed at a specific segment of the market. Jaguar and Land Rover are luxury brands in their respective categories and appeal to affluent buyers; the Nano is clearly a lowest-cost offering, focused on a very specific market niche. Indeed, the Nano focuses on *non-consumption:* Buyers of the Nano will not be replacing other vehicles. They will be first-time car buyers moving up from bicycles and mopeds. Ratan Tata, then chairman of the Tata group, conceived of the Nano while seeing a family of four cramped on a moped in heavy rains.

By offering the Nano, Tata Motors is still hoping to bring millions of new car buyers from emerging countries into the market and thus increase the size of the automobile market. The Nano GenX is an attempt to offer more features and compete in the space occupied by competitors Maruti Suzuki and Hyundai. Taken together, Tata's corporate strategy is attempting to integrate different strategic positions, pursued by different strategic business units, each with its own profit and loss responsibility.[57]

managerial decisions in regard to diversification strategies. The first task for managers is to identify their existing core competencies and understand the firm's current market situation. When applying an existing or new dimension to core competencies and markets, four quadrants emerge, each with distinct strategic implications.

The lower-left quadrant combines existing core competencies with existing markets. Here, managers must come up with ideas of how to leverage existing core competencies to improve the firm's current market position. Bank of America is one of the largest banks in the United States and has at least one customer in 50 percent of U.S. households.[59] Developed from the Bank of Italy and started in San Francisco, California, in 1904, it became the Bank of America and Italy in 1922. Over the next 60 years it grew in California and then nationally into a major banking powerhouse. And then in 1997, in what was the largest bank acquisition of its time, NationsBank bought Bank of America.

You could say that acquisitions were a NationsBank specialty. While still the North Carolina National Bank (NCNB), one of its unique core competencies was identifying, appraising, and integrating acquisition targets. In particular, it bought smaller banks to supplement its organic growth throughout the 1970s and '80s, and from 1989 to 1992, NCNB purchased over 200 regional community and thrift banks to further improve its market position. It then turned its core competency to national banks, with the goal of becoming the first nationwide bank. Known as NationsBank in the 1990s, it purchased Barnett Bank, BankSouth, FleetBank, LaSalle, CountryWide Mortgages, and its eventual namesake, Bank of America. This example illustrates how NationsBank, rebranded as Bank of America since 1998, honed and deployed its core competency of selecting, acquiring, and integrating other commercial banks to grow dramatically in size and geographic scope and emerge as one of the leading banks in the United States. As a key vehicle of corporate strategy, we study acquisitions in more detail in Chapter 9.

The lower-right quadrant of Exhibit 8.9 combines existing core competencies with new market opportunities. Here, managers must strategize about how to redeploy and recombine existing core competencies to compete in future markets. At the height of the financial crisis in the fall of 2008, Bank of America bought the investment bank Merrill Lynch for $50 billion.[60] Although many problems ensued for Bank of America

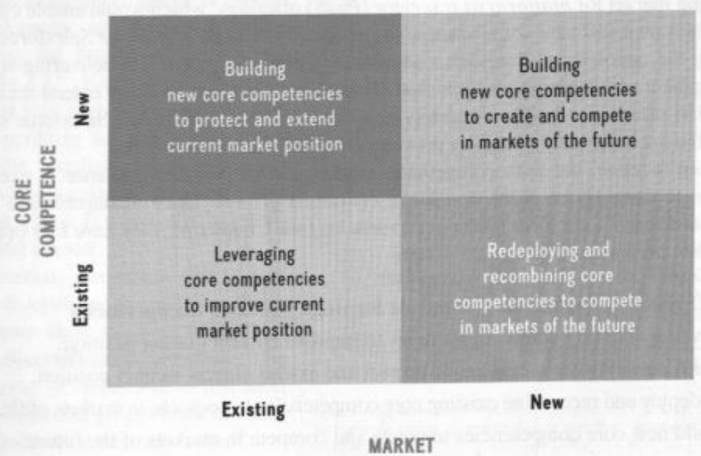


EXHIBIT 8.9 /
The Core Competence–Market Matrix
Source: Adapted from G. Hamel and C.K. Prahalad (1994), *Competing for the Future* (Boston, MA: Harvard Business School Press).

following the Merrill Lynch acquisition, it is now the bank's investment and wealth management division. Bank of America's corporate managers applied an existing competency (acquiring and integrating) into a new market (investment and wealth management). The combined entity is now leveraging economies of scope through cross-selling when, for example, consumer banking makes customer referrals for investment bankers to follow up.[61]

The upper-left quadrant combines new core competencies with existing market opportunities. Here, managers must come up with strategic initiatives to build new core competencies to protect and extend the company's current market position. For example, in the early 1990s, Gatorade dominated the market for sports drinks, a segment in which it had been the original innovator. Some 25 years earlier, medical researchers at the University of Florida had created the drink to enhance the performance of the Gators, the university's football team, thus the name Gatorade. Stokely-Van Camp commercialized and marketed the drink, and eventually sold it to Quaker Oats. PepsiCo brought Gatorade into its lineup of soft drinks when it acquired Quaker Oats in 2001.

By comparison, Coca-Cola had existing core competencies in marketing, bottling, and distributing soft drinks, but had never attempted to compete in the sports-drink market. Over a 10-year R&D effort, Coca-Cola developed competencies in the development and marketing of its own sports drink, Powerade, which launched in 1990. In 2014, Powerade held about 25 percent of the sports-drink market, making it a viable competitor to Gatorade, which still holds about 70 percent of the market.[62]

Finally, the upper-right quadrant combines new core competencies with new market opportunities. Hamel and Prahalad call this combination "mega-opportunities"—those that hold significant future-growth opportunities. At the same time, it is likely the most challenging diversification strategy because it requires building new core competencies to create and compete in future markets.

Salesforce.com, for example, is a company that employs this diversification strategy well.[63] In recent years, Salesforce experienced tremendous growth, the bulk of it coming from the firm's existing core competency in delivering customer relationship management (CRM) software to its clients. Salesforce's product distinguished itself from the competition by providing software as a service via cloud computing: Clients did not need to install software or manage any servers, but could easily access the CRM through a web browser (a business model called *software as a service,* or *SaaS*). In 2007, Salesforce recognized an emerging market for *platform as a service* (*PaaS*) offerings, which would enable clients to build their own software solutions that are accessed the same way as the Salesforce CRM. Seizing the opportunity, Salesforce developed a new competency in delivering software development and deployment tools that allowed its customers to either extend their existing CRM offering or build completely new types of software. Today, Salesforce's Force.com offering is one of the leading providers of PaaS tools and services.

Taken together, the core competence–market matrix provides guidance to executives on how to diversify in order to achieve continued growth. Once managers have a clear understanding of their firm's core competencies (see Chapter 4), they have four options to formulate corporate strategy:

Four Options to Formulate Corporate Strategy via Core Competencies

1. Leverage existing core competencies to improve current market position.
2. Build new core competencies to protect and extend current market position.
3. Redeploy and recombine existing core competencies to compete in markets of the future.
4. Build new core competencies to create and compete in markets of the future.

CORPORATE DIVERSIFICATION AND FIRM PERFORMANCE

LO 8-9

Explain when a diversification strategy creates a competitive advantage and when it does not.

Corporate managers pursue diversification to gain and sustain competitive advantage. But does corporate diversification indeed lead to superior performance? To answer this question, we need to evaluate the performance of diversified companies. The critical question to ask when doing so is whether the individual businesses are worth more under the company's management than if each were managed individually.

The diversification-performance relationship is a function of the underlying type of diversification. A cumulative body of research indicates an inverted U-shaped relationship between the type of diversification and overall firm performance, as depicted in Exhibit 8.10.[64] High and low levels of diversification are generally associated with lower overall performance, while moderate levels of diversification are associated with higher firm performance. This implies that companies that focus on a single business, as well as companies that pursue unrelated diversification, often fail to achieve additional value creation. Firms that compete in single markets could potentially benefit from economies of scope by leveraging their core competencies into adjacent markets.

Firms that pursue unrelated diversification are often unable to create additional value. They experience a **diversification discount** in the stock market: The stock price of such highly diversified firms is valued at less than the sum of their individual business units.[65] For the last decade or so, GE experienced a diversification discount, as its capital unit contributed 50 percent of profits on one-third of the conglomerate's revenues. The presence of the diversification discount in GE's depressed stock price was a major reason GE's CEO, Jeffrey Immelt, decided in 2015 to spin out GE Capital. On the day of the announcement, GE's stock price jumped 11 percent, adding some $28 billion to GE's market capitalization. This provides some idea of the diversification discount that firms pursuing unrelated diversification may experience.[66] Through this restructuring of the corporate portfolio, GE is now better positioned to focus more fully on its core competencies in industrial engineering and management processes.

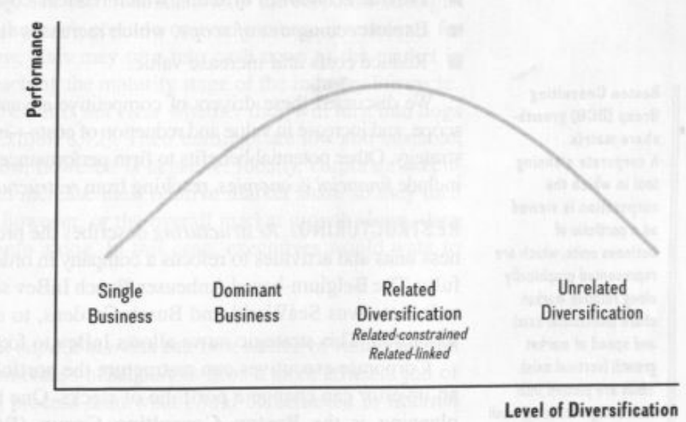
diversification discount Situation in which the stock price of highly diversified firms is valued at less than the sum of their individual business units.

diversification premium Situation in which the stock price of related-diversification firms is valued at greater than the sum of their individual business units.

The presence of the diversification discount, however, depends on the institutional context. Although it holds in developed economies with developed capital markets, some research evidence suggests that an unrelated diversification strategy can be advantageous in emerging economies as mentioned when discussing the Tata group in Strategy Highlight 8.2.[67] Here, unrelated diversification may help firms gain and sustain competitive advantage because it allows the conglomerate to overcome institutional weaknesses in emerging economies such as a lack of a functioning capital market.

In contrast, companies that pursue related diversification are more likely to improve their performance. They create a **diversification premium**: The stock price of related-diversification firms is valued at greater than the sum of their individual business units.[68]

EXHIBIT 8.10 / The Diversification-Performance Relationship



Source: Adapted from L.E. Palich, L.B. Cardinal, and C.C. Miller (2000), "Curvilinearity in the diversification-performance linkage: An examination of over three decades of research," *Strategic Management Journal* 21: 155–174.

EXHIBIT 8.11

Vertical Integration and Diversification: Sources of Value Creation and Costs

Corporate Strategy	Sources of Value Creation (*V*)	Sources of Costs (*C*)
Vertical Integration	• Can lower costs (but can go other way too) • Can improve quality (but can go other way too) • Can facilitate scheduling and planning (but can go other way too)	• Can increase costs (but can go other way too) • Can reduce quality (but can go other way too) • Can reduce flexibility (but can go other way too)
	• Facilitating investments in specialized assets • Securing critical supplies and distribution channels	• Increasing potential for legal repercussions
Related Diversification	• Economies of scope • Economies of scale • Financial economies ■ Restructuring ■ Internal capital markets	• Coordination costs • Influence costs
Unrelated Diversification	• Financial economies ■ Restructuring ■ Internal capital markets	• Influence costs

Why is this so? At the most basic level, a corporate diversification strategy enhances firm performance when its value creation is greater than the costs it incurs. Exhibit 8.11 lists the sources of value creation and costs for different corporate strategies, for vertical integration as well as related and unrelated diversification. For diversification to enhance firm performance, it must do at least one of the following:

- Provide *economies of scale,* which reduces costs.
- Exploit *economies of scope,* which increases value.
- Reduce costs *and* increase value.

We discussed these drivers of competitive advantage—economies of scale, economies of scope, and increase in value and reduction of costs—in depth in Chapter 6 in relation to business strategy. Other potential benefits to firm performance when following a diversification strategy include *financial economies,* resulting from *restructuring* and using *internal capital markets.*

Boston Consulting Group (BCG) growth-share matrix
A corporate planning tool in which the corporation is viewed as a portfolio of business units, which are represented graphically along relative market share (horizontal axis) and speed of market growth (vertical axis). SBUs are plotted into four categories (dog, cash cow, star, and question mark), each of which warrants a different investment strategy.

RESTRUCTURING. *Restructuring* describes the process of reorganizing and divesting business units and activities to refocus a company in order to leverage its core competencies more fully. The Belgium-based Anheuser-Busch InBev sold Busch Entertainment, its theme park unit that owns SeaWorld and Busch Gardens, to a group of private investors for roughly $3 billion. This strategic move allows InBev to focus more fully on its core business.[69]

Corporate executives can restructure the portfolio of their firm's businesses, much like an investor can change a portfolio of stocks. One helpful tool to guide corporate portfolio planning is the **Boston Consulting Group (BCG) growth-share matrix**, shown in Exhibit 8.12.[70] This matrix locates the firm's individual SBUs in two dimensions: relative market share (horizontal axis) and speed of market growth (vertical axis). The firm plots its SBUs into one of four categories in the matrix: dog, cash cow, star, and question mark.

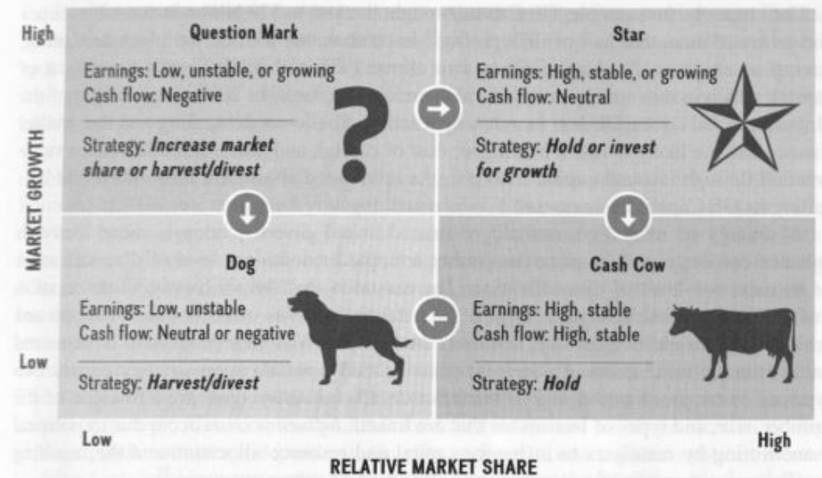


EXHIBIT 8.12

Restructuring the Corporate Portfolio: The Boston Consulting Group Growth-Share Matrix

Each category warrants a different investment strategy. All four categories shape the firm's corporate strategy.

SBUs identified as *dogs* are relatively easy to identify: They are the underperforming businesses. Dogs hold a small market share in a low-growth market; they have low and unstable earnings, combined with neutral or negative cash flows. The strategic recommendations are either to *divest* the business or to *harvest* it. This implies stopping investment in the business and squeezing out as much cash flow as possible before shutting it or selling it.

Cash cows, in contrast, are SBUs that compete in a low-growth market but hold considerable market share. Their earnings and cash flows are high and stable. The strategic recommendation is to invest enough into cash cows to hold their current position and to avoid having them turn into dogs (as indicated by the arrow).

A corporation's *star* SBUs hold a high market share in a fast-growing market. Their earnings are high and either stable or growing. The recommendation for the corporate strategist is to invest sufficient resources to hold the star's position or even increase investments for future growth. As indicated by the arrow, stars may turn into cash cows as the market in which the SBU is situated slows after reaching the maturity stage of the industry life cycle.

Finally, some SBUs are *question marks:* It is not clear whether they will turn into dogs or stars (as indicated by the arrows in Exhibit 8.12). Their earnings are low and unstable, but they might be growing. The cash flow, however, is negative. Ideally, corporate executives want to invest in question marks to increase their relative market share so they turn into stars. If market conditions change, however, or the overall market growth slows, then a question-mark SBU is likely to turn into a dog. In this case, executives would want to harvest the cash flow or divest the SBU.

INTERNAL CAPITAL MARKETS. *Internal capital markets* can be a source of value creation in a diversification strategy if the conglomerate's headquarters does a more efficient job of allocating capital through its budgeting process than what could be achieved in external capital markets. Based on private information, corporate managers are in a position to discover which of their strategic business units will provide the highest return on invested capital. In addition, internal capital markets may allow the company to access capital at a lower cost.

Until recently, for example, GE Capital brought in close to $70 billion in annual revenues and generated more than half of GE's profits.[71] In combination with GE's triple-A debt rating, having access to such a large finance arm allowed GE to benefit from a lower cost of capital, which in turn was a source of value creation in itself. In 2009, at the height of the global financial crises, GE lost its AAA debt rating. The lower debt rating and the smaller finance unit are likely to result in a higher cost of capital, and thus a potential loss in value creation through internal capital markets. (As mentioned above, GE announced that it is selling its GE Capital business unit.)

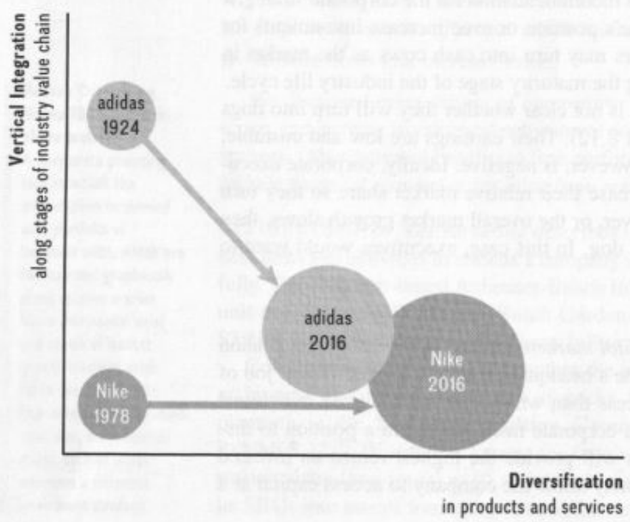
A strategy of related-constrained or related-linked diversification is more likely to enhance corporate performance than either a single or dominant level of diversification or an unrelated level of diversification. The reason is that the sources of value creation include not only restructuring, but also the potential benefits of economies of scope and scale. To create additional value, however, the benefits from these sources of incremental value creation must outweigh their costs. A related-diversification strategy entails two types of costs: coordination and influence costs. *Coordination costs* are a function of the number, size, and types of businesses that are linked. *Influence costs* occur due to political maneuvering by managers to influence capital and resource allocation and the resulting inefficiencies stemming from suboptimal allocation of scarce resources.[72]

8.5 ◂▸ Implications for the Strategist

An effective corporate strategy increases a firm's chances to gain and sustain a competitive advantage. By formulating corporate strategy, executives make important choices along three dimensions that determine the boundaries of the firm:

- **The degree of vertical integration**—in what stages of the industry value chain to participate.
- **The type of diversification**—what range of products and services to offer.
- **The geographic scope**—where to compete.

EXHIBIT 8.13 / Dynamic Corporate Strategy: Nike vs. adidas



Since a firm's external environment never remains constant over time, *corporate strategy needs to be dynamic over time.* As firms grow, they tend to diversify and globalize to capture additional growth opportunities. Exhibit 8.13 shows the dynamic nature of corporate strategy through decisions made by two top competitors in the sports footwear and apparel industry: Nike and adidas.

Adidas was founded in 1924 in Germany. It began its life in the laundry room of a small apartment. Two brothers focused on one product: athletic shoes. Initially, adidas was a fairly integrated manufacturer of athletic shoes. The big breakthrough for the company came in 1954 when the underdog West Germany won the soccer World Cup in adidas cleats. As the world markets globalized and became more competitive in the decades after World War II, adidas not only vertically disintegrated to focus mainly on the design of athletic shoes but also diversified into sports apparel. Adidas' annual revenues are $20 billion. It is a diversified company active across the globe in sports shoes (40 percent of revenues), sports apparel (50 percent of revenues), and sports equipment (10 percent of revenues). The change in adidas' corporate strategy from a small, highly integrated single business to a disintegrated and diversified global company is shown in Exhibit 8.13.

Nike is the world's leader in sports shoes and apparel with annual sales of $30 billion. Founded in 1978, and thus much younger than adidas, Nike was vertically disintegrated from the very beginning. After moving beyond importing Japanese shoes to the United States, Nike focused almost exclusively on R&D, design, and marketing of running shoes. Although Nike diversified into different lines of business, it stayed true to its vertical disintegration by focusing on only a few activities (see Exhibit 8.13). Nike is a global company and its revenues come from sports shoes (50 percent) and apparel (25 percent), as well as sports equipment and other businesses, such as affiliate brands Cole Haan, Converse, Hurley, and Umbro. The changes in the strategic positions shown in Exhibit 8.13 highlight the dynamic nature of corporate strategy. Also, keep in mind that the relationship between diversification strategy and competitive advantage depends on the *type of diversification.* There exists an inverted U-shaped relationship between the level of diversification and performance improvements. On average, related diversification (either related-constrained or related-linked such as in the Nike and adidas example) is most likely to lead to superior performance because it taps into multiple sources of value creation (economies of scale and scope; financial economies). To achieve a net positive effect on firm performance, however, related diversification must overcome additional sources of costs such as coordination and influence costs.

In the next chapter, we discuss strategic alliances in more depth as well as mergers and acquisitions, both are critical tools in executing corporate strategy. In Chapter 10, we take a closer look at geographic diversification by studying how firms compete for competitive advantage around the world.

CHAPTERCASE 8 / Consider This...

AMAZON.COM CONTINUES TO diversify at a relentless pace. Besides offering same-day delivery of groceries in some metropolitan areas and testing drones for even faster distribution, Amazon now plans to capture a large piece of the over $10 billion college bookstore market. In a pilot project, Amazon initiated a student-centered program at three large universities: Purdue University, the University of California, Davis, and the University of Massachusetts Amherst. The goal of Amazon Campus is co-branded university-specific websites that offer textbooks, paraphernalia such as the ubiquitous logo sweaters and baseball hats, as well as 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, loaning one e-book a month for free, discounts on hardware, etc.). To accomplish next-day delivery, Amazon is building fashionable delivery centers on campus, university co-branded 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 student return centers.

Amazon's new campus initiative allows it to bind a younger generation of shoppers ever closer into its web of products, services, and content. Next-day delivery makes students less likely to shop at traditional campus

bookstores. Amazon also has a history of selling textbooks at a discount in comparison to old-line campus bookstores. All course materials automatically qualify for next-day delivery and do not require a Prime membership. The Amazon Campus initiative is predicted to save students $200 to $400 a year on textbooks and other supplies.

Questions

1. Amazon.com continues to spend billions on seemingly unrelated diversification efforts. Do you believe these efforts contribute to Amazon gaining and sustaining a competitive advantage? Why or why not?
2. Amazon.com is now over 20 years old and makes some $100 billion in annual revenues. As an investor, would it concern you that Amazon.com has yet to deliver any profits? Why or why not? How much longer do you think investors will be patient with Jeff Bezos as he continues to pursue billion-dollar diversification initiatives?
3. One of the most profitable business endeavors that Amazon pursues is its cloud service offering, AWS. In 2014, AWS revenues were an estimated $6 billion, but bringing in $1 billion in profits. What is Amazon's core business? Is AWS related to Amazon's core business? Why or why not? Some investors are pressuring Jeff Bezos to spin out AWS as a standalone company. Do you agree with this corporate strategy recommendation? Why or why not? Hint: Do you believe AWS would be more valuable within Amazon or as a standalone company?

TAKE-AWAY CONCEPTS

This chapter defined corporate strategy and then looked at two fundamental corporate strategy topics—vertical integration and diversification—as summarized by the following learning objectives and related take-away concepts.

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

- Corporate strategy addresses "where to compete." Business strategy addresses "how to compete."
- Corporate strategy concerns the boundaries of the firm along three dimensions: (1) industry value chain, (2) products and services, and (3) geography (regional, national, or global markets).
- To gain and sustain competitive advantage, any corporate strategy must support and strengthen a firm's strategic position, regardless of whether it is a differentiation, cost-leadership, or blue ocean strategy.

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

- Firm growth is motivated by the following: increasing profits, lowering costs, increasing market power, reducing risk, and managerial motives.
- Not all growth motives are equally valuable.
  - Increasing profits and lowering expenses are clearly related to enhancing a firm's competitive advantage.
  - Increasing market power can also contribute to a greater competitive advantage, but can also result in legal repercussions such as antitrust lawsuits.
  - Growing to reduce risk has fallen out of favor with investors, who argue that they are in a better position to diversify their stock portfolio in comparison to a corporation with a number of unrelated strategic business units.
  - Managerial motives such as increasing company perks and job security are not legitimate reasons a firm needs to grow.

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

- Transaction cost economics help managers decide what activities to do in-house ("make") versus what services and products to obtain from the external market ("buy").
- When the costs to pursue an activity in-house are less than the costs of transacting in the market ($C_{in\text{-}house} < C_{market}$), then the firm should vertically integrate.
- Principal–agent problems and information asymmetries can lead to market failures, and thus situations where internalizing the activity is preferred.
- A principal–agent problem arises when an agent, performing activities on behalf of a principal, pursues his or her own interests.
- Information asymmetries arise when one party is more informed than another because of the possession of private information.
- Moving from less integrated to more fully integrated forms of transacting, alternatives include short-term contracts, strategic alliances (including long-term contracts, equity alliances, and joint ventures), and parent–subsidiary relationships.

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

- Vertical integration denotes a firm's addition of value—what percentage of a firm's sales is generated by the firm within its boundaries.
- Industry value chains (vertical value chains) depict the transformation of raw materials into finished goods and services. Each stage typically represents a distinct industry in which a number of different firms compete.
- Backward vertical integration involves moving ownership of activities upstream nearer to the originating (inputs) point of the industry value chain.
- Forward vertical integration involves moving ownership of activities closer to the end (customer) point of the value chain.

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

- Benefits of vertical integration include securing critical supplies and distribution channels, lowering costs, improving quality, facilitating scheduling and planning, and facilitating investments in specialized assets.
- Risks of vertical integration include increasing costs, reducing quality, reducing flexibility, and increasing the potential for legal repercussions.

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

- Taper integration is a strategy 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 if its distribution.
- Strategic outsourcing involves moving one or more value chain activities outside the firm's boundaries to other firms in the industry value chain. Offshoring is the outsourcing of activities outside the home country.

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

- A single-business firm derives 95 percent or more of its revenues from one business.
- A dominant-business firm derives between 70 and 95 percent of its revenues from a single business, but pursues at least one other business activity.
- A firm follows a related diversification strategy when it derives less than 70 percent of its revenues from a single business activity, but obtains revenues from other lines of business that are linked to the primary business activity. Choices within a related diversification strategy can be related-constrained or related-linked.
- A firm follows an unrelated diversification strategy when less than 70 percent of its revenues come from a single business, and there are few, if any, linkages among its businesses.

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

- When applying an existing/new dimension to core competencies and markets, four quadrants emerge, as depicted in Exhibit 8.9.
- The lower-left quadrant combines existing core competencies with existing markets. Here, managers need to come up with ideas of how to leverage existing core competencies to improve their current market position.
- The lower-right quadrant combines existing core competencies with new market opportunities.

Chapter 9

Corporate Strategy: Strategic Alliances and Mergers and Acquisitions

Chapter Outline

9.1 How Firms Achieve Growth
The Build-Borrow-Buy Framework

9.2 Strategic Alliances
Why Do Firms Enter Strategic Alliances?
Governing Strategic Alliances
Alliance Management Capability

9.3 Mergers and Acquisitions
Why Do Firms Merge with Competitors?
Why Do Firms Acquire Other Firms?
M&A and Competitive Advantage

9.4 Implications for the Strategist

Learning Objectives

LO 9-1 Apply the build-borrow-or-buy framework to guide corporate strategy.

LO 9-2 Define strategic alliances, and explain why they are important to implement corporate strategy and why firms enter into them.

LO 9-3 Describe three alliance governance mechanisms and evaluate their pros and cons.

LO 9-4 Describe the three phases of alliance management and explain how an alliance management capability can lead to a competitive advantage.

LO 9-5 Differentiate between mergers and acquisitions, and explain why firms would use either to execute corporate strategy.

LO 9-6 Define horizontal integration and evaluate the advantages and disadvantages of this option to execute corporate-level strategy.

LO 9-7 Explain why firms engage in acquisitions.

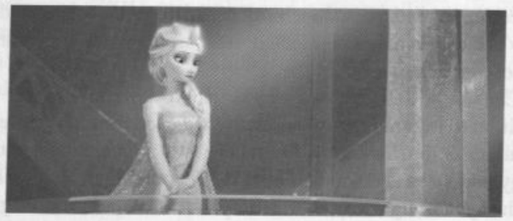
LO 9-8 Evaluate whether mergers and acquisitions lead to competitive advantage.

CHAPTERCASE 9

Disney: Building Billion-Dollar Franchises

WITH OVER $50 BILLION in annual revenues, Disney is the world's largest media company. In recent years, Disney has grown through a number of high-profile acquisitions, including Pixar (2006), Marvel (2009), and Lucasfilm (2012), the creator of *Star Wars*. All this was done with the goal to build billion-dollar franchises based on movie sequels, park rides, and merchandise. Let's take a closer look at how an alliance with Pixar turned into an acquisition.

Pixar started as a computer hardware company producing high-end graphic display systems. One of its customers was Disney. To demonstrate the graphic display systems' capabilities, Pixar produced short, computer-animated movies. Despite being sophisticated, Pixar's computer hardware was not selling well, and the new venture was hemorrhaging money. To the rescue rode not Buzz Lightyear, but Steve Jobs. Shortly after being ousted from Apple in 1986, Jobs bought the struggling hardware company for $5 million and founded Pixar Animation Studios, investing another $5 million into the company. The Pixar team led by Edwin Catmull and John Lasseter then transformed the company into a computer animation film studio.



Elsa from the animated Disney blockbuster hit *Frozen*.
© Moviestore collection Ltd / Alamy

To finance and distribute its newly created computer-animated movies, Pixar entered a strategic alliance with Disney. Disney's distribution network and its stellar reputation in animated movies were critical complementary assets that Pixar needed to commercialize its new type of films. In turn, Disney was able to rejuvenate its floundering product lineup, retaining the rights to the newly created Pixar characters and to any sequels.

Pixar became successful beyond imagination as it rolled out one blockbuster after another: *Toy Story (1, 2,* and *3), A Bug's Life, Monsters, Inc., Finding Nemo, The Incredibles,* and *Cars,* grossing several billion dollars. Given Pixar's huge success and Disney's abysmal performance with its own releases during this time, the bargaining power in the alliance shifted dramatically. Renegotiations of the Pixar–Disney alliance broke down in 2004, reportedly because of personality conflicts between Steve Jobs and then-Disney Chairman and CEO Michael Eisner.

After Robert Iger was appointed CEO, Disney acquired Pixar for $7.4 billion in 2006. The success of the alliance demonstrated that the two entities' complementary assets matched, and gave Disney an inside perspective on the value of Pixar's core competencies in the creation of computer-animated features. In 2009, Disney turned to acquisitions again. The acquisition of Marvel Entertainment for $4 billion added Spiderman, Iron Man, The Incredible Hulk, and Captain America to its lineup of characters. Marvel's superheroes grossed a cumulative $15 billion at the box office, with *The Avengers* bringing in some $2 billion. In 2012, Mickey's extended family was joined by Darth Vader, Obi-Wan Kenobi, Princess Leia, and Luke Skywalker when Disney acquired Lucasfilm for more than $4 billion.

After taking the reins, Iger transformed a lackluster Disney after a decade or so of inferior performance by refocusing it around what he calls "franchises," which generally begin with a big movie hit and are followed up with derivative TV shows, theme park rides, video games, toys, clothing such as T-shirts and PJs, among many other spin-offs. Rather than churning out some 30 movies per year as it did prior to Iger, Disney now produces about 10 movies per year, focusing on box office hits. Disney's annual movie lineup is now dominated by such franchises as *Stars Wars* and Marvel superhero movies and also live-action versions of animated classics such as *Cinderella* and *Beauty and the Beast.* The biggest Disney franchises that started with a movie hit are *Pirates of Caribbean* (grossing almost $4 billion, with

its fifth installment due in 2017), *Toy Story* (some $2 billion with a fourth movie also due in 2017), *Monsters, Inc.* (some $1.5 billion), *Cars* (over $1 billion, with a third sequel rumored to be in the making), and, of course, *Frozen*.

To further build its *Frozen* franchise, Disney is already working on a sequel of its animated movie hit as well as offering *Frozen Ever After*, a new dreamlike ride through the fictional world of Arendelle at Disney World's Epcot Center, which had grown stale. The animated movie *Frozen* (made by Walt Disney Animation Studios run by Pixar execs Catmull and Lasseter) has grossed some $1.5 billion since its release in 2013, making it the most successful animated movie ever![1]

You will learn more about Disney from reading this chapter; related questions appear on page 316.

DISNEY ENTERED STRATEGIC alliances and acquired other media businesses to create theme-based franchises. CEO Iger's corporate strategy around building billion-dollar franchises is certainly paying off: Disney's revenues are up almost 10 percent and it earned some $8 billion in profits in 2015. Its stock has risen by over 230 percent between 2010 and 2015, outperforming its rivals such as Time Warner, Sony's Columbia Pictures, or 21st Century Fox.

As a diversified media company, Disney is active in a wide array of business activities, from movies to amusement parks as well as cable and broadcast television networks (ABC, ESPN, and others), cruises, and retailing. It became the world's leading media company to a large extent by pursuing a corporate strategy of *related-linked diversification* (see Chapter 8). This is because some, but not all, of Disney's business activities share common resources, capabilities, and competencies. As detailed in the ChapterCase, Disney's executives implemented its corporate strategy through the use of strategic alliances and acquisitions.

In Chapter 8, we discussed *why* firms grow. In this chapter we discuss *how* firms grow. In addition to internal organic growth (achieved through reinvesting profits, see discussion of Exhibit 4.3 in Chapter 4), firms have two critical strategic options to execute corporate strategy: alliances and acquisitions. We devote this chapter to the study of these fundamental pathways through which firms implement corporate strategy.

We begin this chapter by introducing the *build-borrow-buy framework* to guide corporate strategy in deciding whether and when to grow *internally (build)*, use *alliances (borrow)*, or *make acquisitions (buy)*. We then take a closer look at strategic alliances before studying mergers and acquisitions. We discuss alliances before acquisitions because alliances are smaller strategic commitments and thus are much more frequent. Moreover, in some cases, alliances may lead to acquisitions later; offering a "try before you buy" approach as in the Disney–Pixar example. We conclude with "Implications for the Strategist," in which we discuss practical applications.

9.1 How Firms Achieve Growth

After discussing in Chapter 8 why firms need to grow, the next question that arises is: *How do firms achieve growth?* Corporate executives have three options at their disposal to drive firm growth: organic growth through internal development, external growth through alliances, or external growth through acquisitions. Laurence Capron and Will Mitchell developed an insightful step-by-step decision model to guide managers in selecting the most appropriate corporate strategy vehicle.[2] Selecting the most appropriate vehicle for corporate strategy in response to a specific strategic challenge also makes successful implementation more likely.

THE BUILD-BORROW-BUY FRAMEWORK

LO 9-1

Apply the build-borrow-or-buy framework to guide corporate strategy.

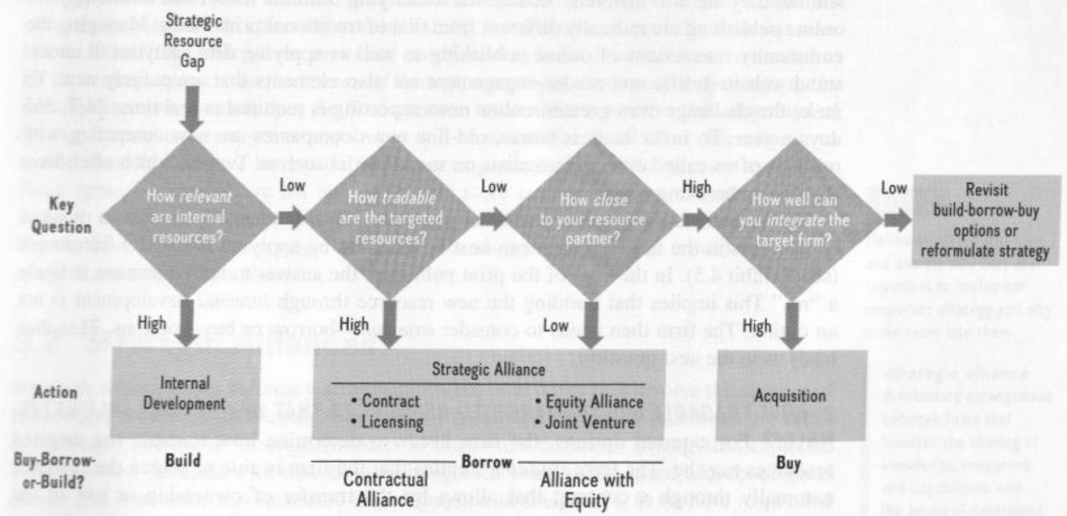
The **build-borrow-or-buy framework** provides a conceptual model that aids firms in deciding whether to pursue internal development (*build*), enter a contractual arrangement or strategic alliance (*borrow*), or acquire new resources, capabilities, and competencies (*buy*). Firms that are able to learn how to select the right pathways to obtain new resources are more likely to gain and sustain a competitive advantage. Note that in the build-borrow-or-buy model, the term *resources* is defined broadly to include capabilities and competencies (as in the *VRIO model* discussed in Chapter 4). Exhibit 9.1 shows the *build-borrow-or-buy* decision framework.

build-borrow-or-buy framework Conceptual model that aids firms in deciding whether to pursue internal development *(build)*, enter a contractual arrangement or strategic alliance *(borrow)*, or acquire new resources, capabilities, and competencies *(buy)*.

The starting point is the firm's identification of a strategic resource gap that will impede future growth. The resource gap is *strategic* because closing this gap is likely to lead to a competitive advantage. As discussed in Chapter 4, resources with the potential to lead to competitive advantage cannot be simply bought on the open market. Indeed, if any firm could readily buy this type of resource, its availability would negate its potential for competitive advantage. It would no longer be *rare*, a key condition for a resource to form the basis of competitive advantage. Moreover, resources that are *valuable, rare,* and *difficult to imitate* are often embedded deep within a firm, frequently making up a resource bundle that is hard to unplug whole or in part. The options to close the strategic resource gap are, therefore, to build, borrow, or buy. *Build* in the build-borrow-buy framework refers to internal development; *borrow* refers to the use of strategic alliances; and *buy* refers to acquiring a firm. When acquiring a firm, you buy an entire "resource bundle," not just a specific resource. This resource bundle, if obeying VRIO principles and successfully integrated, can then form the basis of competitive advantage.

Exhibit 9.1 provides a schematic of the build-borrow-or-buy framework. In this approach executives must determine the degree to which certain conditions apply, either

EXHIBIT 9.1 / Guiding Corporate Strategy: The Build-Borrow-or-Buy Framework



Source: Adapted from L. Capron and W. Mitchell (2012), *Build, Borrow, or Buy: Solving the Growth Dilemma* (Boston, MA: Harvard Business Review Press).

high or low, by responding to up to four questions sequentially before finding the best course. The questions cover issues of *relevancy, tradability, closeness,* and *integration:*

1. **Relevancy.** How *relevant* are the firm's existing internal resources to solving the resource gap?
2. **Tradability.** How *tradable* are the targeted resources that may be available externally?
3. **Closeness.** How *close* do you need to be to your external resource partner?
4. **Integration.** How well can you *integrate* the targeted firm, should you determine you need to acquire the resource partner?

As shown in Exhibit 9.1, the answers to these questions lead to a recommended action or the next question. We'll review each in more depth.

1. HOW *RELEVANT* ARE THE FIRM'S EXISTING INTERNAL RESOURCES TO SOLVING THE RESOURCE GAP? The firm starts by asking whether the firm's internal resources are high or low in relevance. If the firm's internal resources are highly relevant to closing the identified gap, the firm should itself build the new resources needed through internal development.

But how does a manager know whether the firm's resources are relevant in addressing a new challenge or opportunity? Firms evaluate the relevance of internal resources in two ways: they test whether resources are (1) *similar* to those the firm needs to develop and (2) *superior* to those of competitors in the targeted area.[3] If *both* conditions are met, then the firm's internal resources are relevant and the firm should pursue internal development.

Let's look at both conditions. Managers are often misled by the first test because things that might appear similar at the surface are actually quite different deep down.[4] Moreover, managers tend to focus on the (known) similarities rather than on (unknown) differences. They often don't know how the resources needed for the existing and new business opportunity differ. An executive at a newspaper publisher such as *The New York Times* may conclude that the researching, reporting, writing, and editing activities done for a printed newspaper are similar to those done for an online one. Although the activities may be similar, they are also different because the underlying business model and technology for online publishing are radically different from that of traditional print media. Managing the community interactions of online publishing as well as applying data analytics to understand website traffic and reader engagement are also elements that are entirely new. To make the challenge even greater, online news reporting is required in real time, 24/7, 365 days a year. To make matters worse, old-line news companies are now competing with millions of so-called citizen journalists on social media such as Twitter, which often have an edge on breaking news.[5]

The second test, determining whether your internal resources are *superior* to those of competitors in the targeted area, can best be assessed by applying the VRIO framework (see Exhibit 4.5). In the case of the print publisher, the answer to both questions is likely a "no." This implies that building the new resource through *internal* development is not an option. The firm then needs to consider *external*—borrow or buy—options. This then leads us to the next question.

2. HOW *TRADABLE* ARE THE TARGETED RESOURCES THAT MAY BE AVAILABLE EXTERNALLY? For external options, the firm needs to determine how tradable the targeted resources may be. The term *tradable* implies that the firm is able to source the resource externally through a contract that allows for the transfer of ownership or use of the resource. Short-term as well as long-term contracts, such as licensing or franchising, are a way to *borrow* resources from another company (see discussion in Chapter 8).

In the biotech-pharma industry, some producers use licensing agreements to transfer knowledge and technology from the licensor's R&D to the licensee's manufacturing. Eli Lilly, for example, has commercialized several breakthrough biotech drugs using licensing agreements with new ventures. The implication is that if a resource is highly tradable, then the resource should be *borrowed* via a licensing agreement or other contractual agreement. If the resource in question is not easily tradable, then the firm needs to consider either a deeper strategic alliance through an equity alliance or a joint venture, or an outright acquisition.

3. HOW *CLOSE* DO YOU NEED TO BE TO YOUR EXTERNAL RESOURCE PARTNER? Many times, firms are able to obtain the required resources to fill the strategic gap through more integrated strategic alliances such as equity alliances or joint ventures (see Exhibit 8.4) rather than through outright acquisition. Mergers and acquisitions are the most costly, complex, and difficult to reverse strategic option. This implies that only if extreme closeness to the resource partner is necessary in order to understand and obtain its underlying knowledge should M&A be considered the *buy* option. Regardless, the firm should always first consider *borrowing* the necessary resources through integrated strategic alliances before looking at M&A.

4. HOW WELL CAN YOU *INTEGRATE* THE TARGETED FIRM, SHOULD YOU DETERMINE YOU NEED TO ACQUIRE THE RESOURCE PARTNER? The final decision question using the build-borrow-buy lens is: *Can you integrate the target firm?* The list of post-integration failure, often due to cultural differences, is long. Multibillion-dollar failures include the Daimler-Chrysler integration, AOL and Time Warner, HP and Autonomy, and Bank of America and Merrill Lynch. More than cultural differences were involved in Microsoft's 2015 decision to write down $7.6 billion in losses on its $9.4 billion acquisition of Nokia (or more than 80 percent) some 15 months earlier. It's now up to Microsoft CEO Satya Nadella to decide how to compete in the mobile device arena after former CEO Steve Ballmer made a desperate gamble on acquiring the Finnish cell phone maker.[6]

Only if the three prior conditions *(low relevancy, low tradability,* and *high need for closeness)* shown in the decision tree in Exhibit 9.1 are met, should the firm consider M&A: If the firm's internal resources are insufficient to *build, and* the resource needed to fill the strategic gap cannot be *borrowed* through a strategic alliance, *and* closeness to the resource partner is needed, then the final question to consider is whether the integration of the two firms using a merger or acquisition will be successful. In all other cases, the firms should consider finding a less costly *borrow* arrangement when *building* is not an option. Since strategic alliances are the less costly and more common tool to execute corporate strategy, we discuss alliances first before mergers and acquisitions. Per the build-borrow-buy decision framework, strategic alliances *(borrow)* also need to be considered before mergers and acquisitions *(buy).*

LO 9-2

Define strategic alliances, and explain why they are important to implement corporate strategy and why firms enter into them.

9.2 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.[7] The use of strategic alliances to implement corporate strategy has exploded in the past few decades, with thousands forming each year. As the speed of technological change and innovation has increased (see discussion in Chapter 7), firms have responded by entering more alliances. Globalization has also contributed to an increase in cross-border strategic alliances (see discussion in Chapter 10).

strategic alliance
A voluntary arrangement between firms that involves the sharing of knowledge, resources, and capabilities with the intent of developing processes, products, or services.

Strategic alliances may join complementary parts of a firm's value chain, such as R&D and marketing, or they may focus on joining the same value chain activities. Strategic alliances are attractive because they enable firms to achieve goals faster and at lower costs than going it alone. In contrast to M&A, strategic alliances also allow firms to circumvent potential legal repercussions including potential lawsuits filed by U.S. federal agencies or the European Union.

Firms enter many types of alliances, from small contracts that have no bearing on a firm's competitiveness to multibillion-dollar joint ventures that can make or break the company. An alliance, therefore, qualifies as *strategic* only if it has the potential to affect a firm's competitive advantage. A strategic alliance has the potential to help a firm gain and sustain a competitive advantage when it joins together resources and knowledge in a combination that obeys the VRIO principles (introduced in Chapter 4).[8] The locus of competitive advantage is often not found within the individual firm but within a strategic partnership.

relational view of competitive advantage
Strategic management framework that proposes that critical resources and capabilities frequently are embedded in strategic alliances that span firm boundaries.

According to this **relational view of competitive advantage**, critical resources and capabilities frequently are embedded in strategic alliances that span firm boundaries. Applying the VRIO framework, we know that the basis for competitive advantage is formed when a strategic alliance creates resource combinations that are valuable, rare, and difficult to imitate, and the alliance is organized appropriately to allow for value capture. In support of this perspective, over 80 percent of Fortune 1000 CEOs indicated in a recent survey that more than one-quarter of their firm's revenues were derived from strategic alliances.[9]

WHY DO FIRMS ENTER STRATEGIC ALLIANCES?

To affect a firm's competitive advantage, an alliance must promise a positive effect on the firm's economic value creation through increasing value and/or lowering costs (see discussion in Chapter 5). This logic is reflected in the common reasons firms enter alliances.[10] They do so to

- Strengthen competitive position.
- Enter new markets.
- Hedge against uncertainty.
- Access critical complementary assets.
- Learn new capabilities.

STRENGTHEN COMPETITIVE POSITION. Firms can use strategic alliances to change the industry structure in their favor.[11] Firms frequently use strategic alliances when competing in so-called battles for industry standards (see discussion in Chapter 7). Strategy Highlight 9.1 shows how IBM and Apple entered a strategic alliance to strengthen their respective competitive position in mobile computing and business productivity apps. This in turn increases the competitive pressure on rivals of both companies, in particular, Microsoft.

ENTER NEW MARKETS. Firms may use strategic alliances to enter new markets, either in terms of products and services or geography.[12]

Using a strategic alliance, HP and DreamWorks Animation SKG created the Halo Collaboration Studio, which makes virtual communication possible around the globe.[13] Halo's conferencing technology gives participants the vivid sense that they are in the same room. The conference rooms of clients match, down to the last detail, giving participants the impression that they are sitting together at the same table. DreamWorks produced the

Strategy Highlight 9.1

IBM and Apple: From Big Brother to Alliance Partner

An excerpt from a speech by Apple co-founder Steve Jobs introducing the iconic "1984" Macintosh ad that aired during the Super Bowl XVIII telecast provides a historic perspective about the relationship between Apple and IBM:[14]

> In 1977, Apple, a young fledgling company on the West Coast, invents the Apple II, the first personal computer as we know it today. IBM dismisses the personal computer as too small to do serious computing and unimportant. The early 1980s. Apple II has become the world's most popular computer, and Apple has grown to a $300 million company, becoming the fastest-growing corporation in American business history. IBM enters the personal computer market in 1981. Apple and IBM emerge as the industry's strongest competitors, each selling approximately $1 billion worth of personal computers in 1983. The shakeout is in full swing. The first major firm goes bankrupt, with others teetering on the brink. It is now 1984. IBM wants it all and is aiming its guns on its last obstacle to industry control: Apple. Will Big Blue dominate the entire computer industry—the entire information age? Was George Orwell right about 1984?

Steve Jobs compares IBM to George Orwell's Big Brother, the all-present dictator of a totalitarian state that has absolute power over its inhabitants, including thought control. In the ad, Apple—portrayed by an athletic heroine with a stylized line drawing of Apple's Macintosh on her tank top—is the only hope to save humanity from total oppression and ensure its freedom.

Fast-forward 30 years to 2014. Apple has become the world's most valuable company and IBM is struggling. Although Jobs had a visceral disdain for IBM, Apple CEO Tim Cook took his first job out of college with IBM, where he worked for 12 years. Nonetheless, given their adversarial past and decades as rivals, it came somewhat as a surprise when Apple and IBM announced a strategic alliance to create simple-to-use business productivity apps and to sell

Source: "1984 Apple's Macintosh Commerical," YouTube, posted by Mac History, February 1, 2012

iPhones and iPads to IBM's corporate clients. Why would the former archenemies form a partnership?

Both parties stand to benefit from this arrangement. Although hugely successful, Apple has mainly been a consumer company (B2C). Historically, Apple did not sell directly to business clients. As more and more people bring their mobile devices to work, Apple sees the enterprise business as a huge opportunity for future growth. Cook, for example, claims that he does 80 percent of the work of running the world's most valuable company on his iPad.

In contrast, IBM has long-standing and deep ties as a business-to-business (B2B) company and major seller of tech services, especially in government, banking, finance, and insurance. Yet, IBM has been slow to catch the wave of mobile computing. With this seminal partnership, IBM is hoping to capitalize on the popularity of Apple's devices as it moves more and more of its software productivity tools onto mobile platforms. IBM will be selling and servicing Apple mobile devices to its corporate clients. Together, they plan to create simple to use business apps that bring together Apple's core competency of hardware and software integration to produce a seamless user experience with IBM's core competency in business services and big data analytics. One of the first new business apps resulting from this alliance will help airline pilots determine the right amount of fuel to carry on a particular flight. This task requires significant data analytics displayed in an easily understandable way so that pilots can digest it quickly when glancing at their iPad in a cockpit before departure.[15]

computer-animated movie *Shrek 2* using this new technology for its meetings. People with different creative skills—script writers, computer animators, directors—though dispersed geographically, were able to participate as if in the same room, even seeing the work on each other's laptops. Use of the technology enabled faster decision making, enhanced productivity, reduced (or even eliminated) travel time and expense, and increased job satisfaction. Neither HP nor DreamWorks would have been able to produce this technology breakthrough alone, but moving into the videoconferencing arena together via a strategic alliance allowed both partners to pursue related diversification. Moreover, HP's alliance with DreamWorks Animation SKG enabled HP to compete head on with Cisco's high-end videoconferencing solution, TelePresence. The HP and DreamWorks Animation SKG was motivated by the desire to enter a new market, in terms or products and services offered, that neither could enter alone.[16]

When entering new geographic markets, in some instances, governments such as Saudi Arabia or China may require that foreign firms have a local joint venture partner before doing business in their countries. These cross-border strategic alliances have both benefits and risks. While the foreign firm can benefit from local expertise and contacts, it is exposed to the risk that some of its proprietary know-how may be appropriated by the foreign partner. We will address such issues in Chapter 10 when studying global strategy.

HEDGE AGAINST UNCERTAINTY. In dynamic markets, strategic alliances allow firms to limit their exposure to uncertainty in the market.[17] For instance, in the wake of the biotechnology revolution, incumbent pharmaceutical firms such as Pfizer, Novartis, and Roche entered into hundreds of strategic alliances with biotech startups.[18] These alliances allowed the big pharma firms to make small-scale investments in many of the new biotechnology ventures that were poised to disrupt existing market economics. In some sense, the pharma companies were taking *real options* in these biotechnology experiments, providing them with the right but not the obligation to make further investments when new drugs were introduced from the biotech companies.

real-options perspective
Approach to strategic decision making that breaks down a larger investment decision into a set of smaller decisions that are staged sequentially over time.

A **real-options perspective** to strategic decision making breaks down a larger investment decision (such as whether to enter biotechnology or not) into a set of smaller decisions that are staged sequentially over time. This approach allows the firm to obtain additional information at predetermined stages. At each stage, after new information is revealed, the firm evaluates whether or not to make further investments. In a sense, a real option, which is the right, but not the obligation, to continue making investments allows the firm to buy time until sufficient information for a go versus no-go decision is revealed. Once the new biotech drugs were a known quantity, the uncertainty was removed, and the incumbent firms could react accordingly.

For example, in 1990 the Swiss pharma company Roche initially invested $2.1 billion in an equity alliance to purchase a controlling interest (greater than 50 percent) in the biotech startup Genentech. In 2009, after witnessing the success of Genentech's drug discovery and development projects in subsequent years, Roche spent $47 billion to purchase the remaining minority interest in Genentech, making it a wholly owned subsidiary.[19] Taking a wait-and-see approach by entering strategic alliances allows incumbent firms to buy time and wait for the uncertainty surrounding the market and technology to fade. Many firms in fast-moving markets subscribe to this rationale. Waiting can also be expensive, however. To acquire the remaining less than 50 percent of Genentech some 20 years after its initial investment required a price that was

some 24 times higher than the initial investment, as uncertainty settled and the biotech startup turned out to be hugely successful. Besides biotechnology, the use of a *real-options perspective* in making strategic investments has also been documented in nanotechnology, semiconductors, and other dynamic markets.[20]

ACCESS CRITICAL COMPLEMENTARY ASSETS. The successful commercialization of a new product or service often requires complementary assets such as marketing, manufacturing, and after-sale service.[21] In particular, new firms are in need of complementary assets to complete the value chain from upstream innovation to downstream commercialization. This implies that a new venture that has a core competency in R&D, for example, will need to access distribution channels and marketing expertise to complete the value chain. Building downstream complementary assets such as marketing and regulatory expertise or a sales force is often prohibitively expensive and time-consuming, and thus frequently not an option for new ventures. Strategic alliances allow firms to match complementary skills and resources to complete the value chain. Moreover, licensing agreements of this sort allow the partners to benefit from a division of labor, allowing each to efficiently focus on its core competency.

LEARN NEW CAPABILITIES. Firms also enter strategic alliances because they are motivated by the desire to learn new capabilities from their partners.[22] When the collaborating firms are also competitors, *co-opetition* ensues.[23] **Co-opetition** is a portmanteau describing cooperation by competitors. They may cooperate to create a larger pie but then might compete about how the pie should be divided. Such co-opetition can lead to **learning races** in strategic alliances,[24] a situation in which both partners are motivated to form an alliance for learning, but the rate at which the firms learn may vary. The firm that learns faster and accomplishes its goal more quickly has an incentive to exit the alliance or, at a minimum, to reduce its knowledge sharing. Since the cooperating firms are also competitors, learning races can have a positive effect on the winning firm's competitive position vis-à-vis its alliance partner.

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

learning races
Situations in which both partners in a strategic alliance are motivated to form an alliance for learning, but the rate at which the firms learn may vary.

NUMMI (New United Motor Manufacturing, Inc.) was the first joint venture in the U.S. automobile industry, formed between GM and Toyota in 1984. Recall from Chapter 8 that joint ventures are a special type of a strategic alliance in which two partner firms create a third, jointly owned entity. In the NUMMI joint venture, each partner was motivated to learn new capabilities: GM entered the equity-based strategic alliance to learn the lean manufacturing system pioneered by Toyota in order to produce high-quality, fuel-efficient cars at a profit. Toyota entered the alliance to learn how to implement its lean manufacturing program with an American work force. NUMMI was a test-run for Toyota before building fully owned *greenfield plants* (new manufacturing facilities) in Alabama, Indiana, Kentucky, Mississippi, Texas, and West Virginia. In this 25-year history, GM and Toyota built some 7 million high-quality cars at the NUMMI plant. In fact, NUMMI was transformed from worst performer (under GM ownership before the joint venture) to GM's highest-quality plant in the United States. In the end, as part of GM's bankruptcy reorganization during 2009–2010, it pulled out of the NUMMI joint venture.

The joint venture between GM and Toyota can be seen as a learning race. Who won? Strategy scholars argue that Toyota was faster in accomplishing its alliance goal—learning how to manage U.S. labor—because of its limited scope.[25] Toyota had already perfected lean manufacturing; all it needed to do was learn how to train U.S. workers in the

method and transfer this knowledge to its subsidiary plants in the United States. On the other hand, GM had to learn a completely new production system. GM was successful in transferring lean manufacturing to its newly created Saturn brand (which was discontinued in 2010 as part of GM's reorganization), but it had a hard time implementing lean manufacturing in its *existing* plants. These factors suggest that Toyota won the learning race with GM, which in turn helped Toyota gain and sustain a competitive advantage over GM in the U.S. market.

Also, note that different motivations for forming alliances are not necessarily independent and can be intertwined. For example, firms that collaborate to access critical complementary assets may also want to learn from one another to subsequently pursue vertical integration. In sum, alliance formation is frequently motivated by leveraging economies of scale, scope, specialization, and learning.

LO 9-3

Describe three alliance governance mechanisms and evaluate their pros and cons.

GOVERNING STRATEGIC ALLIANCES

In Chapter 8, we showed that strategic alliances lie in the middle of the make-or-buy continuum (see Exhibit 8.4). Alliances can be governed by the following mechanisms:

- Non-equity alliances
- Equity alliances
- Joint ventures[26]

Exhibit 9.2 provides an overview of the key characteristics of the three alliance types, including their advantages and disadvantages.

non-equity alliance Partnership based on contracts between firms.

explicit knowledge Knowledge that can be codified; concerns *knowing about* a process or product.

NON-EQUITY ALLIANCES. The most common type of alliance is a **non-equity alliance**, which is based on contracts between firms. The most frequent forms of non-equity alliances are *supply agreements, distribution agreements,* and *licensing agreements.* As suggested by their names, these contractual agreements are vertical strategic alliances, connecting different parts of the industry value chain. In a non-equity alliance, firms tend to share **explicit knowledge**—knowledge that can be codified. Patents, user manuals, fact sheets, and scientific publications are all ways to capture explicit knowledge, which concerns the notion of *knowing about* a certain process or product.

Licensing agreements are contractual alliances in which the participants regularly exchange codified knowledge. The biotech firm Genentech licensed its newly developed drug Humulin (human insulin) to the pharmaceutical firm Eli Lilly for manufacturing, facilitating approval by the Food and Drug Administration (FDA), and distribution. This partnership was an example of a vertical strategic alliance: One partner (Genentech) was positioned upstream in the industry value chain focusing on R&D, while the other partner (Eli Lilly) was positioned downstream focusing on manufacturing and distribution. This type of vertical arrangement is often described as a "hand-off" from the upstream partner to the downstream partner and is possible because the underlying knowledge is largely explicit and can be easily codified. When Humulin reached the market, it was the first approved genetically engineered human therapeutic drug worldwide.[27] Subsequently, Humulin became a billion-dollar blockbuster drug.

Because of their contractual nature, non-equity alliances are flexible and easy to initiate and terminate. However, because they can be temporary in nature, they also sometimes produce weak ties between the alliance partners, which can result in a lack of trust and commitment.

EXHIBIT 9.2 / Key Characteristics of Different Alliance Types

Alliance Type	Governance Mechanism	Frequency	Type of Knowledge Exchanged	Pros	Cons	Examples
Non-equity (supply, licensing, and distribution agreements)	Contract	Most common	Explicit	• Flexible • Fast • Easy to initiate and terminate	• Weak tie • Lack of trust and commitment	• Genentech–Lilly (exclusive) licensing agreement for Humulin • Microsoft–IBM (nonexclusive) licensing agreement for MS-DOS
Equity (purchase of an equity stake or corporate venture capital, CVC investment)	Equity investment	Less common than non-equity alliances, but more common than joint ventures	Explicit; exchange of tacit knowledge possible	• Stronger tie • Trust and commitment can emerge • Window into new technology (option value)	• Less flexible • Slower • Can entail significant investments	• Renault–Nissan alliance based on cross equity holdings, with Renault owning 44.4% in Nissan; and Nissan owning 15% in Renault • Roche's equity investment in Genentech (prior to full integration)
Joint venture (JV)	Creation of new entity by two or more parent firms	Least common	Both tacit and explicit knowledge exchanged	• Strongest tie • Trust and commitment likely to emerge • May be required by institutional setting	• Can entail long negotiations and significant investments • Long-term solution • JV managers have double reporting lines (2 bosses)	• Hulu, owned by NBC, Fox, and Disney-ABC • Dow Corning, owned by Dow Chemical and Corning

equity alliance Partnership in which at least one partner takes partial ownership in the other.

tacit knowledge Knowledge that cannot be codified; concerns *knowing how* to do a certain task and can be acquired only through active participation in that task.

EQUITY ALLIANCES. In an **equity alliance**, at least one partner takes partial ownership in the other partner. Equity alliances are less common than contractual, non-equity alliances because they often require larger investments. Because they are based on partial ownership rather than contracts, equity alliances are used to signal stronger commitments. Moreover, equity alliances allow for the sharing of **tacit knowledge**—knowledge that cannot be codified.[28] Tacit knowledge concerns *knowing how* to do a certain task. It can be acquired only through actively participating in the process. In an equity alliance, therefore, the partners frequently exchange personnel to make the acquisition of tacit knowledge possible.

Toyota used an equity alliance with Tesla Motors, a designer and maker of electric cars (and featured in ChapterCase 3), to learn new knowledge and gain a window into

new technology. In 2010, Toyota made a $50 million equity investment in the California startup. In the same year, Tesla Motors purchased the NUMMI plant in Fremont, California, where it now manufactures its Models S and X. Tesla CEO Elon Musk stated, "The Tesla factory effectively leverages an ideal combination of hardcore Silicon Valley engineering talent, traditional automotive engineering talent, and the proven Toyota production system."[29] Toyota in turn hopes to infuse its company with Tesla's entrepreneurial spirit. Toyota President Akio Toyoda commented, "By partnering with Tesla, my hope is that all Toyota employees will recall that 'venture business spirit' and take on the challenges of the future."[30] Toyoda hoped that a transfer of tacit knowledge would occur, in which Tesla's entrepreneurial spirit would reinvigorate Toyota.[31] This equity-based learning race ended in 2014 when Toyota sold its stake in Tesla.[32] The Japanese automaker is shifting away from electric cars, renewing its focus on hybrid vehicles and exploring fuel-cell technology.

corporate venture capital (CVC) Equity investments by established firms in entrepreneurial ventures; CVC falls under the broader rubric of equity alliances.

Another governance mechanism that falls under the broad rubric of equity alliances is **corporate venture capital (CVC)** investments, which are equity investments by established firms in entrepreneurial ventures.[33] The value of CVC investments is estimated to be in the double-digit billion-dollar range each year. Larger firms frequently have dedicated CVC units, such as Dow Venture Capital, Siemens Venture Capital, Kaiser Permanente Ventures, and Johnson & Johnson Development Corporation. Rather than hoping primarily for financial gains, as venture capitalists traditionally do, CVC investments create real options in terms of gaining access to new, and potentially disruptive, technologies.[34] Strategy scholars find that CVC investments have a positive impact on value creation for the investing firm, especially in high-tech industries such as semiconductors, computing, and the medical-device sector.[35]

Taken together, equity alliances tend to produce stronger ties and greater trust between partners than non-equity alliances do. They also offer a window into new technology that, like a real option, can be exercised if successful or abandoned if not promising. Equity alliances are frequently stepping-stones toward full integration of the partner firms either through a merger or an acquisition. Essentially, they are often used as a "try before you buy" strategic option.[36] The downside of equity alliances is the amount of investment that can be involved, as well as a possible lack of flexibility and speed in putting together and reaping benefits from the partnership.

JOINT VENTURES. A *joint venture* (JV) is a standalone organization created and jointly owned by two or more parent companies (as discussed in Chapter 8). For example, Hulu (a video-on-demand service) is jointly owned by NBC, Disney-ABC, and Fox. Since partners contribute equity to a joint venture, they are making a long-term commitment. Exchange of both explicit and tacit knowledge through interaction of personnel is typical. Joint ventures are also frequently used to enter foreign markets where the host country requires such a partnership to gain access to the market in exchange for advanced technology and know-how. In terms of frequency, joint ventures are the least common of the three types of strategic alliances.

The advantages of joint ventures are the strong ties, trust, and commitment that can result between the partners. However, they can entail long negotiations and significant investments. If the alliance doesn't work out as expected, undoing the JV can take some time and involve considerable cost. A further risk is that knowledge shared with the new partner could be misappropriated by opportunistic behavior. Finally, any rewards from the collaboration must be shared between the partners.

ALLIANCE MANAGEMENT CAPABILITY

LO 9-4 Describe the three phases of alliance management and explain how an alliance management capability can lead to a competitive advantage.

Strategic alliances create a paradox for managers. Although alliances appear to be necessary to compete in many industries, between 30 and 70 percent of all strategic alliances do not deliver the expected benefits, and are considered failures by at least one alliance partner.[37] Given the high failure rate, effective alliance management is critical to gaining and sustaining a competitive advantage, especially in high-technology industries.[38]

alliance management capability A firm's ability to effectively manage three alliance-related tasks concurrently: (1) partner selection and alliance formation, (2) alliance design and governance, and (3) post-formation alliance management.

Alliance management capability is a firm's ability to effectively manage three alliance-related tasks concurrently, often across a portfolio of many different alliances (see Exhibit 9.3):[39]

- Partner selection and alliance formation.
- Alliance design and governance.
- Post-formation alliance management.

PARTNER SELECTION AND ALLIANCE FORMATION. When making the business case for an alliance, the expected benefits of the alliance must exceed its costs. When one or more of the five reasons for alliance formation are present—to strengthen competitive position, enter new markets, hedge against uncertainty, access critical complementary resources, or learn new capabilities—the firm must select the best possible alliance partner. Partner compatibility and partner commitment are necessary conditions for successful alliance formation.[40] *Partner compatibility* captures aspects of cultural fit between different firms. *Partner commitment* concerns the willingness to make available necessary resources and to accept short-term sacrifices to ensure long-term rewards.

ALLIANCE DESIGN AND GOVERNANCE. Once two or more firms agree to pursue an alliance, managers must then design the alliance and choose an appropriate governance mechanism from among the three options: non-equity contractual agreement, equity alliances, or joint venture. For example, in a study of over 640 alliances, researchers found that the joining of specialized complementary assets increases the likelihood that the alliance is governed hierarchically. This effect is stronger in the presence of uncertainties concerning the alliance partner as well as the envisioned tasks.[41]

In addition to the formal governance mechanisms, *interorganizational trust* is a critical dimension of alliance success.[42] Because all contracts are necessarily incomplete, trust between the alliance partners plays an important role for effective post-formation alliance management. Effective governance, therefore, can be accomplished only by skillfully combining formal and informal mechanisms.

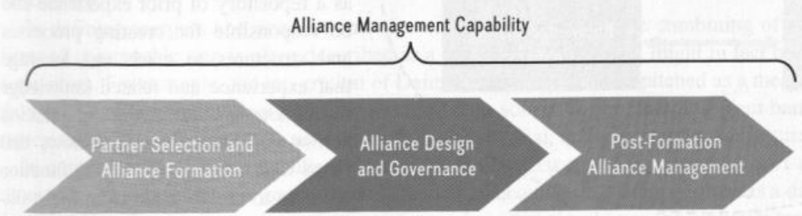


EXHIBIT 9.3 Alliance Management Capability

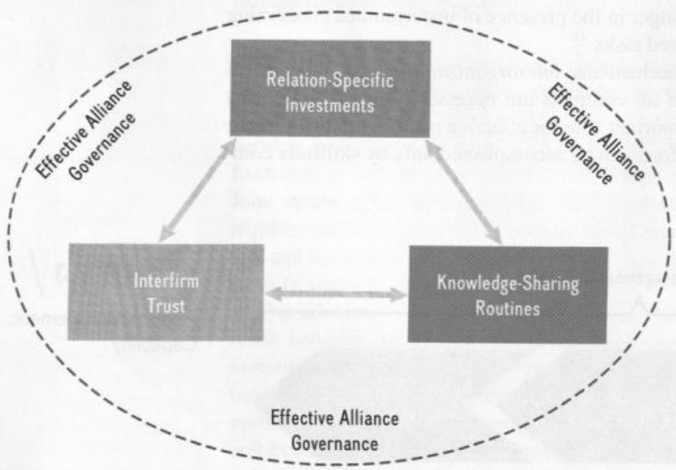
POST-FORMATION ALLIANCE MANAGEMENT. The third phase in a firm's alliance management capability concerns the ongoing management of the alliance. To be a source of competitive advantage, the partnership needs to create resource combinations that obey the VRIO criteria. As shown in Exhibit 9.4, this can be most likely accomplished if the alliance partners *make relation-specific investments, establish knowledge-sharing routines,* and *build interfirm trust.*[43]

Trust is a critical aspect of any alliance. Interfirm trust entails the expectation that each alliance partner will behave in good faith and develop norms of reciprocity and fairness.[44] Such trust helps ensure that the relationship survives and thereby increases the possibility of meeting the intended goals of the alliance. Interfirm trust is also important for fast decision making.[45] Several firms such as Eli Lilly, HP, Procter & Gamble, and IBM compete to obtain trustworthy reputations in order to become the alliance "partner of choice" for small technology ventures, universities, and individual inventors.

Indeed, the systematic differences in firms' alliance management capability can be a source of competitive advantage.[46] But how do firms build alliance management capability? The answer is to build capability through repeated experiences over time. In support of this idea, several empirical studies have shown that firms move down the learning curve and become better at managing alliances through repeated alliance exposure.[47]

The "learning-by-doing" approach has value for small ventures in which a few key people coordinate most of the firms' activities.[48] However, there are clearly limitations for larger companies. Conglomerates such as ABB, GE, Philips, or Siemens are engaged in hundreds of alliances simultaneously. In fact, if alliances are not managed from a portfolio perspective at the corporate level, serious negative repercussions can emerge.[49] Groupe Danone, a large French food conglomerate, lost its leading position in the highly lucrative and fast-growing Chinese market because its local alliance partner, Hangzhou Wahaha Group, terminated their long-standing alliance.[50] Wahaha accused different Danone business units of subsequently setting up partnerships with other Chinese firms that were a direct competitive threat to Wahaha. This example makes it clear that although alliances are important pathways by which to pursue business-level strategy, they are best managed at the corporate level.

EXHIBIT 9.4 / How to Make Alliances Work



Source: Adapted from J.H. Dyer and H. Singh (1998), "The relational view: Cooperative strategy and the sources of intraorganizational advantage," *Academy of Management Review* 23: 660–679.

To accomplish effective alliance management, strategy scholars suggest that firms create a *dedicated alliance function,*[51] led by a vice president or director of alliance management and endowed with its own resources and support staff. The dedicated alliance function should be given the tasks of coordinating all alliance-related activity in the entire organization, taking a corporate-level perspective. It should serve as a repository of prior experience and be responsible for creating processes and structures to teach and leverage that experience and related knowledge throughout the rest of the organization across all levels. Research shows that firms with a dedicated alliance function are able to create value from their alliances above and beyond what could be expected based on experience alone.[52]

Pharmaceutical company Eli Lilly is an acknowledged leader in alliance management.[53] Lilly's Office of Alliance Management, led by a director and endowed with several full-time positions, manages its far-flung alliance activity across all hierarchical levels and around the globe. Lilly's process prescribes that each alliance is managed by a three-person team: an alliance champion, alliance leader, and alliance manager.

- The *alliance champion* is a senior, corporate-level executive responsible for high-level support and oversight. This senior manager is also responsible for making sure that the alliance fits within the firm's existing alliance portfolio and corporate-level strategy.
- The *alliance leader* has the technical expertise and knowledge needed for the specific technical area and is responsible for the day-to-day management of the alliance.
- The *alliance manager,* positioned within the Office of Alliance Management, serves as an alliance process resource and business integrator between the two alliance partners and provides alliance training and development, as well as diagnostic tools.

Some companies are also able to leverage the relational capabilities obtained through managing alliance portfolios into a successful acquisition strategy.[54] As detailed earlier, Eli Lilly has an entire department at the corporate level devoted to managing its alliance portfolio. Following up on an earlier 50/50 joint venture formed with Icos, maker of the $1 billion-plus erectile-dysfunction drug Cialis, Lilly acquired Icos in 2007. Just a year later, Eli Lilly outmaneuvered Bristol-Myers Squibb to acquire biotech venture ImClone for $6.5 billion. ImClone discovered and developed the cancer-fighting drug Erbitux, also a $1 billion blockbuster in terms of annual sales. The acquisition of these two smaller biotech ventures allowed Lilly to address its problem of an empty drug pipeline.[55]

9.3 Mergers and Acquisitions

LO 9-5

Differentiate between mergers and acquisitions, and explain why firms would use either to execute corporate strategy.

A popular vehicle for executing corporate strategy is mergers and acquisitions (M&A). Hundreds of mergers and acquisitions occur each year, with a cumulative value in the trillions of dollars.[56] Although the terms are often used interchangeably, and usually in tandem, mergers and acquisitions are, by definition, distinct from each other. A **merger** describes the joining of two independent companies to form *a combined entity.* Mergers tend to be friendly; in mergers, the two firms agree to join in order to create a combined entity. In the live event-promotion business, for example, Live Nation merged with Ticketmaster.

merger
The joining of two independent companies to form a combined entity.

An **acquisition** describes the purchase or takeover of one company by another. Acquisitions can be friendly or unfriendly. As discussed in the ChapterCase, Disney's acquisition of Pixar, for example, was a friendly one, in which both management teams believed that joining the two companies was a good idea. When a target firm does not want to be acquired, the acquisition is considered a **hostile takeover**. British telecom company Vodafone's acquisition of Germany-based Mannesmann, a diversified conglomerate with holdings in telephony and Internet services, at an estimated value of $150 billion, was a hostile one.

acquisition
The purchase or takeover of one company by another; can be friendly or unfriendly.

hostile takeover
Acquisition in which the target company does not wish to be acquired.

In defining mergers and acquisitions, size can matter as well. The combining of two firms of comparable size is often described as a merger even though it might in fact be an acquisition. For example, the integration of Daimler and Chrysler was pitched as a merger, though in reality Daimler acquired Chrysler, and later sold it. After emerging from bankruptcy restructuring, Chrysler is now majority-owned by Fiat, an Italian auto manufacturer.

In contrast, when large, incumbent firms such as GE, Cisco, or Microsoft buy start-up companies, the transaction is generally described as an acquisition. Although there is a distinction between mergers and acquisitions, many observers simply use the umbrella term *mergers and acquisitions,* or M&A.

LO 9-6

Define horizontal integration and evaluate the advantages and disadvantages of this option to execute corporate-level strategy.

WHY DO FIRMS MERGE WITH COMPETITORS?

In contrast to vertical integration, which concerns the number of activities a firm participates in up and down the industry value chain (as discussed in Chapter 8), **horizontal integration** is the process of merging with a competitor at the same stage of the industry value chain. Horizontal integration is a type of corporate strategy that can improve a firm's strategic position in a single industry. As a rule of thumb, firms should go ahead with horizontal integration (i.e., acquiring a competitor) *if the target firm is more valuable inside the acquiring firm than as a continued standalone company.* This implies that the net value creation of a horizontal acquisition must be positive to aid in gaining and sustaining a competitive advantage.

horizontal integration
The process of merging with competitors, leading to industry consolidation.

An industry-wide trend toward horizontal integration leads to industry consolidation. In particular, competitors in the same industry such as airlines, banking, telecommunications, pharmaceuticals, or health insurance frequently merge to respond to changes in their external environment and to change the underlying industry structure in their favor.

There are three main benefits to a horizontal integration strategy:

- Reduction in competitive intensity.
- Lower costs.
- Increased differentiation.

Exhibit 9.5 previews the sources of value creation and costs in horizontal integration, which we discuss next.

REDUCTION IN COMPETITIVE INTENSITY. Looking through the lens of Porter's five forces model with a focus on rivalry among competitors (introduced in Chapter 3), horizontal integration changes the underlying industry structure in favor of the surviving firms. Excess capacity is taken out of the market, and competition tends to decrease as a consequence of horizontal integration, assuming no new entrants. As a whole, the industry structure becomes more consolidated and potentially more profitable. If the surviving firms find themselves in an oligopolistic industry structure and maintain a focus on non-price competition (i.e., focus on R&D spending, customer service, or advertising), the industry can indeed be quite profitable, and rivalry would likely decrease among existing firms. The wave of recent horizontal integration in the U.S. airline industry, for example, provided several benefits to the surviving carriers. By reducing excess capacity, the mergers between Delta and Northwest Airlines, United Airlines and Continental, Southwest and AirTran, and American and US Airways lowered competitive intensity in the industry overall.

Horizontal integration can favorably affect several of Porter's five forces for the surviving firms: strengthening bargaining power vis-à-vis suppliers and buyers, reducing the threat of entry, and reducing rivalry among existing firms. Because of the potential to reduce competitive intensity in an industry, government authorities such as the Federal Trade Commission (FTC) in the United States and/or the European Commission usually

EXHIBIT 9.5 / Sources of Value Creation and Costs in Horizontal Integration

Corporate Strategy	Sources of Value Creation (*V*)	Sources of Costs (*C*)
Horizontal integration through M&A	• Reduction in competitive intensity • Lower costs • Increased differentiation	• Integration failure • Reduced flexibility • Increased potential for legal repercussions

must approve any large horizontal integration activity. Industry dynamics, however, are in constant flux as new competitors emerge and others fall by the wayside.

In 2005, for example, the FTC did not approve the proposed merger between Staples and Office Depot, arguing that the remaining industry would have only two competitors, with Office Max being the other. Staples and Office Depot argued that the market for office supplies needed to be defined more broadly to include large retailers such as Walmart and Target. The U.S. courts sided with the FTC, which argued that the prices for end consumers would be significantly higher if the market had only two category killers.[57] A few years later, however, the competitive landscape had shifted further as Walmart and Amazon had emerged as ferocious competitors offering rock-bottom prices for office supplies. Subsequently, in 2013, the FTC approved the merger between Staples and Office Max. Just two years later, the FTC also approved the merger between the now much larger Staples and Office Depot.[58]

LOWER COSTS. Firms use horizontal integration to lower costs through economies of scale and to enhance their economic value creation, and in turn their performance.[59] In industries that have high fixed costs, achieving economies of scale through large output is critical in lowering costs. The dominant pharmaceutical companies such as Pfizer, Roche, and Novartis, for example, maintain large sales forces ("detail people") who call on doctors and hospitals to promote their products. These specialized sales forces often number 10,000 or more and thus are a significant fixed cost to the firms, even though part of their compensation is based on commissions. Maintaining such a large and sophisticated sales force (many with MBAs) is costly if the firm has only a few drugs it can show the doctor. As a rule of thumb, if a pharma company does not possess a blockbuster drug that brings in more than $1 billion in annual revenues, it cannot maintain its own sales force.[60] When existing firms such as Pfizer and Wyeth merge, they join their drug pipelines and portfolios of existing drugs. They are likely to have one sales force for the combined portfolio, consequently reducing the size of the sales force and lowering the overall cost of distribution.

INCREASED DIFFERENTIATION. Horizontal integration through M&A can help firms strengthen their competitive positions by increasing the differentiation of their product and service offerings. In particular, horizontal integration can do this by filling gaps in a firm's product offering, allowing the combined entity to offer a complete suite of products and services.

As mentioned in the ChapterCase, Disney acquired Marvel for $4 billion. This acquisition certainly allowed Disney to further differentiate its product offering as an entire new lineup of superheroes was joining Mickey's family, besides being able to offer Marvel superhero themed-rides and merchandise such as clothing (T-shirts, PJs, etc.) and toys. The Marvel acquisition passed an important test of value creation because Marvel is seen as more valuable inside Disney than outside Disney.[61] Because of economies of scope and economies of scale, Marvel is becoming more valuable inside Disney than as a standalone enterprise. The same argument could be made for the other recent Disney acquisitions, including Pixar and Lucasfilm, both highlighted in the ChapterCase.

WHY DO FIRMS ACQUIRE OTHER FIRMS?

LO 9-7

Explain why firms engage in acquisitions.

When first defining the terminology at the beginning of the chapter, we noted that an *acquisition* describes the purchase or takeover of one company by another. Why do firms make acquisitions? Three main reasons stand out:

- To gain access to new markets and distribution channels.
- To gain access to a new capability or competency.
- To preempt rivals.

Strategy Highlight 9.2

Food Fight: Kraft's Hostile Takeover of Cadbury

In 2010, Kraft Foods bought UK-based Cadbury PLC for close to $20 billion in a hostile takeover. Unlike the more diversified food-products company Kraft, Cadbury was focused solely on candy and gum. Hailing to 1824, Cadbury established itself in markets across the globe, in concert with the British Empire.

Kraft was attracted to Cadbury due to its strong position in countries such as India, Egypt, and Thailand and in fast-growing markets in Latin America. Cadbury held 70 percent of the market share for chocolate in India, with more than 1 billion people. Children there specifically ask for "Cadbury chocolate" instead of just plain "chocolate." It is difficult for outsiders like Kraft to break into emerging economies because earlier entrants have developed and perfected their distribution systems to meet the needs of millions of small, independent vendors. To secure a strong strategic position in these fast-growing emerging markets, therefore, Kraft felt that horizontal integration with Cadbury was critical. Kraft continues to face formidable competitors in global markets, including Nestlé and Mars, both of which are especially strong in China.

To focus its different strategic business units more effectively and to reduce costs, Kraft Foods restructured in 2012. It separated its North American grocery-food business from its global snack-food and candy business (including Oreos and Cadbury chocolate), which is now Mondelez International. In 2015, Kraft Foods merged with Heinz (owned

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by Warren Buffett's Berkshire Hathaway and 3G Capital, a Brazilian hedge fund) in a $37 billion merger, creating the fifth-largest food company in the world, behind Nestlé, Mondelez, PepsiCo, and Unilever.

In the U.S. market, the Cadbury acquisition allows the new Kraft Heinz greater access to convenience stores, gives it a new distribution channel, and opens a market for it that is growing fast and tends to have high profit margins. Domestically, Kraft Heinz has to compete with The Hershey Company, the largest U.S. chocolate manufacturer. This battle is intense because Hershey's main strategic focus is squarely on its home market. With the U.S. population growing slowly and becoming more health-conscious, however, Hershey decided to enter the Chinese market in 2013, the world's fastest-growing candy market. Since its founding in 1894, Hershey's entry into China is the company's first new product launch outside the United States. Hershey's sales growth in China, however, has been disappointing so far. Combined with little or no growth in the United States, Hershey announced job cuts in 2015.[62]

TO GAIN ACCESS TO NEW MARKETS AND DISTRIBUTION CHANNELS. Firms may resort to acquisitions when they need to overcome entry barriers into markets they are currently not competing in or to access new distribution channels. Strategy Highlight 9.2 discusses Kraft's acquisition of Cadbury to tap into new distribution channels in both the United States and fast-growing international markets.

TO GAIN ACCESS TO A NEW CAPABILITY OR COMPETENCY. Firms often resort to M&A to obtain new capabilities or competencies. To strengthen its capabilities in server systems and equipment and to gain access to the capability of designing mobile chips for the Internet of things (the concept that everyday objects such as cell phones, wearable devices,

temperature controls, household appliances, cars, etc., have network connectivity, allowing them to send and receive data), Intel acquired Altera for $17 billion.[63]

TO PREEMPT RIVALS. Sometimes firms may acquire promising startups not only to gain access to a new capability or competency, but also to preempt rivals from doing so. Let's look at the acquisitions made by two of the leading Internet companies: Facebook and Google.[64]

To preempt rivals Facebook acquired Instagram, a photo- and video-sharing social media site, for $1 billion in 2012. Snapchat, however, spurned a $3 billion offer from Facebook in 2013. Facebook then went on to buy the text messaging service start-up WhatsApp for $22 billion in 2014, making it one of the largest tech acquisitions ever. In the same year, Facebook paid $2 billion to acquire Oculus, a new venture making virtual reality headsets.

Google has made a string of acquisitions of new ventures to preempt rivals. In 2006, Google bought YouTube, the video-sharing website, for $1.65 billion. Google engaged in a somewhat larger acquisition when it bought Motorola's cell phone unit for $12.5 billion (in 2011). This was done to gain access to Motorola's valuable patent holdings in mobile technology. Google later sold the cell phone unit to Lenovo, while retaining Motorola's patents. In 2013, Google purchased the Israeli start-up company Waze for $1 billion. Google acquired Waze to gain access to a new capability and to prevent rivals from gaining access. Waze's claim to fame is its interactive mobile map app. Google is already the leader in online maps and wanted to extend this capability to mobile devices. Perhaps even more importantly, Google's intent was to preempt its competitors Apple and Facebook from buying Waze. Apple and Facebook are each comparatively weaker than Google in the increasingly important interactive mobile map and information services segment.

M&A AND COMPETITIVE ADVANTAGE

LO 9-8

Evaluate whether mergers and acquisitions lead to competitive advantage.

Do mergers and acquisitions create competitive advantage? Despite their popularity, the answer, surprisingly, is that in most cases they do not. In fact, the M&A performance track record is rather mixed. Many mergers destroy shareholder value because the anticipated synergies never materialize.[65] If value is created, it generally accrues to the shareholders of the firm that was taken over (the acquiree), because acquirers often pay a premium when buying the target company.[66] Indeed, sometimes companies get involved in a bidding war for an acquisition; the winner may end up with the prize but may have overpaid for the acquisition—thus falling victim to the *winner's curse*.

Given that mergers and acquisitions, *on average*, destroy rather than create shareholder value, why do we see so many mergers? Reasons include:

- Principal–agent problems.
- The desire to overcome competitive disadvantage.
- Superior acquisition and integration capability.

PRINCIPAL-AGENT PROBLEMS. When discussing diversification in the previous chapter, we noted that some firms diversify through acquisitions due to principal–agent problems (see Chapter 8 discussion of managerial motives behind firm growth).[67] Managers, as agents, are supposed to act in the best interest of the principals, the shareholders. However,

Sometimes the combined value of two companies is less than the value of each company separately.
Oatmeal: © McGraw-Hill Education/ Mark Dierker, photographer; Snapple: © George W. Bailey/ Shutterstock.com RF

managers may have incentives to grow their firms through acquisitions—not for anticipated shareholder value appreciation, but to build a larger empire, which is positively correlated with prestige, power, and pay. Besides providing higher compensation and more corporate perks, a larger organization may also provide more job security, especially if the company pursues unrelated diversification.

A related problem is **managerial hubris**, a form of self-delusion in which managers convince themselves of their superior skills in the face of clear evidence to the contrary.[68] Managerial hubris comes in two forms:

managerial hubris A form of self-delusion in which managers convince themselves of their superior skills in the face of clear evidence to the contrary.

1. Managers of the acquiring company convince themselves that they are able to manage the business of the target company more effectively and, therefore, create additional shareholder value. This justification is often used for an unrelated diversification strategy.
2. Although most top-level managers are aware that the majority of acquisitions destroy rather than create shareholder value, they see themselves as the exceptions to the rule.

Managerial hubris has led to many ill-fated deals, destroying billions of dollars. For example, Quaker Oats Company acquired Snapple because its managers thought Snapple was another Gatorade, which was a successful previous acquisition.[69] The difference was that Gatorade had been a standalone company and was easily integrated, but Snapple relied on a decentralized network of independent distributors and retailers who did not want Snapple to be taken over and who made it difficult and costly for Quaker Oats Company to integrate Snapple. The acquisition failed—and Quaker Oats itself was taken over by PepsiCo. Snapple was spun out and eventually ended up being part of the Dr Pepper Snapple Group.

THE DESIRE TO OVERCOME COMPETITIVE DISADVANTAGE. In some instances, mergers are not motivated by gaining competitive advantage, but by the attempt to overcome a competitive disadvantage. For example, to compete more successfully with Nike, the worldwide leader in sports shoes and apparel, adidas (number two) acquired Reebok (number three) for $3.8 billion in 2006. This acquisition allows the now-larger adidas group to benefit from economies of scale and scope that were unachievable when adidas and Reebok operated independently. The hope was that this would help in overcoming adidas' competitive disadvantage vis-à-vis Nike. In the meantime, Under Armour has outperformed adidas in the U.S. market and has become the number two after Nike.

SUPERIOR ACQUISITION AND INTEGRATION CAPABILITY. Acquisition and integration capabilities are not equally distributed across firms. Although there is strong evidence that mergers and acquisitions, *on average,* destroy rather than create shareholder value, it does not exclude the possibility that *some* firms are consistently able to identify, acquire, and

integrate target companies to strengthen their competitive positions. Since it is valuable, rare, and difficult to imitate, a superior acquisition and integration capability, together with past experience, can lead to competitive advantage.

Disney has shown superior post-merger integration capabilities after acquiring Pixar, Marvel, and Lucasfilm. Disney managed its new subsidiaries more like alliances rather than attempting full integration, which could have destroyed the unique value of the acquisitions. In Pixar's case, Disney kept the entire creative team in place and allowed its members to continue to work in Pixar's headquarters near San Francisco with minimum interference. The hands-off approach paid huge dividends: Although Disney paid a steep $7.4 billion for Pixar, it made some $10 billion on Pixar's *Toy Story 3* franchise revenues alone. As a consequence, Disney has gained a competitive advantage over its rivals such as Sony and has also outperformed the Dow Jones Industrial Average over the past few years by a wide margin.

9.3 ◂▸ Implications for the Strategist

The business environment is constantly changing.[70] New opportunities come and go quickly. Firms often need to develop new resources, capabilities, or competencies to take advantage of opportunities. Examples abound. Traditional book publishers must transform themselves into digital content companies. Old-line banking institutions with expensive networks of branches must now offer seamless online banking services. They must make them work between a set of traditional and nontraditional payment services on a mobile platform. Energy providers are in the process of changing their coal-fired power plants to gas-fired ones in the wake of the shale gas boom. Pharmaceutical companies need to take advantage of advances in biotechnology to drive future growth. Food companies are now expected to offer organic, all natural, and gluten-free products.

The strategist also knows that firms need to grow to survive and prosper, especially if they are publicly traded stock companies. A firm's corporate strategy is critical in pursuing growth. To be able to grow as well as gain and sustain a competitive advantage, a firm must not only possess VRIO resources but also be able to leverage existing resources, often in conjunction with partners, and build new ones. The question of how to build new resources, capabilities, and competencies to grow your enterprise lies at the center of corporate strategy. Strategic alliances, mergers, and acquisitions are the key tools that the strategist uses in executing corporate strategy.

Ideally, the tools to execute corporate strategy—strategic alliances and acquisitions—should be centralized and managed at the corporate level, rather than at the level of the strategic business unit. This allows the company to not only assess their effect on the overall company performance, but also to harness spillovers between the different corporate development activities. That is, corporate-level managers should not only coordinate the firm's portfolio of alliances, but also leverage their relationships to successfully engage in mergers and acquisitions.[71] Rather than focusing on developing an alliance management capability in isolation, firms should develop a *relational capability* that allows for the successful management of both strategic alliances *and* mergers and acquisitions. In sum, to ensure a positive effect on competitive advantage, the management of strategic alliances and M&A needs to be placed at the corporate level.

We now have concluded our discussion of corporate strategy. Acquisitions and alliances are the key vehicles to execute corporate strategy, each with its distinct advantages and disadvantages. It is also clear from this chapter that strategic alliances, as well as mergers and acquisitions, are a global phenomenon. In the next chapter, we discuss strategy in a global world.

CHAPTERCASE 9 / Consider This . . .

THE CORPORATE STRATEGY of creating billion-dollar franchises is Disney's main focus. CEO Iger leads a group of about 20 executives whose sole responsibility is to hunt for new billion-dollar franchises. This group of senior leaders decides top-down which projects are a go and which are not. They also allocate resources to particular projects. Disney even organized its employees in the consumer products group around franchises such as *Frozen, Toy Story, Star Wars,* and other cash cows.

While things seem to be sunny right now in Southern California, there are clouds on the horizon. First, relying on a few big franchises is quite risky. What if the pipeline dries up? Many of Disney's greatest franchises such as *Star Wars* joined the family through an acquisition. (The newly released *Star Wars* sequel *The Force Awakens* is predicted to gross over $1 billion on the big screens, making it the third-bestselling movie ever after *Avatar* and *Titanic.)* An acquisition-led growth strategy, however, may not be sustainable because of the limited number of media companies such as Pixar, Marvel, or Lucasfilm that Disney can acquire. Second, some critics assert that focusing too much on billion-dollar franchises reduces originality and leaves consumers bored more quickly. Disney's recipe of success also becomes too predictable.

Third, and perhaps most important, roughly half of Disney profits come from its TV networks ESPN, ABC, and others. The media industry, however, is being disrupted: People spend much less time and money watching movies on the large screen and spend more time consuming content online via YouTube, Netflix, Hulu, and other streaming services. While ESPN is certainly very successful, the cost of rights to show the big sporting events live has escalated dramatically in recent years. In addition, more and more subscribers have cut their cable cord and get their media online. As a response, cable providers are more likely to unbundle their service offerings, which may create challenges for ESPN, an expensive part of the cable bundle (some estimate $8) with a narrow focus that doesn't appeal to everyone.

Questions

1. Do you think focusing on billion-dollar franchises is a good corporate strategy for Disney? What are pros and cons of this strategy?
2. Given the build-borrow-or-buy framework discussed in the chapter, do you think Disney should pursue alternatives to acquisitions? Why or why not?
3. Why do you think Disney was so successful with the Pixar and Marvel acquisitions, while other media interactions such as Sony's acquisition of Columbia Pictures or News Corp.'s acquisition of MySpace were much less successful?
4. Given Disney's focus on creating and milking billion-dollar franchises, some industry observers now view Disney more as a global consumer products company like Nike rather than a media company. Do you agree with this perspective? Why or why not? What strategic implications would it have if Disney is truly a global consumer products company rather than a media company?

TAKE-AWAY CONCEPTS

This chapter discussed two mechanisms of corporate-level strategy—alliances and acquisitions—as summarized by the following learning objectives and related take-away concepts.

LO 9-1 / Apply the build-borrow-or-buy framework to guide corporate strategy.

- The build-borrow-or-buy framework provides a conceptual model that aids strategists in deciding whether to pursue internal development *(build)*, enter a contract arrangement or strategic alliance *(borrow)*, or acquire new resources, capabilities, and competencies *(buy)*.

- Firms that are able to learn how to select the right pathways to obtain new resources are more likely to gain and sustain a competitive advantage.

LO 9-2 / Define strategic alliances, and explain why they are important to implement corporate strategy and why firms enter into them.

- Strategic alliances have the goal of sharing knowledge, resources, and capabilities to develop processes, products, or services.
- An alliance qualifies as strategic if it has the potential to affect a firm's competitive advantage by increasing value and/or lowering costs.
- The most common reasons firms enter alliances are to (1) strengthen competitive position, (2) enter new markets, (3) hedge against uncertainty, (4) access critical complementary resources, and (5) learn new capabilities.

LO 9-3 / Describe three alliance governance mechanisms and evaluate their pros and cons.

- Alliances can be governed by the following mechanisms: contractual agreements for non-equity alliances, equity alliances, and joint ventures.
- There are pros and cons of each alliance governance mechanism, shown in detail in Exhibit 9.2 with highlights as follows:

  Non-equity alliance's pros: flexible, fast, easy to get in and out; cons: weak ties, lack of trust/commitment.

  Equity alliance's pros: stronger ties, potential for trust/commitment, window into new technology (option value); cons: less flexible, slower, can entail significant investment.

  Joint venture pros: strongest tie, trust/commitment most likely, may be required by institutional setting; cons: potentially long negotiations and significant investments, long-term solution, managers may have two reporting lines (two bosses).

LO 9-4 / Describe the three phases of alliance management and explain how an alliance management capability can lead to a competitive advantage.

- An alliance management capability consists of a firm's ability to effectively manage alliance-related tasks through three phases: (1) partner selection and alliance formation, (2) alliance design and governance, and (3) post-formation alliance management.
- An alliance management capability can be a source of competitive advantage as better management of alliances leads to more likely superior performance.
- Firms build a superior alliance management capability through "learning by doing" and by establishing a dedicated alliance function.

LO 9-5 / Differentiate between mergers and acquisitions, and explain why firms would use either to execute corporate strategy.

- A merger describes the joining of two independent companies to form a combined entity.
- An acquisition describes the purchase or takeover of one company by another. It can be friendly or hostile.
- Although there is a distinction between mergers and acquisitions, many observers simply use the umbrella term *mergers and acquisitions,* or M&A.
- Firms can use M&A activity for competitive advantage when they possess a superior relational capability, which is often built on superior alliance management capability.

LO 9-6 / Define horizontal integration and evaluate the advantages and disadvantages of this option to execute corporate-level strategy.

- Horizontal integration is the process of merging with competitors, leading to industry consolidation.
- As a corporate strategy, firms use horizontal integration to (1) reduce competitive intensity, (2) lower costs, and (3) increase differentiation.

LO 9-7 / Explain why firms engage in acquisitions.

- Firms engage in acquisitions to (1) access new markets and distributions channels, (2) gain access to a new capability or competency, and (3) preempt rivals.

LO 9-8 / Evaluate whether mergers and acquisitions lead to competitive advantage.

- Most mergers and acquisitions destroy shareholder value because anticipated synergies never materialize.
- If there is any value creation in M&A, it generally accrues to the shareholders of the firm that is taken over (the acquiree), because acquirers

Chapter **10**

Global Strategy: Competing Around the World

Chapter Outline

10.1 What Is Globalization?
Stages of Globalization
State of Globalization

10.2 Going Global: Why?
Advantages of Going Global
Disadvantages of Going Global

10.3 Going Global: Where and How?
Where in the World to Compete? The CAGE Distance Framework
How Do MNEs Enter Foreign Markets?

10.4 Cost Reductions vs. Local Responsiveness: The Integration-Responsiveness Framework
International Strategy
Multidomestic Strategy
Global-Standardization Strategy
Transnational Strategy

10.5 National Competitive Advantage: World Leadership in Specific Industries
Porter's Diamond Framework

10.6 Implications for the Strategist

Learning Objectives

LO 10-1 Define globalization, multinational enterprise (MNE), foreign direct investment (FDI), and global strategy.

LO 10-2 Explain why companies compete abroad, and evaluate the advantages and disadvantages of going global.

LO 10-3 Apply the CAGE distance framework to guide MNE decisions on which countries to enter.

LO 10-4 Compare and contrast the different options MNEs have to enter foreign markets.

LO 10-5 Apply the integration-responsiveness framework to evaluate the four different strategies MNEs can pursue when competing globally.

LO 10-6 Apply Porter's diamond framework to explain why certain industries are more competitive in specific nations than in others.

CHAPTERCASE 10

The Wonder from Sweden: Is IKEA's Success Sustainable?

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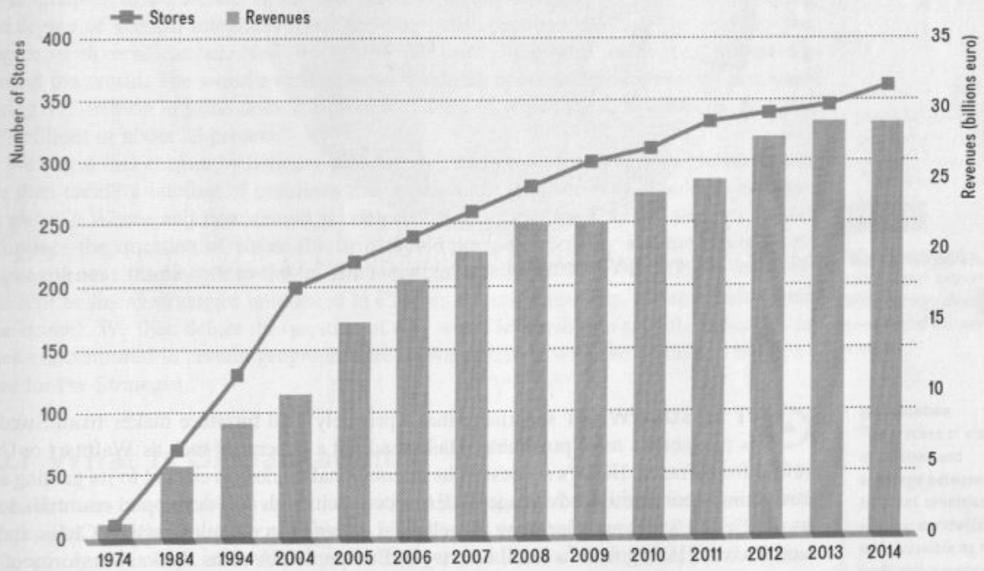
THE WORLD'S MOST profitable retailer is not Walmart, but IKEA—a privately owned home-furnishings company with origins in Sweden. By 2015, IKEA had more than 360 stores worldwide in over 40 countries, employed more than 150,000 people, and earned revenues of 37 billion euros. Exhibit 10.1 shows IKEA's growth in the number of stores and revenues worldwide since 1974.

Known today for its iconic blue-and-yellow big-box retail stores, focusing on flat-pack furniture boxes combined with a large do-it-yourself component, IKEA started as a small retail outlet in 1943 by then-17-year-old Ingvar Kamprad. Now a global phenomenon, it was initially slow to internationalize. It took 20 years before the company expanded beyond Sweden to its neighboring country of Norway. After honing and refining its core competencies of designing modern functional home furnishings at low prices and offering a unique retail experience in its home market, IKEA followed an *international*

EXHIBIT 10.1 / IKEA Stores and Revenues, 1974–2014



Source: Depiction of data from "The secret of IKEA's success," *The Economist*, February 24, 2011, and various IKEA "Yearly Summaries" (www.ikea.com).

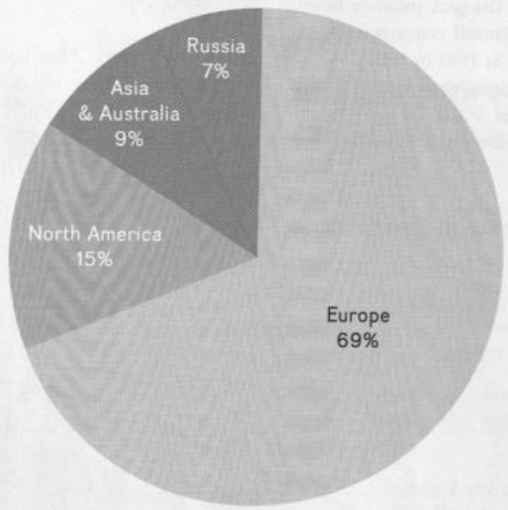
strategy, expanding first to Europe, and then beyond. Using an international strategy allowed IKEA to sell the same types of home furnishings across the globe with little adaptation, although it does make some allowances for country preferences.

Because keeping costs low is critical to IKEA's value innovation (see discussion in Chapter 6), it shifted from an international strategy to a *global-standardization strategy*, in which it attempts to achieve economies of scale through efficiently managing a global supply chain. Although Asia accounts currently for less than 10 percent of its sales, IKEA sources 35 percent of its inputs from this region. To drive costs down further, IKEA has begun to implement production techniques from auto and electronics industries, in which cutting-edge technologies are employed to address complexity while achieving flexibility and low cost.

IKEA's revenues by geographic region are 69 percent from Europe, with the rest from North America (15 percent), Asia and Australia (9 percent), and Russia (7 percent); see Exhibit 10.2. Although IKEA's largest market is in Germany (14 percent of total sales), its fastest-growing markets are the United States, China, and Russia.[1]

You will learn more about IKEA by reading this chapter; related questions appear on page 353.

EXHIBIT 10.2 / IKEA's Sales by Geographic Region (2014)



Source: Depiction of data from "IKEA's Yearly Summary FY 2014" (www.ikea.com).

IT IS SOMEWHAT surprising that a privately held furniture maker from Sweden is the world's most profitable retailer and not a behemoth such as Walmart or Carrefour from France. IKEA's success in its international markets is critical to its gaining and sustaining a competitive advantage. IKEA succeeds in both rich developed countries such as the United States and Germany as well as in emerging economies such as China, India, and Russia. Hailing from a small country in Europe, IKEA earns the vast majority of its revenues outside of its borders. Moreover, IKEA's fastest growth is outside Europe.

IKEA's strategic intent is to reach 50 billion euros in sales by 2020, up from 29 billion euros in 2014, and double its 2011 sales of 25 billion euro. IKEA wants to own 500 profitable stores globally by 2020, up from some 360 stores in 2014. To accomplish these lofty

goals, IKEA must get its global strategy right, especially in rapidly growing markets such as China and India. Both are countries with more than 1 billion people each and a rapidly growing middle class on which IKEA wants to capitalize.

For more and more U.S. companies, international markets offer the biggest growth opportunities, just as they do for IKEA. Firms from a wide variety of industries—such as Apple, Caterpillar, GE, Intel, and IBM—are global enterprises. They have a global work force and manage global supply chains, and they obtain the majority of their revenues from outside their home market. Once-unassailable U.S. firms now encounter formidable foreign competitors such as Brazil's Embraer (aerospace); China's Alibaba (ecommerce), Haier (home appliances), Lenovo (PCs), and Xiaomi (cell phones); India's ArcelorMittal (steel), Infosys (IT services), and Reliance Group (conglomerate); Germany's Siemens (engineering conglomerate), Daimler, BMW, and VW (vehicles); Japan's Toyota, Honda, and Nissan (vehicles); Mexico's Cemex (cement); Russia's Gazprom (energy); South Korea's LG and Samsung (both in electronics and appliances); and Sweden's IKEA (home furnishings), to name just a few. This chapter is about how firms gain and sustain competitive advantage when competing around the world.

The competitive playing field is becoming increasingly global, as the ChapterCase about the home-furnishings industry indicates. This globalization provides significant opportunities for individuals, companies, and countries. Indeed, you can probably see the increase in globalization on your own campus. The number of students enrolled at universities outside their native countries quadrupled between 1980 and 2014 to over 4 million.[2] The country of choice for foreign students remains the United States, with more than 1 million international students enrolled per year, followed by the UK. The top five countries sending the most students to study abroad are (in rank order): China, India, Korea, Germany, and Saudi Arabia.[3]

In Chapter 8, we looked at the first two dimensions of corporate strategy: managing the degree of vertical integration, and deciding which products and services to offer (the degree of diversification). Now we turn to the third dimension: competing effectively around the world. The world's marketplace—made up of some 200 countries—is a staggering $75 trillion in gross domestic product (GDP), of which the U.S. market is roughly $17 trillion, or about 23 percent.[4]

We begin this chapter by defining globalization and presenting stages of globalization. We then tackle a number of questions that a firm must answer: Why should a company go global? Where and how should it compete? We present the CAGE[5] distance model to answer the question of where the firm should compete globally and the integration-responsiveness framework to link a firm's options of how to compete globally with the different business strategies introduced in Chapter 6 (cost leadership, differentiation, and blue ocean). We then debate the question of why world leadership in specific industries is often concentrated in certain geographic areas. We conclude with the practical "Implications for the Strategist."

LO 10-1

Define globalization, multinational enterprise (MNE), foreign direct investment (FDI), and global strategy.

10.1 What Is Globalization?

Globalization is a process of closer integration and exchange between different countries and peoples worldwide, made possible by falling trade and investment barriers, advances in telecommunications, and reductions in transportation costs.[6] Combined, these factors reduce the costs of doing business around the world, opening the doors to a much larger market than any one home country. Globalization also allows companies to source supplies at lower costs, to learn new competencies, and to further differentiate products. Consequently, the world's market economies are becoming more integrated and interdependent.

globalization
The process of closer integration and exchange between different countries and peoples worldwide, made possible by falling trade and investment barriers, advances in telecommunications, and reductions in transportation costs.

Globalization has led to significant increases in living standards in many economies around the world. Germany and Japan, countries that were basically destroyed after World War II, turned into industrial powerhouses, fueled by export-led growth. The Asian Tigers—Hong Kong, Singapore, South Korea, and Taiwan—turned themselves from underdeveloped countries into advanced economies, enjoying some of the world's highest standards of living. The BRIC countries (Brazil, Russia, India, and China), with more than 40 percent of the world's population and producing roughly half of the world's economic growth over the past decade, continue to offer significant business opportunities.[7] Indeed, China, with over $9 trillion in GDP, has become the second-largest economy worldwide after the United States (with $17 trillion in GDP) and ahead of Japan in third place ($5 trillion GDP), in absolute terms.[8]

multinational enterprise (MNE) A company that deploys resources and capabilities in the procurement, production, and distribution of goods and services in at least two countries.

foreign direct investment (FDI) A firm's investments in value chain activities abroad.

global strategy Part of a firm's corporate strategy to gain and sustain a competitive advantage when competing against other foreign and domestic companies around the world.

The engine behind globalization is the **multinational enterprise (MNE)**—a company that deploys resources and capabilities in the procurement, production, and distribution of goods and services in at least two countries. By making investments in value chain activities abroad, MNEs engage in **foreign direct investment (FDI)**.[9] For example, the European aircraft maker Airbus is investing $600 million in Mobile, Alabama, to build jetliners.[10] It's doing so in order to avoid import restrictions, be closer to customers in North America, and take advantage of business-friendly conditions such as lower taxes, labor cost, and cost of living, plus other incentives provided by host states in the Southern United States. For similar reasons, German carmaker Volkswagen invested $1 billion in its Chattanooga, Tennessee, plant.[11] MNEs need an effective **global strategy** that enables them to gain and sustain a competitive advantage when competing against other foreign and domestic companies around the world.[12]

In the digital age, some companies are *born global*—their founders start them with the intent of running global operations. Internet-based companies such as Alibaba, Amazon, eBay, Google, and LinkedIn by nature have a global presence. Indeed, Facebook, with over 1.5 billion users around the globe, would—were it a country—be the most populous nation worldwide, even ahead of China (1.4 billion) and India (1.3 billion). To better customize their websites to suit local preferences and cultures, these companies tend to establish offices and maintain computer servers in different countries.[13] Amazon.com, for example, customizes its offerings for different markets. You can see country-specific sites at www.amazon.cn (China), www.amazon.de (Germany), and www.amazon.com.br (Brazil).

U.S. MNEs have a disproportionately positive impact on the U.S. economy.[14] Well-known U.S. multinational enterprises include Boeing, Caterpillar, Coca-Cola, GE, John Deere, Exxon Mobil, IBM, P&G, and Walmart. They make up less than 1 percent of the number of total U.S. companies, but they:

- Account for 11 percent of private-sector employment growth since 1990.
- Employ 19 percent of the work force.
- Pay 25 percent of the wages.
- Provide for 31 percent of the U.S. gross domestic product (GDP).
- Make up 74 percent of private-sector R&D spending.

As a business student, you have several reasons to be interested in MNEs. Not only can these companies provide interesting work assignments in different locations throughout the world, but they also frequently offer the highest-paying jobs for college graduates. Even if you don't want to work for an MNE, chances are that the organization you will be working for will do business with one, so it's important to understand how they compete around the globe.

STAGES OF GLOBALIZATION

Since the beginning of the 20th century, globalization has proceeded through three notable stages.[15] Each stage presents a different global strategy pursued by MNEs headquartered in the United States.

GLOBALIZATION 1.0: 1900–1941. Globalization 1.0 took place from about 1900 through the early years of World War II. In that period, basically all the important business functions were located in the home country. Typically, only sales and distribution operations took place overseas—essentially exporting goods to other markets. In some instances, firms procured raw materials from overseas. Strategy formulation and implementation, as well as knowledge flows, followed a one-way path—from domestic headquarters to international outposts. This time period saw the blossoming of the idea of MNEs. It ended with the U.S. entry into World War II.

GLOBALIZATION 2.0: 1945–2000. With the end of World War II came a new focus on growing business—not only to meet the needs that went unfulfilled during the war years but also to reconstruct the damage from the war. From 1945 to the end of the 20th century, in the Globalization 2.0 stage, MNEs began to create smaller, self-contained copies of themselves, with all business functions intact, in a few key countries; notably, Western European countries, Japan, and Australia.

This strategy required significant amounts of foreign direct investment. Although it was costly to duplicate business functions in overseas outposts, doing so allowed for greater local responsiveness to country-specific circumstances. While the U.S. corporate headquarters set overarching strategic goals and allocated resources through the capital budgeting process, local mini-MNE replicas had considerable leeway in day-to-day operations. Knowledge flow back to U.S. headquarters, however, remained limited in most instances.

GLOBALIZATION 3.0: 21ST CENTURY. We are now in the Globalization 3.0 stage. MNEs that had been the vanguard of globalization have since become global-collaboration networks (see Exhibit 10.3). Such companies now freely locate business functions anywhere in the world based on an optimal mix of costs, capabilities, and PESTEL factors. Huge investments in fiber-optic cable networks around the world have effectively reduced communication distances, enabling companies to operate 24/7, 365 days a year. When an engineer in Minneapolis, Minnesota, leaves for the evening, an engineer in Mumbai, India, begins her workday. In the Globalization 3.0 stage, the MNE's strategic objective changes. The MNE reorganizes from a multinational company with self-contained operations in a few selected countries to a more seamless global enterprise with centers of expertise. Each of these centers of expertise is a hub within a global network for delivering products and services. Consulting companies, for example, can now tap into a worldwide network of experts in real time, rather than relying on the limited number of employees in their local offices.

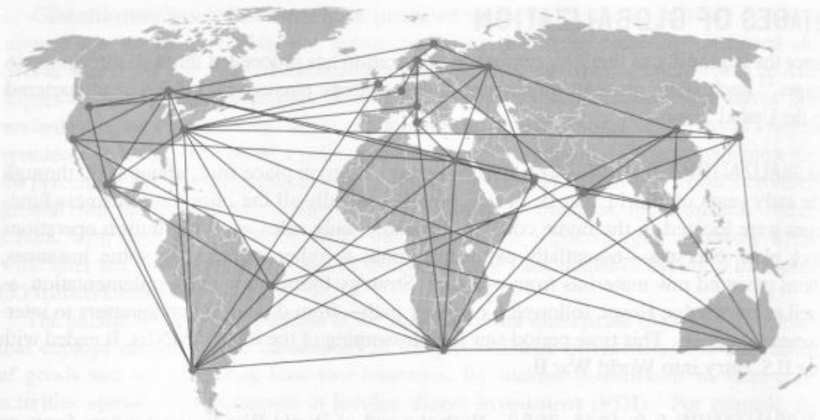
Creating a global network of local expertise is beneficial not only in service industries, but also in the industrial sector. To increase the rate of low-cost innovation that can then be used to disrupt existing markets, GE organizes local growth teams in China, India, Kenya, and many other emerging countries.[16] GE uses the slogan "in country, for country" to describe the local growth teams' autonomy in deciding which products and services to develop, how to make them, and how to shape the business model. Many of these low-cost innovations, first developed to serve local needs, are later introduced in Western markets to become disruptive innovations. Examples include the Vscan, a handheld ultrasound device

EXHIBIT 10.3

Globalization 3.0: 21st Century

Based on an optimal mix of costs, skills, and PESTEL factors, MNEs are organized as global-collaboration networks that perform business functions throughout the world.

Source: Adapted from IBM (2009), "A Decade of Generating Higher Value at IBM," www.ibm.com.



developed in China; the Mac 400, an ECG device developed in India—more details later in the chapter; and the 9100c, an anesthesia system developed in Kenya.[17]

Some new ventures organize as global-collaboration networks from the start. Logitech, the maker of wireless peripherals such as computer mice, presentation "clickers," and video game controllers, started in Switzerland but quickly established offices in Silicon Valley, California.[18] Pursuing a global strategy right from the start allowed Logitech to tap into the innovation expertise contained in Silicon Valley.[19] In 2014, Logitech had sales of over $2 billion, with offices throughout the Americas, Asia, and Europe. Underlying Logitech's innovation competence is a network of best-in-class skills around the globe. Moreover, Logitech can organize work continuously because its teams in different locations around the globe can work 24/7.

Indeed, the trend toward global collaboration networks during the Globalization 3.0 stage raises the interesting question, "What defines a U.S. company?" If it's the address of the headquarters, then IBM, GE, and others are U.S. companies—despite the fact that a majority of their employees work outside the United States. In many instances, the majority of their revenues also come from outside the United States. On the other hand, non-U.S. companies such as carmakers from Japan (Toyota, Honda, and Nissan) and South Korea (Hyundai and Kia) and several engineering companies (Siemens from Germany, and ABB, a Swiss-Swedish MNE) all have made significant investments in the United States and created a large number of well-paying jobs.

STATE OF GLOBALIZATION

Before we delve deeper into the question of why and how firms compete for advantage globally, a cautionary note concerning *globalization* is in order. Although many large firms are more than 50 percent globalized—meaning that more than half of their revenues are from outside the home country—the world itself is far less global.[20] If we look at a number of different indicators, the level of globalization is no more than 10 to 25 percent. For example, only

- 2 percent of all voice-calling minutes are cross-border.[21]
- 3 percent of the world's population are first-generation immigrants.
- 9 percent of all investments in the economy are foreign direct investments.
- 15 percent of patents list at least one foreign inventor.
- 18 percent of Internet traffic crosses national borders.

These data indicate that the world is not quite flat yet,[22] or fully globalized, but at best *semi-globalized*.[23] Pankaj Ghemawat reasons that many more gains in social welfare and living standards can be had through further globalization if future integration is managed effectively through coordinated efforts by governments.[24] The European Union is an example of coordinated economic and political integration by 28 countries, of which 19 use the euro as a common currency. This coordinated integration took place over several decades following World War II, precisely to prevent future wars in Europe. The EU now encompasses more than 500 million people. This makes it one of the largest economic zones in the world; indeed with a GDP of 19 trillion it is a little bit larger than the United States, the largest single country market in the world. Further coordinated integration appears to be one solution to the current eurozone crisis. Although the EU has monetary authority administered through the European Central Bank, it does not have fiscal (i.e., budgetary) authority. This important responsibility remains with national governments, leading to the sovereign debt crisis.

Continued economic development across the globe has two consequences for MNEs. First, rising wages and other costs are likely to negate any benefits of access to low-cost input factors. Second, as the standard of living rises in emerging economies, MNEs are hoping that increased purchasing power will enable workers to purchase the products they used to make for export only.[25] China's labor costs, for example, are steadily rising in tandem with an improved standard of living, especially in the coastal regions, where wages have risen 50 percent since 2005.[26] Some MNEs have boosted wages an extra 30 percent following labor unrest in recent years. Many now offer bonuses to blue-collar workers and are taking other measures to avoid sweatshop allegations that have plagued companies such as Nike, Apple, and Levi Strauss. Rising wages, fewer workers due to the effects of China's one-child-per-family policy, and appreciation of the Chinese currency now combine to lessen the country's advantage in low-cost manufacturing.[27] This shift is in alignment with the Chinese government's economic policy, which wants to see a move from "Made in China" to "Designed in China," to capture more of the value added.[28] The value added of manufacturing an iPhone by Foxconn in China is only about 5 percent.[29] We next discuss in more detail the reasons firms "go global."

10.2 Going Global: Why?

LO 10-2

Explain why companies compete abroad, and evaluate the advantages and disadvantages of a global strategy.

The decision to pursue a global strategy comes from the firm's assessment that doing so enhances its competitive advantage and that the benefits of globalization exceed the costs. Simply put, firms expand beyond their domestic borders if they can increase their economic value creation ($V - C$) and enhance competitive advantage. As detailed in Chapter 5, firms enlarge their competitive advantage by increasing a consumer's willingness to pay through higher perceived value based on differentiation and/or lower production and service delivery costs. Expanding beyond the home market, therefore, should reinforce a company's basis of competitive advantage—whether differentiation, low-cost, or value innovation. Here we consider both the advantages and disadvantages of expanding beyond the home market.

ADVANTAGES OF GOING GLOBAL

Why do firms expand internationally? The main reasons firms expand abroad are to

- Gain access to a larger market.
- Gain access to low-cost input factors.
- Develop new competencies.

Strategy Highlight 10.1

The Gulf Airlines Are Landing in the United States

Fasten your seat belts Delta, American, and United. Severe turbulence may be ahead.

New entrants into both the domestic and international routes are increasing the competitive pressure on U.S. legacy air carriers. Three airlines—Emirates, Etihad Airways, and Qatar Airways—all from the Persian Gulf, are using a blue ocean strategy to attract new customers. The gulf carriers offer higher quality at lower cost to break into international routes, the last remaining profit sanctuary of U.S. carriers. The legacy carriers have long been squeezed domestically by low-cost competitors such as Southwest, Frontier, Spirit, and others (see Strategy Highlight 3.2). Although most of the future growth is in Asia, the United States remains the world's largest air traffic market, still holding on to one-third of all business.

But look at the latest U.S. competitors. The gulf carriers make flying enjoyable again, getting away from the Greyhound bus feel adopted in the 1980s and persisting today at U.S. carriers. At many U.S. airlines, service has deteriorated as air travel has become a commodity, and price has become the main competitive weapon. The gulf airlines, in contrast, bring back some of the service and glamour that used to be associated with air travel. They offer amenities such as higher-quality complimentary meals and hot towels in economy, in addition, to an open bar in business class, and private suites with showers in first. Their ratio of flight attendants to passengers is also greater, including offering flying nannies to keep kids occupied, happy, and most importantly not crying. In their home base, they build airports reminiscent of luxury hotels with swimming pools above the concourse for laps during layovers, high-speed Wi-Fi, high-end conference rooms with the latest audiovisual equipment, plush lounges, and many other amenities.

Given their location on the Persian peninsula, the gulf airlines offer direct flights to major hubs in Europe, Asia, and the United States, using the newest and most modern aircraft. Their reach via direct flights extends to about 80 percent of the world's population. In particular, the gulf carriers are already connecting Europe and Asia, having taken away major business from European airlines such as Lufthansa of Germany and British Airways. Moreover, traditional international airport hubs such as London, Frankfurt, and Amsterdam all have lost a large share of their business to the new luxury hubs in Dubai, Abu Dhabi, and Doha. The gulf carriers are now attempting to repeat this feat in the United States, offering direct flights to and from Atlanta, Boston, Chicago, Dallas, Houston, Los Angeles, New York, and Orlando.

There are some complaints by U.S. carriers, however, that the Persian Gulf airlines receive unfair subsidies. CEOs of U.S. carriers have turned to politicians in Washington to stem the onslaught of the gulf carriers. They demand that the competition by gulf carriers should be curbed. Customers, however, are voting with their wallets by flocking to the gulf carriers, enjoying competitive prices and a better service experience. Moreover, the gulf carriers counter that U.S. airlines have long enjoyed tightly regulated markets, restricting foreign competition. Moreover, they also remind the public that each of the U.S. legacy carriers has used bankruptcy filings to obtain debt relief, and that some legacy carriers received direct government bailouts. They suggest that the investments made by the government owners of the Persian Gulf carriers are merely equity investments as done by other stockholders.

One thing is clear, the competitive pressure by the gulf carriers on U.S. legacy carriers will only increase. The Persian Gulf states have decided that international air travel is a strategic future industry for the region. To back up their intent, the carriers made strong strategic commitments, not only by building the most modern and luxurious airports in the world, but also by locking up about half of the airframe makers' future production capacity. In particular, they ordered new super-modern, long-range airplanes made by Boeing (such as the new 787 Dreamliner) and Airbus (such as the A-380, the superjumbo). The gulf carriers are already the fastest-growing airlines globally, yet they continue to push into larger markets and more attractive routes. In the meantime, consumers enjoy the benefits of globalization: more choice, more routes, better service and amenities, as well as lower prices.[30]

GAIN ACCESS TO A LARGER MARKET. Becoming an MNE provides significant opportunities for companies, given *economies of scale* and *scope* that can be reaped by participating in a much larger market. Companies that base their competitive advantage on *economies of scale* and *economies of scope* have an incentive to gain access to larger markets because this can reinforce the basis of their competitive advantage. This in turn allows MNEs to outcompete local rivals. In Strategy Highlight 6.1, we detailed how Narayana Health, a specialty hospital chain in India, founded and led by Dr. Devi Shetty, obtained a low-cost competitive advantage in complex procedures such as open heart surgery. Narayana Health is now leveraging its low-cost, high-quality position by opening specialty hospitals in the Cayman Islands (to serve U.S. patients) and Kuala Lumpur, Malaysia.

At the same time, some countries with relatively weak domestic demand, such as China, Germany, South Korea, and Japan, focus on export-led economic growth, which drives many of their domestic businesses to become MNEs. For companies based in smaller economies, becoming an MNE may be necessary to achieve growth or to gain and sustain competitive advantage. Examples include Acer (Taiwan), Casella Wines (Australia), IKEA (featured in the ChapterCase), Nestlé (Switzerland), Novo Nordisk (Denmark), Philips (Netherlands), Samsung (South Korea), and Zara (Spain). Unless companies in smaller economies expand internationally, their domestic markets are often too small for them to reach significant economies of scale to compete effectively against other MNEs. Strategy Highlight 10.1 shows how the Persian Gulf airlines (all coming from small countries) are entering the much larger U.S. and international markets, competing directly with legacy carriers such as American, Delta, and United.

GAIN ACCESS TO LOW-COST INPUT FACTORS. MNEs that base their competitive advantage on a low-cost leadership strategy are particularly attracted to go overseas to gain access to low-cost input factors. Access to low-cost raw *materials* such as lumber, iron ore, oil, and coal was a key driver behind Globalization 1.0 and 2.0. During Globalization 3.0, firms have expanded globally to benefit from lower *labor costs* in manufacturing and services. India carved out a competitive advantage in business process outsourcing (BPO), not only because of low-cost labor but because of an abundance of well-educated, English-speaking young people. Infosys, TCS, and Wipro are some of the more well-known Indian IT service companies. Taken together, these companies employ more than 250,000 people and provide services to many of the Global Fortune 500. Many MNEs have close business ties with Indian IT firms. Some, such as IBM, are engaged in foreign direct investment through equity alliances or building their own IT and customer service centers in India. More than a quarter of Accenture's work force, a consultancy specializing in technology and outsourcing, is now in Bangalore, India.[31]

Likewise, China has emerged as a manufacturing powerhouse because of low labor costs and an efficient infrastructure. An American manufacturing worker costs about 20 times more in wages alone than a similarly skilled worker in China.[32] A significant cost differential exists not only for low-skilled labor, but for high-skilled labor as well. A Chinese engineer trained at Purdue University, for example, works for only a quarter of the salary in his native country compared with an engineer working in the United States.[33] Of course, this absolute wage disparity also reflects the relative difference in the two countries' cost of living.

DEVELOP NEW COMPETENCIES. Some MNEs pursue a global strategy in order to develop new competencies.[34] This motivation is particularly attractive for firms that base their competitive advantage on a differentiation strategy. These companies are making foreign direct investments to be part of *communities of learning*, which are often contained in specific geographic regions.[35] AstraZeneca, a Swiss-based pharmaceutical company, relocated its research facility to Cambridge, Massachusetts, to be part of the Boston biotech cluster, in hopes of developing new R&D competencies in biotechnology.[36] Cisco invested more

A GE team in China developed the Vscan, an inexpensive, portable ultrasound device, costing some $5,000, rather than $250,000—the cost of a traditional ultrasound machine used in Western hospitals. The Vscan is now widely used in rural areas of developing countries (as shown here in Vietnam), and has made its entry as a disruptive innovation in the United States and other rich countries. © Thierry Falise/LightRocket via Getty Images

than $1.6 billion to create an Asian headquarters in Bangalore and support other locations in India, in order to be in the middle of India's top IT location.[37] Unilever's new-concept center is located in downtown Shanghai, China, attracting hundreds of eager volunteers to test the firm's latest product innovations on-site, while Unilever researchers monitor consumer reactions. In these examples, AstraZeneca, Cisco, and Unilever all reap **location economies**—benefits from locating value chain activities in optimal geographies for a specific activity, wherever that may be.[38]

Many MNEs now are replacing the one-way innovation flow from Western economies to developing markets with a *polycentric innovation strategy*—a strategy in which MNEs now draw on multiple, equally important innovation hubs throughout the world characteristic of Globalization 3.0; see Exhibit 10.3. GE Global Research, for example, orchestrates a "network of excellence" with facilities in Niskayuna, New York (USA); Bangalore (India); Shanghai (China); and Munich (Germany). Indeed, emerging economies are becoming hotbeds for low-cost innovations that find their way back to developed markets.[39] In Bangalore, GE researchers developed the Mac 400, a handheld electrocardiogram (ECG).[40] The device is small, portable, and runs on batteries. Although a conventional ECG machine costs $2,000, this handheld version costs $800 and enables doctors to do an ECG test at a cost of only $1 per patient. The Mac 400 is now entering the United States and other Western markets as a disruptive innovation, with anticipated widespread use in the offices of general practitioners and emergency ambulances.

DISADVANTAGES OF GOING GLOBAL

Companies expanding internationally must carefully weigh the benefits and costs of doing so. If the cost of going global as captured by the following disadvantages exceeds the expected benefits in terms of value added ($C > V$), that is, if the economic value creation is negative, then firms are better off by not expanding internationally. Disadvantages to going global include

- Liability of foreignness.
- Loss of reputation.
- Loss of intellectual property.

location economies Benefits from locating value chain activities in the world's optimal geographies for a specific activity, wherever that may be.

LIABILITY OF FOREIGNNESS. In international expansion, firms face risks. In particular, MNEs doing business abroad also must overcome the **liability of foreignness**. This liability consists of the additional costs of doing business in an unfamiliar cultural and economic environment, and of coordinating across geographic distances.[41] Strategy Highlight 10.2 illustrates how Walmart underestimated its liability of foreignness when entering and competing in Germany.

liability of foreignness Additional costs of doing business in an unfamiliar cultural and economic environment, and of coordinating across geographic distances.

LOSS OF REPUTATION. One of the most valuable resources that a firm may possess is its reputation. A firm's reputation can have several dimensions, including a reputation for innovation, customer service, or brand reputation. Apple's brand, for example, stands for innovation and superior customer experience. Apple's brand reputation is also one of its most important resources. Apple's brand is valued at $250 billion, making it the most

Strategy Highlight 10.2

Walmart Retreats from Germany

After losing billions of dollars, Walmart exited Germany in 2006. The massive failure came as a shock to a company that was used to success. What went wrong?

Around 1998, facing a saturated U.S. market, Walmart entered Germany, then the third-largest economy in the world behind the United States and Japan. At that time, the big-box retailer was already active in six foreign countries, with some 500 stores outside U.S. borders. Given the intense pressure for cost reductions in the retail industry and Walmart's superior strategic position as the dominant cost leader in the United States, executives decided to pursue a similar low-cost strategy in Germany.

To enter Germany, Walmart acquired the 21-store Wertkauf chain and 74 hypermarkets from German retailer Spar Handels AG. Next, Walmart attempted to implement its U.S. personnel policies and procedures: the Walmart cheer, a door greeter, every associate within 10 feet of a customer smiling and offering help, bagging groceries at the checkout, video surveillance, a prohibition against dating co-workers, and so on. German employees, however, simply refused to comply. There were no door greeters in the German Walmart stores. The front-line employees behaved as gruffly as they do in other retail outlets in Germany. It also didn't help that the first Walmart boss in Germany was installed from Walmart headquarters in Bentonville, Arkansas. The executive didn't speak any German and simply decreed that English would be the official in-house language.

Significant cultural differences aside, one of the biggest problems Walmart faced in Germany was that, lacking its usual economies of scale and efficient distribution centers, it couldn't get its costs down far enough to successfully implement its trademark cost-leadership strategy. Higher required wages and restrictive labor laws further drove up costs. As a result, the prices at Walmart in Germany were not "always low" as the company slogan suggested, but fell in the medium range. Germany was already home to retail discount powerhouses such as Aldi and Lidl, with thousands of smaller outlets offering higher convenience combined with lower prices. Walmart was unable to be cost-competitive against such tough domestic competition. It also faced Metro, a dominant large-box retailer, that upon entering Germany immediately initiated a price war against Walmart. In the end, a defeated Walmart sold its stores to—guess who?—Metro!

Walmart experienced a similar fate in South Korea, where it also exited in 2006. In addition, Walmart has tried for many years to successfully enter the fast-growing markets in Russia and India, but with little or no success. Walmart's success recipe that worked so well domestically didn't work in Germany, South Korea, Russia, or India—to a large part because of the liability of foreignness.[42]

valuable in the world.[43] We detailed in Chapter 4 that a brand can be the basis for a competitive advantage if it is valuable, rare, and difficult to imitate.

Globalizing a supply chain can have unintended side effects. These can lead to a loss of reputation and diminish the MNE's competitiveness. A possible loss in reputation can be a considerable risk and cost for doing business abroad. Because Apple's stellar consumer reputation is critical to its competitive advantage, it should be concerned about any potential negative exposure from its global activities. Problems at Apple's main supplier, Foxconn, brought this concern to the fore.

Low wages, long hours, and poor working and living conditions contributed to a spate of suicides at Foxconn, Apple's main supplier in China.[44] The Taiwanese company, which employs more than a million people, manufactures computers, tablets, smartphones, and other consumer electronics for Apple and other leading consumer electronics companies. The backlash against alleged sweatshop conditions in Foxconn prompted Apple to work with its main supplier to improve working conditions and wages. Tim Cook, Apple's CEO, visited Foxconn in China to personally inspect its manufacturing facility and workers' living conditions. Although conditions at Foxconn have been improving,[45] Apple started to diversify its supplier base by adding Pegatron, another Taiwanese original equipment manufacturer (OEM).[46]

MNEs' search for low-cost labor has had tragic effects where local governments are corrupt and unwilling or unable to enforce a minimum of safety standards. The textile industry is notorious for sweatshop conditions, and many Western companies such as the Gap (U.S.), H&M (Sweden), and Carrefour (France) have taken a big hit to their reputation in factory accidents in Bangladesh and elsewhere in Southeast Asia. Hundreds of factory workers were killed when a textile factory collapsed in Rana Plaza in 2013 on the outskirts of Dhaka, Bangladesh.[47] Although much of the blame lies with the often corrupt host governments not enforcing laws, regulations, and building codes, the MNEs that source their textiles in these factories also receive some of the blame with negative consequences for their reputation. The MNEs are accused of exploiting workers and being indifferent to their working conditions and safety, all in an unending quest to drive down costs.

This challenge directly concerns the MNEs' *corporate social responsibility (CSR)*, discussed in Chapter 2. Since some host governments are either unwilling or unable to enforce regulation and safety codes, MNEs need to rise to the challenge.[48] Walmart responded by posting a public list of "banned suppliers" on its website. These are suppliers that do not meet adequate safety standards and working conditions. Before the Rana Plaza accident, Walmart had already launched a working and fire-safety academy in Bangladesh to train textile workers.

Given the regulatory and legal void that local governments often leave, several Western MNEs have proposed a concerted action to finance safety efforts and worker training as well as structural upgrades to factory buildings. After earlier revelations about the frequent practice of child labor in many developing countries, Western MNEs in the textile industry worked together to ban their suppliers from using child labor. Ensuring ethical sourcing of raw materials and supplies is becoming ever more important. Besides a moral responsibility, MNEs have a market incentive to protect their reputations given the public backlash in the wake of factory accidents, child labor, worker suicides, and other horrific externalities.

LOSS OF INTELLECTUAL PROPERTY. Finally, the issue of protecting intellectual property in foreign markets also looms large. The software, movie, and music industries have long lamented large-scale copyright infringements in many foreign markets. In addition, when required to partner with a foreign host firm, companies may find their intellectual property being siphoned off and reverse-engineered.

Japanese and European engineering companies entered China to participate in building the world's largest network of high-speed trains worth billions of dollars.[49] Companies such as Kawasaki Heavy Industries (Japan), Siemens (Germany), and Alstom (France) were joint venture partners with domestic Chinese companies. These firms now allege that the Chinese partners built on the Japanese and European partners' advanced technology to create their own, next-generation high-speed trains. To make matters worse, they also claim that the Chinese companies now compete against them in other lucrative markets, such as Saudi Arabia, Brazil, and even California, with trains of equal or better capabilities but at much lower prices. This example highlights the *intellectual property exposure* that firms can face when expanding overseas.

LO 10-3

Apply the CAGE distance framework to guide MNE decisions on which countries to enter.

10.3 Going Global: Where and How?

After discussing why companies expand internationally, we now turn to the question of how to guide MNE decisions on which countries to enter and how to then enter those countries.

WHERE IN THE WORLD TO COMPETE? THE CAGE DISTANCE FRAMEWORK

The question of where to compete geographically is, following vertical integration and diversification, the third dimension of determining a firm's corporate strategy. The primary driver behind firms expanding beyond their domestic market is to strengthen their competitive position by gaining access to larger markets and low-cost input factors and to develop new competencies. So wouldn't companies choose new markets solely based on logical measures, such as per capita consumptions of the product and per capita income?

Yes and no. Consider that several countries and locations can score similarly on such *absolute* metrics of attractiveness. Ireland and Portugal, for example, have similar cost structures, and both provide access to some 500 million customers in the European Union. Both countries use the euro as a common currency, and both have a similarly educated work force and infrastructure. Given these similarities, how does an MNE decide? Rather than looking at absolute measures, MNEs need to consider *relative distance* in the CAGE model.

To aid MNEs in deciding where in the world to compete, Pankaj Ghemawat introduced the **CAGE distance framework**. CAGE is an acronym for different kinds of distance:

- Cultural
- Administrative and political
- Geographic
- Economic.[50]

CAGE distance framework
A decision framework based on the *relative* distance between home and a foreign target country along four dimensions: cultural distance, administrative and political distance, geographic distance, and economic distance.

Most of the costs and risks involved in expanding beyond the domestic market are created by *distance*. Distance not only denotes geographic distance (in miles or kilometers), but also includes, as the CAGE acronym points out, cultural distance, administrative and political distance, and economic distance. The CAGE distance framework breaks distance into different relative components between any two country pairs that affect the success of FDI.

Although absolute metrics such as country wealth or market size matter to some extent—as we know, for example, that a 1 percent increase in country wealth leads to a 0.8 percent increase in international trade—the relative factors captured by the CAGE distance model matter more. For instance, countries that are 5,000 miles apart trade only 20 percent of the amount traded among countries that are 1,000 miles apart. Cultural distance matters even more. A common language increases trade between two countries by 200 percent over country pairs without one. Thus, in the earlier example regarding which EU country to select for FDI, a U.S. MNE should pick Ireland, while a Brazilian MNE should select Portugal. In the latter case, Brazil and Portugal also share a historic colony–colonizer relationship. This link increases the expected trade intensity between these two countries by yet another 900 percent in comparison to country pairs where absent.

Other CAGE distance factors are significant in predicting the amount of trade between two countries. If the countries belong to the same regional trading bloc, they can expect another 330 percent in trade intensity. Examples include the United States and Mexico in NAFTA, or the 28 member states of the European Union. If the two countries use the same currency it increases trade intensity by 340 percent. An example is use of the euro as the common currency in 19 of 28 EU countries.[51]

Exhibit 10.4 presents the CAGE distance model. In particular, it details factors that increase the overall distance between the two countries and how distance affects different industries or products along the CAGE dimensions.[52] Next, we briefly discuss each of the CAGE distance dimensions.[53]

EXHIBIT 10.4 / The CAGE Distance Framework

Distance	C Cultural	A Administrative and Political	G Geographic	E Economic
between two countries increases with . . .	• Different languages, ethnicities, religions, social norms, and dispositions • Lack of connective ethnic or social networks • Lack of trust and mutual respect	• Absence of trading bloc • Absence of shared currency, monetary or political association • Absence of colonial ties • Political hostilities • Weak legal and financial institutions	• Lack of common border, waterway access, adequate transportation, or communication links • Physical remoteness • Different climates and time zones	• Different consumer incomes • Different costs and quality of natural, financial, and human resources • Different information or knowledge
most affects industries or products . . .	• With high linguistic content (TV) • Related to national and/or religious identity (foods) • Carrying country-specific quality associations (wines)	• That a foreign government views as staples (electricity), as building national reputations (aerospace), or as vital to national security (telecommunications)	• With low value-to-weight ratio (cement) • That are fragile or perishable (glass, meats) • In which communications are vital (financial services)	• For which demand varies by income (cars) • In which labor and other cost differences matter (textiles)

Source: Adapted from P. Ghemawat (2001), "Distance still matters: The hard reality of global expansion," *Harvard Business Review*, September: 137–147.

national culture
The collective mental and emotional "programming of the mind" that differentiates human groups.

CULTURAL DISTANCE. In his seminal research, Geert Hofstede defined and measured **national culture**, the collective mental and emotional "programming of the mind" that differentiates human groups.[54] Culture is made up of a collection of social norms and mores, beliefs, and values. Culture captures the often unwritten and implicitly understood rules of the game.

Although there is no one-size-fits-all culture that accurately describes any nation, Hofstede's work provides a useful tool to proxy cultural distance. Based on data analysis from more than 100,000 individuals from many different countries, four main dimensions of culture emerged: *Power distance, individualism, masculinity–femininity,* and *uncertainty avoidance.*[55] Hofstede's data analysis yielded scores for the different countries, for each dimension, on a range of zero to 100, with 100 as the high end. More recently, Hofstede added two additional cultural dimensions: *long-term orientation* and *indulgence.*[56]

Cultural differences find their expression in language, ethnicity, religion, and social norms. They directly affect customer preferences (see Exhibit 10.4). Because of their religious beliefs, for example, Hindus do not eat beef, while Muslims do not eat pork. In terms of content-intensive service, cultural and language differences are also the reason global Internet companies such as Amazon or Google offer country-specific variations of their sites. Despite these best efforts, they are often outflanked by native providers because of their deeper cultural understanding. For example, in China the leading websites are domestic ones: Alibaba in ecommerce, and Baidu in online search. In Russia, the leading ecommerce site is Ozon, while the leading search engine is Yandex.

Hofstede's national-culture research becomes even more useful for managers by combining the distinct dimensions of culture into an aggregate measure for each country. MNEs then can compare the national-culture measures for any two country pairings to inform their entry decisions.[58] The difference between scores indicates **cultural distance**, the cultural disparity between the internationally expanding firm's home country and its targeted host country. A firm's decision to enter certain international markets is influenced by cultural differences. A greater cultural distance can increase the cost and uncertainty of conducting business abroad. In short, greater cultural distance increases the liability of foreignness.

cultural distance
Cultural disparity between an internationally expanding firm's home country and its targeted host country.

If we calculate the cultural distance from the United States to various countries, for example, we find that some countries are culturally very close to the United States. Australia, for example, has an overall cultural distance score of 0.02. Others are culturally quite distant. Russia has an overall cultural distance score of 4.42. As can be expected, English-speaking countries such as Canada (0.12), Ireland (0.35), New Zealand (0.26), and the UK (0.09) all exhibit a low cultural distance to the United States. Since culture is embedded in language, it comes as no surprise that cultural and linguistic differences are highly correlated.

Culture even matters in the age of Facebook with its global reach of 1.5 billion users. Most Facebook friends are local rather than across borders. This makes sense when one considers that the online social graph that Facebook users develop in their network of friends is actually a virtual network laid above a (pre)existing social network, rather than forming one anew.[59]

In 2000 when Starbucks entered the Chinese market, it moved fast to overcome cultural barriers by handing out key chains to help new customers order! Now it leverages Chinese approaches to social media (WeChat, Weibo, and Jiepang) and fine-tunes its own mobile apps and loyalty programs to lure China's growing middle class. The result? Today China is its second-largest market and growing.[57] Courtesy of Resonance China

ADMINISTRATIVE AND POLITICAL DISTANCE. Administrative and political distances are captured in factors such as the absence or presence of shared monetary or political associations, political hostilities, and weak or strong legal and financial institutions.[60] The 19 European countries in the eurozone, for example, not only share the same currency but also integrate politically to some extent. It should come as no surprise then that most cross-border trade between European countries takes place within the EU. Germany, one of the world's largest exporters, conducts roughly 75 percent of its cross-border business within the EU.[61] Similarly, Canada and Mexico partner with the United States in the North American Free Trade Agreement (NAFTA), increasing trade in goods and services between the three countries. Colony–colonizer relationships also have a strong positive effect on bilateral trade between countries. British companies continue to trade heavily with businesses from its former colonies in the commonwealth; Spanish companies trade heavily with Latin American countries; and French businesses trade with the franc zone of West Africa.

Many foreign (target) countries also erect other political and administrative barriers, such as tariffs, trade quotas, FDI restrictions, and so forth, to protect domestic competitors. In many instances, China, for example, requests the sharing of technology in a joint venture when entering the country. This was the case in the high-speed train developments discussed earlier. Other countries, including the United States and EU members, protect national

champions such as Boeing or Airbus from foreign competition. Industries that are considered critical to national security—domestic airlines or telecommunications—are often protected. Finally, strong legal and ethical pillars as well as well-functioning economic institutions such as capital markets and an independent central bank reduce distance. Strong institutions, both formal and informal, reduce uncertainty and thus reduce transaction costs.[62]

GEOGRAPHIC DISTANCE. The costs to cross-border trade rise with geographic distance. It is important to note, however, that geographic distance does not simply capture how far two countries are from each other but also includes additional attributes, such as the country's physical size (Canada versus Singapore), the within-country distances to its borders, the country's topography, its time zones, and whether the countries are contiguous to one another or have access to waterways and the ocean. The country's infrastructure, including road, power, and telecommunications networks, also plays a role in determining geographic distance. Geographic distance is particularly relevant when trading products with low value-to-weight ratios, such as steel, cement, or other bulk products, and fragile and perishable products, such as glass or fresh meats and fruits.

ECONOMIC DISTANCE. The wealth and per capita income of consumers is the most important determinant of economic distance. Wealthy countries engage in relatively more cross-border trade than poorer ones. Rich countries tend to trade with other rich countries; in addition, poor countries also trade more frequently with rich countries than with other poor countries. Companies from wealthy countries benefit in cross-border trade with other wealthy countries when their competitive advantage is based on *economies of experience, scale, scope,* and *standardization.* This is because replication of an existing business model is much easier in a country where the incomes are relatively similar and resources, complements, and infrastructure are of roughly equal quality. Although Walmart in Canada is a virtual carbon copy of the Walmart in the United States, Walmart in China is quite different.[63]

Companies from wealthy countries also trade with companies from poor countries to benefit from *economic arbitrage.* The textile industry (discussed earlier) is a prime example. We also highlighted economic arbitrage as one of the main benefits of going global: access to low-cost input factors.

In conclusion, although the CAGE distance framework helps determine the attractiveness of foreign target markets in a more fine-grained manner based on relative differences, it is necessarily only a first step. A deeper analysis requires looking inside the firm (as done in Chapter 4) to see how a firm's strengths and weaknesses work to increase or reduce distance from specific foreign markets. A company with a large cadre of cosmopolitan managers and a diverse work force will be much less affected by cultural differences, for example, than a company with a more insular and less diverse culture with all managers from the home country. Although technology may make the world seem smaller, the costs of distance along all its dimensions are real. The costs of distance in expanding internationally are often very high. Ignoring these costs can be expensive (see Walmart's adventure in Germany, discussed in Strategy Highlight 10.2) and lead to a competitive disadvantage.

HOW DO MNEs ENTER FOREIGN MARKETS?

LO 10-4

Compare and contrast the different options MNEs have to enter foreign markets.

Assuming an MNE has decided why and where to enter a foreign market, the remaining decision is *how* to do so. Exhibit 10.5 displays the different options managers have when entering foreign markets, along with the required investments necessary and the control they can exert. On the left end of the continuum in Exhibit 10.5 are vehicles of foreign

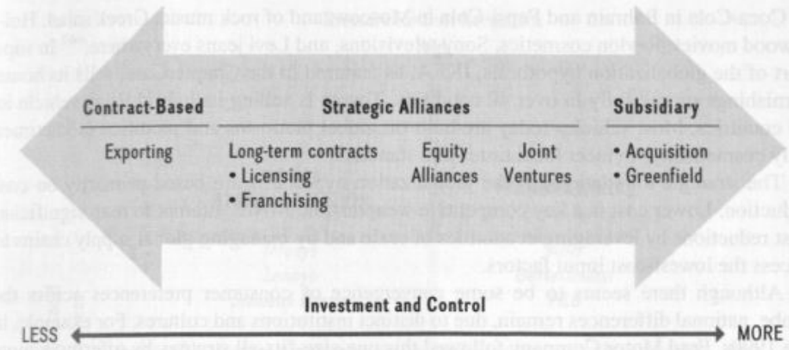


EXHIBIT 10.5 Modes of Foreign-Market Entry along the Investment and Control Continuum

expansion that require low investments but also allow for a low level of control. On the right are foreign-entry modes that require a high level of investments in terms of capital and other resources, but also allow for a high level of control. Foreign-entry modes with a high level of control such as foreign acquisitions or greenfield plants reduce the firm's exposure to two particular downsides of global business: loss of reputation and loss of intellectual property.

Exporting—producing goods in one country to sell in another—is one of the oldest forms of internationalization (part of Globalization 1.0). It is often used to test whether a foreign market is ready for a firm's products. When studying vertical integration and diversification (in Chapter 8), we discussed in detail different forms along the make-or-buy continuum. As discussed in Chapter 9, strategic alliances (including licensing, franchising, and joint ventures) and acquisitions are popular vehicles for entry into foreign markets. Since we discussed these organizational arrangements in detail in previous chapters, we therefore keep this section on foreign-entry modes brief.

The framework illustrated in Exhibit 10.5, moving from left to right, has been suggested as a *stage model* of sequential commitment to a foreign market over time.[64] Though it does not apply to globally born companies, it is relevant for manufacturing companies that are just now expanding into global operations. In some instances, companies are required by the host country to form joint ventures in order to conduct business there, while some MNEs prefer *greenfield operations*—building new, fully owned plants and facilities from scratch, as Motorola did when it entered China in the 1990s.[65]

10.4 Cost Reductions vs. Local Responsiveness: The Integration-Responsiveness Framework

LO 10-5

Apply the integration-responsiveness framework to evaluate the four different strategies MNEs can pursue when competing globally.

MNEs face two opposing forces when competing around the globe: *cost reductions* versus *local responsiveness* in a way that can affect strategy. Indeed, cost reductions achieved through a global-standardization strategy often reinforce a cost-leadership strategy at the business level. Similarly, local responsiveness increases the differentiation of products and services, reinforcing a differentiation strategy at the business level.

One of the core drivers for globalization is to expand the total market of firms in order to achieve economies of scale and drive down costs. For many business executives, the move toward globalization is based on the **globalization hypothesis**, which states that consumer needs and preferences throughout the world are converging and thus becoming increasingly homogenous.[66] Theodore Levitt stated: "Nothing confirms [the globalization hypothesis] as much as the success of McDonald's from [the] Champs-Élysées to Ginza,

globalization hypothesis Assumption that consumer needs and preferences throughout the world are converging and thus becoming increasingly homogenous.

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of Coca-Cola in Bahrain and Pepsi-Cola in Moscow, and of rock music, Greek salad, Hollywood movies, Revlon cosmetics, Sony televisions, and Levi jeans everywhere."[67] In support of the globalization hypothesis, IKEA, as featured in the ChapterCase, sells its home furnishings successfully in over 40 countries. Toyota is selling its hybrid Prius vehicle in 80 countries. Most vehicles today are built on global platforms and modified (sometimes only cosmetically) to meet local tastes and standards.

The strategic foundations of the globalization hypothesis are based primarily on cost reduction. Lower cost is a key competitive weapon, and MNEs attempt to reap significant cost reductions by leveraging economies of scale and by managing global supply chains to access the lowest-cost input factors.

Although there seems to be some convergence of consumer preferences across the globe, national differences remain, due to distinct institutions and cultures. For example, in the 1990s, Ford Motor Company followed this one-size-fits-all strategy by offering a more or less identical car throughout the world: the Ford Mondeo, sold as the Ford Contour and the Mercury Mystique in North America. Ford learned the hard way, by lack of sales, that consumers did not subscribe to the globalization hypothesis at the same level as the Ford executives and were not yet prepared to ignore regional differences.[68] In some instances, MNEs experience pressure for **local responsiveness**—the need to tailor product and service offerings to fit local consumer preferences and host-country requirements; it generally entails higher costs. Walmart sells live animals (snakes, eels, toads, etc.) for food preparation in China. IKEA sells kimchi refrigerators and metal chopsticks in South Korea. McDonald's uses mutton instead of beef in India and offers a teriyaki burger in Japan, even though its basic business model of offering fast food remains the same the world over. Local responsiveness generally entails higher cost, and sometimes even outweighs cost advantages from economies of scale and lower-cost input factors.

local responsiveness The need to tailor product and service offerings to fit local consumer preferences and host-country requirements.

Given the two opposing pressures of cost reductions versus local responsiveness, scholars have advanced the **integration-responsiveness framework**, shown in Exhibit 10.6.[69] This framework juxtaposes the opposing pressures for cost reductions and local responsiveness to derive four different strategic positions to gain and sustain competitive advantage when competing globally. The four strategic positions, which we will discuss in the following sections, are

- International
- Multidomestic
- Global-standardization
- Transnational[70]

integration-responsiveness framework Strategy framework that juxtaposes the pressures an MNE faces for cost reductions and local responsiveness to derive four different strategies to gain and sustain competitive advantage when competing globally.

At the end of that discussion, Exhibit 10.8 summarizes each global strategy.

INTERNATIONAL STRATEGY

An **international strategy** is essentially a strategy in which a company sells the same products or services in both domestic and foreign markets. It enables MNEs to leverage their home-based core competencies in foreign markets. An international strategy is one of the oldest types of global strategies (Globalization 1.0) and is frequently the first step companies take when beginning to conduct business abroad. As shown in the integration-responsiveness framework, it is advantageous when the MNE faces low pressures for both local responsiveness and cost reductions.

international strategy Strategy that involves leveraging home-based core competencies by selling the same products or services in both domestic and foreign markets.

An international strategy is often used successfully by MNEs with relatively large domestic markets and with strong reputations and brand names. These MNEs, capitalizing on the fact that foreign customers want to buy the original product, tend to use

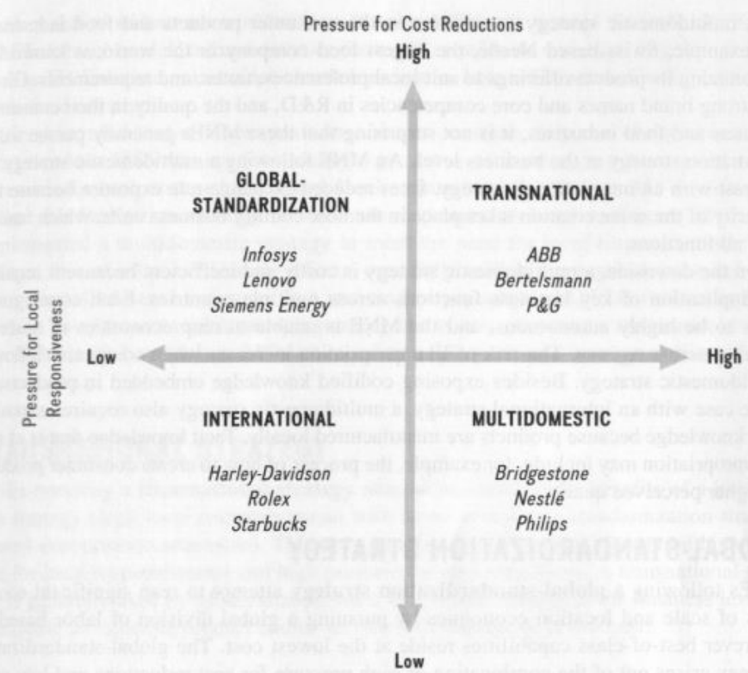


EXHIBIT 10.6 The Integration-Responsiveness Framework: Global Strategy Positions and Representative MNEs

differentiation as their preferred business strategy. For example, bikers in Shanghai, China, like their Harley-Davidson motorcycles to roar just like the ones ridden by the Hells Angels in the United States. Similarly, a Brazilian entrepreneur importing machine tools from Germany expects superior engineering and quality. An international strategy tends to rely on exporting or the licensing of products and franchising of services to reap economies of scale by accessing a larger market.

A strength of the international strategy—its limited local responsiveness—is also a weakness in many industries. For example, when an MNE sells its products in foreign markets with little or no change, it leaves itself open to the expropriation of intellectual property (IP). Looking at the MNE's products and services, pirates can reverse-engineer the products to discover the intellectual property embedded in them. In Thailand, for example, a flourishing market for knockoff luxury sports cars (e.g., Ferraris, Lamborghinis, and Porsches) has sprung up.[71] Besides the risk of exposing IP, MNEs following an international strategy are highly affected by exchange-rate fluctuations. Given increasing globalization, however, fewer and fewer markets correspond to this situation—low pressures for local responsiveness *and* cost reductions—that gives rise to the international strategy.

MULTIDOMESTIC STRATEGY

MNEs pursuing a **multidomestic strategy** attempt to maximize local responsiveness, hoping that local consumers will perceive their products or services as local ones. This strategy arises out of the combination of high pressure for local responsiveness and low pressure for cost reductions. MNEs frequently use a multidomestic strategy when entering host countries with large and/or idiosyncratic domestic markets, such as Japan or Saudi Arabia. This is one of the main strategies MNEs pursued in the Globalization 2.0 stage.

multidomestic strategy Strategy pursued by MNEs that attempts to maximize local responsiveness, with the intent that local consumers will perceive them to be domestic companies.

A multidomestic strategy is common in the consumer products and food industries. For example, Swiss-based Nestlé, the largest food company in the world, is known for customizing its product offerings to suit local preferences, tastes, and requirements. Given the strong brand names and core competencies in R&D, and the quality in their consumer products and food industries, it is not surprising that these MNEs generally pursue a differentiation strategy at the business level. An MNE following a multidomestic strategy, in contrast with an international strategy, faces reduced exchange-rate exposure because the majority of the value creation takes place in the host-country business units, which tend to span all functions.

On the downside, a multidomestic strategy is costly and inefficient because it requires the duplication of key business functions across multiple countries. Each country unit tends to be highly autonomous, and the MNE is unable to reap economies of scale or learning across regions. The risk of IP appropriation increases when companies follow a multidomestic strategy. Besides exposing codified knowledge embedded in products, as is the case with an international strategy, a multidomestic strategy also requires exposing tacit knowledge because products are manufactured locally. Tacit knowledge that is at risk of appropriation may include, for example, the process of how to create consumer products of higher perceived quality.

GLOBAL-STANDARDIZATION STRATEGY

global-standardization strategy Strategy attempting to reap significant economies of scale and location economies by pursuing a global division of labor based on wherever best-of-class capabilities reside at the lowest cost.

MNEs following a **global-standardization strategy** attempt to reap significant economies of scale and location economies by pursuing a global division of labor based on wherever best-of-class capabilities reside at the lowest cost. The global-standardization strategy arises out of the combination of high pressure for cost reductions and low pressure for local responsiveness. MNEs using this strategy are often organized as networks (Globalization 3.0). This lets them strive for the lowest-cost position possible. Their business-level strategy tends to be cost leadership. Because there is little or no differentiation or local responsiveness because products are standardized, price becomes the main competitive weapon. To be price competitive, the MNE must maintain a minimum efficient scale (see Chapter 6).

MNEs that manufacture commodity products such as computer hardware or offer services such as business process outsourcing generally pursue a global-standardization strategy. Lenovo, the Chinese computer manufacturer, is the maker of the ThinkPad line of laptops, which it acquired from IBM in 2005. To keep track of the latest developments in computing, Lenovo's research centers are located in Beijing and Shanghai in China, in Raleigh, North Carolina (in the Research Triangle Park), and in Japan.[72] To benefit from low-cost labor and to be close to its main markets in order to reduce shipping costs, Lenovo's manufacturing facilities are in Mexico, India, and China. The company describes the benefits of its global-standardization strategy insightfully: "Lenovo organizes its worldwide operations with the view that a truly global company must be able to quickly capitalize on new ideas and opportunities from anywhere. By forgoing a traditional headquarters model and focusing on centers of excellence around the world, Lenovo makes the maximum use of its resources to create the best products in the most efficient and effective way possible."[73]

One of the advantages of the global-standardization strategy—obtaining the lowest cost point possible by minimizing local adaptations—is also one of its key weaknesses. The American MTV network cable channel started out with a global-standardization strategy.[74] The main inputs—music videos by vocal artists—were sourced more or less globally based on the prevailing music hits. MTV reasoned that music videos were a commodity

product that would attract worldwide audiences. MTV was wrong! As indicated by the CAGE distance model, cultural distance most affects products with high linguistic content such as TV. Even in a music video channel, audiences have a distinct preference for at least some local content.

Keep in mind that strategic positions are not constant; they can change over time. Consider how MTV changed its strategic positions as it attempted to respond to the pressures for both cost reduction and local responsiveness. At first, MTV followed a global standardization strategy. To be more responsive to local audiences, MTV then implemented a multidomestic strategy to meet the need for local responsiveness. This led to a loss of all possible scale effects, especially rolling out expensive content over a large installed base of viewers. In a move a few years later, MTV shifted its strategic position away from a multidomestic strategy and is now pursuing a transnational strategy. Exhibit 10.7 tracks how MTV changed strategic positions in its quest for competitive advantage.

TRANSNATIONAL STRATEGY

transnational strategy Strategy that attempts to combine the benefits of a localization strategy (high local responsiveness) with those of a global-standardization strategy (lowest-cost position attainable).

MNEs pursuing a **transnational strategy** attempt to combine the benefits of a localization strategy (high local responsiveness) with those of a global-standardization strategy (lowest-cost position attainable). This strategy arises out of the combination of high pressure for local responsiveness and high pressure for cost reductions. A transnational strategy is generally used by MNEs that pursue a blue ocean strategy at the business level by attempting to reconcile product and/or service differentiations at low cost.

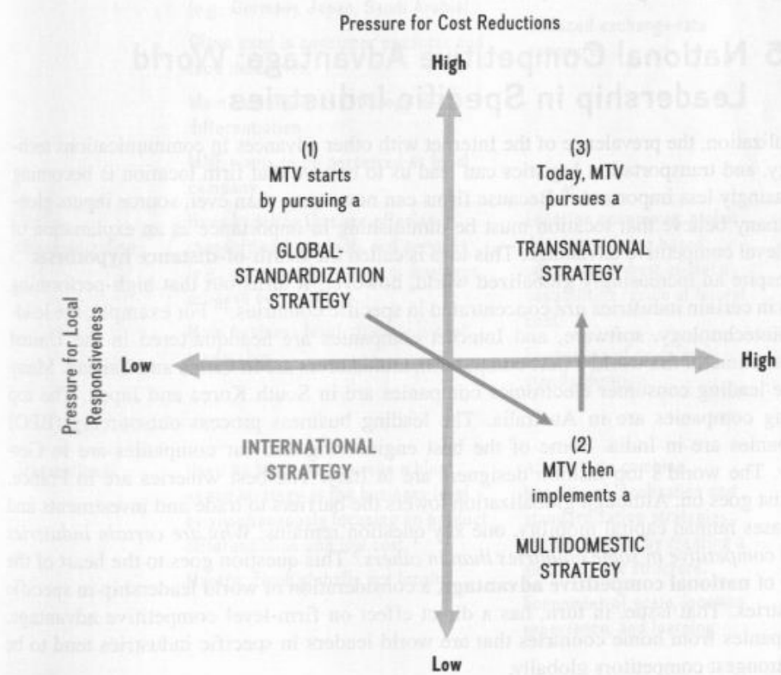


EXHIBIT 10.7 Dynamic Strategic Positioning: The MTV Music Chanel

Besides harnessing economies of scale and location, a transnational strategy also aims to benefit from global learning. MNEs typically implement a transnational strategy through a global matrix structure. That structure combines economies of scale along specific product divisions with economies of learning attainable in specific geographic regions. The idea is that best practices, ideas, and innovations will be diffused throughout the world, regardless of their origination. The managers' mantra is to *think globally, but act locally.*

Although a transnational strategy is quite appealing, the required matrix structure is rather difficult to implement because of the organizational complexities involved. High local responsiveness typically requires that key business functions are frequently duplicated in each host country, leading to higher costs. Further compounding the organizational complexities is the challenge of finding managers who can dexterously work across cultures in the ways required by a transnational strategy. We'll discuss organizational structure in more depth in the next chapter.

The German multimedia conglomerate Bertelsmann attempts to follow a transnational strategy. Bertelsmann employs over 100,000 people, with two-thirds of that work force outside its home country. Bertelsmann operates in more than 60 countries throughout the world and owns many regional leaders in their specific product categories, including Random House Publishing in the United States and RTL Group, Europe's second-largest TV, radio, and production company (after the BBC). Bertelsmann operates its over 500 regional media divisions as more or less autonomous profit-and-loss centers but attempts to share best practices across units; global learning and human resource strategies for executives are coordinated at the network level.[75]

As a summary, Exhibit 10.8 provides a detailed description of each of the four global strategies in the integration-responsiveness framework.

10.5 National Competitive Advantage: World Leadership in Specific Industries

Globalization, the prevalence of the Internet with other advances in communications technology, and transportation logistics can lead us to believe that firm location is becoming increasingly less important.[76] Because firms can now, more than ever, source inputs globally, many believe that location must be diminishing in importance as an explanation of firm-level competitive advantage. This idea is called the **death-of-distance hypothesis**.[77]

death-of-distance hypothesis
Assumption that geographic location alone should not lead to firm-level competitive advantage because firms are now, more than ever, able to source inputs globally.

Despite an increasingly globalized world, however, it turns out that high-performing firms in certain industries *are* concentrated in specific countries.[78] For example, the leading biotechnology, software, and Internet companies are headquartered in the United States. Some of the world's best computer manufacturers are in China and Taiwan. Many of the leading consumer electronics companies are in South Korea and Japan. The top mining companies are in Australia. The leading business process outsourcing (BPO) companies are in India. Some of the best engineering and car companies are in Germany. The world's top fashion designers are in Italy. The best wineries are in France. The list goes on. Although globalization lowers the barriers to trade and investments and increases human capital mobility, one key question remains: *Why are certain industries more competitive in some countries than in others?* This question goes to the heart of the issue of **national competitive advantage**, a consideration of world leadership in specific industries. That issue, in turn, has a direct effect on firm-level competitive advantage. Companies from home countries that are world leaders in specific industries tend to be the strongest competitors globally.

national competitive advantage
World leadership in specific industries.

EXHIBIT 10.8 / International, Multidomestic, Global-Standardization, and Transnational Strategies: Characteristics, Benefits, and Risks

Strategy	Characteristics	Benefits	Risks
International	Often the first step in internationalizing. Used by MNEs with relatively large domestic markets or strong exporters (e.g., MNEs from the United States, Germany, Japan, South Korea). Well-suited for high-end products with high value-to-weight ratios such as machine tools and luxury goods that can be shipped across the globe. Products and services tend to have strong brands. Main business-level strategy tends to be differentiation because exporting, licensing, and franchising add additional costs.	Leveraging core competencies. Economies of scale. Low-cost implementation through: • Exporting or licensing (for products) • Franchising (for services) • Licensing (for trademarks)	No or limited local responsiveness. Highly affected by exchange-rate fluctuations. IP embedded in product or service could be expropriated.
Multidomestic	Used by MNEs to compete in host countries with large and/or lucrative but idiosyncratic domestic markets (e.g., Germany, Japan, Saudi Arabia). Often used in consumer products and food industries. Main business-level strategy is differentiation. MNE wants to be perceived as local company.	Highest-possible local responsiveness. Increased differentiation. Reduced exchange-rate exposure.	Duplication of key business functions in multiple countries leads to high cost of implementation. Little or no economies of scale. Little or no learning across different regions. Higher risk of IP expropriation.
Global-Standardization	Used by MNEs that are offering standardized products and services (e.g., computer hardware or business process outsourcing). Main business-level strategy is cost leadership.	Location economies: global division of labor based on wherever best-of-class capabilities reside at lowest cost. Economies of scale and standardization.	No local responsiveness. Little or no product differentiation. Some exchange-rate exposure. "Race to the bottom" as wages increase. Some risk of IP expropriation.
Transnational	Used by MNEs that pursue a blue ocean strategy at the business level by simultaneously focusing on product differentiation and low cost. Mantra: Think globally, act locally.	Attempts to combine benefits of localization and standardization strategies simultaneously by creating a global matrix structure. Economies of scale, location, experience, and learning.	Global matrix structure is costly and difficult to implement, leading to high failure rate. Some exchange-rate exposure. Higher risk of IP expropriation.

LO 10-6

Apply Porter's diamond framework to explain why certain industries are more competitive in specific nations than in others.

PORTER'S DIAMOND FRAMEWORK

Michael Porter advanced a framework to explain national competitive advantage—why are some nations outperforming others in specific industries. This framework is called Porter's diamond of national competitive advantage. As shown in Exhibit 10.9, it consists of four interrelated factors:

- Factor conditions.
- Demand conditions.
- Competitive intensity in focal industry.
- Related and supporting industries/complementors.

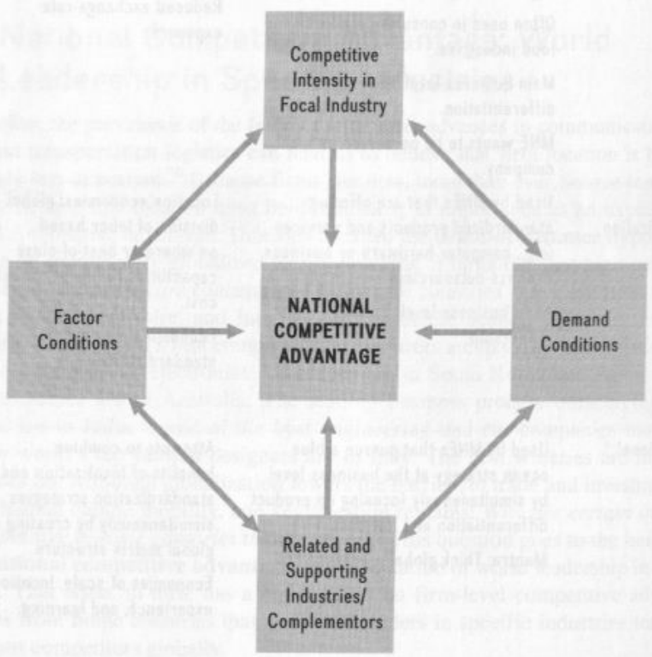
FACTOR CONDITIONS. *Factor conditions* describe a country's endowments in terms of natural, human, and other resources. Other important factors include capital markets, a supportive institutional framework, research universities, and public infrastructure (airports, roads, schools, health care system), among others.

Interestingly, *natural resources* are often not needed to generate world-leading companies, because competitive advantage is often based on other factor endowments such as human capital and know-how. Several of the world's most resource-rich countries (such as Afghanistan,[79] Iran, Iraq, Russia, Saudi Arabia, and Venezuela) are not home to any of the world's leading companies, even though some (though not all) do have in place institutional frameworks allowing them to be a productive member of world commerce. In contrast, countries that lack natural resources (e.g., Denmark, Finland, Israel, Japan, Singapore, South Korea, Switzerland, Taiwan, and the Netherlands) often develop world-class human capital to compensate.[80]

EXHIBIT 10.9 /

Porter's Diamond of National Competitive Advantage

Source: Adapted from M.E. Porter (1990). "The competitive advantage of nations." *Harvard Business Review*, March–April: 78.



DEMAND CONDITIONS. *Demand conditions* are the specific characteristics of demand in a firm's domestic market. A home market made up of sophisticated customers who hold companies to a high standard of value creation and cost containment contributes to national competitive advantage. Moreover, demanding customers may also clue firms in to the latest developments in specific fields and may push firms to move research from basic findings to commercial applications for the marketplace.

For example, due to dense urban living conditions, hot and humid summers, and high energy costs, it is not surprising that Japanese customers demand small, quiet, and energy-efficient air conditioners. In contrast to the Japanese, Finns have a sparse population living in a more remote countryside. A lack of landlines for telephone service has resulted in the Finnish demand for high-quality wireless services, combined with reliable handsets (and long-life batteries) that can be operated in remote, often hostile, environments. Cell phones have long been a necessity for survival in rural areas of Finland. This situation enabled Nokia to become an early leader in cell phones.[81]

COMPETITIVE INTENSITY IN A FOCAL INDUSTRY. Companies that face a highly competitive environment at home tend to outperform global competitors that lack such intense domestic competition. Fierce domestic competition in Germany, for example, combined with demanding customers and the no-speed-limit autobahn make a tough environment for any car company. Success requires top-notch engineering of chassis and engines, as well as keeping costs and fuel consumption ($9-per-gallon gas) in check. This extremely tough home environment amply prepared German car companies such as Volkswagen (which also owns Audi and Porsche), BMW, and Daimler for global competition.

RELATED AND SUPPORTING INDUSTRIES/COMPLEMENTORS. Leadership in related and supporting industries can also foster world-class competitors in downstream industries. The availability of top-notch *complementors*—firms that provide a good or service that leads customers to value the focal firm's offering more when the two are combined—further strengthens national competitive advantage. Switzerland, for example, leveraged its early lead in industrial chemicals into pharmaceuticals.[82] A sophisticated health care service industry sprang up alongside as an important complementor, to provide further stimulus for growth and continuous improvement and innovation.

The effects of sophisticated customers and highly competitive industries ripple through the industry value chain to create top-notch suppliers and complementors. Toyota's global success in the 1990s and early 2000s was based to a large extent on a network of world-class suppliers in Japan.[83] This tightly knit network allowed for fast two-way knowledge sharing—this in turn improved Toyota's quality and lowered its cost, which it leveraged into a successful blue ocean strategy at the business level.

It is also interesting to note that by 2010, Toyota's supplier advantage had disappeared.[84] It was unable to solve the trade-off between drastically increasing its volume and maintaining superior quality. Toyota's rapid growth in its quest to become the world's leader in volume required quickly bringing on new suppliers outside Japan. Quality standards, however, could not be maintained. Part of the problem lies in path dependence (discussed in Chapter 4), because Chinese and other suppliers could not be found quickly enough, nor could most foreign suppliers build at the required quality levels fast enough. The cultural distance between Japan and China exacerbated these

problems. Combined, these factors explain the quality problems Toyota experienced recently and highlight the importance of related and supporting industries to national competitive advantage.

10.6 ◄► Implications for the Strategist

In addition to determining the degree of vertical integration and level of diversification, the strategist needs to decide if and how the firm should compete beyond its home market. Decisions along all three dimensions formulate the firm's corporate strategy. Because of increasing global integration in products and services as well as capital markets, the benefits of competing globally outweigh the costs for more and more enterprises. This is true not just for large MNEs, but also for small and medium ones (SMEs). Even small startups are now able to leverage technology such as the Internet to compete beyond their home market.

Strategists have a number of frameworks at their disposal to make global strategy decisions. The CAGE framework allows for a detailed analysis of any country pairing. Rather than looking at simple absolute measures such as market size, the strategist can determine the *relative* distance or closeness of a target market to the home market along cultural, administrative/political, geographic, and economic dimensions. Once the strategist has decided which countries to enter, the *mode* of foreign entry needs to be determined. Considerations of the degree of investment and level of control help in this decision. Higher levels of control, and thus greater protection of IP and a lower likelihood of any loss in reputation, go along with more investment-intensive foreign-entry modes such as acquisitions or greenfield plants (see Exhibit 10.5).

A firm's business-level strategy (discussed in Chapter 6) provides an important clue to possible strategies to be pursued globally. A cost leader, for example, is more likely to have the capabilities to be successful with a global-standardization strategy. In contrast, a differentiator is more likely to be successful in pursuing an international or multidomestic strategy. The same caveats raised concerning a blue ocean strategy at the business level apply at the corporate level: Although attractive on paper, a transnational strategy combining high pressures for cost reductions with high pressures for local responsiveness is difficult to implement because of inherent trade-offs.

Finally, the strategist must be aware of the fact that despite globalization and the emergence of the Internet, firm geographic location has actually maintained its importance. Critical masses of world-class firms are clearly apparent in *regional geographic clusters*. Think of computer technology firms in Silicon Valley, medical device firms in the Chicago area, and biotechnology firms in and around Boston. This is a worldwide phenomenon. Known for their engineering prowess, car companies such as Daimler, BMW, Audi, and Porsche are clustered in southern Germany. Many fashion-related companies (clothing, shoes, and accessories) are located in northern Italy. Singapore is a well-known cluster for semiconductor materials, and India's leading IT firms are in Bangalore. Porter captures this phenomenon succinctly: "Paradoxically, the enduring competitive advantages in a global economy lie increasingly in local things—knowledge, relationships, and motivation that distant rivals cannot match."[85]

This concludes our discussion of global strategy. Moreover, we have now completed our study of the first two pillars of the AFI framework—*strategy analysis* (Chapters 1–5) and *strategy formulation* (Chapters 6–10). Next, we turn to the third and final pillar of the AFI framework—*strategy implementation*. In Chapter 11, we'll study what managers can do to implement their carefully crafted strategies successfully and how to avoid failure. In Chapter 12, we study corporate governance and business ethics.

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CHAPTERCASE 10 / Consider This...

DESPITE ITS TREMENDOUS success, IKEA faces significant external and internal challenges going forward. Opening new stores is critical to drive future growth (see Exhibit 10.1). Finding new sources of supply to support more store openings, however, is a significant challenge. Although demand for IKEA's low-cost home furnishings increased during the global financial crisis as more customers became price conscious, IKEA's annual store growth has slowed to less than 10 new stores a year. This is because its global supply chain has become a bottleneck. IKEA has difficulty finding suppliers that are a strategic fit with its highly efficient operations. Related to this issue is the fact that wood remains one of IKEA's main input factors, and the world's consumers are becoming more sensitive to the issue of deforestation and its possible link to global warming. In the near future, IKEA must find low-cost replacement materials for wood. In addition, powerful competitors have taken notice of IKEA's success. Although IKEA is growing in North America, it holds less than 5 percent of the home-furnishings market. To keep IKEA at bay in the United States, Target has recently recruited top designers and launched a wide range of low-priced furnishings. In some European markets, IKEA holds 30 percent market share.

Besides these external challenges, IKEA also faces significant internal ones. Since the company's founding in 1943, no strategic decisions have been made without Kamprad's involvement and explicit approval. In 2013, Kamprad (in his late 80s) stepped down from chairing Inter IKEA, the foundation that owns the company, and passed the position to one of his sons. Many observers compare Kamprad's influence on IKEA's culture and organization to that of the legendary Sam Walton at Walmart. Kamprad's three sons will take on stronger leadership roles at IKEA.

Moreover, IKEA is privately held through a complicated network of foundations and holding companies in the Netherlands, Lichtenstein, and Luxembourg. This arrangement provides benefits in terms of reducing tax exposure, but also creates constraints in accessing large sums of capital needed for rapid global expansion. In addition, many EU countries as well as the United States have become increasingly more sensitive to the issue of tax avoidance schemes by large multinational enterprises. IKEA will need to address these challenges to live up to its strategic intent of doubling its number of yearly openings in an attempt to capture a larger slice of fast-growing markets such as the United States, China, and Russia.

Questions

1. Ingvar Kamprad's influence over IKEA may even be stronger than that of Sam Walton over Walmart because IKEA is privately held, while Walmart is a public company (since 1970). Walmart entered a period of difficulties after Sam Walton stepped down (in 1988 at age 70). Do you anticipate IKEA having similar leadership transition challenges? Why or why not?
2. Did it surprise you to learn that both a rich developed country (the United States) and emerging economies (i.e., China and Russia) are the fastest-growing international markets for IKEA? Does this fact pose any challenges in the way IKEA ought to compete across the globe? Why or why not?
3. What can IKEA do to continue to drive growth globally, especially given its strategic intent to double annual store openings?
4. Assume you are hired to consult IKEA on the topic of *corporate social responsibility* (see the discussion in Chapter 2). Which areas would you recommend the company be most sensitive to, and how should these be addressed?

TAKE-AWAY CONCEPTS

This chapter discussed the roles of MNEs for economic growth; the stages of globalization; why, where, and how companies go global; four strategies MNEs use to navigate between cost reductions and local responsiveness; and national competitive advantage, as summarized by the following learning objectives and related take-away concepts.

LO 10-1 / Define globalization, multinational enterprise (MNE), foreign direct investment (FDI), and global strategy.

- Globalization involves closer integration and exchange between different countries and peoples worldwide, made possible by factors such as falling trade and investment barriers, advances in telecommunications, and reductions in transportation costs.
- A multinational enterprise (MNE) deploys resources and capabilities to procure, produce, and distribute goods and services in at least two countries.
- Many MNEs are more than 50 percent globalized; they receive the majority of their revenues from countries other than their home country.
- Product, service, and capital markets are more globalized than labor markets. The level of everyday activities is roughly 10 to 25 percent integrated, and thus *semi-globalized.*
- Foreign direct investment (FDI) denotes a firm's investments in value chain activities abroad.

LO 10-2 / Explain why companies compete abroad, and evaluate the advantages and disadvantages of going global.

- Firms expand beyond their domestic borders if they can increase their economic value creation ($V - C$) and enhance competitive advantage
- Advantages to competing internationally include gaining access to a larger market, gaining access to low-cost input factors, and developing new competencies.
- Disadvantages to competing internationally include the liability of foreignness, the possible loss of reputation, and the possible loss of intellectual capital.

LO 10-3 / Apply the CAGE distance framework to guide MNE decisions on which countries to enter.

- Most of the costs and risks involved in expanding beyond the domestic market are created by *distance.*
- The CAGE distance framework determines the *relative* distance between home and foreign target country along four dimensions: cultural distance, administrative and political distance, geographic distance, and economic distance.

LO 10-4 / Compare and contrast the different options MNEs have to enter foreign markets.

- The strategist has the following foreign-entry modes available: exporting, strategic alliances (licensing for products, franchising for services), joint venture, and subsidiary (acquisition or greenfield).
- Higher levels of control, and thus a greater protection of IP and a lower likelihood of any loss in reputation, go along with more investment-intensive foreign-entry modes such as acquisitions or greenfield plants.

LO 10-5 / Apply the integration-responsiveness framework to evaluate the four different strategies MNEs can pursue when competing globally.

- To navigate between the competing pressures of cost reductions and local responsiveness, MNEs have four strategy options: international, multidomestic, global-standardization, and transnational.
- An international strategy leverages home-based core competencies into foreign markets, primarily through exports. It is useful when the MNE faces low pressures for both local responsiveness and cost reductions.
- A multidomestic strategy attempts to maximize local responsiveness in the face of low pressure for cost reductions. It is costly and inefficient because it requires the duplication of key business functions in multiple countries.
- A global-standardization strategy seeks to reap economies of scale and location by pursuing a global division of labor based on wherever best-of-class capabilities reside at the lowest cost. It involves little or no local responsiveness.
- A transnational strategy attempts to combine the high local responsiveness of a localization strategy with the lowest-cost position attainable from a global-standardization strategy. It also aims to benefit from global learning. Although appealing, it is difficult to implement due to the organizational complexities involved.

LO 10-6 / Apply Porter's diamond framework to explain why certain industries are more competitive in specific nations than in others.

- National competitive advantage, or world leadership in specific industries, is created rather than inherited.
- Four interrelated factors explain national competitive advantage: (1) factor conditions, (2) demand conditions, (3) competitive intensity in a focal industry, and (4) related and supporting industries/complementors.
- Even in a more globalized world, the basis for competitive advantage is often local.

KEY TERMS

CAGE distance framework *(p. 339)*
Cultural distance *(p. 341)*
Death-of-distance hypothesis *(p. 348)*
Foreign direct investment (FDI) *(p. 330)*
Global-standardization strategy *(p. 346)*
Global strategy *(p. 330)*
Globalization *(p. 329)*
Globalization hypothesis *(p. 343)*
Integration-responsiveness framework *(p. 344)*
International strategy *(p. 344)*
Liability of foreignness *(p. 336)*
Local responsiveness *(p. 344)*
Location economies *(p. 336)*
Multidomestic strategy *(p. 345)*
Multinational enterprise (MNE) *(p. 330)*
National competitive advantage *(p. 348)*
National culture *(p. 340)*
Transnational strategy *(p. 347)*

DISCUSSION QUESTIONS

1. Multinational enterprises (MNEs) have an impact far beyond their firm boundaries. Assume you are working for a small firm that supplies a product or service to an MNE. How might your relationship change as the MNE moves from Globalization 2.0 to Globalization 3.0 operations?
2. Professor Pankaj Ghemawat delivered a TED talk titled "Actually, the World Isn't Flat." Do you agree with his assessment that the world is at most *semi-globalized,* and that we need to be careful not to fall victim to "globalony"? View the talk at: www.ted.com/talks/pankaj_ghemawat_actually_the_world_isn_t_flat?language=en.
3. The chapter notes that global strategy can change over time for a firm. MTV is highlighted as one example in Exhibit 10.7. Conduct a web search of a firm you know to be operating internationally and determine its current global strategy position. How long has the firm stayed with this approach? Can you find evidence it had a different global strategy earlier?
4. "Licensing patented technology to a foreign competitor is likely to reduce or eliminate the firm's competitive advantage." True or false? Write a paragraph discussing this statement.

ETHICAL/SOCIAL ISSUES

1. A "race-to-the-bottom" process may set in as MNEs search for ever-lower-cost locations. Discuss the trade-offs between the positive effects of raising the standard of living in some of the world's poorest countries with the drawbacks of moving jobs established in one country to another. Does your perspective change in light of the recent accidents in textile factories in Bangladesh, Cambodia, and elsewhere, where the cumulative death was over 1,000 workers? What responsibilities do MNEs have?

Chapter **11**

Organizational Design: Structure, Culture, and Control

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Chapter Outline

11.1 Organizational Design and Competitive Advantage
Organizational Inertia: The Failure of Established Firms
Organizational Structure
Mechanistic vs. Organic Organizations

11.2 Strategy and Structure
Simple Structure
Functional Structure
Multidivisional Structure
Matrix Structure

11.3 Organizational Culture: Values, Norms, and Artifacts
Where Do Organizational Cultures Come From?
How Does Organizational Culture Change?
Organizational Culture and Competitive Advantage

11.4 Strategic Control-and-Reward Systems
Input Controls
Output Controls

11.5 Implications for the Strategist

Learning Objectives

LO 11-1 Define organizational design and list its three components.

LO 11-2 Explain how organizational inertia can lead established firms to failure.

LO 11-3 Define organizational structure and describe its four elements.

LO 11-4 Compare and contrast mechanistic versus organic organizations.

LO 11-5 Describe different organizational structures and match them with appropriate strategies.

LO 11-6 Describe the elements of organizational culture, and explain where organizational cultures can come from and how they can be changed.

LO 11-7 Compare and contrast different strategic control-and-reward systems.

Zappos: From Happiness to Holacracy

DELIVERING HAPPINESS is the title of *The New York Times* bestseller by Tony Hsieh, CEO of Zappos, the online shoe and clothing store (www.zappos.com). Today, Zappos stocks more than 3 million shoes, handbags, clothing items, eyewear, and accessories from over 1,200 brands. Shoes continue to be the main business for Zappos, bringing in some three-quarters of revenues and making it the world's largest shoe store. Delivering happiness is also Zappos' mission. The company is known for "delivering WOW through service," providing a positive online shopping experience including free shipping to and from its customers, including a generous 365-day return policy.

In addition to making customers happy, Zappos has also made its investors happy. In 2008, just 10 years after its founding, Zappos achieved more than $1 billion in annual sales. In 2009, Amazon.com acquired the company for $1.2 billion. Although now a subsidiary of Amazon, Zappos continues to operate as an independent brand, as Amazon maintains a hands-off policy. Instead of top-down management from Amazon, if anything, new ideas flow from Zappos up to its parent. One example is Zappos' novel approach to weed out cultural misfits by paying employees to leave after the orientation program. Amazon recently implemented a similar program for its warehouse workers.

A flock of birds in flight, immediately shifting direction with self-regulating unity, frequently serves as a poetic symbol of holacracy in action.
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Zappos has grown so much—receiving over 20 million unique visitors a month to its website—that it sometimes reorganizes to offer the best customer service possible. At one point, to keep the organization flat and responsive to customers, Zappos restructured into 10 separate business units including Zappos.com, Zappos Gift Cards, Zappos IP, and 6pm.com, among others. This step, however, was not sufficient to accommodate the rapid growth, as employee productivity was declining. To continue to make its customers, employees, and other stakeholders happy, Zappos is redesigning its structure radically to create a unique organization that is even more responsive to its customers' needs as well as external and internal changes. Zappos CEO Tony Hsieh decided to implement a radically new structure called *holacracy*, and explains why:

> Research shows that every time the size of a city doubles, innovation or productivity per resident increases by 15 percent. But when companies get bigger, innovation or productivity per employee generally goes down. So we're trying to figure out how to structure Zappos more like a city and less like a bureaucratic corporation. In a city, people and businesses are self-organizing. We're trying to do the same thing by switching from a normal hierarchical structure to a system called Holacracy, which enables employees to act more like entrepreneurs and self-direct their work instead of reporting to a manager who tells them what to do.[1]

This focus explains why Zappos is implementing holacracy, but what exactly is it? Often compared to a computer's operating system, holacracy provides a new organizational structure for governing and running a company. Because it greatly changes how workers interact, proponents hail it as a "social technology." It was developed by Brian Robertson in the 2000s, who was working from ideas introduced by Arthur Koestler in the 1967 book, *The Ghost in the Machine*, the work in which Koestler coined the term *holacracy*.[2] Rather than relying on a traditional top-down hierarchical management structure, holacracy attempts to achieve control and coordination by distributing power and authority to self-organizing groups (so-called circles) of employees. Circles of employees are meant to self-organize and own a specific task, such as confirming online orders or authorizing a customer's credit card.

At this point of its reorganization, Zappos grouped its over 1,500 employees in some 400 circles, with each employee in two or more circles. Order is supposed to emerge from the bottom up, rather than rely on top-down command and control as in traditional organizational structures.

How? Rules are explicit in a so-called constitution, which defines the power and authority of each circle. For coordination, the employee circles overlap horizontally, and without vertical hierarchy. Teams in circles of employees self-organize and self-govern. The CEO's last act as the highest-ranking person in the organization is to sign the constitution in a symbolic act, relinquishing all executive powers. Thereafter the former leader becomes the "ratifier of the holacracy constitution." All this is done to serve the overarching goal of achieving rapid organizational evolution and adaptation to constantly changing external and internal environments. Exhibit 11.1 provides an overview comparing a traditional organizational structure with holacracy.

As often happens, a new organizational structure sounds great in theory, but proves hard to implement. In fact, Zappos is the first large corporation to try; previously firms adopting the approach tended to be small startups and nonprofits. Robertson, the inventor of holacracy as organizational form, ran a software company of 12 people where he tested his ideas. Twitter co-founder Evan Williams is a fan; he implemented holacracy—not at Twitter, but at his *new* venture, Medium, a blog-publishing platform. With Zappos the first large corporation attempting to make a wholesale switch to this approach, curiosity remains high as to how it will play out.[3]

You will learn more about Zappos by reading this chapter; related questions appear on page 392.

EXHIBIT 11.1 / Traditional Organizational Structure vs. Holacracy

Source: Adapted from Robertson, B. (2015). *Holacracy: The New Management System for a Rapidly Changing World* (New York: Henry Holt).

Traditional Organizational Structure	Holacracy
Static job description	Dynamic roles
Top-down	Self-organizing teams
Hierarchical decision making	Employee senses tension as dissonance between *what is* (current reality) and *what could be* (the purpose). How to resolve tension is worked out in circle meetings.
Formal authority	Distributed authority
Command and control	Employee autonomy
Functional areas	Employee circles
Alignment via politics	Transparent rules defined in constitution
Large scale re-organizations	Rapid, fluid, and constant iterations

ZAPPOS CEO TONY HSIEH believes that about one-half of all retail transactions in the United States will be online soon, and that people will buy from the company with the best customer service and best selection. His strategic intent for Zappos is to be that online store, to differentiate itself from the competition with superior service and selection. Hsieh remains unusually thoughtful about what type of structure, culture, and processes will advance that strategy. He initially designed Zappos as a flat organization to help Zappos provide exceptional service, and he continued to refine its organizational design through trial and error, with transparency, while nurturing a supportive culture by soliciting bottom-up feedback. And he celebrated the emphasis on happiness as noted in his book, with the understanding that happy employees are productive employees.

Yet, a loss of productivity and increased bureaucracy could not be avoided as the company grew and matured. To move Zappos forward, in 2014 Hsieh proposed a new organizational

structure called **holacracy**, a form of social technology that Hsieh believes will allow Zappos to pursue its purpose of delivering happiness and WOW through customer service.

holacracy An organizational structure in which decision-making authority is distributed through loose collections or circles of self-organizing teams.

This chapter opens the final part of the *AFI framework:* strategy implementation. *Strategy implementation* concerns the organization, coordination, and integration of how work gets done. (See discussion in Chapter 2.)

Effective strategy implementation is critical to gaining and sustaining competitive advantage. Although the discussion of *strategy formulation* (what to do) is distinct from *strategy implementation* (how to do it), formulation and implementation must be part of an interdependent, reciprocal process in order to ensure continued success. That need for interdependence explains why the AFI framework is illustrated as a circle, rather than a linear diagram (see page 365). The design of an organization, the matching of strategy and structure, and its control-and-reward systems determine whether or not an organization that has chosen an effective strategy will be able to gain and sustain a competitive advantage. As discussed in the ChapterCase, Zappos pursues a differentiation strategy at the business level, which it is now implementing internally and structurally through holacracy. Whether Zappos' strategy implementation will be successful or not remains to be seen.

In this chapter, we study the three key levers that managers have at their disposal when designing their organizations for competitive advantage: *structure, culture,* and *control.* Managers employ these three levers to coordinate work and motivate employees across different levels, functions, and geographies. How successful they are in this endeavor determines whether they are able to translate their chosen business, corporate, and global strategy into strategic actions and business models, and ultimately whether the firm is able to gain and sustain a competitive advantage.

We begin our discussion with organizational structure. We discuss different types of organizational structures as well as why and how they need to change over time as successful firms grow in size and complexity. We highlight the critical need to match strategy and structure, and then take a closer look at corporate culture. An organization's culture can either support or hinder its quest for competitive advantage.[4] We next study strategic control systems, which allow managers to receive feedback on how well a firm's strategy is being implemented. We conclude our discussion of how to design an organization for competitive advantage with practical "Implications for the Strategist."

11.1 Organizational Design and Competitive Advantage

LO 11-1 Define organizational design and list its three components.

Organizational design is the process of creating, implementing, monitoring, and modifying the structure, processes, and procedures of an organization. The key components of organizational design are structure, culture, and control. The goal is to design an organization that allows managers to effectively translate their chosen strategy into a realized one.

organizational design The process of creating, implementing, monitoring, and modifying the structure, processes, and procedures of an organization.

Not surprisingly, the inability to implement strategy effectively is the number-one reason boards of directors fire CEOs.[5] Yahoo's co-founder and CEO Jerry Yang was ousted in 2008 precisely because he failed to implement necessary strategic changes after Yahoo lost its competitive advantage.[6] In the two years leading up to his exit, Yahoo lost more than 75 percent of its market value. Yang was described as someone who preferred consensus among his managers to making tough strategic decisions needed to change Yahoo's structure. That preference, though, led to bickering and infighting. Yang's failure to make the necessary changes to the Internet firm's organizational structure led to a destruction of billions of dollars in shareholder value and thousands of layoffs. Once a leader in online search, Yahoo is struggling to make a comeback. A number of short-term and interim CEOs followed Yang without much success. Then in 2012, as detailed in ChapterCase 2,

Yahoo tapped former Google executive Marissa Mayer as president and CEO; Mayer's turnaround efforts hinge on improving the user experience to drive mobile advertising revenues. Such changes in strategy required changes in structure as well.

Because strategy implementation transforms strategy into actions and business models, it often requires changes within the organization. However, strategy implementation often fails because managers are unable to make the necessary changes due to the effects on resource allocation and power distribution within an organization.[7] Managers are leery to disturb the status quo.

As demonstrated by business historian Alfred Chandler in his seminal book *Strategy and Structure,* organizational structure must follow strategy in order for firms to achieve superior performance: "Structure can be defined as the design of organization through which the enterprise is administered . . . *structure follows strategy.*"[8] This tenet implies that to implement a strategy successfully, organizational design must be flexible enough to accommodate the formulated strategy and future growth and expansion.

Featured in the ChapterCase, Zappos provides an example of a company with flexible organizational structure. When establishing customer service as a core competency, one of the hardest decisions Hsieh made early was to pull the plug on drop-shipment orders. These are orders for which Zappos would be the intermediary, relaying them to particular shoe vendors who then ship directly to the customer. Such orders were profitable because Zappos would not have to stock all the shoes. They were also appealing because the fledgling startup was still losing money. But the problem was twofold. The vendors were slower than Zappos in filling orders. In addition, they did not accomplish the reliability metric that Zappos wanted for exceptional service: 95 percent accuracy was simply not good enough! Instead, Zappos decided to forgo drop shipments and instead built a larger warehouse in Kentucky to stock a full inventory. This move enabled the firm to achieve close to 100 percent accuracy in its shipments, many of which were overnight. Unlike other online retailers, Zappos stocks everything it sells in its own warehouses—this is the only way to get the merchandise as quickly as possible with 100 percent accuracy to the customer. Strategy, therefore, is as much about deciding what to do as it is about deciding what *not* to do.

LO 11-2

Explain how organizational inertia can lead established firms to failure.

ORGANIZATIONAL INERTIA: THE FAILURE OF ESTABLISHED FIRMS

To implement a formulated business strategy successfully, structure must accommodate strategy, not the other way around. In reality, however, a firm's strategy often follows its structure.[9] This reversal implies that some managers consider only strategies that do not change existing organizational structures; they do not want to confront the inertia that often exists in established organizations.[10] **Inertia**, a firm's resistance to change the status quo, can set the stage for the firm's subsequent failure. Successful firms often plant the seed of subsequent failure: They optimize their organizational structure to the current situation. That tightly coupled system can break apart when internal or external pressures occur.

inertia
A firm's resistance to change the status quo, which can set the stage for the firm's subsequent failure.

Note that organizational inertia is often the result of success in a particular market during a particular time; it becomes difficult to argue with success. The pattern for successful firms often follows a particular path:

1. Mastery of, and fit with, the current environment.
2. Success, usually measured by financial measurements.
3. Structures, measures, and systems to accommodate and manage size.
4. A resulting organizational inertia that tends to minimize opportunities and challenges created by shifts in the internal and external environment.

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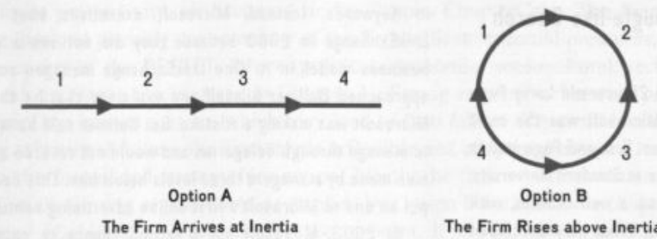
What's missing, of course, is the conscious strategic decision to change the firm's internal environment to fit with the new external environment, turning four steps leading to the endpoint of inertia (Option A) into the kind of a virtual circle where the firm essentially reboots and reinvents itself (Option B).



Consider that the need for structural reorganization can be especially intense in many industries where the rate of change is high and potential disruption frequent. Consider also that business leaders find it much easier to create and manage within developed structures than to restructure their organizations to be where they will need to be in future.

Exhibit 11.2 shows how success in the current environment can lead to a firm's downfall in the future, when the tightly coupled system of strategy and structure experiences internal or external shifts.[11] First, the managers achieve a mastery of, and fit with, the firm's current environment. Second, the firm often defines and measures success by financial metrics, with a focus on short-term performance (see discussion in Chapter 5). Third, the firm puts in place structures, metrics, and systems to accommodate and

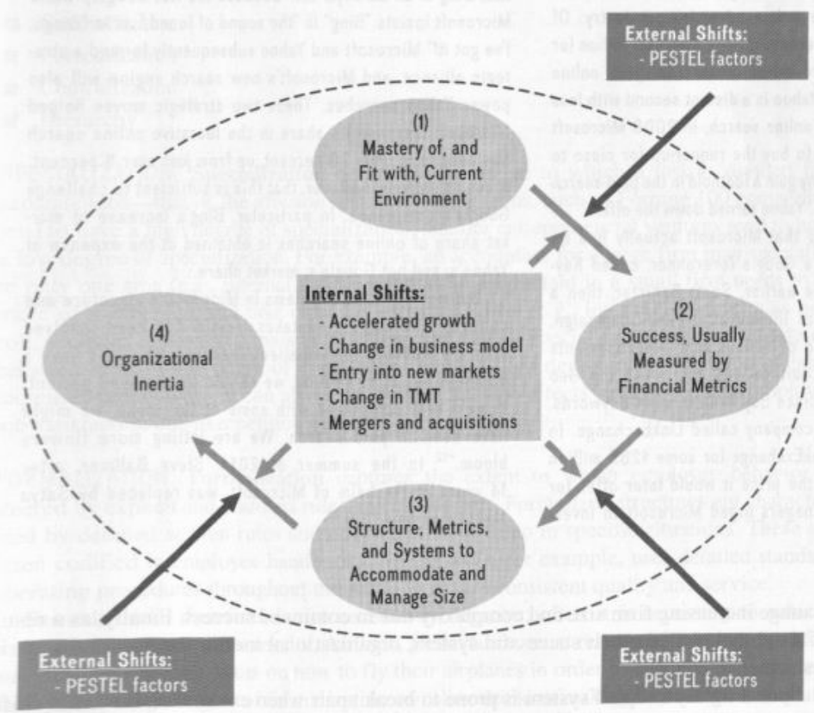


EXHIBIT 11.2 Organizational Inertia and the Failure of Established Firms to Respond to Shifts in the External or Internal Environments

Strategy Highlight 11.1

The Premature Death of a Google-like Search Engine at Microsoft

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

Today, Google is the world's leading online search company with 65 percent market share in the United States and over 90 percent in Europe. It leverages this dominant position into leadership in the online advertising industry: Of some $70 billion in annual revenues, more than $60 billion (or 90 percent) of Google's revenues come from paid online search advertising. Though Yahoo is a distant second with less than a 15 percent share in online search, in 2008 Microsoft CEO Steve Ballmer offered to buy the runner-up for close to $50 billion to help his company gain a foothold in the paid-search business where Google rules. Yahoo turned down the offer.

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

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

Having missed two huge opportunities to pursue promising strategic initiatives that emerged from lower levels within the firm, Microsoft has been playing catch-up in online search and advertising ever since. In the summer of 2009, it launched its own search engine, Bing. Industry pundits joked that Bing is an acronym for "Because It's Not Google," while Microsoft insists "Bing" is "the sound of found," as in "Bingo, I've got it!" Microsoft and Yahoo subsequently formed a strategic alliance, and Microsoft's new search engine will also power Yahoo searches. These two strategic moves helped Microsoft increase its share in the lucrative online search business to roughly 20 percent, up from just over 8 percent. It seems unlikely, however, that this is sufficient to challenge Google's dominance. In particular, Bing's increase in market share of online searches is obtained at the expense of Yahoo's, and not Google's, market share.

Ballmer admitted problems in Microsoft's structure and culture: "The biggest mistakes I claim I've been involved with are where I was impatient—because we didn't have a business yet in something, we should have stayed patient. If we'd kept consistent with some of the ideas, we might have been in paid search. We are letting more flowers bloom."[12] In the summer of 2014, Steve Ballmer, after 14 years at the helm of Microsoft, was replaced by Satya Nadella as new CEO.[13]

manage increasing firm size and complexity due to continued success. Finally, as a result of a tightly coupled albeit successful system, organizational inertia sets in—and with it, resistance to change.

Such a tightly coupled system is prone to break apart when external and internal shifts put pressure on the system.[14] In Exhibit 11.2, inside the oval, the longer internal arrows

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show the firm's tightly coupled organizational design over time. The shorter internal arrows indicate pressures radiating from internal shifts such as accelerated growth, a change in the business model, entry into new markets, a change in the top management team (TMT), or mergers and acquisitions. Accelerated growth, for example, was the reason for a decline in employee productivity, as discussed in the Zappos ChapterCase. The longest arrows pointing into and piercing the boundary of the firm indicate external pressures, which can stem from any of the PESTEL forces (political, economic, sociocultural, technological, ecological, and legal, as discussed in Chapter 3). Strong external or internal pressure can break apart the current system, which may lead to firm failure. To avoid inertia and possible organizational failure, the firm needs a flexible and adaptive structure to effectively translate the formulated strategy into action. Ideally the firm would maintain a virtuous cycle of reconsidering organization, as implied by Option B earlier in the chapter.

Strategy Highlight 11.1 provides a case in point. It shows how Microsoft's strategy and decision-making process were negatively affected by organizational inertia due to its success and dominance in the Windows-based PC world.

ORGANIZATIONAL STRUCTURE

LO 11-3

Define organizational structure and describe its four elements.

Some of the key decisions managers must make when designing effective organizations pertain to the firm's **organizational structure**. That structure determines how the work efforts of individuals and teams are orchestrated and how resources are distributed. In particular, an organizational structure defines how jobs and tasks are divided and integrated, delineates the reporting relationships up and down the hierarchy, defines formal communication channels, and prescribes how individuals and teams coordinate their work efforts. The key building blocks of an organizational structure are:

- Specialization
- Formalization
- Centralization
- Hierarchy

organizational structure
A key to determining how the work efforts of individuals and teams are orchestrated and how resources are distributed.

SPECIALIZATION. **Specialization** describes the degree to which a task is divided into separate jobs—that is, the *division of labor.* Larger firms, such as Fortune 100 companies, tend to have a high degree of specialization; smaller entrepreneurial ventures tend to have a low degree of specialization. For example, an accountant for a large firm may specialize in only one area (e.g., internal audit), whereas an accountant in a small firm needs to be more of a generalist and take on many different things (e.g., internal auditing, plus payroll, accounts receivable, financial planning, and taxes). Specialization requires a trade-off between breadth and depth of knowledge. While a high degree of the division of labor increases productivity, it can also have unintended side-effects such as reduced employee job satisfaction due to repetition of tasks.

specialization
An organizational element that describes the degree to which a task is divided into separate jobs (i.e., the division of labor).

FORMALIZATION. **Formalization** captures the extent to which employee behavior is steered by explicit and codified rules and procedures. Formalized structures are characterized by detailed written rules and policies of what to do in specific situations. These are often codified in employee handbooks. McDonald's, for example, uses detailed standard operating procedures throughout the world to ensure consistent quality and service.

Formalization, therefore, is not necessarily negative; often it is necessary to achieve consistent and predictable results. Airlines, for instance, must rely on a high degree of formalization to instruct pilots on how to fly their airplanes in order to ensure safety and reliability. Yet a high degree of formalization can slow decision making, reduce creativity and innovation, and hinder customer service.[15] Most customer service reps in call centers, for

formalization
An organizational element that captures the extent to which employee behavior is steered by explicit and codified rules and procedures.

example, follow a detailed script. This is especially true when call centers are outsourced to overseas locations. Zappos deliberately avoided this approach when it made customer service its core competency.

centralization
An organizational element that refers to the degree to which decision making is concentrated at the top of the organization.

CENTRALIZATION. **Centralization** refers to the degree to which decision making is concentrated at the top of the organization. Centralized decision making often correlates with slow response time and reduced customer satisfaction. In decentralized organizations such as Zappos, decisions are made and problems solved by empowered lower-level employees who are closer to the sources of issues.

Different strategic management processes (discussed in Chapter 2) match with different degrees of centralization:

- Top-down strategic planning takes place in highly centralized organizations.
- Planned emergence is found in more decentralized organizations.

Whether centralization or decentralization is more effective depends on the specific situation. During the Gulf of Mexico oil spill in 2010, BP's response was slow and cumbersome because key decisions were initially made in its UK headquarters and not onsite. In this case, centralization reduced response time and led to a prolonged crisis. In contrast, the FBI and the CIA were faulted in the 9/11 Commission Report for *not being centralized enough.*[16] The report concluded that although each agency had different types of evidence that a terrorist strike in the United States was imminent, their decentralization made them unable to put together the pieces to prevent the 9/11 attacks.

hierarchy
An organizational element that determines the formal, position-based reporting lines and thus stipulates who reports to whom.

span of control
The number of employees who directly report to a manager.

HIERARCHY. **Hierarchy** determines the formal, position-based reporting lines and thus stipulates *who reports to whom.* Let's assume two firms of roughly equal size: Firm A and Firm B. If many levels of hierarchy exist between the frontline employee and the CEO in Firm A, it has a *tall structure.* In contrast, if there are few levels of hierarchy in Firm B, it has a *flat structure.*

The number of levels of hierarchy, in turn, determines the managers' **span of control**—how many employees directly report to a manager. In tall organizational structures (Firm A), the span of control is narrow. In flat structures (Firm B), the span of control is wide, meaning one manager supervises many employees. In recent years, firms have de-layered by reducing the headcount (often middle managers), making themselves flatter and more nimble. This, however, puts more pressure on the remaining managers who have to supervise and monitor more direct reports due to an increased span of control.[17] Recent research suggests that managers are most effective at an intermediate point where the span of control is not too narrow or too wide.[18]

LO 11-4
Compare and contrast mechanistic versus organic organizations.

MECHANISTIC VS. ORGANIC ORGANIZATIONS

Several of the building blocks of organizational structure frequently appear together, creating distinct organizational forms—mechanistic or organic organizations.[19]

mechanistic organization
Characterized by a high degree of specialization and formalization and by a tall hierarchy that relies on centralized decision making.

MECHANISTIC ORGANIZATIONS. **Mechanistic organizations** are characterized by a high degree of specialization and formalization and by a tall hierarchy that relies on centralized decision making. The fast food chain McDonald's fits this description quite well. Each step of every job such as deep-frying fries is documented in minute detail (e.g., what kind of vat, the quantity of oil, how many fries, what temperature, how long, and so on). Decision power is centralized at the top of the organization: McDonald's headquarters provides detailed instructions to each of its franchisees so that they provide comparable quality and service across the board although with some local menu variations.

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Communication and authority lines are top-down and well defined. To ensure standardized operating procedures and consistent food quality throughout the world, McDonald's operates Hamburger University, a state-of-the-art teaching facility in a Chicago suburb, where 50 full-time instructors teach courses in chemistry, food preparation, and marketing. In 2010, McDonald's opened a second Hamburger University campus in Shanghai, China. Mechanistic structures allow for standardization and economies of scale, and often are used when the firm pursues a cost-leadership strategy at the business level.

organic organization
Characterized by a low degree of specialization and formalization, a flat organizational structure, and decentralized decision making.

ORGANIC ORGANIZATIONS. **Organic organizations** have a low degree of specialization and formalization, a flat organizational structure, and decentralized decision making. Organic structures tend to be correlated with the following: a fluid and flexible information flow among employees in both horizontal and vertical directions; faster decision making; and higher employee motivation, retention, satisfaction, and creativity. Organic organizations also typically exhibit a higher rate of entrepreneurial behaviors and innovation. Organic structures allow firms to foster R&D and/or marketing, for example, as a core competency. Firms that pursue a differentiation strategy at the business level frequently have an organic structure.

Strategy Highlight 11.2 shows how W.L. Gore & Associates uses an organic structure to foster continuous innovation.

Exhibit 11.3 summarizes the key features of mechanistic and organic structures.

Although at first glance organic organizations may appear to be more attractive than mechanistic ones, their relative effectiveness depends on context. McDonald's, with its over 36,000 restaurants across the globe, would not be successful with an organic structure.

EXHIBIT 11.3 / Mechanistic vs. Organic Organizations: Building Blocks of Organizational Structure

	Mechanistic Organizations	Organic Organizations
Specialization	• High degree of specialization • Rigid division of labor • Employees focus on narrowly defined tasks	• Low degree of specialization • Flexible division of labor • Employees focus on "bigger picture"
Formalization	• Intimate familiarity with rules, policies, and processes necessary • Deep expertise in narrowly defined domain required • Task-specific knowledge valued	• Clear understanding of organization's core competencies and strategic intent • Domain expertise in different areas • Generalized knowledge of how to accomplish strategic goals valued
Centralization	• Decision power centralized at top • Vertical (top-down) communication	• Distributed decision making • Vertical (top-down and bottom-up) as well as horizontal communication
Hierarchy	• Tall structures • Low span of control • Clear lines of authority • Command and control	• Flat structures • High span of control • Horizontal as well as two-way vertical communication • Mutual adjustment
Business Strategy	• Cost-leadership strategy • Examples: McDonald's; Walmart	• Differentiation strategy • Examples: W.L. Gore, Zappos

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Strategy Highlight 11.2

W.L. Gore & Associates: Informality and Innovation

W.L. Gore & Associates is the inventor of path-breaking new products such as breathable GORE-TEX fabrics, Glide dental floss, and Elixir guitar strings. Bill Gore, a former longtime employee of chemical giant DuPont, founded the company with the vision to create an organization "devoted to innovation, a company where imagination and initiative would flourish, where chronically curious engineers would be free to invent, invest, and succeed."[20] When founding the company in 1958, Gore articulated four core values that still guide the company and its associates to this day:

1. Fairness to each other and everyone with whom the firm does business.
2. Freedom to encourage, help, and allow other associates to grow in knowledge, skill, and scope of responsibility.
3. The ability to make one's own commitments and keep them.
4. Consultation with other associates before undertaking actions that could cause serious damage to the reputation of the company ("blowing a hole below the waterline").

W.L. Gore & Associates is organized in an informal and decentralized manner: It has no formal job titles, job descriptions, chains of command, formal communication channels, written rules or standard operating procedures. Face-to-face communication is preferred over e-mail. There is no organizational chart. In what is called a *lattice* or *boundaryless* organizational form, everyone is empowered and encouraged to speak to anyone else in the organization. People who work at Gore are called "associates" rather than employees, indicating professional expertise and status. Gore associates organize themselves in project-based teams that are led by sponsors, not bosses. Associates invite other team members based on their expertise and interests in a more or less ad hoc fashion. Peer control in these multidisciplinary teams further enhances associate productivity. Group members evaluate each other's performance annually, and these evaluations determine each associate's level of compensation. Moreover, all associates at W.L. Gore are also shareholders of the company, and thus are part owners sharing in profits and losses.

Gore's freewheeling and informal culture has been linked to greater employee satisfaction and retention, higher personal initiative and creativity, and innovation at the firm level. Although W.L. Gore's organizational structure may look like something you might find in a small, high-tech startup, the company has 10,000 employees and over $3 billion in revenues, making Gore one of the largest privately held companies in the United States. W.L. Gore is consistently ranked in the top 25 of *Fortune*'s "100 Best Companies to Work For" list (number 17 in 2015), and has been included in every edition of that prestigious ranking.[21]

Similarly, a mechanistic structure would not allow Zappos or W.L. Gore to develop and hone their respective core competencies in customer service and product innovation.

The key point is this: To gain and sustain competitive advantage, structure must follow strategy. Moreover, the chosen organizational form must match the firm's business strategy. We will expand further on the required strategy–structure relationship in the next section.

LO 11-5

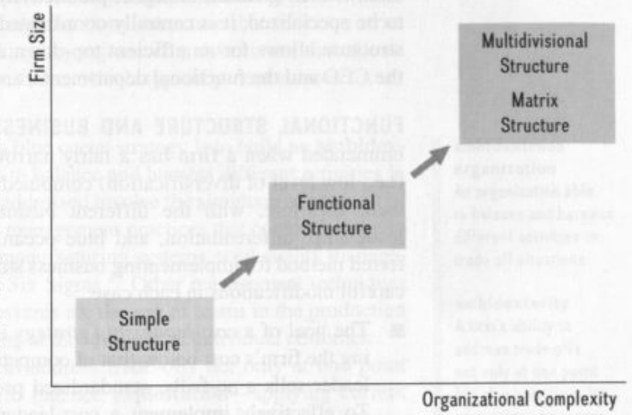
Describe different organizational structures and match them with appropriate strategies.

11.2 Strategy and Structure

The important and interdependent relationship between strategy and structure directly impacts a firm's performance. Moreover, the relationship is dynamic—changing over time in a somewhat predictable pattern as firms grow in size and complexity. Successful new ventures generally grow first by increasing sales, then by obtaining larger geographic reach, and finally by diversifying through vertical integration and entering into related and unrelated businesses.[22] Different stages in a firm's growth require different

organizational structures. This important evolutionary pattern is depicted in Exhibit 11.4. As we discuss next, organizational structures range from simple to functional to multidivisional to matrix.

EXHIBIT 11.4 / Changing Organizational Structures and Increasing Complexity as Firms Grow



SIMPLE STRUCTURE

A **simple structure** generally is used by small firms with low organizational complexity. In such firms, the founders tend to make all the important strategic decisions and run the day-to-day operations. Examples include entrepreneurial ventures such as Facebook in 2004, when the startup operated out of Mark Zuckerberg's dorm room, and professional service firms such as smaller advertising, consulting, accounting, and law firms, as well as family-owned businesses. Simple structures are flat hierarchies operated in a decentralized fashion. They exhibit a low degree of formalization and specialization. Typically, neither professional managers nor sophisticated systems are in place, which often leads to an overload for the founder and/or CEO when the firms experience growth.

simple structure Organizational structure in which the founders tend to make all the important strategic decisions as well as run the day-to-day operations.

FUNCTIONAL STRUCTURE

As sales increase, firms generally adopt a **functional structure,** which groups employees into distinct functional areas based on domain expertise. These functional areas often correspond to distinct stages in the value chain such as R&D, engineering and manufacturing, and marketing and sales, as well as supporting areas such as human resources, finance, and accounting. Exhibit 11.5 shows a functional structure, with the lines indicating reporting and authority relationships. The department head of each functional area reports to the CEO, who coordinates and integrates the work of each function. A business school student generally majors in one of these functional areas such as finance, accounting, IT, marketing, operations, or human resources, and is then recruited into a corresponding functional group.

W.L. Gore began as a company by operating out of Bill Gore's basement and using a simple structure. Two years after its founding, the company received a large manufacturing order for high-tech cable that it could not meet with its ad hoc basement operation. At that point, W.L. Gore reorganized itself into a functional structure. A simple structure could not provide the effective division, coordination, and integration of work required to accommodate future growth.

functional structure Organizational structure that groups employees into distinct functional areas based on domain expertise.

EXHIBIT 11.5 / Typical Functional Structure

A functional structure allows for a higher degree of specialization and deeper domain expertise than a simple structure. Higher specialization also allows for a greater division of labor, which is linked to higher productivity.[23] While work in a functional structure tends to be specialized, it is centrally coordinated by the CEO (see Exhibit 11.5). A functional structure allows for an efficient top-down and bottom-up communication chain between the CEO and the functional departments, and thus relies on a relatively flat structure.

FUNCTIONAL STRUCTURE AND BUSINESS STRATEGY. A functional structure is recommended when a firm has a fairly narrow focus in terms of product/service offerings (i.e., low level of diversification) combined with a small geographic footprint. It matches well, therefore, with the different *business* strategies discussed in Chapter 6: cost leadership, differentiation, and blue ocean. Although a functional structure is the preferred method for implementing business strategy, different variations and contexts require careful modifications in each case:

- The goal of a *cost-leadership strategy* is to create a competitive advantage by reducing the firm's cost below that of competitors while offering acceptable value. The cost leader sells a no-frills, standardized product or service to the mainstream customer. To effectively implement a cost-leadership strategy, therefore, managers must create a functional structure that contains the organizational elements of a *mechanistic structure*—one that is centralized, with well-defined lines of authority up and down the hierarchy. Using a functional structure allows the cost leader to nurture and constantly upgrade necessary core competencies in manufacturing and logistics. Moreover, the cost leader needs to create incentives to foster process innovation in order to drive down cost. Finally, because the firm services the average customer, and thus targets the largest market segment possible, it should focus on leveraging economies of scale to further drive down costs.
- The goal of a *differentiation strategy* is to create a competitive advantage by offering products or services at a higher perceived value, while controlling costs. The differentiator, therefore, sells a non-standardized product or service to specific market segments in which customers are willing to pay a higher price. To effectively implement a differentiation strategy, managers rely on a functional structure that resembles an *organic organization.* In particular, decision making tends to be decentralized to foster and incentivize continuous innovation and creativity as well as flexibility and mutual adjustment across areas. Using a functional structure with an organic organization allows the differentiator to nurture and constantly upgrade necessary core competencies in R&D, innovation, and marketing. Finally, the functional structure should be set up to allow the firm to reap economies of scope from its core competencies, such as by leveraging its brand name across different products or its technology across different devices.
- A successful *blue ocean strategy* requires reconciliation of the trade-offs between differentiation and low cost. To effectively implement a blue ocean strategy, the firm must be both efficient and flexible. It must balance centralization to control costs with decentralization to foster creativity and innovation. Managers must, therefore, attempt to combine the advantages of the functional-structure variations used for cost leadership and differentiation while mitigating their disadvantages. Moreover, the firm pursuing a blue ocean strategy needs to develop several distinct core competencies to both drive up perceived value and lower cost. It must further pursue both product and process innovations in an attempt to reap economies of scale and scope. All of these challenges make it clear that although a blue ocean strategy is attractive at first glance, it is quite difficult to implement given the range of important trade-offs that must be addressed.

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A firm's structure is therefore critical when pursuing a blue ocean strategy. The challenge that managers face is to structure their organizations so that they control cost *and* allow for creativity that can lay the basis for differentiation. Doing both is hard. Achieving a low-cost position requires an organizational structure that relies on strict budget controls, while differentiation requires an organizational structure that allows creativity and customer responsiveness to thrive, which typically necessitates looser organizational structures and controls.

The goal for managers who want to pursue a blue ocean strategy is to build an **ambidextrous organization,** one that enables managers to balance and harness different activities in trade-off situations.[24] Here, the trade-offs to be addressed involve the simultaneous pursuit of low-cost and differentiation strategies. Notable management practices that companies use to resolve this trade-off include flexible and lean manufacturing systems, total quality management, just-in-time inventory management, and Six Sigma.[25] Other management techniques that allow firms to reconcile cost and value pressures are the use of teams in the production process, as well as decentralized decision making at the level of the individual customer.

ambidextrous organization An organization able to balance and harness different activities in trade-off situations.

Ambidexterity describes a firm's ability to address trade-offs not only at one point but also over time. It encourages managers to balance **exploitation**—applying current knowledge to enhance firm performance in the short term—with **exploration**—searching for new knowledge that may enhance a firm's future performance.[26] For example, while Intel focuses on maximizing sales from its *current* cutting-edge microprocessors, it also has several different teams with different time horizons working on *future* generations of microprocessors.[27] In ambidextrous organizations, managers must constantly analyze their existing business processes and routines, looking for ways to change them in order to resolve trade-offs across internal value chain activities and time.[28]

ambidexterity A firm's ability to address trade-offs not only at one point but also over time. It encourages managers to balance *exploitation* with *exploration.*

exploitation Applying current knowledge to enhance firm performance in the short term.

exploration Searching for new knowledge that may enhance a firm's future performance.

Exhibit 11.6 presents a detailed match between different business strategies and their corresponding functional structures.

DISADVANTAGES. While certainly attractive, the functional structure is not without significant drawbacks. Although the functional structure facilitates rich and extensive communication between members of the *same* department, it frequently lacks effective communication channels *across* departments. Notice in Exhibit 11.5 the lack of links between different functions. The lack of linkage between functions is the reason, for example, why R&D managers often do not communicate directly with marketing managers. In an ambidextrous organization, a top-level manager such as the CEO must take on the necessary coordination and integration work.

To overcome the lack of cross-departmental collaboration in a functional structure, a firm can set up *cross-functional teams.* In these temporary teams, members come from different functional areas to work together on a specific project or product, usually from start to completion. Each team member reports to two supervisors: the team leader and the respective functional department head. As we saw in Strategy Highlight 11.2, W.L. Gore employs cross-functional teams successfully.

A second critical drawback of the functional structure is that it cannot effectively address a higher level of diversification, which often stems from further growth.[29] This is the stage at which firms find it effective to evolve and adopt a multidivisional or matrix structure, both of which we will discuss next.

MULTIDIVISIONAL STRUCTURE

Over time, as a firm diversifies into different product lines and geographies, it generally implements a multidivisional or a matrix structure (as shown in Exhibit 11.4). The **multidivisional structure** (or **M-form**) consists of several distinct strategic business

multidivisional structure (M-form) Organizational structure that consists of several distinct strategic business units (SBUs), each with its own profit-and-loss (P&L) responsibility.

EXHIBIT 11.6

Matching Business Strategy and Structure

Business Strategy	Structure
Cost leadership	**Functional** • Mechanistic organization • Centralized • Command and control • Core competencies in efficient manufacturing and logistics • Process innovation to drive down cost • Focus on economies of scale
Differentiation	**Functional** • Organic organization • Decentralized • Flexibility and mutual adjustment • Core competencies in R&D, innovation, and marketing • Product innovation • Focus on economies of scope
Blue ocean	**Functional** • Ambidextrous organization • Balancing centralization with decentralization • Multiple core competencies along the value chain required: R&D, manufacturing, logistics, marketing, etc. • Process and product innovations • Focus on economies of scale and scope

units (SBUs), each with its own profit-and-loss (P&L) responsibility. Each SBU is operated more or less independently from one another, and each is led by a CEO (or equivalent general manager) who is responsible for the unit's business strategy and its day-to-day operations. The CEOs of each division report to the corporate office, which is led by the company's highest-ranking executive (titles vary and include president or CEO for the entire corporation). Because most large firms are diversified to some extent across different product lines and geographies, the M-form is a widely adopted organizational structure.

Consider that Zappos is an SBU under Amazon, which employs a multidivisional structure. Also, W.L. Gore uses a multidivisional structure to administer its differentiation and related diversification strategies. It has four product divisions (electronic products, industrial products, medical products, and fabrics division) with manufacturing facilities in the United States, China, Germany, Japan, and Scotland, and business activities in 30 countries across the globe.[30]

A typical M-form is shown in Exhibit 11.7. In this example, the company has four SBUs, each led by a CEO. Corporations may use SBUs to organize around different businesses and product lines or around different geographic regions. Each SBU represents a self-contained business with its own hierarchy and organizational structure. Note that in Exhibit 11.7, SBU 2 is organized using a functional structure, while SBU 4 is organized using a matrix structure. The CEO of each SBU must determine which organizational structure is most appropriate to implement the SBU's business strategy.

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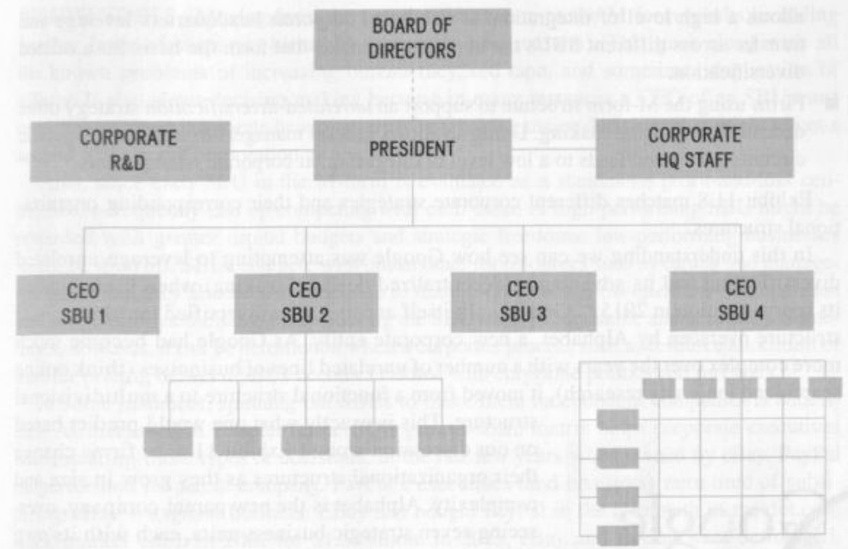


EXHIBIT 11.7

Typical Multidivisional (M-Form) Structure

Note that SBU 2 uses a functional structure, and SBU 4 uses a matrix structure.

A firm's corporate office is supported by company-wide staff functions such as human resources, finance, and corporate R&D. These staff functions support all of the company's SBUs, but are centralized at corporate headquarters to benefit from economies of scale and to avoid duplication within each SBU. Since most of the larger enterprises are publicly held stock companies, the president reports to a board of directors who represents the interests of the shareholders, indicated by the dashed line in Exhibit 11.7.

The president, with support from corporate headquarters staff, monitors the performance of each SBU and determines how to allocate resources across units.[31] Corporate headquarters adds value by functioning as an internal capital market. The goal is to be more efficient at allocating capital through its budgeting process than what could be achieved in external capital markets. This can be especially effective if the corporation overall can access capital at a lower cost than competitors due to a favorable (AAA) debt rating. Corporate headquarters can also add value through restructuring the company's portfolio of SBUs by selling low-performing businesses and adding promising businesses through acquisitions.

M-FORM AND CORPORATE STRATEGY. To achieve an optimal match between strategy and structure, different corporate strategies require different organizational structures. In Chapter 8, we identified four types of corporate diversification (see Exhibit 8.8: *single business, dominant business, related diversification,* and *unrelated diversification.* Each is defined by the percentage of revenues obtained from the firm's primary activity.

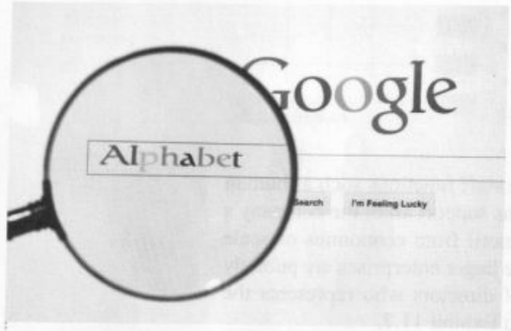
- Firms that follow a single-business or *dominant-business strategy* at the corporate level gain at least 70 percent of their revenues from their primary activity; they generally employ a *functional structure.*
- For firms that pursue either *related* or *unrelated diversification,* the *M-form* is the preferred organizational structure.
- Firms using the M-form organizational structure to support a *related-diversification* strategy tend to concentrate decision making at the top of the organization. Doing so

allows a high level of integration. It also helps corporate headquarters leverage and transfer across different SBUs the core competencies that form the basis for a related diversification.

- Firms using the M-form structure to support an *unrelated-diversification* strategy often decentralize decision making. Doing so allows general managers to respond to specific circumstances, and leads to a low level of integration at corporate headquarters.

Exhibit 11.8 matches different corporate strategies and their corresponding organizational structures.

In this understanding we can see how Google was attempting to leverage unrelated diversification and its advantages (decentralized decision making) when it announced its reorganization in 2015.[32] Google split itself and created a diversified multidivisional structure overseen by Alphabet, a new corporate entity. As Google had become much more complex over the years with a number of unrelated lines of businesses (think online search and longevity research), it moved from a functional structure to a multidivisional structure. This is exactly what one would predict based on our discussion around Exhibit 11.4, as firms change their organizational structures as they grow in size and complexity. Alphabet is the new parent company, overseeing seven strategic business units, each with its own CEO and profit-and-loss responsibility.



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The seven business units start with Google's core businesses (search, ads, YouTube, Android, Chrome) in a single unit joined by Google X (self-driving cars, delivery drones, Internet balloons), Nest (smart thermostats), Google Fiber (broadband service), Calico (longevity research), Life Sciences (contact lenses), and Google Ventures (start-up investments). This sweeping restructuring allows the company to separate its highly profitable search and advertising business from its "moon shots" such as providing wireless Internet connectivity via high-altitude balloons or developing contact lenses that double as a "computer monitor" and provide real-time information to the wearer.

EXHIBIT 11.8 / Matching Corporate Strategy and Structure

Corporate Strategy	Structure
Single business	Functional structure
Dominant business	Functional structure
Related diversification	Cooperative multidivisional (M-form) • Centralized decision making • High level of integration at corporate headquarters • Co-opetition among SBUs – Competition for resources – Cooperation in competency sharing
Unrelated diversification	Competitive multidivisional (M-form) • Decentralized decision making • Low level of integration at corporate headquarters • Competition among SBUs for resources

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DISADVANTAGES. Moving from the functional structure to the M-form results in adding another layer of corporate hierarchy (corporate headquarters). This goes along with all the known problems of increasing bureaucracy, red tape, and sometimes duplication of efforts. It also slows decision making because in many instances a CEO of an SBU must get approval from corporate headquarters when making major decisions that might affect a second SBU or the corporation as a whole.

Also, since each SBU in the M-form is evaluated as a standalone profit-and-loss center, SBUs frequently end up competing with each other. A high-performing SBU might be rewarded with greater capital budgets and strategic freedoms; low-performing businesses might be spun off. SBUs compete with one another for resources such as capital and managerial talent, but they also need to cooperate to share competencies. *Co-opetition*—competition and cooperation at the same time—among the SBUs is both inevitable and necessary. Sometimes, however, it can be detrimental when a corporate process such as resource allocation or transfer pricing between SBUs becomes riddled with corporate politics and turf wars.

In some instances, spinning out SBUs to make them independent companies is beneficial. As discussed in Chapter 8, the BCG growth-share matrix helps corporate executives when making these types of decisions. In the last few years when owned by eBay, PayPal outperformed its parent company. PayPal's executives (and investors) were tired of subsidizing eBay's stagnant business. EBay had bought PayPal in the aftermath of the dot.com stock market crash in 2002 for $1.5 billion. In 2015, eBay and PayPal were de-merged. PayPal was spun out and became an independent company again. Now, PayPal is able to fully unlock its value. Investors also liked separating eBay and PayPal, giving it a valuation that is estimated to be as high as $100 billion; eBay's standalone valuation is about $35 billion.[33]

MATRIX STRUCTURE

matrix structure Organizational structure that combines the functional structure with the M-form.

To reap the benefits of both the M-form and the functional structure, many firms employ a mix of these two organizational forms, called a **matrix structure.** Exhibit 11.9 shows an example. In it, the firm is organized according to SBUs along a horizontal axis (like in the

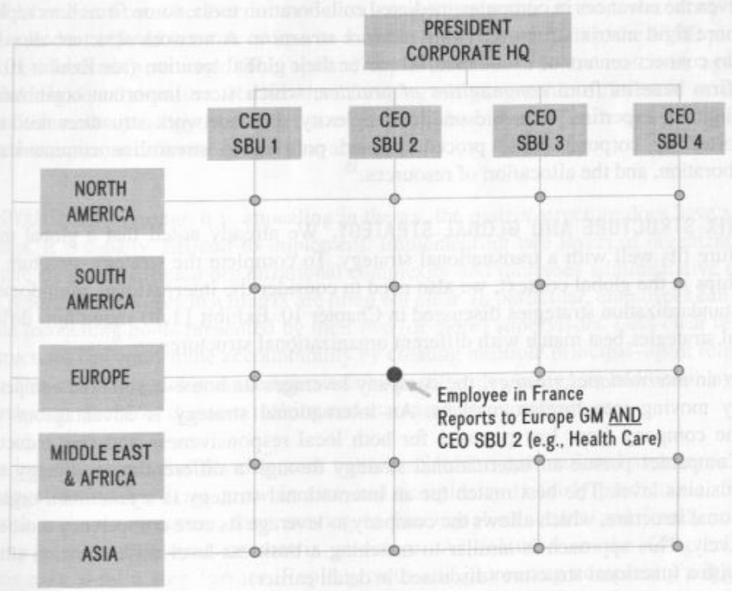

EXHIBIT 11.9 / Typical Matrix Structure with Geographic and SBU Divisions

M-form), but also has a second dimension of organizational structure along a vertical axis. In this case, the second dimension consists of different geographic areas, each of which generally would house a full set of functional activities. The idea behind the matrix structure is to combine the benefits of the M-form (domain expertise, economies of scale, and the efficient processing of information) with those of the functional structure (responsiveness and decentralized focus).

The horizontal and vertical reporting lines between SBUs and geographic areas intersect, creating nodes in the matrix. Exhibit 11.9 highlights one employee, represented by a large dot and called out by an arrow. This employee works in a group with other employees in SBU 2, the company's health care unit for the Europe division in France. This employee has two bosses—the CEO of the health care SBU and the general manager (GM) for the Europe division. Both supervisors report to corporate headquarters, which is led by the president of the corporation (indicated in Exhibit 11.9 by the reporting lines from the SBUs and geographic units to the president).

Firms tend to use a *global matrix structure* to pursue a *transnational strategy*, in which the firm combines the benefits of a multidomestic strategy (high local responsiveness) with those of a global-standardization strategy (lowest-cost position attainable). In a global matrix structure, the geographic divisions are charged with local responsiveness and learning. At the same time, each SBU is charged with driving down costs through economies of scale and other efficiencies. A global matrix structure also allows the firm to feed local learning back to different SBUs and thus diffuse it throughout the organization. The specific organizational configuration depicted in Exhibit 11.9 is a global matrix structure.

The matrix structure is quite versatile, because managers can assign different groupings along the vertical and horizontal axes. A common form of the matrix structure uses different projects or products on the vertical axis and different functional areas on the horizontal axis. In that traditional matrix structure, *cross-functional* teams work together on different projects. In contrast to the cross-functional teams discussed earlier in the W.L. Gore example, the teams in a matrix structure tend to be more permanent rather than project-based with a pre-determined time horizon.

Given the advances in computer-mediated collaboration tools, some firms have replaced the more rigid matrix structure with a *network structure*. A network structure allows the firm to connect centers of excellence, whatever their global location (see Exhibit 10.3).[34] The firm benefits from *communities of practice*, which store important organizational learning and expertise. To avoid undue complexity, these network structures need to be supported by corporate-wide procedures and policies to streamline communication, collaboration, and the allocation of resources.[35]

MATRIX STRUCTURE AND GLOBAL STRATEGY. We already noted that a global matrix structure fits well with a transnational strategy. To complete the strategy–structure relationships in the global context, we also need to consider the international, multidomestic, and standardization strategies discussed in Chapter 10. Exhibit 11.10 shows how different global strategies best match with different organizational structures.

- In an *international strategy*, the company leverages its home-based core competency by moving into foreign markets. An international strategy is advantageous when the company faces low pressure for both local responsiveness and cost reductions. Companies pursue an international strategy through a differentiation strategy at the business level. The best match for an international strategy is a *functional* organizational structure, which allows the company to leverage its core competency most effectively. This approach is similar to matching a business-level differentiation strategy with a functional structure (discussed in detail earlier).

EXHIBIT 11.10 Matching Global Strategy and Structure

Global Strategy	Structure
International	Functional
Multidomestic	Multidivisional • Geographic areas • Decentralized decision making
Global standardization	Multidivisional • Product divisions • Centralized decision making
Transnational	Global matrix • Balance of centralized and decentralized decision making • Additional layer of hierarchy to coordinate both: – Geographic areas – Product divisions

- When a multinational enterprise (MNE) pursues a *multidomestic strategy*, it attempts to maximize local responsiveness in the face of low pressures for cost reductions. An appropriate match for this type of global strategy is the *multidivisional* organizational structure. That structure would enable the MNE to set up different divisions based on geographic regions (e.g., by continent). The different geographic divisions operate more or less as standalone SBUs to maximize local responsiveness. Decision making is decentralized.
- When following a *global-standardization strategy*, the MNE attempts to reap significant economies of scale as well as location economies by pursuing a global division of labor based on wherever best-of-class capabilities reside at the lowest cost. Since the product offered is more or less an undifferentiated commodity, the MNE pursues a cost-leadership strategy. The optimal organizational structure match is, again, a *multidivisional* structure. Rather than focusing on geographic differences as in the multidomestic strategy, the focus is on driving down costs due to consolidation of activities across different geographic areas.

DISADVANTAGES. Though it is appealing in theory, the matrix structure does have shortcomings. It is usually difficult to implement: Implementing two layers of organizational structure creates significant organizational complexity and increases administrative costs. Also, reporting structures in a matrix are often not clear. In particular, employees can have trouble reconciling goals presented by their two (or more) supervisors. Less-clear reporting structures can undermine accountability by creating multiple principal–agent relationships. This can make performance appraisals more difficult. Adding an additional layer of hierarchy can also slow decision making and increase bureaucratic costs.

As just discussed, the development pattern of how organizational structures tend to change in time as firms grow in size and complexity is fairly predictable: Starting with a simple structure, then moving to functional structure, and finally implementing a multidivisional or matrix structure. As featured in the ChapterCase, Zappos even went a step further. Rapid growth and increasing complexity triggered Zappos' move away from a multidivisional structure with different business units to

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the radically new organizational structure, holacracy, with its nonhierarchical, overlapping employee circles. While the organizational structures shown in Exhibit 11.4 have been around for many decades, holacracy as an organizational structure is new and yet untested in a larger firm.

LO 11-6

Describe the elements of organizational culture, and explain where organizational cultures can come from and how they can be changed.

11.3 Organizational Culture: Values, Norms, and Artifacts

Organizational culture is the second key building block when designing organizations for competitive advantage. Just as people have distinctive personalities, so too do organizations have unique cultures that capture "how things get done around here." **Organizational culture** describes the collectively shared values and norms of an organization's members.[36] *Values* define what is considered important. *Norms* define appropriate employee attitudes and behaviors.[37]

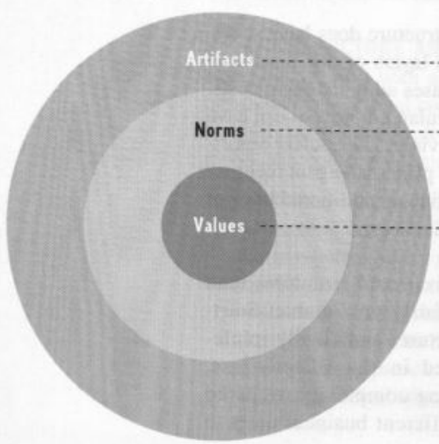
organizational culture
The collectively shared values and norms of an organization's members; a key building block of organizational design.

Employees learn about an organization's culture through *socialization*, a process whereby employees internalize an organization's values and norms through immersion in its day-to-day operations.[38] Zappos' new-employee orientation and immersion is now a four-week extensive course. Successful socialization, in turn, allows employees to function productively and to take on specific roles within the organization. *Strong cultures* emerge when the company's core values are widely shared among the firm's employees and when the norms have been internalized.

Corporate culture finds its expression in *artifacts*. Artifacts include elements such as the design and layout of physical space (e.g., cubicles or private offices); symbols (e.g., the type of clothing worn by employees); vocabulary; what stories are told (see the Zappos pizza-ordering example that follows); what events are celebrated and highlighted; and how they are celebrated (e.g., a formal dinner versus a casual BBQ when the firm reaches its sales target).

Exhibit 11.11 depicts the elements of organizational culture—values, norms, and artifacts—in concentric circles. The most important yet least visible element—values—is in the center. As we move outward in the figure, from values to norms to artifacts, culture becomes more observable. Understanding what organizational culture is, and how

EXHIBIT 11.11 / The Elements of Organizational Culture: Values, Norms, and Artifacts



Artifacts: At Zappos, even under its previous structure, all employees including CEO Tony Hsieh, worked from a cubicle

Norms: Zappos continues to celebrate the norm of happiness; employees are encouraged to promote happiness in the workplace in creative ways.

Values: Zappos turned to the employees themselves to articulate company values, conspicuous in orientation, daily operations, and evaluation reviews.

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it is created, maintained, and changed, can help you be a more effective manager. A unique culture that is strategically relevant can also be the basis of a firm's competitive advantage.

As Zappos grew, its managers realized that it was critical to explicitly define a set of core values from which to develop the company's culture, brand, and strategy. Zappos CEO Tony Hsieh wanted to make sure that all employees understood the same set of values and expected behaviors. Zappos' list of 10 core values (see Exhibit 11.12) was crafted through a bottom-up initiative, in which all employees were invited to participate.

EXHIBIT 11.12 / Zappos' 10 Core Values

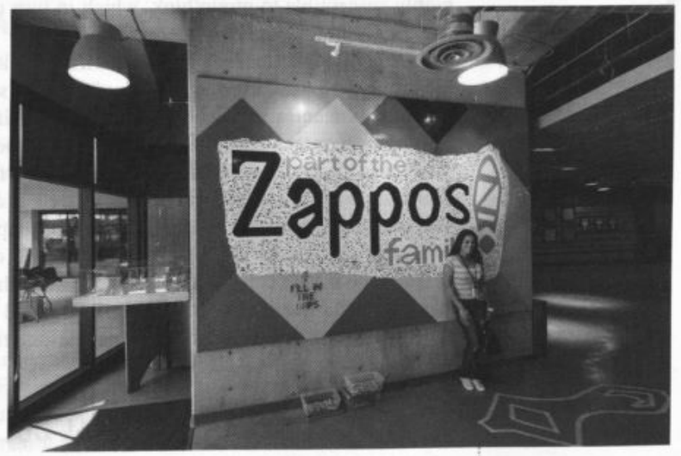
1. Deliver WOW through service.
2. Embrace and drive change.
3. Create fun and a little weirdness.
4. Be adventurous, creative, and open-minded.
5. Pursue growth and learning.
6. Build open and honest relationships with communication.
7. Build a positive team and family spirit.
8. Do more with less.
9. Be passionate and determined.
10. Be humble.

Source: T. Hsieh (2010), *Delivering Happiness: A Path to Profits, Passion, and Purpose* (New York: Business Plus), pp. 157–160.

To live up to its mission of delivering happiness, Zappos decided that exceptional customer service should be its number-one core value. The company put several policies and procedures in place to "deliver WOW through service." For example, shipments to and from customers within the United States are free, allowing customers to order several pairs of shoes and send back (within a liberal 365 days) those that don't fit or are no longer wanted. Repeat customers are automatically upgraded to complimentary express shipping. One of the most important lessons Hsieh learned is "Never outsource your core competency!"[39] Customer service, therefore, is done exclusively in-house.

Perhaps even more importantly, Zappos does not provide a script or measure customer service reps' call times. Rather, the company leaves it up to the individual member of the "Customer Loyalty Team" to deliver exceptional customer service: "We want our reps to let their true personalities shine during each phone call so that they can develop a personal emotional connection with the customer."[40] In fact, one customer service phone call lasted almost six hours! The same trust in the customer service reps applies to e-mail communication. Zappos' official communication policy is to "be real and use your best judgment."[41] Most of Zappos' more than 1,500 employees are in some type of sales function, to maintain constant contact with the customer. The customer call centers are staffed 24/7, seven days a week, 365 days a year.

Zappos third core value, "create fun and a little weirdness," encourages a unique culture based on shared experiences including costume play ("cosplay") at work, parades, fun contests, themed courtyard events, ice cream trucks, Nerf guns, Ping-Pong, live animals, and so on.[42] One of the hardest choices Zapponians need to make each day is choosing which fun event to support, including trivia nights, family picnics, pinewood derby races, talent shows, Foosball, snow sledding, spring break days, pajama days, and karaoke. This is all just part of another day at the Zappos office.



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Besides creating a strong culture that binds employees together through shared fun experiences, Zappos believes that encouraging a little weirdness and fun helps people to

think outside the box and thus be more creative and innovative. All this helps to achieve their number-one core value to "deliver WOW through service," but also other core values such as "do more with less." Taken together, employees are more engaged in their work, not only with their hands, but also their minds and hearts, and the company is being more innovative and nimble as a whole.

WHERE DO ORGANIZATIONAL CULTURES COME FROM?

founder imprinting
A process by which the founder defines and shapes an organization's culture, which can persist for decades after his or her departure.

Often, company founders define and shape an organization's culture, which can persist for many decades after their departure. This phenomenon is called **founder imprinting**.[43] Founders set the initial strategy, structure, and culture of an organization by transforming their vision into reality. Famous founders who have left strong imprints on their organizations include Steve Jobs (Apple), Walt Disney (Disney), Michael Dell (Dell), Sergey Brin and Larry Page (Google), Oprah Winfrey (Harpo Productions and *OWN*, the Oprah Winfrey Network), Bill Gates (Microsoft), Larry Ellison (Oracle), Ralph Lauren (Polo Ralph Lauren), Martha Stewart (Martha Stewart Living Omnimedia), and Herb Kelleher (Southwest Airlines).

Walmart founder Sam Walton personified the retailer's cost-leadership strategy. At one time the richest man in America, Sam Walton drove a beat-up Ford pickup truck, got $5 haircuts, went camping for vacations, and lived in a modest ranch home in Bentonville, Arkansas.[44] Everything Walton did was consistent with the low-cost strategy. Walmart stays true to its founder's tradition. Home to one of the largest companies on the planet, the company's Arkansas headquarters in Bentonville was described by Thomas Friedman in his book *The World Is Flat* as "crammed into a reconfigured warehouse . . . a large building made of corrugated metal, I figured it was the maintenance shed."[45]

The culture that founders initially imprint is reinforced by their strong preference to recruit, retain, and promote employees who subscribe to the same values. In turn, more people with similar values are attracted to that organization.[46] As the values and norms held by the employees become more similar, the firm's corporate culture becomes stronger and more distinct. This in turn can have a serious negative side-effect: **groupthink**, a situation in which opinions coalesce around a leader without individuals critically evaluating and challenging that leader's opinions and assumptions. Cohesive, non-diverse groups are highly susceptible to groupthink, which in turn can lead to flawed decision making with potentially disastrous consequences.

groupthink
A situation in which opinions coalesce around a leader without individuals critically evaluating and challenging that leader's opinions and assumptions.

In addition to founder imprinting, a firm's culture also flows from its values, especially when they are linked to the company's reward system. For example, Zappos established its unique organizational culture through explicitly stated values that are connected to its reward system (see Exhibit 11.12). To recruit people that fit with the company's values, Hsieh has all new hires go through a four-week training program. It covers such topics as company history, culture, and vision, as well as customer service.[47] New hires also spend two weeks on the phone as customer service reps. What's novel about Zappos' approach is that at the end of the monthlong employee orientation, the company offers an "exit prize:" one month's pay plus pay for the time already with Zappos. This allows the company to entice people to leave that are qualified for the job but may not fit with Zappos' culture. Individuals who choose to stay despite the enticing offer tend to fit well with and strengthen Zappos' distinct culture.[48]

HOW DOES ORGANIZATIONAL CULTURE CHANGE?

An organization's culture can be one of its strongest assets, but also its greatest liability. An organization's culture can turn from a core competency into a *core rigidity* if a firm relies too long on the competency without honing, refining, and upgrading as the firm and the

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environment change.[49] (See discussion in Chapter 4.) Over time, the original core competency is no longer a good fit and turns from an asset into a liability. This is the time when a culture needs to change.

GM's bureaucratic culture, combined with its innovative M-form structure, was once hailed as the key to superior efficiency and management.[50] However, that culture became a liability when the external environment changed following the oil-price shocks in the 1970s and the entry of Japanese carmakers into the United States.[51] As a consequence, GM's strong culture led to organizational inertia. This resulted in a failure to adapt to changing customer preferences for more fuel-efficient cars, and it prevented higher quality and more innovative designs. GM lost customers to foreign competitors that offered these features.

Mary Barra, CEO, General Motors
© Jeff Kowalsky/Bloomberg/Getty Images

More recently, GM's strong culture was again faulted for corporate ineptitude when delaying recalling defective cars.[52] In 2014, over 25 million GM cars were recalled for safety defects, the largest recall ever. In particular, many GM cars were eventually recalled because of a faulty ignition switch, which could turn off the engine while driving and thus disable the airbags. This problem has been linked to more than 120 fatalities in the United States alone.[53] GM is alleged to knowingly have withheld information about the faulty ignition switches and delayed the needed recalls by several years. Indeed, during a U.S. Senate hearing, GM was described as dominated by a "culture of cover-up."[54] In such times of crisis, corporate culture must be changed to avoid such problems in the future and to address a breakdown in the culture-environment fit.

The primary means of cultural change is for the corporate board of directors to bring in new leadership at the top, which is then charged to make changes in strategy and structure. After all, executives shape corporate culture in their decisions on how to structure the organization and its activities, allocate its resources, and develop its system of rewards (see the discussion on strategic leadership in Chapter 2). In 2014, GM's board of directors appointed Mary Barra as CEO with the charge to fix GM's dysfunctional corporate culture and to make the company competitive again.

ORGANIZATIONAL CULTURE AND COMPETITIVE ADVANTAGE

Can organizational culture be the basis of a firm's competitive advantage? For this to occur, the firm's unique culture must help it in some way to increase its *economic value creation* (*V–C*). That is, it must either help in increasing the perceived value of the product/service and/or lower its cost of production/delivery. Moreover, according to the resource-based view of the firm, the resource—in this case, organizational culture—must be *valuable, rare, difficult to imitate,* and the firm must be *organized* to capture the value created. The VRIO principles (see Chapter 4) must apply even as to organizational culture itself.[55]

Let's look at two examples of how culture affects employee behavior and ultimately firm performance:

- If you have flown with Southwest Airlines (SWA), you may have noticed that things are done a little differently there. Flight attendants might sing a song about the city you're landing in, or they might slide bags of peanuts down the aisle at takeoff. Employees celebrate Halloween in a big way by wearing costumes to work. Some argue that SWA's business strategy—being a cost leader in point-to-point air travel—is fairly simple, and that SWA's competitive advantage actually comes from its unique culture.[56] It's not all fun and games, though: Friendly and highly energized

employees work across functional and hierarchical levels. Even Southwest's pilots pitch in to help load baggage quickly when needed. As a result, SWA's turn time between flights is only 15 minutes, whereas competitors frequently take two to three times as long.

- Zappos' number-one core value is to "deliver WOW through service." CEO Hsieh shares the following story to illustrate this core value in action: "I was in Santa Monica, California, a few years ago at a Skechers sales conference. . . . [In the early hours of the morning], a small group of us headed up to someone's hotel room to order some food. My friend from Skechers tried to order a pepperoni pizza from the room-service menu but was disappointed to learn that the hotel did not deliver hot food after 11:00 p.m. We had missed the deadline by several hours. . . . A few of us cajoled her into calling Zappos to try to order a pizza. She took us up on our dare, turned on the speakerphone, and explained to the (very) patient Zappos rep that she was staying in a Santa Monica hotel and really craving a pepperoni pizza, that room service was no longer delivering hot food, and that she wanted to know if there was anything Zappos could do to help. The Zappos rep was initially a bit confused by the request, but she quickly recovered and put us on hold. She returned two minutes later, listing the five closest places in the Santa Monica area that were still open and delivering pizzas at that time."[57]

In the SWA example, the company's unique culture helps it keep costs low by turning around its planes faster, thus keeping them flying longer hours (among many other activities that lower SWA's cost structure).[58] In the Zappos example, providing a "wow" customer experience by "going the extra mile" didn't save Zappos money, but in the long run superior experience does increase the company's perceived value and thereby its economic value creation. Indeed, Hsieh makes it a point to conclude the story with the following statement: "As for my friend from Skechers? After that phone call, she's now a customer for life."[59]

Let's consider how an organization's culture can have a strong influence on employee behavior.[60] A positive culture motivates and energizes employees by appealing to their higher ideals. Internalizing the firm's values and norms, employees feel that they are part of a larger, meaningful community attempting to accomplish important things. When employees are intrinsically motivated this way, the firm can rely on fewer levels of hierarchy; thus close monitoring and supervision are not needed as much. Moreover, motivating through inspiring values allows the firms to tap employees' emotions so they use both their heads and their hearts when making business decisions. Strong organizational cultures that are strategically relevant, therefore, align employees' behaviors more fully with the organization's strategic goals. In doing so, they better coordinate work efforts, and they make cooperation more effective. They also strengthen employee commitment, engagement, and effort. Effective alignment in turn allows the organization to develop and refine its core competencies, which can form the basis for competitive advantage.

Applying the VRIO principles to the SWA and Zappos examples, we see that both cultures are *valuable* (lowering costs for SWA and increasing perceived value created for Zappos), *rare* (none of their competitors has an identical culture), *non-imitable* (despite attempts by competitors), and *organized* to capture some part of the incremental economic value created due to their unique cultures. It appears that at both SWA and Zappos, a unique organizational culture can provide the basis for a competitive advantage. These cultures, of course, need to be in sync with and in support of the respective business strategies pursued: cost leadership for SWA and differentiation for Zappos. Moreover, as the firms grow and external economic environments change, these cultures must be flexible enough to adapt.

Once it becomes clear that a firm's culture is a source of competitive advantage, some competitors will attempt to imitate that culture. Therefore, only a culture that cannot be easily copied can provide a competitive advantage. It can be difficult, at best, to imitate the cultures of successful firms, for two reasons: *causal ambiguity* and *social complexity*. While one can observe that a firm has a unique culture, the causal relationships among values, norms, artifacts, and the firm's performance may be hard to establish, even for people who work within the organization. For example, employees may become aware of the effect culture has on performance only after significant organizational changes occur. Moreover, organizational culture is socially complex. It encompasses not only interactions among employees across layers of hierarchy, but also the firm's outside relationships with its customers and suppliers.[61] Such a wide range of factors is difficult for any competing firm to imitate.

It is best to develop a strong and strategically relevant culture in the first few years of a firm's existence. Strategy scholars have documented that the initial structure, culture, and control mechanisms established in a new firm can be a significant predictor of later success.[62] In other empirical research, founder CEOs had a stronger positive imprinting effect than non-founder CEOs.[63] This stronger imprinting effect, in turn, resulted in higher performance of firms led by founder CEOs. In addition, consider that the vehicles of cultural change—changing leadership and M&As—do not have a stellar record of success.[64] Indeed, researchers estimate that only about 20 percent of organizational change attempts are successful.[65] Thus, it is even more important to get the culture right from the beginning and then adapt it as the business evolves.

By combining theory and empirical evidence, we can see that organizational culture can help a firm gain and sustain competitive advantage *if* the culture makes a positive contribution to the firm's economic value creation and obeys the VRIO principles. Organizational culture is an especially effective lever for new ventures due to its malleability. Firm founders, early-stage CEOs, and venture capitalists, therefore, should be proactive in attempting to create a culture that supports a firm's economic value creation.

11.4 Strategic Control-and-Reward Systems

LO 11-7

Compare and contrast different strategic control-and-reward systems.

Strategic control-and-reward systems are the third and final key building block when designing organizations for competitive advantage. **Strategic control-and-reward systems** are internal-governance mechanisms put in place to align the incentives of principals (shareholders) and agents (employees). These systems allow managers to specify goals, measure progress, and provide performance feedback.

strategic control-and-reward systems Internal-governance mechanisms put in place to align the incentives of principals (shareholders) and agents (employees).

Zappos restructured its performance-evaluation system to give these values teeth: The firm rewards employees who apply the values (shown in Exhibit 11.11) well in their day-to-day decision making. It created an open market (referred to internally as OM) based on an online scheduling platform that allows Zappos, customer service employees to select their work hours. The novel tweak in the OM system is that it compensates customer service employees based on a surge-pricing payment model (first popularized by the taxi-hailing service, Uber). Hsieh states, "Ideally, we want all 10 core values to be reflected in everything we do, including how we interact with each other, how we interact with our customers, and how we interact with our vendors and business partners. . . . Our core values should always be the framework

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from which we make all of our decisions."[66] Zappos' 10 core values are important to its employees; they define their identity of what it means to be working at Zappos.[67]

Chapter 5 discussed how firms can use the balanced-scorecard framework as a strategic control system. Here, we discuss additional control-and-reward systems: organizational culture, input controls, and output controls.

As just demonstrated, *organizational culture* can be a powerful motivator. It also can be an effective control system. Norms, informal and tacit in nature, act as a social control mechanism. Zappos, for example, achieves organizational control partly through an employee's peer group: Each group member's compensation, including the supervisor's, depends in part on the group's overall productivity. Peer control, therefore, exerts a powerful force on employee conformity and performance.[68] Values and norms also provide control by helping employees address unpredictable and irregular situations and problems (common in service businesses). In contrast, rules and procedures (e.g., codified in an employee handbook) can address only circumstances that can be predicted.

INPUT CONTROLS

input controls Mechanisms in a strategic control-and-reward system that seek to define and direct employee behavior through a set of explicit, codified rules and standard operating procedures that are considered prior to the value-creating activities.

Input controls seek to define and direct employee behavior through a set of explicit, codified rules and standard operating procedures. Firms use input controls when the goal is to define the ways and means to reach a strategic goal and to ensure a predictable outcome. They are called input controls because management designs these mechanisms so they are considered *before* employees make any business decisions; thus, they are an input into the value-creating activities.

The use of *budgets* is key to input controls. Managers set budgets before employees define and undertake the actual business activities. For example, managers decide how much money to allocate to a certain R&D project before the project begins. In diversified companies using the M-form, corporate headquarters determines the budgets for each division. Public institutions, like some universities, also operate on budgets that must be balanced each year. Their funding often depends to a large extent on state appropriations and thus fluctuates depending on the economic cycle. During recessions, budgets tend to be cut, and they expand during boom periods.

Standard operating procedures, or policies and rules, are also a frequently used mechanism when relying on input controls. The discussion on formalization described how McDonald's relies on detailed operating procedures to ensure consistent quality and service worldwide. The goal is to specify the conversion process from beginning to end in great detail to guarantee standardization and minimize deviation. This is important when a company operates in different geographies and with different human capital throughout the globe but needs to deliver a standardized product or service.

OUTPUT CONTROLS

output controls Mechanisms in a strategic control-and-reward system that seek to guide employee behavior by defining expected results (outputs), but leave the means to those results open to individual employees, groups, or SBUs.

Output controls seek to guide employee behavior by defining expected results (outputs), but leave the means to those results open to individual employees, groups, or SBUs. Firms frequently tie employee compensation and rewards to predetermined goals, such as a specific sales target or return on invested capital. When factors internal to the firm determine the relationship between effort and expected performance, outcome controls are especially effective. At the corporate level, outcome controls discourage collaboration among different strategic business units. They are best applied when a firm focuses on a single line of business or pursues unrelated diversification.

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These days, more and more work requires creativity and innovation, especially in highly developed economies.[69] As a consequence, so-called *results-only-work-environments (ROWEs)* have attracted significant attention. ROWEs are output controls that attempt to tap intrinsic (rather than extrinsic) employee motivation, which is driven by the employee's interest in and the meaning of the work itself. In contrast, extrinsic motivation is driven by external factors such as awards and higher compensation, or punishments like demotions and layoffs (the *carrot-and-stick approach*). According to a recent synthesis of the strategic human resources literature, intrinsic motivation in a task is highest when an employee has:

- Autonomy *(about what to do).*
- Mastery *(how to do it).*
- Purpose *(why to do it).*[70]

Today, 3M is best known for its adhesives and other consumer and industrial products.[71] But its full name reflects its origins: 3M stands for Minnesota Mining and Manufacturing Company. Over time, 3M has relied on the ROWE framework and has morphed into a highly science-driven innovation company. At 3M, employees are encouraged to spend 15 percent of their time on projects of their *own choosing.* If any of these projects look promising, 3M provides financing through an internal venture capital fund and other resources to further develop their commercial potential. In fact, several of 3M's flagship products, including Post-it Notes and Scotch Tape, were the results of serendipity. To foster continued innovation, moreover, 3M requires each of its divisions to derive at least 30 percent of their revenues from products introduced in the past four years.

11.5 ◀▶ Implications for the Strategist

This chapter has a clear practical implication for the strategist: Formulating an effective strategy is a necessary but not sufficient condition for gaining and sustaining competitive advantage; strategy *execution* is at least as important for success. Successful strategy implementation requires managers to design and shape structure, culture, and control mechanisms. In doing so, they execute a firm's strategy as they put its accompanying business model into action. Strategy formulation and strategy implementation, therefore, are iterative and interdependent activities.

Some argue that strategy implementation is more important than strategy formulation.[72] Often, managers do a good job of analyzing the firm's internal and external environments to formulate a promising business, corporate, and global strategy, but then fail to implement the chosen strategy successfully. That is why some scholars refer to implementation as the "graveyard of strategy."[73]

As a company grows and its operations become more complex, it adopts different organizational structures over time following a generally predictable pattern: beginning with a simple structure, then a functional structure, and followed by a multidivisional or matrix structure.

Organizing for competitive advantage, therefore, is a dynamic and not a static process. As seen in the Zappos example discussed throughout the chapter, in order to maintain competitive advantage, companies need to restructure as they grow and the competitive environment changes.

This concludes our discussion of organizational design. We now move on to our concluding chapter, where we study corporate governance and business ethics.

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CHAPTERCASE 11 / Consider This . . .

ZAPPOS' IMPLEMENTION OF holacracy is not going well. As a consequence, employee morale has plummeted, and Zappos employees are no longer as happy. In 2014, Zappos was ranked seventh in *Fortune*'s "100 Best Companies to Work For" list (one of the highest ranking for a relatively young firm). By 2015, after it started implementing holacracy, Zappos had dropped to rank 86! In addition, more than 200 employees, or some 14 percent of Zappos' work force, accepted the offer of a three-month severance package if they didn't like the switch to holacracy and quit. Employees that remain with Zappos complain that the holacracy implementation removes clear career paths for advancement and wonder openly how hiring, firing, and promoting will now be done. They are concerned that relying on employee circles for making decisions will not only induce paralysis, but also make the organization more and not less political. In sum, they find that holacracy forces them to waste time in meetings rather than getting the actual work done.

After the initial implementation struggle, Hsieh remains committed and is doubling down on holacracy implementation. He expressed his frustration about the slow process and lack of productivity gains in a lengthy e-mail to all Zappos employees, which was subsequently leaked to the business press. At the same time, the irony that Hsieh decreed top-down that Zappos would be implementing holacracy (or decided a few years earlier to sell the company to Amazon.com) wasn't lost on the company's workers.

Questions

1. What elements of an organic organization are apparent from the chapter material on Zappos? (Refer to Exhibit 11.3.)
2. What is holacracy, and how does this organizational structure differ from the more traditional ones discussed in this chapter?
3. Why is Zappos experiencing significant implementation problems with holacracy? What else could Zappos do to help implement the new structure more effectively?
4. Do you think that holacracy is a good match with Zappos' business strategy? Why or why not? Explain.

TAKE-AWAY CONCEPTS

This chapter explored the three key levers that managers have at their disposal when designing their firms for competitive advantage—structure, culture, and control—as summarized by the following learning objectives and related take-away concepts.

LO 11-1 / Define organizational design and list its three components.

- Organizational design is the process of creating, implementing, monitoring, and modifying the structure, processes, and procedures of an organization.
- The key components of organizational design are structure, culture, and control.
- The goal is to design an organization that allows managers to effectively translate their chosen strategy into a realized one.

LO 11-2 / Explain how organizational inertia can lead established firms to failure.

- Organizational inertia can lead to the failure of established firms when a tightly coupled system of strategy and structure experiences internal or external shifts.
- Firm failure happens through a dynamic, four-step process (see Exhibit 11.2).

LO 11-3 / Define organizational structure and describe its four elements.

- An organizational structure determines how firms orchestrate employees' work efforts and distribute resources. It defines how firms divide and integrate tasks, delineates the reporting relationships up and down the hierarchy, defines formal communication channels, and prescribes how employees coordinate work efforts.
- The four building blocks of an organizational structure are specialization, formalization, centralization, and hierarchy (see Exhibit 11.3).

LO 11-4 / Compare and contrast mechanistic versus organic organizations.

- Organic organizations are characterized by a low degree of specialization and formalization, a flat organizational structure, and decentralized decision making.
- Mechanistic organizations are described by a high degree of specialization and formalization, and a tall hierarchy that relies on centralized decision making.
- The comparative effectiveness of mechanistic versus organic organizational forms depends on the context.

LO 11-5 / Describe different organizational structures and match them with appropriate strategies.

- To gain and sustain competitive advantage, not only must structure follow strategy, but also the chosen organizational form must match the firm's business strategy.
- The strategy–structure relationship is dynamic, changing in a predictable pattern—from simple to functional structure, then to multidivisional (M-form) and matrix structure—as firms grow in size and complexity.
- In a simple structure, the founder tends to make all the important strategic decisions as well as run the day-to-day operations.
- A functional structure groups employees into distinct functional areas based on domain expertise. Its different variations are matched with different business strategies: cost leadership, differentiation, and blue ocean (see Exhibit 11.6).
- The multidivisional (M-form) structure consists of several distinct SBUs, each with its own profit-and-loss responsibility. Each SBU operates more or less independently from one another, led by a CEO responsible for the business strategy of the unit and its day-to-day operations (see Exhibit 11.7).
- The matrix structure is a mixture of two organizational forms: the M-form and the functional structure (see Exhibit 11.9).
- Exhibits 11.8 and 11.10 show how best to match different corporate and global strategies with respective organizational structures.

LO 11-6 / Describe the elements of organizational culture, and explain where organizational cultures can come from and how they can be changed.

- Organizational culture describes the collectively shared values and norms of its members.
- Values define what is considered important, and norms define appropriate employee attitudes and behaviors.
- Corporate culture finds its expression in artifacts, which are observable expressions of an organization's culture.

LO 11-7 / Compare and contrast different strategic control-and-reward systems.

- Strategic control-and-reward systems are internal governance mechanisms put in place to align the incentives of principals (shareholders) and agents (employees).
- Strategic control-and-reward systems allow managers to specify goals, measure progress, and provide performance feedback.
- In addition to the balanced-scorecard framework, managers can use organizational culture, input controls, and output controls as part of the firm's strategic control-and-reward systems.
- Input controls define and direct employee behavior through explicit and codified rules and standard operating procedures.
- Output controls guide employee behavior by defining expected results, but leave the means to those results open to individual employees, groups, or SBUs.

Chapter 12

Corporate Governance and Business Ethics

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Chapter Outline

12.1 The Shared Value Creation Framework
Public Stock Companies and Shareholder Capitalism
Creating Shared Value

12.2 Corporate Governance
Agency Theory
The Board of Directors
Other Governance Mechanisms

12.3 Strategy and Business Ethics

12.4 Implications for the Strategist

Learning Objectives

LO 12-1 Describe the shared value creation framework and its relationship to competitive advantage.

LO 12-2 Explain the role of corporate governance.

LO 12-3 Apply agency theory to explain why and how companies use governance mechanisms to align interests of principals and agents.

LO 12-4 Evaluate the board of directors as the central governance mechanism for public stock companies.

LO 12-5 Evaluate other governance mechanisms.

LO 12-6 Explain the relationship between strategy and business ethics.

Uber: Most Ethically Challenged Tech Company?

IN THE SUMMER of 2015 Uber surpassed a valuation of over $50 billion and became the most valuable private startup ever. Yet in the wake of its business success, Uber leaves a trail of lawsuits and accusations.

RECORD-BREAKING GROWTH

Only one other new venture—Facebook—has ever reached a $50 billion valuation for a private, venture-capital-backed firm. But it took Facebook seven years to reach this mark; Uber only five. For perspective, the valuation of the car rental giant Hertz, with some 150 locations, a fleet of 500,000 cars, and some 30,000 employees, is only about a fifth of Uber's valuation.

Uber reached this astronomical valuation because it successfully expanded both in the United States and globally to more than 300 cities. Uber's popularity grows exponentially, as it already transports millions of riders daily, and continues to expand rapidly here and abroad. Although Uber is still losing money as it continues to subsidize customer fares, its revenues race ahead, from $400 million in 2014 to $2 billion in 2015.

Protest against Uber
© Lucy Nicholson/Reuters/Corbis

UBER'S BEGINNING

Uber started in 2008 when Travis Kalanick and Garrett Camp were bothered by the inconvenience of getting a cab in San Francisco. The two tech entrepreneurs worked up a prototype of a cab-hailing app and won the first round of funding a year later to further develop the service. They chose the name Uber when inspired by the idea of using a Mercedes limousine and driver instead of a regular cab—the German word *über* means "superior." By 2010, Uber debuted its service in San Francisco.

ETHICALLY CHALLENGED?

Despite its meteoric rise, not all is roses for Uber. Venture capitalist Peter Thiel called Uber the "most ethically challenged company in Silicon Valley."[1] But then, Thiel, the billionaire co-founder of PayPal and Palantir (a big data analytics company), is also an investor in Lyft, Uber's main competitor. Lyft has a valuation of only $2.5 billion. Thiel argues that Uber is pushing the envelope of what is acceptable, ethical, and even legal with all its stakeholders, including its dealings with regulators, government bodies at different levels, freelance drivers, journalists, and competitors. Thiel further argues that Uber is on the cusp of going too far.

ITS OWN RIVAL

Echoing Thiel's assessment, *The Wall Street Journal (WSJ)* argued Uber itself—rather than Lyft or old-line taxi and limo services—is its own biggest threat, thereby functioning as its own biggest rival. The competitive tactics and comments by Uber executives are harming the company's reputation and becoming a liability, the *WSJ* argues. The company's short history provides rich examples for such claims.

- **Open disregard for laws, rules, and regulations.** Within months of its San Francisco launch, the local Metro Transit Authority and the state Public Utilities Commission each ordered Uber to cease and desist. They argued that Uber was operating as a taxi service without proper licensing. Pushback and injunctions followed in major domestic markets, including New York City and Los Angeles, and internationally in Toronto, Paris, London, Berlin, and Delhi. Ignoring such warnings, Uber continues to expand.
- **Dynamic pricing**. While the taxi industry operates under regulation with fixed pricing, Uber opts for the dynamic pricing used by airlines, hotels, and other industries. That is, Uber's fares go up or down based on real-time supply and demand. So during a

snowstorm or on New Year's Eve, short Uber rides can cost hundreds of dollars. CEO Kalanick argues that surge pricing efficiently matches supply and demand. But many Uber users see it as price gouging and vent their frustrations on Twitter and Facebook.

- **Competitive tactics**. Lyft, the competing ride-share app, accused Uber of ordering over 5,000 rides from Lyft, and then canceling, so Lyft drivers lost business from legitimate rides. Reportedly Uber tells its drivers in New York that they cannot work for both Uber and Lyft because of city regulations; the city says Uber's claim is untrue. Accusers say that Uber brand ambassadors actively target successful drivers from Lyft and other competitors to defect.
- **Poisoning sources of funding**. Kalanick reportedly poisoned Lyft's efforts to raise venture capital, telling investors, "before you decide whether you want to invest in [Lyft], just make sure you know that we are going to be fund-raising immediately after."[2]
- **Death of a child**. An Uber driver, while between fares, tragically struck and killed 6-year-old Sophia Liu in a crosswalk in San Francisco. Claims arose that the driver was busy using the Uber app at the time and did not see the girl. Uber, rather than dealing with this public relations disaster by expressing condolences to the family for their loss, focused on its legal posture and coldly denied all liability, making sure that people knew that the driver was between Uber jobs.
- **Sexist ad campaign**. Uber's office in Lyon, France, ran a sexist ad campaign that promised rides with "avions de chasse" as drivers, which is French for fighter jets, but colloquially it means "hot chicks." The ads were accompanied by revealing photos of models. Uber headquarters canceled the ad campaign and apologized for the "clear misjudgment by the local team."
- **Attacking critics**. In late 2014, Uber senior executive Emil Michael was heard to say that Uber should spend a million dollars to hire private investigators to dig up dirt on journalists who wrote damaging pieces on Uber, with particular focus on Sarah Lacy, of tech blog PandoDaily. When the remarks became public, he apologized. Uber CEO Kalanick said that Michael's comments were "a departure from our values and ideals," but Michaels was not otherwise disciplined.
- **Stealth tech transfer**. In the spring of 2015, Uber opened its Advanced Tech Center in Pittsburgh to develop autonomous cars and sophisticated mapping services. Uber gained access to scientists when it funded research at Carnegie Mellon University's National Robotics Engineering Center (NREC). A few months later, Uber poached entire NREC research teams with signing bonuses, twice the salaries, and stock options. It is also building a super-modern research center adjacent to the CMU campus. The NREC was left a shell, with its entire future in question. To add insult to injury to Carnegie Mellon, Uber rented a billboard next to its computer science department, reading, "We are looking for the best software engineers in Pittsburgh."
- **Thumbing its nose**. With the announced agenda of its Advanced Tech Center, Uber moves into direct conflict with one of its biggest partners and investors, Google, the leader in online maps and a pioneer in self-driving cars. After successfully demonstrating an autonomous vehicle on California's highways and cities, Google is hopeful that its self-driving car technology will be viable by 2020 for widespread adoption.[3]

You will learn more about Uber from reading this chapter; related questions appear on page 419.

THE UBER CHAPTERCASE illustrates how intricate and intertwined business ethics issues and competitive advantage can be. With over $50 billion in valuation, Uber is riding high as the world's most valuable private start-up firm. Its huge cash pile fuels its rapid expansion in the United States and abroad. It allows Uber to subsidize fares and to attract more drivers to its platform. All this is done to create network effects based on a large installed base of Uber drivers and users. In what is likely to be a winner-take-all market, Uber is planning to be the winner in the ride-hailing business. Some caution that Uber is risking going too far in its competitive tactics. Uber is certainly pushing the envelope with what is ethical as well as legal in its business practices. This strong-arm approach might harm the company's reputation and negatively impact its competitive advantage.

In this chapter, we wrap up our discussion of strategy implementation and close the circle in the AFI framework by studying two important areas: corporate governance and

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business ethics. We begin with the *shared value creation framework* to illuminate the link between strategic management, competitive advantage, and society more fully. We then discuss effective *corporate-governance* mechanisms to direct and control the enterprise, which a firm must put in place to ensure pursuit of its intended goals. Next, we study *business ethics,* which enable managers to think through complex decisions in an increasingly dynamic, interdependent, and global marketplace. The vignettes in the ChapterCase documenting controversial decisions, tactics, and statements by Uber highlight the link between business ethics and competitive advantage. We conclude with "Implications for the strategist."

12.1 The Shared Value Creation Framework

LO 12-1

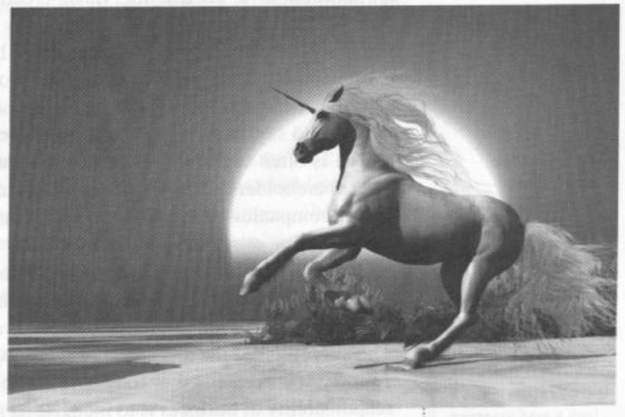
Describe the shared value creation framework and its relationship to competitive advantage.

The shared value creation framework provides guidance to managers about how to reconcile the economic imperative of gaining and sustaining competitive advantage with corporate social responsibility (introduced in Chapter 1).[4] It helps managers create a larger pie that benefits both shareholders and other stakeholders. To develop the shared value creation framework, though, we first must understand the role of the public stock company.

PUBLIC STOCK COMPANIES AND SHAREHOLDER CAPITALISM

The public stock company is an important institutional arrangement in modern, free market economies. It provides goods and services as well as employment, pays taxes, and increases the standard of living. There exists an implicit contract based on trust between society and the public stock company. Society grants the right to incorporation, but in turn expects companies to be good citizens by adding value to society.

To fund future growth, companies frequently need to go public. Uber, featured in the ChapterCase, is one of the few companies that achieved a huge valuation prior to an initial public offering. Private start-up companies valued at a billion dollars or more are called *unicorns,* because at one time they seemed as rare as the mythical beast. But their elusiveness has changed. The tech sector now has the lion's share: some 75 unicorns valued at $1 billion or more, for a total of $273 billion.[5] The top five most valuable private start-up companies (as of the summer of 2015) are Uber, Airbnb, Snapchat, Palantir Technologies, and SpaceX (rocket science). These new ventures may eventually go public such as Facebook did in 2012, but as long as they remain private they do not have to follow the stringent financial reporting and auditing requirements that public stock companies do. Consider that there may be a connection between firm structure and the degree that it integrates ethics. Not needing to expose themselves to as much public scrutiny as a publicly traded company also allows unicorns such as Uber to push the envelope in their legal and ethical business practices.



In capital markets, private companies that achieve a valuation of $1 billion or greater are rare enough to be called unicorns.
© Catmando/ Shutterstock.com RF

Exhibit 12.1 depicts the levels of hierarchy within a public stock company. The state or society grants a charter of incorporation to the company's shareholders—its owners, who legally own stock in the company. The shareholders appoint a board of directors to govern

EXHIBIT 12.1

The Public Stock Company: Hierarchy of Authority

and oversee the firm's management. The managers hire, supervise, and coordinate employees to manufacture products and provide services. The public stock company enjoys four characteristics that make it an attractive corporate form:[6]

1. *Limited liability for investors.* This characteristic means that the shareholders who provide the risk capital are liable only to the capital specifically invested, and not for other investments they may have made or for their personal wealth. Limited liability encourages investments by the wider public and entrepreneurial risk-taking.
2. *Transferability of investor ownership* through the trading of shares of stock on exchanges such as the New York Stock Exchange (NYSE) and NASDAQ,[7] or exchanges in other countries. Each share represents only a minute fraction of ownership in a company, thus easing transferability.
3. *Legal personality*—that is, the law regards a non-living entity such as a for-profit firm as similar to a person, with legal rights and obligations. Legal personality allows a firm's continuation beyond the founder or the founder's family.
4. *Separation of legal ownership and management control.*[8] In publicly traded companies, the stockholders (the principals, represented by the board of directors) are the legal owners of the company, and they delegate decision-making authority to professional managers (the agents).

The public stock company has been a major contributor to value creation since its inception as a new organizational form more than a hundred years ago. Michael Porter and others, however, argue that many public companies have defined value creation too narrowly in terms of financial performance.[9] This in turn has contributed to some of the *black swan events* discussed in Chapter 1, such as large-scale accounting scandals and the global financial crisis. Managers' pursuit of strategies that define value creation too narrowly may have negative consequences for society at large, as evidenced during the global financial crisis. This narrow focus has contributed to the loss of trust in the corporation as a vehicle for value creation, not only for shareholders but also other stakeholders and society.

Nobel laureate Milton Friedman stated his view of the firm's social obligations: "There is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud."[10] This notion is often captured by the term **shareholder capitalism**. According to this perspective, shareholders—the providers of the necessary risk capital and the legal owners of public companies—have the most legitimate claim on profits. When introducing the notion of *corporate social responsibility* (CSR) in Chapter 1, though, we noted that a firm's obligations frequently go beyond the economic responsibility to increase profits, extending to ethical and philanthropic expectations that society has of the business enterprise.[11]

shareholder capitalism
Shareholders—the providers of the necessary risk capital and the legal owners of public companies—have the most legitimate claim on profits.

A recent survey measured attitudes toward business responsibility in various countries. The survey asked the top 25 percent of income earners holding a university degree in each country surveyed whether they agree with Milton Friedman's philosophy that "the social responsibility of business is to increase its profits."[12] The results, displayed in Exhibit 12.2, revealed some intriguing national differences. The United Arab Emirates (UAE), a small and business-friendly federation of seven emirates, had the highest level of agreement, at 84 percent. The top five also included a number of Asian countries (Japan, India, South Korea, and Singapore), where roughly two-thirds agreed.

The countries where the fewest people agreed with Friedman's philosophy were China, Brazil, Germany, Italy, and Spain; fewer than 40 percent of respondents in those countries supported an exclusive focus on shareholder capitalism. Although they have achieved a

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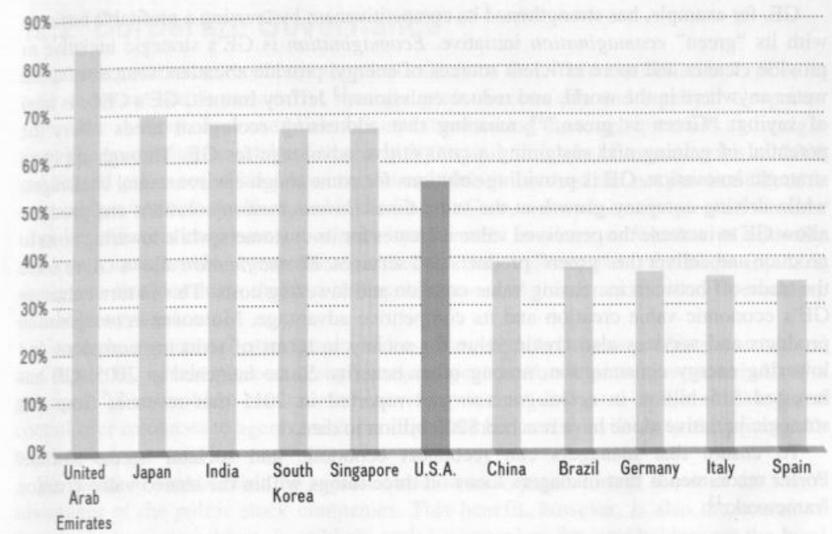

EXHIBIT 12.2

Global Survey of Attitudes toward Business Responsibility

The bar chart indicates the percentage of members of the "informed public" who "strongly agree/somewhat agree" with Milton Friedman's philosophy, "the social responsibility of business is to increase its profits."

Source: Author's depiction of data from Edelman's (2011) Trust Barometer as included in "Milton Friedman goes on tour," The Economist, January 27, 2011.

high standard of living, European countries such as Germany have tempered the free market system with a strong social element, leading to so-called *social market economies*. The respondents from these countries seemed to be more supportive of a *stakeholder strategy* approach to business. Some critics, however, would argue that too strong a focus on the social dimension contributed to the European debt crisis because sovereign governments such as Greece, Italy, and Spain took on nonsustainable debt levels to fund social programs such as early retirement plans, government-funded health care, and so on. The United States placed roughly in the middle of the continuum. In particular, a bit more than half (56 percent) of U.S. respondents subscribed to Friedman's philosophy.

CREATING SHARED VALUE

In contrast to Milton Friedman, Porter argues that executives should not concentrate exclusively on increasing firm profits. Rather, the strategist should focus on creating *shared value*, a concept that involves creating economic value for shareholders while also creating social value by addressing society's needs and challenges. He argues that managers need to reestablish the important relationship between superior firm performance and societal progress. This dual point of view, Porter argues, will not only allow companies to gain and sustain a competitive advantage but also reshape capitalism and its relationship to society.

The **shared value creation framework** proposes that managers maintain a dual focus on shareholder value creation and value creation for society. It recognizes that markets are defined not only by economic needs but also by societal needs. It also advances the perspective that *externalities* such as pollution, wasted energy, and costly accidents actually create *internal costs*, at least in lost reputation if not directly on the bottom line. Rather than pitting economic and societal needs in a trade-off, Porter suggests that the two can be reconciled to create a larger pie. The shared value creation framework seeks to enhance a firm's competitiveness by identifying connections between economic and social needs, and then creating a competitive advantage by addressing these business opportunities.

shared value creation framework
A model proposing that managers have a dual focus on shareholder value creation and value creation for society.

GE, for example, has strengthened its competitiveness by creating a profitable business with its "green" *ecomagination* initiative. *Ecomagination* is GE's strategic initiative to provide cleaner and more efficient sources of energy, provide abundant sources of clean water anywhere in the world, and reduce emissions.[13] Jeffrey Immelt, GE's CEO, is fond of saying: "Green is green,"[14] meaning that addressing ecological needs offers the potential of gaining and sustaining a competitive advantage for GE. Through applying strategic innovation, GE is providing solutions for some tough environmental challenges, while driving company growth at the same time. *Ecomagination* solutions and products allow GE to increase the perceived value it creates for its customers while lowering costs to produce and deliver the "green" products and services. *Ecomagination* allows GE to solve the trade-off between increasing value creation and lowering costs. This in turn enhances GE's economic value creation and its competitive advantage. Moreover, *ecomagination* products and services also create value for society in terms of reducing emissions and lowering energy consumption, among other benefits. Since launched in 2005, GE has invested $15 billion in *ecomagination* and reported in 2015 that revenues from this strategic initiative alone have reached $200 billion to date.

To ensure that managers can reconnect economic and societal needs, Michael Porter recommends that managers focus on three things within the shared value creation framework:[15]

1. **Expand the customer base to bring in *nonconsumers*** such as those at the *bottom of the pyramid*—the largest but poorest socioeconomic group of the world's population. The bottom of the pyramid in the global economy can yield significant business opportunities, which—if satisfied—could improve the living standard of the world's poorest. Muhammad Yunus, Nobel Peace Prize winner, founded Grameen Bank in Bangladesh to provide small loans (termed *microcredit)* to impoverished villagers, who used the funding for entrepreneurial ventures that would help them climb out of poverty. Other businesses have also found profitable opportunities at the bottom of the pyramid. In India, Arvind Mills offers jeans in a ready-to-make kit that costs only a fraction of the high-end Levi's. The Tata group sells its Nano car for around 150,000 rupees (less than $2,500), enabling more Indian families to move from mopeds to cars and adding up to a substantial business.
2. **Expand traditional internal firm value chains to include more nontraditional partners** such as *nongovernmental organizations* (NGOs). NGOs are nonprofit organizations that pursue a particular cause in the public interest and are independent of any governments. Habitat for Humanity and Greenpeace are examples of NGOs.
3. **Focus on creating new *regional clusters*** such as Silicon Valley in the United States, Electronic City in Bangalore, India, and Chilecon Valley in Santiago, Chile.

In line with *stakeholder theory* (discussed in Chapter 1), Porter argues that these strategic actions will lead to a larger pie of revenues and profits that can be distributed among a company's stakeholders. General Electric, for example, recognizes a convergence between shareholders and stakeholders to create shared value. It states in its governance principles: "Both the board of directors and management recognize that the long-term interests of shareowners are advanced by responsibly addressing the concerns of other stakeholders and interested parties, including employees, recruits, customers, suppliers, GE communities, government officials, and the public at large."[16] To ensure that convergence indeed takes place, companies need effective governance mechanisms, which we discuss next.

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12.2 Corporate Governance

LO 12-2

Explain the role of corporate governance.

corporate governance A system of mechanisms to direct and control an enterprise in order to ensure that it pursues its strategic goals successfully and legally.

Corporate governance concerns the mechanisms to direct and control an enterprise in order to ensure that it pursues its strategic goals successfully and legally.[17] Corporate governance is about checks and balances and about asking the tough questions at the right time. The accounting scandals of the early 2000s and the global financial crisis of 2008 and beyond got so out of hand because the enterprises involved did not practice effective corporate governance. As discussed in the ChapterCase, some observers question whether Uber has effective corporate-governance mechanisms in place, or whether its ethically and legally questionable competitive tactics and decisions are part of a larger intended strategy to first dominate the taxi-hailing business and then to address any remaining stakeholder grievances.

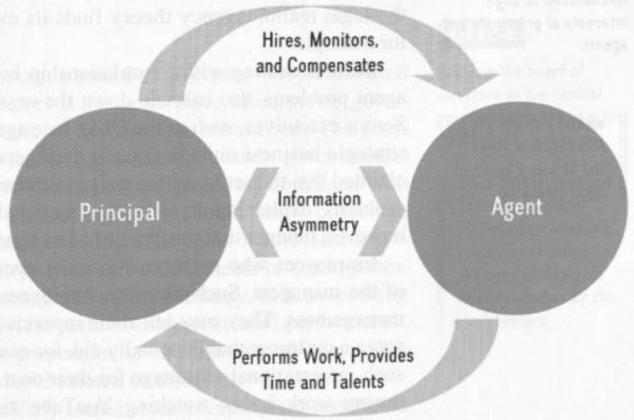
Corporate governance attempts to address the *principal–agent problem* (introduced in Chapter 8), which can occur any time an agent performs activities on behalf of a principal.[18] This problem can arise whenever a principal delegates decision making and control over resources to agents, with the expectation that they will act in the principal's best interest.

We mentioned earlier that the separation of ownership and control is one of the major advantages of the public stock companies. This benefit, however, is also the source of the principal–agent problem. In publicly traded companies, the stockholders are the legal owners of the company, but they delegate decision-making authority to professional managers. The conflict arises if the agents pursue their own personal interests, which can be at odds with the principals' goals. For their part, agents may be more interested in maximizing their total compensation, including benefits, job security, status, and power. Principals desire maximization of total returns to shareholders.

The risk of opportunism on behalf of agents is exacerbated by *information asymmetry:* the agents are generally better informed than the principals. Exhibit 12.3 depicts the principal–agent relationship.

Managers, executives, and board members tend to have access to *private information* concerning important company developments that outsiders, especially investors, are not privy to. Often this informational advantage is based on timing—insiders are the first to learn about important developments before the information is released to the public. Although possessing insider information is not illegal and indeed is part of an executive's job, what *is* illegal is acting upon it through trading stocks or passing on the information to others who might do so. Insider-trading cases, therefore, provide an example of egregious exploitation of information asymmetry. The hedge fund Galleon Group (holding assets worth $7 billion under management at its peak) was engulfed in an insider-trading scandal involving private information about important developments at companies such as Goldman Sachs, Google, IBM, Intel, and P&G.[19] Galleon Group's founder, Raj Rajaratnam, the mastermind behind a complex network of informants, was sentenced to 11 years in

EXHIBIT 12.3 / The Principal–Agent Problem



prison and fined more than $150 million. In one instance, an Intel manager had provided Rajaratnam with internal Intel data such as orders for processors and production runs. These data indicated that demand for Intel processors was much higher than analysts had expected. Galleon bought Intel stock well before this information was public to benefit from the anticipated share appreciation.

In another instance, Rajaratnam benefited from insider tips provided by Rajat Gupta, a former McKinsey chief executive who served on Goldman Sachs' board. Often within seconds after a Goldman Sachs board meeting ended, Gupta called Rajaratnam. In one of these phone calls, Gupta revealed the impending multibillion-dollar liquidity injection by Warren Buffett into Goldman Sachs during the midst of the global financial crisis. This information allowed the Galleon Group to buy Goldman Sachs shares before the official announcement about Buffett's investment was made, profiting from the subsequent stock appreciation. In another call, Gupta informed Rajaratnam that the investment bank would miss earnings estimates. Based on this insider information, the Galleon Group was able to sell its holdings in Goldman Sachs' stock prior to the announcement, avoiding a multimillion-dollar loss.[20]

Information asymmetry also can breed *on-the-job consumption,* perquisites, and excessive compensation. Although use of company funds for golf outings, resort retreats, professional sporting events, or elegant dinners and other entertainment is an everyday manifestation of on-the-job consumption, other forms are more extreme. Dennis Kozlowski, former CEO of Tyco, a diversified conglomerate, used company funds for his $30 million New York City apartment (the shower curtain alone was $6,000) and for a $2 million birthday party for his second wife.[21] John Thain, former CEO of Merrill Lynch, spent $1.2 million of company funds on redecorating his office, while he demanded cost cutting and frugality from his employees.[22] Such uses of company funds, in effect, mean that shareholders pay for those items and activities. Thain also allegedly requested a bonus of up to $30 million in 2009 despite Merrill Lynch having lost billions of dollars and being unable to continue as an independent company. Merrill Lynch was later acquired by Bank of America in a fire sale.

AGENCY THEORY

LO 12-3

Apply agency theory to explain why and how companies use governance mechanisms to align interests of principals and agents.

The principal–agent problem is a core part of **agency theory**, which views the firm as a nexus of legal contracts.[23] In this perspective, corporations are viewed merely as a set of legal contracts between different parties. Conflicts that may arise are to be addressed in the legal realm. Agency theory finds its everyday application in employment contracts, for example.

agency theory
A theory that views the firm as a nexus of legal contracts.

Besides dealing with the relationship between shareholders and managers, principal–agent problems also cascade down the organizational hierarchy (shown in Exhibit 12.3). Senior executives, such as the CEO, face agency problems when they delegate authority of strategic business units to general managers. Uber headquarters staff in the United States claimed that the sexist ad campaign launched by its French office was based on an agency problem, explaining it as a "clear misjudgment of the local team." The local team, however, thought that this type of ad campaign would serve Uber in France well.

Employees who perform the actual operational labor are agents who work on behalf of the managers. Such frontline employees often enjoy an informational advantage over management. They may tell their supervisor that it took longer to complete a project or serve a customer than it actually did, for example. Some employees may be tempted to use such informational advantage for their own self-interest (e.g., spending time on Facebook during work hours, watching YouTube videos, or using the company's computer and Internet connection for personal business).

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The managerial implication of agency theory relates to the management functions of organization and control: The firm needs to design work tasks, incentives, and employment contracts and other control mechanisms in ways that minimize opportunism by agents. Such governance mechanisms are used to align incentives between principals and agents. These mechanisms need to be designed in such a fashion as to overcome two specific agency problems: *adverse selection* and *moral hazard.*

ADVERSE SELECTION. In general, **adverse selection** occurs when information asymmetry increases the likelihood of selecting inferior alternatives. In principal–agent relationships, for example, adverse selection describes a situation in which an agent misrepresents his or her ability to do the job. Such misrepresentation is common during the recruiting process. Once hired, the principal may not be able to accurately assess whether the agent can do the work for which he or she is being paid. The problem is especially pronounced in team production, when the principal often cannot ascertain the contributions of individual team members. This creates an incentive for opportunistic employees to free-ride on the efforts of others.

adverse selection
A situation that occurs when information asymmetry increases the likelihood of selecting inferior alternatives.

MORAL HAZARD. In general, **moral hazard** describes a situation in which information asymmetry increases the incentive of one party to take undue risks or shirk other responsibilities because the costs accrue to the other party. For example, bailing out homeowners from their mortgage obligations or bailing out banks from the consequences of undue risk-taking in lending are examples of moral hazard. The costs of default are rolled over to society. Knowing that there is a high probability of being bailed out ("too big to fail") increases moral hazard. In this scenario, any profits remain private, while losses become public.

moral hazard
A situation in which information asymmetry increases the incentive of one party to take undue risks or shirk other responsibilities because the costs incur to the other party.

In the principal–agent relationship, moral hazard describes the difficulty of the principal to ascertain whether the agent has really put forth a best effort. In this situation, the agent is *able* to do the work but may decide not to do so. For example, a company scientist at a biotechnology company may decide to work on his own research project, hoping to eventually start his own firm, rather than on the project he was assigned.[24] While working on his own research on company time, he might also use the company's laboratory and technicians. Given the complexities of basic research, it is often challenging, especially for nonscientist principals, to ascertain which problem a scientist is working on.[25] To overcome these principal–agent problems, firms put several governance mechanisms in place. We shall discuss several of them next, beginning with the board of directors.

THE BOARD OF DIRECTORS

LO 12-4

Evaluate the board of directors as the central governance mechanism for public stock companies.

The shareholders of public stock companies appoint a **board of directors** to represent their interests (see Exhibit 12.1). The board of directors is the centerpiece of corporate governance in such companies. The shareholders' interests, however, are not uniform. The goals of some shareholders, such as institutional investors (e.g., retirement funds, governmental bodies, and so on), are generally the long-term viability of the enterprise combined with profitable growth. Long-term viability and profitable growth should allow consistent dividend payments and result in stock appreciation over time. The goals of other shareholders, such as hedge funds, are often to profit from short-term movements of stock prices. These more proactive investors often demand changes in a firm's strategy, such as spinning out certain divisions or splitting up companies into parts to enhance overall performance. Votes at shareholder meetings, generally in proportion to the amount of ownership, determine whose representatives are appointed to the board of directors.

board of directors
The centerpiece of corporate governance, composed of inside and outside directors who are elected by the shareholders.

The day-to-day business operations of a publicly traded stock company are conducted by its managers and employees, under the direction of the chief executive officer (CEO)

and the oversight of the board of directors. The board of directors is composed of inside and outside directors who are elected by the shareholders:[26]

inside directors Board members who are generally part of the company's senior management team; appointed by shareholders to provide the board with necessary information pertaining to the company's internal workings and performance.

- **Inside directors** are generally part of the company's senior management team, such as the chief financial officer (CFO) and the chief operating officer (COO). They are appointed by shareholders to provide the board with necessary information pertaining to the company's internal workings and performance. Without this valuable inside information, the board would not be able to effectively monitor the firm. As senior executives, however, inside board members' interests tend to align with management and the CEO rather than the shareholders.
- **Outside directors**, on the other hand, are not employees of the firm. They frequently are senior executives from other firms or full-time professionals, who are appointed to a board and who serve on several boards simultaneously. Given their independence, they are more likely to watch out for the interests of shareholders.

outside directors Board members who are not employees of the firm, but who are frequently senior executives from other firms or full-time professionals.

The board is elected by the shareholders to represent their interests. Each director has a *fiduciary responsibility*—a legal duty to act solely in another party's interests—toward the shareholders because of the trust placed in him or her. Prior to the annual shareholders' meeting, the board proposes a slate of nominees, although shareholders can also directly nominate director candidates. In general, large institutional investors support their favored candidates through their accumulated proxy votes. The board members meet several times a year to review and evaluate the company's performance and to assess its future strategic plans as well as opportunities and threats. In addition to general strategic oversight and guidance, the board of directors has other, more specific functions, including:

- Selecting, evaluating, and compensating the CEO. The CEO reports to the board. Should the CEO lose the board's confidence, the board may fire him or her.
- Overseeing the company's CEO succession plan.
- Providing guidance to the CEO in the selection, evaluation, and compensation of other senior executives.
- Reviewing, monitoring, evaluating, and approving any significant strategic initiatives and corporate actions such as large acquisitions.
- Conducting a thorough risk assessment and proposing options to mitigate risk. The boards of directors of the financial firms at the center of the global financial crisis were faulted for not noticing or not appreciating the risks the firms were exposed to.
- Ensuring that the firm's audited financial statements represent a true and accurate picture of the firm.
- Ensuring the firm's compliance with laws and regulations. The boards of directors of firms caught up in the large accounting scandals were faulted for being negligent in their company oversight and not adequately performing several of the functions listed here.

Board independence is critical to effectively fulfilling a board's governance responsibilities. Given that board members are directly responsible to shareholders, they have an incentive to ensure that the shareholders' interests are pursued. If not, they can experience a loss in reputation or can be removed outright. More and more directors are also exposed to legal repercussions should they fail in their fiduciary responsibility. To perform their strategic oversight tasks, board members apply the strategic management theories and concepts presented herein, among other more specialized tools such as those originating in finance and accounting.

To make the workings of a board of directors more concrete, Strategy Highlight 12.1 takes a closer look at corporate governance at General Electric.[27]

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Strategy Highlight 12.1

GE's Board of Directors

The GE board is composed of individuals from the business world (chairpersons and CEOs of Fortune 500 companies spanning a range of industries), academia (business school and science professors, deans, and provosts), and government (SEC).[28] Including the board's chairperson, GE's board has 16 members. Experts in corporate governance consider that an appropriate number of directors for a company of GE's size (roughly $260 billion in market capitalization as of the summer of 2015).

At GE (as of 2015), 15 of the 16 board members (94 percent) are independent outside directors. To achieve board independence, experts in corporate governance recommend that two-thirds of its directors be outsiders. GE's board has only one inside director, Jeffrey Immelt, GE's CEO, who also serves as chairman of the board. In roughly half of U.S. public firms, the CEO of the company also serves as chair of the board of directors.

GE's board of directors meets a dozen or more times annually. With increasing board accountability in recent years, boards now tend to meet more often. Moreover, many firms limit the number and type of directorships a board member may hold concurrently. To accomplish their responsibilities, boards of directors are usually organized into different committees. GE's board has five committees, each with its own chair: the audit committee; the management development and compensation committee; the nominating, governance, and affairs committee; the risk committee; and the science and technology committee.

In general, women and minorities remain underrepresented on boards of directors across the United States and throughout most of the world. GE's board is somewhat more diverse in gender when compared with other Fortune 500 companies, which in 2014 averaged 19 percent women on their boards versus 25 percent for GE.

Generally, the larger the company, the greater its gender diversity, as demonstrated in recent years by tracking different levels of the Fortune 1000. For example, in 2014 boards of the Fortune 100 companies averaged 22 percent gender diversity; of Fortune 500 (as noted), 19 percent; and of the bottom half of the Fortune 1000, 16 percent. GE as of this writing ranks number eight in the Fortune 1000 rankings in terms of gender diversity.

Diversity in backgrounds and expertise in the boardroom is considered an asset: More diverse boards are less likely to fall victim to *groupthink*, a situation in which opinions coalesce around a leader without individuals critically challenging and evaluating that leader's opinions and assumptions.

As discussed in Strategy Highlight 12.1, Jeffrey Immelt serves not only as the chief executive officer (CEO) of GE, a roughly $260 billion conglomerate, but also as chairman of the board. This practice of **CEO/chairperson duality**—holding both the role of CEO and chairperson of the board—has been declining somewhat in recent years.[29] Among the largest 500 publicly traded companies in the United States, almost 70 percent of firms had the dual CEO-chair arrangement in 2005 (pre global financial crisis), but this number had declined to 56 percent of companies in 2012 (post global financial crisis).

CEO/chairperson duality Situation where the CEO of a publicly traded company is also the chairperson of the board of directors.

The functions of the CEO and chairperson of the board roles are distinctly different. A board of directors broadly oversees a company's business activities. The company's CEO reports to the board of directors and acts as a liaison between the company and the board. The CEO has high-level responsibilities of strategy and all other management activities of a company while the functions of the board of directors include approving the annual budget and dealing with stakeholders. Moreover, a CEO is the public face of a company or organization and takes the hit or pat on the back if a company fails or succeeds, while the board of directors is there to steer a company on behalf of shareholders.

Arguments can be made both for and against splitting the roles of CEO and chairperson of the board. On the one hand, the CEO has invaluable inside information that can help in chairing the board effectively. The benefit of a combined CEO and chair of the board is that they can act in unity to streamline and speed the decision-making process

as well as strategy implementation. On the other hand, the chairperson may influence the board unduly through setting the meeting agendas or suggesting board appointees who are friendly toward the CEO. Because one of the key roles of the board is to monitor and evaluate the CEO's performance, there can be a conflict of interest when the CEO actually chairs the board.

LO 12-5

Evaluate other governance mechanisms.

OTHER GOVERNANCE MECHANISMS

While the board of directors is the central governance piece for a public stock company, several other corporate mechanisms are also used to align incentives between principals and agents, including

- Executive compensation.
- The market for corporate control.
- Financial statement auditors, government regulators, and industry analysts.

EXECUTIVE COMPENSATION. The board of directors determines executive compensation packages. To align incentives between shareholders and management, the board frequently grants **stock options** as part of the compensation package. This mechanism is based on agency theory and gives the recipient the right, but not the obligation, to buy a company's stock at a predetermined price sometime in the future. If the company's share price rises above the negotiated strike price, which is often the price on the day when compensation is negotiated, the executive stands to reap significant gains.

stock options An incentive mechanism to align the interests of shareholders and managers, by giving the recipient the right (but not the obligation) to buy a company's stock at a predetermined price sometime in the future.

The topic of executive compensation—and CEO pay, in particular—has attracted significant attention in recent years. Two issues are at the forefront:

1. The absolute size of the CEO pay package compared with the pay of the average employee.
2. The relationship between CEO pay and firm performance.

Absolute Size of Pay Package. The ratio of CEO to average employee pay in the United States is about 300 to 1, up from roughly 40 to 1 in 1980.[30] Based on a 2014 survey of CEOs among 300 large companies with revenues of at least $9 billion, the average salary for a CEO was $14 million. The five highest paid CEOs were Michael Fries of Liberty Global ($112 million), Satya Nadella of Microsoft ($84 million), Larry Ellison of Oracle ($67 million), Steven Mollenkopf of Qualcomm ($61 million), and Leslie Moonves of CBS ($57 million).[31]

CEO Pay and Firm Performance. Overall, the same survey shows that two-thirds of CEO pay is linked to firm performance.[32] The relationship between pay and performance is positive, but the link is weak at best. Although agency theory would predict a positive link between pay and performance as this aligns incentives, some recent experiments in *behavioral economics* caution that incentives that are too high-powered (e.g., outsized bonuses) may have a negative effect on job performance.[33] That is, when the incentive level is very high, an individual may get distracted from strategic activities because too much attention is devoted to the outsized bonus to be enjoyed in the near future. This can further increase job stress and negatively impact job performance.

THE MARKET FOR CORPORATE CONTROL. Whereas the board of directors and executive compensation are *internal* corporate-governance mechanisms, the *market for corporate control* is an important *external* corporate-governance mechanism. It consists of activist investors who seek to gain control of an underperforming corporation by buying shares of its stock in the open market. To avoid such attempts, corporate managers strive to protect shareholder value by delivering strong share-price performance or putting in place poison pills (discussed later).

Here's how the market for corporate control works: If a company is poorly managed, its performance suffers and its stock price falls as more and more investors sell their shares. Once shares fall to a low enough level, the firm may become the target of a *hostile takeover* (as discussed in Chapter 9) when new bidders believe they can fix the internal problems that are causing the performance decline. Besides competitors, so-called *corporate raiders* (e.g., Carl Icahn and T. Boone Pickens) or *private equity firms* and *hedge funds* (e.g., The Blackstone Group and Pershing Square Capital Management) may buy enough shares to exert control over a company.

In a **leveraged buyout (LBO)**, a single investor or group of investors buys, with the help of borrowed money (leveraged against the company's assets), the outstanding shares of a publicly traded company in order to take it private. In short, an LBO changes the ownership structure of a company from public to private. The expectation is often that the private owners will restructure the company and eventually take it public again through an initial public offering (IPO).

leveraged buyout (LBO) A single investor or group of investors buys, with the help of borrowed money (leveraged against the company's assets), the outstanding shares of a publicly traded company in order to take it private.

Private companies enjoy certain benefits that public companies do not. Private companies are not required to disclose financial statements. They experience less scrutiny from analysts and can often focus more on long-term viability. In 2013, computer maker Dell Inc. became a takeover target of famed corporate raider Carl Icahn.[34] He jumped into action after Dell's founder and its largest shareholder, Michael Dell, announced in January of that year that he intended a *leveraged buyout* with the help of Silverlake Partners, a private equity firm, to take the company private. In the Dell buyout battle, many observers, including Icahn who is the second-largest shareholder of Dell, saw the attempt by Michael Dell to take the company private as the "ultimate insider trade."

This view implied that Michael Dell, who is also CEO and chairman, had private information about the future value of the company and that his offer was too low. Dell Inc., which had $57 billion in revenues in its fiscal year 2013, has been struggling in the ongoing transition from personal computers such as desktops and laptops to mobile devices and services. Between December 2004 and February 2009, Dell (which until just a few years earlier was the number-one computer maker) lost more than 80 percent of its market capitalization, dropping from some $76 billion to a mere $14 billion. In late 2013, Dell's shareholders approved the founder's $25 billion offer to take the company private, thus avoiding a hostile takeover.

If a hostile takeover attempt is successful, however, the new owner frequently replaces the old management and board of directors in order to manage the company in a way that creates more value for shareholders. In some instances, the new owner will break up the company and sell its pieces. In either case, since a firm's existing executives face the threat of losing their jobs and their reputations if the firm sustains a competitive disadvantage, the market for corporate control is a credible governance mechanism.

To avoid being taken over against their consent, some firms put in place a **poison pill**. These are defensive provisions that kick in should a buyer reach a certain level of share ownership without top management approval. For example, a poison pill could allow existing shareholders to buy additional shares at a steep discount. Those additional shares would make any takeover attempt much more expensive and function as a deterrent. With the rise of actively involved institutional investors, poison pills have become rare because they retard an effective function of equity markets.

poison pill Defensive provisions to deter hostile takeovers by making the target firm less attractive.

Although poison pills are becoming rarer, the market for corporate control is alive and well, as shown in the battle over control of Dell Inc. or the hostile takeover of Cadbury by

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Kraft (featured in Strategy Highlight 9.2). However, the market for corporate control is a last resort because it comes with significant transaction costs. To succeed in its hostile takeover bid, buyers generally pay a significant premium over the given share price. This often leads to overpaying for the acquisition and subsequent shareholder value destruction—the so-called *winner's curse*. The market for corporate control is useful, however, when internal corporate-governance mechanisms have not functioned effectively and the company is underperforming.

AUDITORS, GOVERNMENT REGULATORS, AND INDUSTRY ANALYSTS. Auditors, government regulators, and industry analysts serve as additional external-governance mechanisms. All public companies listed on the U.S. stock exchanges must file a number of financial statements with the *Securities and Exchange Commission (SEC)*, a federal regulatory agency whose task it is to oversee stock trading and enforce federal securities laws. To avoid the misrepresentation of financial results, all public financial statements must follow *generally accepted accounting principles (GAAP)*[35] and be audited by certified public accountants.

As part of its disclosure policy, the SEC makes all financial reports filed by public companies available electronically via the EDGAR database.[36] This database contains more than 7 million financial statements, going back several years. Industry analysts scrutinize these reports in great detail, trying to identify any financial irregularities and assess firm performance. Given recent high-profile oversights in accounting scandals and fraud cases, the SEC has come under pressure to step up its monitoring and enforcement.

Industry analysts often base their buy, hold, or sell recommendations on financial statements filed with the SEC and business news published in *The Wall Street Journal, Bloomberg Businessweek, Fortune, Forbes,* and other business media such as CNBC. Researchers have questioned the independence of industry analysts and credit-rating agencies that evaluate companies (such as Fitch, Moody's, and Standard & Poor's),[37] because the investment banks and rating agencies frequently have lucrative business relationships with the companies they are supposed to evaluate, creating conflicts of interest. A study of over 8,000 analysts' ratings of corporate equity securities, for example, revealed that investment bankers rated their own clients more favorably.[38]

In addition, an industry has sprung up around assessing the effectiveness of corporate governance in individual firms. Research outfits such as GovernanceMetrics International (now GMI Ratings)[39] provide independent corporate governance ratings. The ratings from these external watchdog organizations inform a wide range of stakeholders, including investors, insurers, auditors, regulators, and others.

Corporate-governance mechanisms play an important part in aligning the interests of principals and agents. They enable closer monitoring and controlling, as well as provide incentives to align interests of principals and agents. Perhaps even more important are the "most internal of control mechanisms": *business ethics*—a topic we discuss next.

LO 12-6

Explain the relationship between strategy and business ethics.

business ethics An agreed-upon code of conduct in business, based on societal norms.

12.3 Strategy and Business Ethics

Multiple, high-profile accounting scandals and the global financial crisis have placed business ethics center stage in the public eye. **Business ethics** are an agreed-upon code of conduct in business, based on societal norms. Business ethics lay the foundation and provide training for "behavior that is consistent with the principles, norms, and standards of business practice that have been agreed upon by society."[40] These principles, norms, and standards of business practice differ to some degree in different cultures around the globe. But a large number of research studies have found that some notions—such as fairness, honesty, and reciprocity—are universal norms.[41] As such, many of these values have been codified into law.

Law and ethics, however, are not synonymous. This distinction is important and not always understood by the general public. Staying within the law is a *minimum acceptable standard*. A note of caution is therefore in order: A manager's actions can be completely legal, but ethically questionable. For example, consider the actions of mortgage-loan officers who—being incentivized by commissions—persuaded unsuspecting consumers to sign up for exotic mortgages, such as "option ARMs." These mortgages offer borrowers the choice to pay less than the required interest, which is then added to the principal while the interest rate can adjust upward. Such actions may be legal, but they are unethical, especially if there are indications that the borrower might be unable to repay the mortgage once the interest rate moves up.[42]

To go beyond the minimum acceptable standard codified in law, many organizations have explicit *codes of conduct*. These codes go above and beyond the law in detailing how the organization expects an employee to behave and to represent the company in business dealings. Codes of conduct allow an organization to overcome moral hazards and adverse selections as they attempt to resonate with employees' deeper values of justice, fairness, honesty, integrity, and reciprocity. Since business decisions are not made in a vacuum but are embedded within a societal context that expects ethical behavior, managers can improve their decision making by also considering:

- When facing an ethical dilemma, a manager can ask whether the intended course of action falls within the *acceptable norms of professional behavior* as outlined in the organization's code of conduct and defined by the profession at large.
- The manager should imagine whether he or she would feel *comfortable explaining and defending the decision in public*. How would the media report the business decision if it were to become public? How would the company's stakeholders feel about it?

Strategy Highlight 12.2 features Goldman Sachs, which has come under scrutiny and faced tough questions pertaining to its business dealings in the wake of the financial crisis.

In the aftermath of the Abacus debacle (discussed in Strategy Highlight 12.2), Goldman Sachs revised its code of conduct. A former Goldman Sachs employee, Greg Smith, published a book chronicling his career at the investment bank, from a lowly summer intern (in 2000) to head of Goldman Sachs' U.S. equity derivatives business in Europe, the Middle East, and Africa (in 2012).[43] Smith's thesis was that the entire ethical climate within Goldman Sachs changed over that period of time. For its first 130 years, Goldman Sachs was organized as a professional partnership, like most law firms. In this organizational form, a selected group of partners are joint owners and directors of the professional service firms. After years of superior performance, associates in the professional service firms may "make partner"—being promoted to joint owner. During the time when organized as a professional partnership, Goldman Sachs earned a reputation as the best investment bank in the world. It had the best people and put its clients' interests first. Smith describes how Goldman's culture—and with it, employee attitudes—changed after the firm went public (in 1999), from "we are here to serve our clients as honorable business partners, and we have our clients' best interests in mind," to "we [Goldman Sachs and our clients] are all grown-ups and just counter parties to any transaction."[44] In the latter perspective, unsuspecting clients in the Abacus deal were seen just as "counter parties to a transaction," who should have known better.

Some people believe that unethical behavior is limited to a few "bad apples" in organizations.[45] The assumption is that the vast majority of the population—and by extension, organizations—are good, and that we need only safeguard against abuses by a few bad

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Strategy Highlight 12.2

Did Goldman Sachs and the "Fabulous Fab" Commit Securities Fraud?

In April 2010, the SEC sued Goldman Sachs and one of its employees, Fabrice Tourre, for securities fraud. The SEC's case focused on one specific, mortgage-related deal during the financial crisis. The deal began in 2006 during the height of the real estate bubble in the United States. The assumption at this time was that house prices could only go up, after years of consistent real estate appreciation. Indeed, real estate prices in the United States had surged, and a speculative bubble had emerged. The real estate bubble was fueled by cheap mortgages, many of them extended to home buyers who really couldn't afford them. John Paulson, founder of the hedge fund Paulson & Co., approached Goldman Sachs with a trading idea to place a billion-dollar bet that the real estate bubble was about to burst. This would occur when borrowers began to default on their mortgages in large numbers. House prices would collapse as distressed borrowers attempted to unload their properties at fire sale prices and banks foreclosed in large numbers. That is exactly what happened.

To benefit from his timely insight, Paulson asked Goldman Sachs to create an investment instrument, later named "Abacus." Goldman Sachs agreed and assigned Tourre to put Abacus together. This investment vehicle was a *collateralized debt obligation (CDO)*. CDOs are made up of thousands of mortgages bundled together into bonds. These bonds provide stable and regular interest payments as long as the borrowers make mortgage payments. CDOs were considered to be much safer investment choices than regular, standalone mortgages because defaults by a few borrowers would not matter much. To make matters worse, rating agencies such as Standard & Poor's, Fitch, and Moody's frequently rated such CDOs as "triple A," which is the highest-quality rating. A triple A rating indicates an "extremely strong capacity" for the borrower to meet its financial obligation. Only a few companies, such as Exxon, Johnson & Johnson, and Microsoft, hold a triple A rating. Given that the Abacus investment vehicle received a triple A rating, many institutional investors such as pension funds bought into it. Everything looked great: Abacus was offered by Goldman Sachs, the number-one investment bank in the world with a stellar reputation, and it had a triple A rating.

But, according to internal e-mails, Paulson and several Goldman Sachs employees, including Tourre, knew otherwise. For example, Tourre, who had earlier been dubbed "fabulous Fab," by a colleague, saw the nickname redound publicly to his discredit when it came out under oath. Specifically, one e-mail was from Tourre to his girlfriend at the time, in which he described himself wistfully in the third person, anticipating the burst of the real estate bubble:

> The entire building is at risk of collapse at any moment. Only potential survivor, the fabulous Fab (. . . even though there is nothing fabulous about me . . .) standing in the middle of all these complex, highly leveraged, exotic trades he created without necessarily understanding all the implications of these monstrosities.[46]

Paulson and Tourre worked together in selecting highly risky CDOs to roll into Abacus. Goldman Sachs then turned around and sold the Abacus CDOs to unsuspecting clients—without, of course, revealing the motivation behind Abacus. Nor did Goldman Sachs reveal that Paulson helped in selecting the riskiest CDOs to be bundled into Abacus. Paulson then took a "short position" in Abacus—meaning he actually bet against its success. Paulson & Co. sold shares that it did not yet own, in anticipation that the value would fall and Paulson would cover its sold shares by buying them at the fallen price. In contrast, institutional investors, often long-term Goldman clients, believed that Abacus was a great investment opportunity. When the real estate bubble burst, Paulson made more than $1 billion from his position in Abacus.

The question that immediately arose was whether Goldman Sachs defrauded investors—as the SEC believed. The SEC argued that the investment bank knowingly misled investors by not revealing its motives in putting Abacus together and not informing them about John Paulson's role in this transaction. Basically, the SEC alleged that Goldman violated its *fiduciary responsibility* and defrauded its clients. Mounting a strong legal defense, Goldman Sachs argued that it is up to the clients to assess the risks involved in any investments. As public pressure mounted, however, Goldman Sachs settled the lawsuit with the SEC by paying a $550 million fine without admitting any wrongdoing. Tourre declined a settlement, and his case went to court. In August 2013, Tourre was convicted of securities fraud.[47]

Tourre ultimately decided not to appeal the decision, stating instead he wished to complete his doctoral studies and hoped to make contributions to scholarship in the field of economics. He is currently pursuing a PhD at the University of Chicago.

actors. According to agency theory, it's the "bad agents" who act opportunistically, and principals need to be on guard against bad actors.

However, research indicates that it is not just the few "bad apples" but entire organizations that can create a climate in which unethical, even illegal behavior is tolerated.[48] While there clearly are some people with unethical or even criminal inclinations, in general one's ethical decision-making capacity depends very much on the organizational context. Research shows that if people work in organizations that expect and value ethical behavior, they are more likely to act ethically.[49] The opposite is also true. Enron's *stated* key values included respect and integrity, and its mission statement proclaimed that all business dealings should be open and fair.[50] Yet, the ethos at Enron was all about creating an inflated share price at any cost, and its employees observed and followed the behavior set by their leaders.

Sometimes, it's the bad barrel that can spoil the apples! This is precisely what Smith argues in regard to Goldman Sachs: The ethical climate had changed for the worse, so that seeing clients as mere "counter parties" to transactions made deals like Abacus possible. One could argue that Tourre simply followed the values held within Goldman Sachs ("profit is king" and "clients are grown-ups"). As a mid-level employee, many view Tourre as the scapegoat in the Abacus case.[51]

Employees take cues from their environment on how to act. Therefore, ethical leadership is critical, and strategic leaders set the tone for the ethical climate within an organization. This is one of the reasons the HP board removed then-CEO Mark Hurd (in 2010) even without proof of illegal behavior or violation of the company's sexual-harassment policy. The forced resignation was prompted by a lawsuit against Hurd by a former adult movie actress who worked for HP as independent contractor alleging sexual harassment. This action goes to show that CEOs of Fortune 500 companies are under constant public scrutiny and ought to adhere to the highest ethical standards. If they do not, they cannot rationally expect their employees to behave ethically. Unethical behavior can quickly destroy the reputation of a CEO, one of the most important assets he or she possesses.

To foster ethical behavior in employees, boards must be clear in their ethical expectations, and top management must create an organizational structure, culture, and control system that values and encourages desired behavior. Furthermore, a company's formal and informal cultures must be aligned, and executive behavior must be in sync with the formally stated vision and values. Employees will quickly see through any duplicity. Actions by executives speak louder than words in vision statements.

Other leading professions have accepted codes of conduct (e.g., the bar association in the practice of law and the Hippocratic oath in medicine); management has not.[52] Some argue that management needs an accepted code of conduct,[53] holding members to a high professional standard and imposing consequences for misconduct. Misconduct by an attorney, for example, can result in being disbarred and losing the right to practice law. Likewise, medical doctors can lose their professional accreditations if they engage in misconduct.

To anchor future managers in professional values and to move management closer to a truly professional status, a group of Harvard Business School students developed an MBA oath (see Exhibit 12.4).[54] Since 2009, over 6,000 MBA students from over 300 institutions around the world have taken this voluntary pledge. The oath explicitly recognizes the role of business in society and its responsibilities beyond shareholders. It also holds managers to a high ethical standard based on more or less universally accepted principles in order to "create value responsibly and ethically."[55] Having the highest personal integrity is of utmost importance to one's career. It takes decades to build a career, but sometimes just a few moments to destroy one. The voluntary MBA oath sets professional standards, but its effect on behavior is unknown, and it does not impose any consequences for misconduct.

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EXHIBIT 12.4

The MBA Oath

Source: www.mbaoath.org

As a business leader I recognize my role in society.

- *My purpose is to lead people and manage resources to create value that no single individual can create alone.*
- *My decisions affect the well-being of individuals inside and outside my enterprise, today and tomorrow.*

Therefore, I promise that:

- *I will manage my enterprise with loyalty and care, and will not advance my personal interests at the expense of my enterprise or society.*
- *I will understand and uphold, in letter and spirit, the laws and contracts governing my conduct and that of my enterprise.*
- *I will refrain from corruption, unfair competition, or business practices harmful to society.*
- *I will protect the human rights and dignity of all people affected by my enterprise, and I will oppose discrimination and exploitation.*
- *I will protect the right of future generations to advance their standard of living and enjoy a healthy planet.*
- *I will report the performance and risks of my enterprise accurately and honestly.*
- *I will invest in developing myself and others, helping the management profession continue to advance and create sustainable and inclusive prosperity.*

In exercising my professional duties according to these principles, I recognize that my behavior must set an example of integrity, eliciting trust and esteem from those I serve. I will remain accountable to my peers and to society for my actions and for upholding these standards.

This oath I make freely, and upon my honor.

12.4 Implications for the Strategist

An important implication for the strategist is the recognition that effective corporate governance and solid business ethics are critical to gaining and sustaining competitive advantage. Governance and ethics are closely intertwined in an intersection of setting the right organizational core values and then ensuring compliance.

A variety of corporate governance mechanisms can be effective in addressing the principal–agent problem. These mechanisms tend to focus on monitoring, controlling, and providing incentives, and they must be complemented by a strong code of conduct and strategic leaders who act with integrity. The strategist must help employees to "walk the talk"; leading by ethical example often has a stronger effect on employee behavior than words alone.

The strategist needs to look beyond shareholders and apply a stakeholder perspective to ensure long-term survival and success of the firm. A firm that does not respond to stakeholders beyond stockholders in a way that keeps them committed to its vision will not be successful. Stakeholders want fair treatment even if not all of their demands can be met. Fairness and transparency is critical to maintaining good relationships within the network of stakeholders the firm is embedded in. Finally, the large number of glaring ethical lapses over the last decade or so makes it clear that organizational core values and a code of conduct are key to the continued professionalization of management. Strategic leaders need to live organizational core values by example.

CHAPTERCASE 12 / Consider This...

SOME CRITICS WOULD argue that Uber's motto seems to be "we don't care for any laws, rules, or regulations; we will deal with the legal fallout later, after we create a large number of happy users and drivers in a city that will support us and will lobby politicians on our behalf." Uber's customers are happy because they can hail rides conveniently and cheaply, often in areas that are underserved by regular taxis, and drivers are happy because they can choose when and how long to work.

Uber is also vehemently defending its policy of dynamic pricing. Without surge pricing, Uber emphasizes, taxis are simply not available during peak times because the limited supply is filled up so quickly. Surge pricing attracts more drivers on the road and helps in matching demand and supply. In further defense of its business model, it stated that the median income of an Uber driver in San Francisco is $75,000 while it is $91,000 in New York City. Meanwhile, Uber is investing heavily in the development of self-driving cars and more sophisticated online mapping systems. The goal appears to be to offer Uber rides by autonomous vehicles, replacing Uber's some 250,000 drivers, at some point in the future. Commenting on this strategic intent, CEO Travis Kalanick stated: "The reason Uber could be expensive is because you're not just paying for the car — you're paying for the other dude in the car. When there's no other dude in the car, the cost of taking an Uber anywhere becomes cheaper than owning a vehicle."[56] After an outcry by Uber drivers on social media such as Facebook and Twitter, Kalanick backpedaled by stating that he doesn't think autonomous cars will be ready for widespread use until 2035. In contrast, Google sees self-driving cars on the road as early as 2020.

Uber is also much more than a simple ride-hailing service. It is the greatest disruptor that the transportation industry has seen since the invention of the automobile. Uber is first disrupting old-line taxi and limo services, often protected by anticompetitive rules and regulations. But Uber also is disrupting transportation more generally. With a fleet of autonomous vehicles offering cheap rides, people don't need to own cars anymore. When car ownership is no longer needed, it will certainly impact the old-line car manufacturers. From there Uber might expand into the "delivery of everything," taking over last-mile deliveries for Amazon.com, Zappos, and other online retailers. Uber might even work in concert with shippers such as UPS and FedEx.

To improve public relations and to lobby politicians, Uber hired David Plouffe, whose claim to fame is being the manager for the 2008 Obama campaign and then a senior adviser to the president. Now senior vice president of policy and strategy at Uber, Plouffe sees Uber as an integral part of the transportation eco system. He argues that as more and more people live and work in cities, Uber will help to address traffic congestion, provide an alternative to personal cars in suburbs, cut down on drunk driving, and provide reliable and safe services to underserved city and suburban areas. Plouffe highlights that one of the reasons people remain trapped in poverty is the lack of reliable transportation, which Uber helps to overcome. Concludes Plouffe, "I don't subscribe to the idea that the company has an image problem. I actually think when you are a disrupter you are going to have a lot of people throwing arrows."[57]

Questions

1. Have you used a ride-hailing service such as Uber or Lyft? How was your experience?
2. Explain Uber's business model and deduce its strategic intent.
3. Do you agree with Peter Thiel's assessment that Uber is the "most ethically challenged company in Silicon Valley"? Why or why not? Explain.
4. Several lawsuits are under way to determine if Uber drivers are independent contractors or employees. The drivers bringing those lawsuits argue that they are employees and should be treated like employees, which would include being reimbursed for expenses such as gas and car maintenance that they currently pay out of pocket.
   - How do you view the so-called sharing economy with companies such as Uber, Airbnb (hospitality), TaskRabbit (house cleaning and odd jobs)?
   - What are the benefits and downsides of being an employee versus an independent contractor? Do you think drivers for Uber (and other ride-hailing services such as Lyft) are independent contractors or are employees?
   - If the ruling of California's labor commissioner should stand that Uber drivers are employees, and this view would prevail in the United States and other countries, what would this do to Uber's business model? Explain.

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TAKE-AWAY CONCEPTS

In this final chapter, we looked at stakeholder strategy, corporate governance, business ethics, and strategic leadership, as summarized by the following learning objectives and related take-away concepts.

LO 12-1 / Describe the shared value creation framework and its relationship to competitive advantage.

- By focusing on financial performance, many companies have defined value creation too narrowly.
- Companies should instead focus on creating *shared value,* a concept that includes value creation for both shareholders and society.
- The shared value creation framework seeks to identify connections between economic and social needs, and then leverage them into competitive advantage.

LO 12-2 / Explain the role of corporate governance.

- Corporate governance involves mechanisms used to direct and control an enterprise in order to ensure that it pursues its strategic goals successfully and legally.
- Corporate governance attempts to address the principal–agent problem, which describes any situation in which an agent performs activities on behalf of a principal.

LO 12-3 / Apply agency theory to explain why and how companies use governance mechanisms to align interests of principals and agents.

- Agency theory views the firm as a nexus of legal contracts.
- The principal–agent problem concerns the relationship between owners (shareholders) and managers and also cascades down the organizational hierarchy.
- The risk of opportunism on behalf of agents is exacerbated by information asymmetry: Agents are generally better informed than the principals.
- Governance mechanisms are used to align incentives between principals and agents.
- Governance mechanisms need to be designed in such a fashion as to overcome two specific agency problems: adverse selection and moral hazard.

LO 12-4 / Evaluate the board of directors as the central governance mechanism for public stock companies.

- The shareholders are the legal owners of a publicly traded company and appoint a board of directors to represent their interests.
- The day-to-day business operations of a publicly traded stock company are conducted by its managers and employees, under the direction of the chief executive officer (CEO) and the oversight of the board of directors. The board of directors is composed of inside and outside directors, who are elected by the shareholders.
- Inside directors are generally part of the company's senior management team, such as the chief financial officer (CFO) and the chief operating officer (COO).
- Outside directors are not employees of the firm. They frequently are senior executives from other firms or full-time professionals who are appointed to a board and who serve on several boards simultaneously.

LO 12-5 / Evaluate other governance mechanisms.

- Other important corporate mechanisms are executive compensation, the market for corporate control, and financial statement auditors, government regulators, and industry analysts.
- Executive compensation has attracted significant attention in recent years. Two issues are at the forefront: (1) the absolute size of the CEO pay package compared with the pay of the average employee and (2) the relationship between firm performance and CEO pay.
- The board of directors and executive compensation are internal corporate-governance mechanisms. The market for corporate control is an important external corporate-governance mechanism. It consists of activist investors who seek to gain control of an underperforming corporation by buying shares of its stock in the open market.
- All public companies listed on the U.S. stock exchanges must file a number of financial statements with the Securities and Exchange Commission (SEC), a federal regulatory agency whose task it is to oversee stock trading and enforce federal securities laws. Auditors and industry analysts study these public financial statements carefully for clues of a firm's future valuations, financial irregularities, and strategy.

LO 12-6 / Explain the relationship between strategy and business ethics.

- The ethical pursuit of competitive advantage lays the foundation for long-term superior performance.
- Law and ethics are not synonymous; obeying the law is the minimum that society expects of a corporation and its managers.
- A manager's actions can be completely legal, but ethically questionable.
- Some argue that management needs an accepted code of conduct that holds members to a high professional standard and imposes consequences for misconduct.

KEY TERMS

Adverse selection *(p. 409)*
Agency theory *(p. 408)*
Board of directors *(p. 409)*
Business ethics *(p. 414)*
CEO/chairperson duality *(p. 411)*
Corporate governance *(p. 407)*
Inside directors *(p. 410)*
Leveraged buyout (LBO) *(p. 413)*
Moral hazard *(p. 409)*
Outside directors *(p. 410)*
Poison pill *(p. 413)*
Shared value creation framework *(p. 405)*
Shareholder capitalism *(p. 404)*
Stock options *(p. 412)*

DISCUSSION QUESTIONS

1. How can a top management team lower the chances that key managers will pursue their own self-interests at the expense of stockholders? At the expense of the employees? At the expense of other key stakeholders?
2. The Business Roundtable has recommended that the CEO should not also serve as the chairman of the board. Discuss the disadvantages for building a sustainable competitive advantage if the two positions are held by one person. What are the disadvantages for stakeholder management? Are there situations where it would be advantageous to have one person in both positions?
3. The shared value creation framework provides help in making connections between economic needs and social needs in a way that transforms into a business opportunity. Taking the role of consultant to Nike Inc., discuss how Nike might move beyond selling high-quality footwear and apparel and utilize its expertise to serve a social need. Give Nike some advice on actions the company could take in different geographic markets that would connect economic and social needs.

ETHICAL/SOCIAL ISSUES

1. Assume you work in the accounting department of a large software company. Toward the end of December, your supervisor tells you to change the dates on several executive stock option grants from March 15 to July 30. Why would she ask for this change? What should you do?
2. As noted in the chapter, the average compensation for a CEO of a Fortune 500 company was $14 million, and CEO pay was 300 times the average worker pay. This contrasts with historic values of between 25 and 40 times the average pay. In August 2015 the U.S. Securities and Exchange Commission (SEC) approved a rule mandating that U.S. firms publicly disclose the gap between their CEO annual compensation and the median pay of the firm's other employees.

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MiniCase 1

Michael Phelps: Strategy Formulation & Implementation

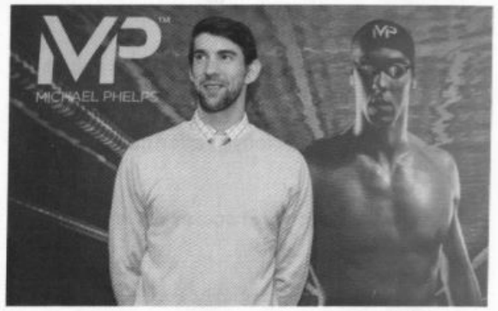
MICHAEL PHELPS, NICKNAMED MP, is the most decorated Olympian of all time. Competing in four Olympic Games,[1] the American swimmer won 22 Olympic medals, including 18 gold! In 2000 at the Sydney Olympics, Phelps at the age of 15 was the youngest U.S. athlete in almost seven decades. In 2008 at the Beijing Olympics, Phelps won an unprecedented eight gold medals, and while doing so set seven world records. Eight short days changed Olympic history and Phelps' life forever, making MP one of the greatest athletes of all time. Immediately after the event, *The Wall Street Journal* reported that Phelps would be likely to turn the eight gold medals into a cash-flow stream of more than $100 million through several product and service endorsements.

Phelps did not rest on his laurels, however. In 2012 at the London Summer Olympics, Michael Phelps added another four gold and two silver medals, elevating him to superstardom. Phelps became an Olympic superhero against long odds. How was he so successful?

Strategy Formulation

In his youth, MP was diagnosed with attention deficit hyperactivity disorder (ADHD). Doctors prescribed swimming to help him release his energy. It worked! Between 2004 and 2008, Michael Phelps attended the University of Michigan, studying marketing and management. He had already competed quite successfully in the 2004 Athens Summer Olympics, where he won eight medals: six gold and two bronze. Right after the Athens Games, the then-19-year-old sat down with his manager, Peter Carlisle, and his longtime swim coach, Bob Bowman, to map out a detailed strategy for the next four years. The explicit goal was to win nothing less than a gold medal in each of the events in which he would compete in Beijing.

Bowman was responsible for getting MP into the necessary physical shape he needed for Beijing and



Michael Phelps, the most decorated Olympian
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nurturing the mental toughness required to break Mark Spitz's 36-year record of seven gold medals won in the 1972 Munich Olympic Games. Carlisle, meanwhile, conceived of a detailed strategy to launch MP as a world superstar during the Beijing Games. While MP spent six hours a day in the pool, Carlisle focused on exposing him to the Asian market, the largest consumer market in the world, with a special emphasis on the Chinese consumer. MP's wide-ranging presence in the real world was combined with a huge exposure in the virtual world. Phelps posts and maintains his own Facebook page, with 7.6 million "phans." MP is also a favorite of Twitter (1.6 million followers), YouTube, and online blogs, garnering worldwide exposure to an extent never before achieved by an Olympian. The gradual buildup of Phelps over a number of years enabled manager Carlisle to launch MP as a superstar right after he won his eighth gold medal at the Beijing Games. By then, MP had become a worldwide brand.

Frank T. Rothaermel prepared this MiniCase from public sources. This MiniCase is developed for the purpose of class discussion. It is not intended to be used for any kind of endorsement, source of data, or depiction of efficient or inefficient management. All opinions expressed, all errors and omissions are entirely the author's. Revised and updated: August 10, 2015. © Frank T. Rothaermel.

A successful strategy can be based on leveraging unique resources and capabilities. Accordingly, some suggest that MP's success can be explained by his unique physical endowments: his long thin torso, which reduces drag; his arm span of 6 feet 7 inches (204 cm), which is disproportionate to his 6-foot-4-inch (193 cm) height; his relatively short legs for a person of his height; and his size-14 feet, which work like flippers due to hypermobile ankles. While MP's physical attributes are a *necessary* condition for winning, they are *not sufficient*. Many other swimmers, like the Australian Ian Thorpe (who has size-17 feet) or the German "albatross" Michael Gross (with an arm span of 7 feet or 213 cm), also brought extraordinary resource endowments to the swim meet. Yet neither of them won eight gold medals in a single Olympics.

Strategy Implementation

Although Phelps was very disciplined in executing his meticulously formulated strategy to win Olympic gold medals, this is much less true for his strategy implementation to monetize his stardom outside the pool. Following the Beijing Olympics, a photo published by a British tabloid showed Phelps using a bong, a device for smoking marijuana, at a party in South Carolina. Kellogg's immediately withdrew Phelps' endorsement contract. After the London 2012 Olympics, Phelps (then 25) announced his retirement from swimming. After 20 months, he announced that he would come out of retirement. Just a few months later, however, in September 2014, Phelps was arrested for driving under the influence (DUI). In 2004, Phelps had also been arrested for DUI. After the second DUI arrest, Phelps received a one-year suspended jail sentence and 18 months of supervised probation. Phelps also spent 45 days in an in-patient rehab center for alcohol abuse in Arizona. USA Swimming, the national governance body, suspended Phelps for 6 months from all competitions and from representing the United States at the 2015 world championships.

In the spring of 2015, Michael Phelps announced his intention to compete at the 2016 Rio Olympics. Many experts predict that Phelps has a good chance of winning two more gold medals. What sponsors want to know, however, is whether the promised personal change is real, given that Phelps has made such promises before after his first DUI and then again when photographed smoking a marijuana pipe. Retaining a clean public image will also be critical for Phelps because he just launched his own line of swimwear MP, designed in collaboration with Aqua Sphere, a swimming equipment manufacturer. Phelps grew up idolizing Michael Jordan, and his goal is to change the public image and marketing of swimming to something akin to what Jordan accomplished with his Nike sponsorship in basketball.

DISCUSSION QUESTIONS

1. Olympians generally do not turn into global phenomena. One reason is that they are highlighted only every four years; e.g., not too many people follow competitive swimming or downhill skiing outside the Olympics. How did Michael Phelps (think Lindsey Vonn) turn into a global brand?
2. Which approach to the strategy process did Phelps, his coach, and manager use? Why was this approach successful?
3. Phelps was embroiled in a number of controversies outside the pool. What impact did these shortcomings have on his brand value? What do these incidents tell you about maintaining and increasing brand value over time?
4. What does Phelps need to do if he wants to play a similar transformative role in the marketing and sponsoring of swimming as Michael Jordan achieved in basketball?

Endnote

[1] Sydney in 2000; Athens in 2004; Beijing in 2008; and London in 2012.

Sources: This MiniCase is based on: "Michael Phelps confirms he's aiming to swim at 2016 Olympics," *The Baltimore Sun*, April 15, 2015; "Profile: Michael Phelps—A normal guy from another planet," *Telegraph*, August 15, 2008; "Now, Phelps chases gold on land," *The Wall Street Journal*, August 18, 2008; and "Michael Phelps' agent has been crafting the swimmer's image for years," Associated Press, September 14, 2008.