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.

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.).

Chapter 1

What Is Strategy?

Chapter Outline

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. Cofounder 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.

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.

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

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

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 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?

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

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 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.

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.

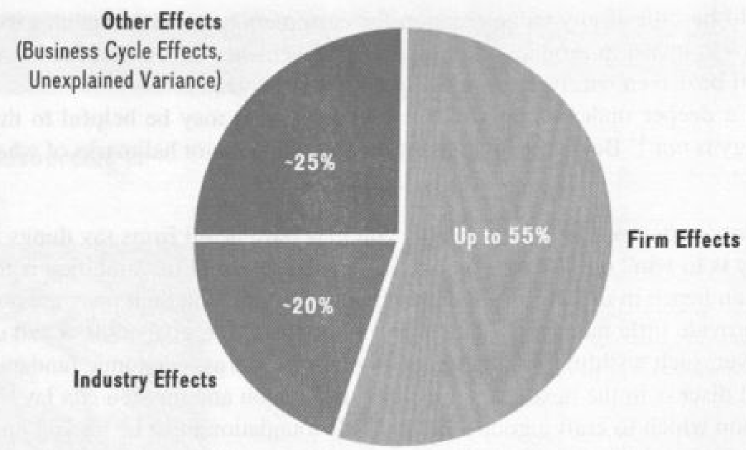
industry effects Firm performance attributed to the structure of the industry in which the firm competes.

firm effects Firm performance attributed to the actions managers take.

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.

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.

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 be affected by a firm's actions.

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.

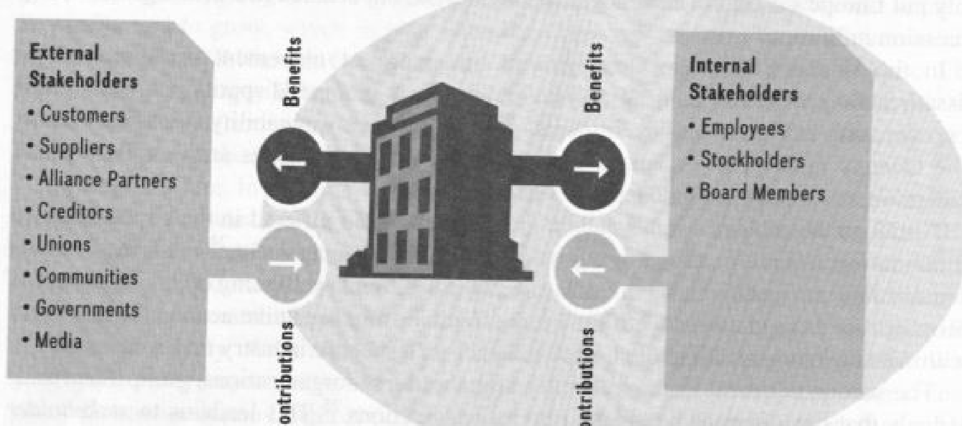
If any stakeholder withholds participation in the firm's exchange relationships, it can negatively affect firm performance. The aerospace company Boeing, for example, has a long history of acrimonious labor relations, leading to walk-outs and strikes. This in turn has not only delayed production of airplanes 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.

- 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.

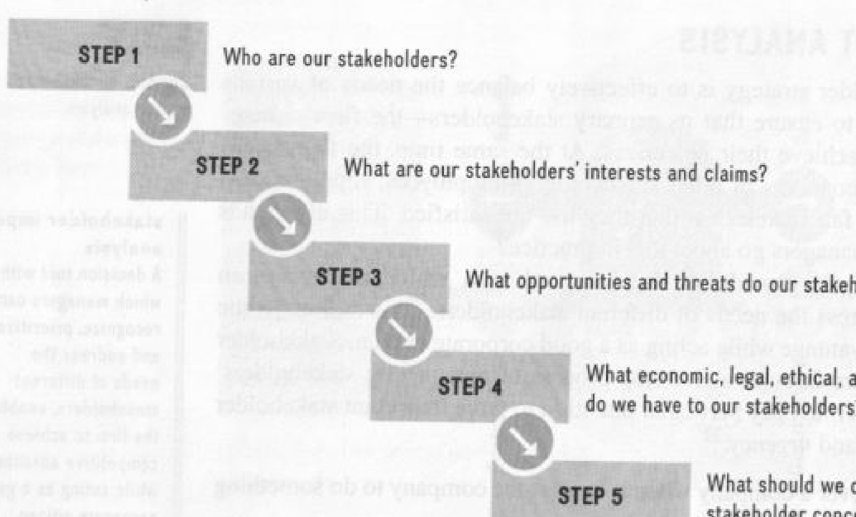
STEP 1: IDENTIFY STAKEHOLDERS. In step 1, the firm asks, "Who are our stakeholders?" In this step, the firm focuses on stakeholders that currently have, or potentially can have, a material effect on a company. This prioritization identifies the most powerful internal and external stakeholders as well 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.

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.

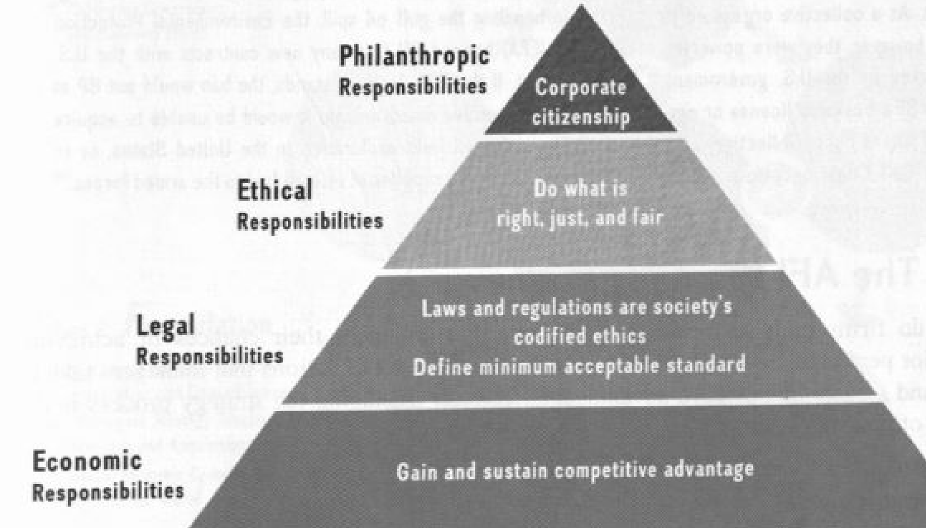


EXHIBIT 1.4 / The Pyramid of Corporate Social Responsibility

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.

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.

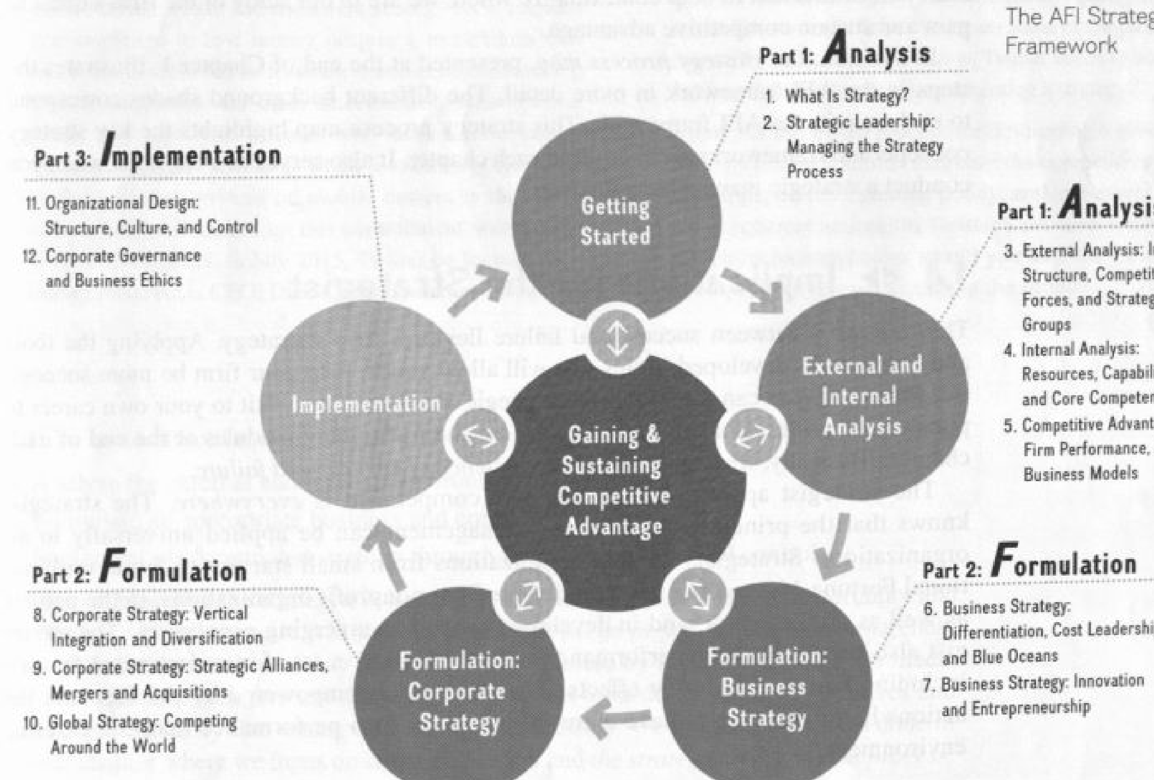
We've captured these interdependent relationships in the **AFI strategy framework** shown in Exhibit 1.5. This framework (1) explains and predicts differences in firm performance, and (2) helps managers formulate and implement a strategy that can result in superior performance. In each of the three broad 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



- 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.

CHAPTER**CASE 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.*

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 trade-offs 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