Strategic Management

Strategic Management

JOHN MORRIS

TOBIAS HODGES

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Suggest a correction

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PART 1. STRATEGIC MANAGEMENT OVERVIEW

Part Contents

- What's in it for Me?
- What Is Strategic Management?
- Intended and Realized Strategies
- KEY TAKEAWAY
- EXERCISES
- Essential Unit Vocabulary

What's in it for Me?

Reading these chapters will help you do the following:

1. See how strategy fits in the planning-organizing-leading-controlling (P-O-L-C) framework.
2. Better understand how strategies emerge.
3. Understand strategy as trade-offs, discipline, and focus.
4. Conduct internal analysis to develop strategy.
5. Conduct external analysis to develop strategy.

What Is Strategic Management?

Strategic management, *strategy* for short, is essentially about choice – in terms of what the organization will do and won't do to achieve specific goals and objectives, where such goals and objectives lead to the realization of a stated mission and vision. Strategy is a central part of the planning function in P-O-L-C. Strategy is also about making choices that provide the organization with some measure of a sustainable competitive advantage. For the most part, this chapter emphasizes strategy formulation (answers to the "What should our strategy *be*?" question) as opposed to strategy implementation (answers to question "How do we *execute* our strategy?"). The central position of strategy is summarized in **Figure 1.1**.

Figure 1.1 The P-O-L-C Framework

Planning	**Organizing**	**Leading**	**Controlling**
1. Vision & Mission 2. Strategizing 3. Goals & Objectives	1. Organization Design 2. Culture 3. Social Networks	1. Leadership 2. Decision Making 3. Communications 4. Groups/ Teams 5. Motivation	1. Systems/Processes 2. Strategic Human Resources

As you can see in **Figure 1.1**, the P-O-L-C framework starts with "planning". Planning is related to, but not synonymous with, strategic management. The concept of strategic management reflects what a firm is doing to achieve its mission and vision as seen by its achievement of specific goals and objectives. A more formal definition tells us that strategic management "is the process by which a firm manages the formulation and implementation of its strategy."[1]

Using the definition of strategic management above then, the strategic management *process* is "the coordinated means by which an organization achieves its goals and objectives."[2] Others have described strategy as the pattern of resource allocation choices

1. Carpenter, M. A., & Sanders, W. G. (2009). Strategic management (p. 8). Upper Saddle River, NJ: Pearson/Prentice-Hall.
2. Carpenter, M. A., & Sanders, W. G. (2009). Strategic management (p. 10).

and organizational arrangements that result from managerial decision making.[3] Planning activities that lead to the formulation of a strategy is sometimes called strategic planning. Strategy implementation then refers to the tasks and tactics managers must perform to put the desired strategy into action. See **Figure 1.2** for a description of how strategy fits with planning.

The concept of strategy is relevant to all types of organizations, from large, public companies like GE, to religious organizations, political parties, and nonprofits.

Strategic Management in the P-O-L-C Framework

If vision and mission are the heart and soul of planning (in the P-O-L-C framework), then strategy, particularly strategy formulation, would be the brain. **Figure 1.3** summarizes where strategy formulation (strategizing) and implementation fit in the planning and

3. Mintzberg, H. 1978. Patterns in strategy formulation. Management Science, 24, 934–949.

other components of P-O-L-C. We will focus primarily on the strategy formulation aspects of strategic management because implementation is essentially organizing, leading, and controlling P-O-L-C components. **Unit 4: Internal Capabilities** of this textbook will provide additional information regarding the implementation components (O-L-C).

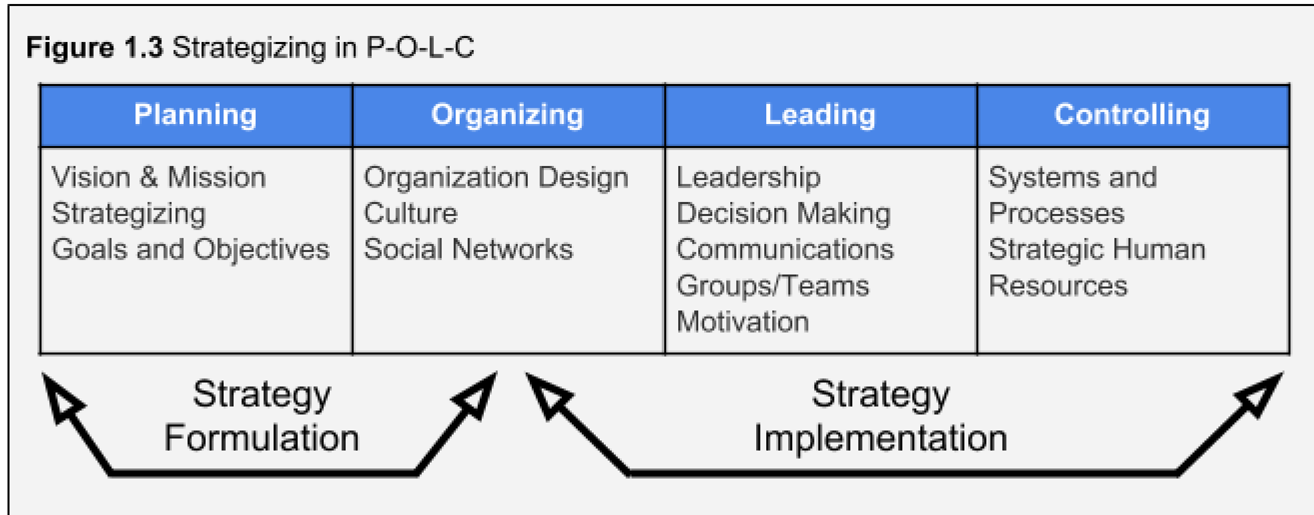


Figure 1.3 Strategizing in P-O-L-C

You see that planning starts with vision and mission and concludes with setting goals and objectives. In between is the critical role played by strategy. Specifically, a strategy captures and communicates how vision and mission will be achieved and sets forth the goals and objectives needed to demonstrate that the organization is on the right path for achieving them. At this point, even in terms of strategy formulation, there are two aspects of strategizing that you should recognize. The first, corporate strategy answers strategy questions related to "What business or businesses should we be in?" and "How does business X help us compete in business Y, and vice versa?" In many ways, corporate strategy considers an organization to be a portfolio of businesses, resources, capabilities, or activities.

Example 1.1 – Synergy

The largest U.S. grocery chain, Kroger, has invested in autonomous vehicles which will deliver groceries to online shoppers. Kroger's is working to create a better shopping experience for their customers. Rather than simply shopping online and picking up, the customer has the option to have a self driving vehicle show up loaded with groceries for them to unload. Customers are notified via text message when the vehicle arrives at their delivery address. This is expected to bring more business to Kroger's and creates a better experience for its customers. For the time, the autonomous vehicles will still have a safety operator who can take control in emergencies as well as a co-pilot who monitors the technology. But the Texas Department of Transportation is monitoring the program and may allow it freer range of operation in the future.

Source: Houston Chronicle, Kroger's autonomous delivery cars latest salvo in Houston grocery wars, 2019Sp

The logic behind corporate strategy is one of synergy and diversification. That is, synergies arise when each of YUM! Brands food outlets does better because they have common ownership and can share valuable inputs into their businesses. Specifically, synergy exists when the interaction of two or more activities (such as those in a business) create a combined effect greater than the sum of their individual effects. The idea is that the combination of certain businesses is stronger than those same businesses would be individually. Their coordination under a common owner allows them to either do things less expensively, or of a higher quality.

Example 1.2 – Concentric Diversification

The German software company, SAP, recently acquired the experience management software company, Qualtrics, after Qualtrics announced their IPO price range. SAP plans to implement Qualtrics' cloud-based experience data into their own operational data software to diversify into the customer relationship management market so they may compete against companies like Salesforce.

Source: Forbes, SAP Acquires Cloud Unicorn Qualtrics For $8 Billion Just Before Its IPO, 2018Fa

Diversification, in contrast, is where an organization participates in multiple businesses that are in some way distinct from each other, as Taco Bell is from Pizza Hut, for instance. Just as with a portfolio of stock, the purpose of diversification is to spread out risk and opportunities over a larger set of businesses. Some may be high growth, some slow growth or declining; some may perform worse during recessions, while others perform better. There are three major diversification strategies: (1) concentric diversification, where the new business produces products that are technically similar to the company's current product but that appeal to a new consumer group; (2) horizontal diversification, where the new business produces products that are totally unrelated to the company's current product but that appeal to the same consumer group; and (3) conglomerate diversification, where the new business produces products that are totally unrelated to the company's current product and that appeal to an entirely new consumer group.

Whereas corporate strategy looks at an organization as a portfolio of things, business strategy focuses on how a given business needs to compete to be effective. Again, all organizations need strategies to survive and thrive. A neighborhood church, for instance, probably wants to serve existing members, build new membership, and, at the same

time, raise surplus monies to help it with outreach activities. Its strategy would answer questions surrounding the accomplishment of these key objectives. In a for-profit company such as McDonald's, its business strategy would help it keep existing customers, expanding its business by moving into new markets, and taking customers from competitors like Taco Bell and Burger King, all while maintaining a profit level demanded by the stock market.

Strategic Inputs

So what are the inputs into strategizing? At the most basic level, you will need to gather information and conduct analysis about the internal characteristics of the organization and the external market conditions. This means both an internal and an external appraisal. On the internal side, you will want to gain a sense of the organization's strengths and weaknesses; on the external side, develop a sense of the organization's opportunities and threats. Together, these four inputs into strategizing (strengths, weaknesses, opportunities, and threats) are referred to as SWOT analysis. It doesn't matter if you start this appraisal internally or externally, but you will quickly see the two perspectives need to mesh eventually.

Example 1.3 Sustainable Advantage

Walmart's supply chain management strategy has given them multiple sustainable competitive advantages that include lower product costs, reduced inventory carrying costs, competitive pricing and a large variety in store products. All of these advantages are hard to duplicate at the scale Walmart is currently at as well as provide a favorable long term position over their competitors.

Source: TradeGecko, Walmart's successful supply chain management, 2018Fa

Strengths and Weaknesses

A good starting point for strategizing is an assessment of what an organization does well and what it doesn't do well. In general good strategies take advantage of *strengths* and minimize the disadvantages posed by any *weaknesses*. Michael Jordan, for instance, is an

excellent all-around athlete; he excels in baseball and golf, but his athletic skills show best in basketball. As with Jordan, when you can identify certain strengths that set an organization well apart from actual and potential competitors, that strength is considered a source of competitive advantage. The hardest thing for an organization to do is to develop its competitive advantage into a sustainable competitive advantage. This means the organization's strengths cannot be easily duplicated or imitated by other firms, nor made redundant or less valuable by changes in the external environment.

Opportunities and Threats

On the basis of what you just learned about competitive advantage and sustainable competitive advantage, you can see why some understanding of the external environment is a critical input into strategy. *Opportunities* assess the external attractive factors that represent the reason for a business to exist and prosper. These are external to the business. What opportunities exist in its market, or in the environment, from which managers might hope the organization will benefit? *Threats* include factors beyond your control that could place the strategy, or the business, at risk. These are also external—managers typically have no control over them, but may benefit by having contingency plans to address them if they occur.

In a nutshell, SWOT analysis helps you identify strategic alternatives that address the following questions:

1. Strengths and Opportunities (SO)—How can you use your strengths to take advantage of the opportunities?
2. Strengths and Threats (ST)—How can you take advantage of your strengths to avoid real and potential threats?
3. Weaknesses and Opportunities (WO)—How can you use your opportunities to overcome the weaknesses you are experiencing?
4. Weaknesses and Threats (WT)—How can you minimize your weaknesses and avoid threats?

Most importantly, a SWOT analysis needs to both draw a set of concrete conclusions from the firm's specific situation and identify a set of strategic actions to address each. The ultimate goal is to match the company's resource strengths and market opportunities, correct important weaknesses, and defend against external threats.

Internal Analysis Tools

While SWOT helps you identify an organization's strengths and weaknesses, there are other tools available for internal analysis too; notably value chain and VRIO analysis. In effect, **value chain analysis** asks you to take the organization apart and identify its important constituent parts. Sometimes these parts take the form of functions, like marketing or manufacturing.

Example 1.4 – Value Chain Analysis

For instance, Disney is really good at developing and making money from its branded products, such as Cinderella or Pirates of the Caribbean. This is a marketing function (it is also a design function, which is another Disney strength).

Earn credit, add your own example!

Value chain functions are also called capabilities. This is where VRIO comes in. VRIO stands for valuable, rare, inimitable, and organization—basically, the VRIO framework suggests that a capability, or a resource, such as a patent or great location, is likely to yield a competitive advantage to an organization when it can be shown that it is valuable, rare, difficult to imitate, and supported by the organization (and, yes, this is the same organization that you find in P-O-L-C).[4] Essentially, where the value chain might suggest internal areas of strength, VRIO helps you understand whether those strengths will give it a competitive advantage.

Example 1.5 – VRIO Analysis

Going back to our Disney example, for instance, strong marketing and design capabilities are valuable, rare, and very difficult to imitate, and Disney is organized to take full advantage of them.

Earn credit, add your own example!

4. Don't be confused, another internal analysis model we will use in this course (value chain analysis) will use similar terms to describe a core competency—valuable, rare, costly to imitate, and non-substitutable.

External Analysis Tools

While there are probably hundreds of different ways for you to study an organization's external environment, the two primary tools are *PESTEL* and *industry analysis*. PESTEL, as you probably guessed, is simply an acronym. It stands for political, economic, sociocultural, technological, environmental, and legal environments. Simply, the PESTEL framework directs you to collect information about, and analyze, each environmental dimension to identify the broad range of threats and opportunities facing the organization. Industry analysis, in contrast, asks you to map out the different relationships that the organization might have with suppliers, customers, and competitors. PESTEL provides you with a good sense of the broader macro-environment, whereas industry analysis should tell you about the organization's competitive environment and the key industry-level factors that seem to influence performance.

Example 1.6 – PESTEL Analysis

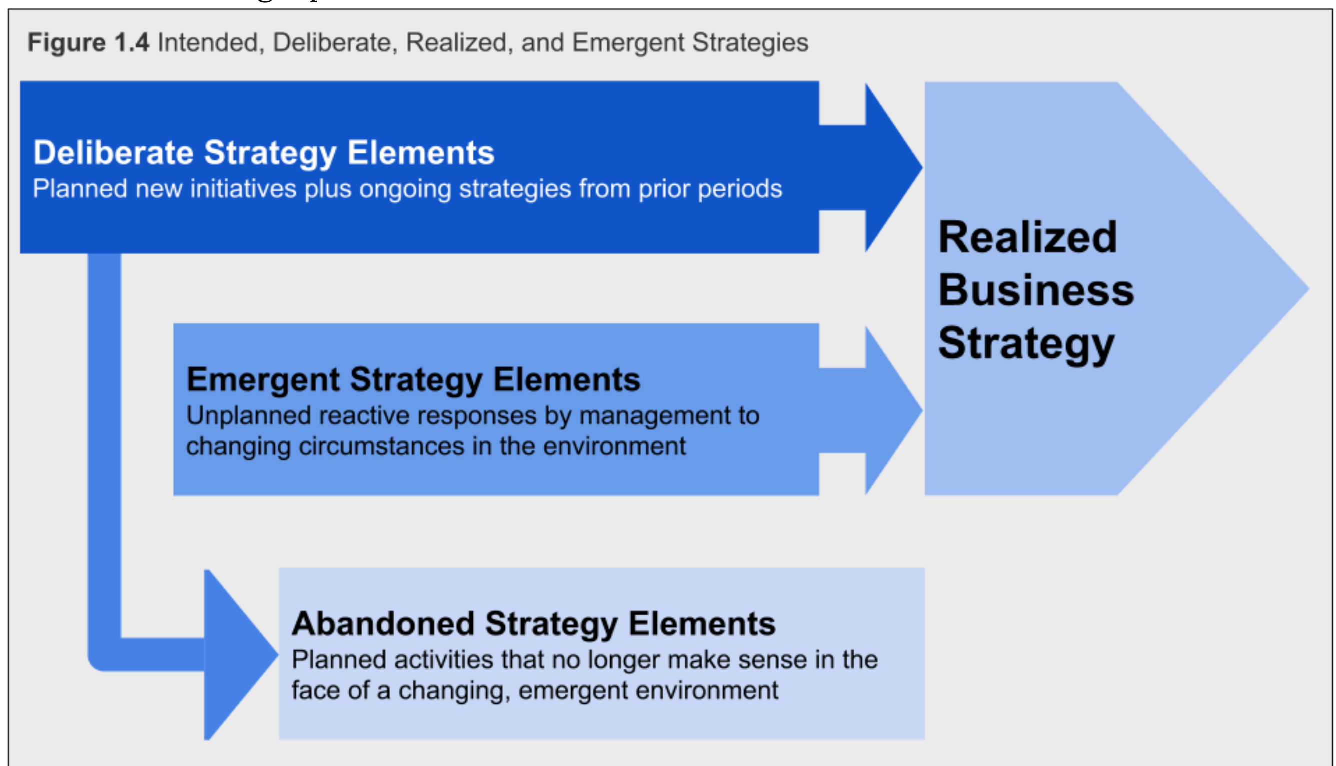
Earn credit, add your own example!

Intended and Realized Strategies

The best-laid plans of mice and men often go awry.

~Robert Burns, "To a Mouse," 1785

This quote from English poet Robert Burns is especially applicable to strategy. While we have been discussing strategy and strategizing as if they were the outcome of a rational, predictable, analytical process, your own experience should tell you that a fine plan does not guarantee a fine outcome. Many things can happen between the development of the plan and its realization, including (but not limited to): (1) the plan is poorly constructed, (2) competitors undermine the advantages envisioned by the plan, or (3) the plan was good but poorly executed. You can probably imagine a number of other factors that might undermine a strategic plan and the results that follow.



The ways in which organizations make strategy has emerged as an area of intense debate within the strategy field. Henry Mintzberg and his colleagues at McGill University distinguish intended, deliberate, realized, and emergent strategies.[1] These four different

1. Mintzberg, H. (1987, July–August). Crafting strategy. Harvard Business Review, pp. 66–75; Mintzberg, H. (1996). The entrepreneurial organization. In H. Mintzberg & J. B. Quinn (Eds.),The strategy process

aspects of strategy are summarized in **Figure 1.4**. Intended strategy is strategy as conceived by the top management team. Even here, rationality is limited and the intended strategy is the result of a process of negotiation, bargaining, and compromise, involving many individuals and groups within the organization. However, realized strategy—the actual strategy that is implemented—is only partly related to that which was intended (Mintzberg suggests only 10%–30% of intended strategy is realized).

Example 1.7 – Realized Strategy

Analysis of Honda's successful entry into the U.S. motorcycle market has provided a battleground for the debate between those who view strategy making as primarily a rational, analytical process of deliberate planning (the design school) and those that envisage strategy as emerging from a complex process of organizational decision making (the emergence or learning school).

Earn credit, add your own example!

The primary determinant of realized strategy is what Mintzberg terms emergent strategy—the decisions that emerge from the complex processes in which individual managers interpret the intended strategy and adapt to changing external circumstances.[2] Thus, the realized strategy is a consequence of deliberate and emerging factors.

Although the debate between the two schools continues,[3] we hope that it is apparent that the central issue is not, "Which school is right?" but, "How can the two views complement one another to give us a richer understanding of strategy making?" Let us explore these complementarities in relation to the factual question of how strategies are made and the normative question of how strategies should be made.

(3rd ed.). Englewood Cliffs, NJ: Prentice-Hall; Mintzberg, H., & Waters, J. A. (1985). Of strategies, deliberate and emergent. Strategic Management Journal, 6, 257–272.

2. See Mintzberg, H. Patterns in strategy formulation. (1978). Management Science, 24, 934–948; Mintzberg, H., & Waters, J. A. (1985). Of strategies, deliberate and emergent. Strategic Management Journal, 6, 257–272. (1985); and Mintzberg, H. (1988). Mintzberg on management: Inside our strange world of organizations. New York: Free Press.
3. For further debate of the Honda case, see Mintzberg, H., Pascale, R. T., Goold, M., & Rumelt, Richard P. (1996, Summer). The Honda effect revisited. California Management Review, 38, 78–117.

The Making of Strategy

How Is Strategy Made?

Robert Grant, author of *Contemporary Strategy Analysis*, shares his view on how strategy is made as follows.[4] For most organizations, strategy making combines design and emergence. The deliberate design of strategy (through formal processes such as board meetings and strategic planning) has been characterized as a primarily top-down process. Emergence has been viewed as the result of multiple decisions at many levels, particularly within middle management, and has been viewed as a bottom-up process. These processes may interact in interesting ways.

Example 1.8 – Emergent Strategy

At Intel, the key historic decision to abandon memory chips and concentrate on microprocessors was the result of a host of decentralized decisions taken at divisional and plant level that were subsequently acknowledged by top management and promulgated as strategy.

Earn credit, add your own example!

In practice, both design and emergence occur at all levels of the organization. The strategic planning systems of large companies involve top management passing directives and guidelines down the organization and the businesses passing their draft plans up to corporate. Similarly, emergence occurs throughout the organization—opportunism by CEOs is probably the single most important reason why realized strategies deviate from intended strategies. What we can say for sure is that the role of emergence relative to design increases as the business environment becomes increasingly volatile and unpredictable.

Organizations that inhabit relatively stable environments—the Roman Catholic Church and national postal services—can plan their strategies in some detail. Organizations whose environments cannot be forecasted with any degree of certainty—a gang of car thieves

4. Grant, R. M. (2002). Contemporary strategy analysis (4th ed., pp. 25–26). New York: Blackwell. 12. [6] Burgelman, R. A., & Grove, A. (1996, Winter). Strategic dissonance. California Management Review, 38, 8–28.

or a construction company located in the Gaza Strip—can establish only a few strategic principles and guidelines; the rest must emerge as circumstances unfold.

What's the Best Way to Make Strategy?

Mintzberg's advocacy of strategy making as an iterative process involving experimentation and feedback is not necessarily an argument against the rational, systematic design of strategy. The critical issues are, first, determining the balance of design and emergence and, second, how to guide the process of emergence. The strategic planning systems of most companies involve a combination of design and emergence. Thus, headquarters sets guidelines in the form of vision and mission statements, business principles, performance targets, and capital expenditure budgets. However, within the strategic plans that are decided, divisional and business unit managers have considerable freedom to adjust, adapt, and experiment.

KEY TAKEAWAY

You learned about the processes surrounding strategy development. Specifically, you saw the difference between intended and realized strategy, where intended strategy is essentially the desired strategy, and realized strategy is what is actually put in place. You also learned how strategy is ultimately made. In the end, the best strategies come about when managers are able to balance the needs for design (planning) with being flexible enough to capitalize on the benefits of emergence.

Strategy formulation is an essential component of planning; it forms the bridge that enables the organization to progress from vision and mission to goals and objectives. In terms of the P-O-L-C framework, strategy formulation is the P (planning) and strategy implementation is realized by O-L-C. Corporate strategy answers questions about which businesses to compete with; while business strategy answers questions about how any one of these businesses should do so. The best strategies are based on a thorough analysis of both internal and external factors—that is, a strategy that capitalizes on an organization's strengths, weaknesses, opportunities, and threats.

EXERCISES

1. What is an intended strategy?
2. What is a realized strategy?
3. Why is it important to understand the difference between intended and realized strategies?
4. Why is there not a perfect match-up between realized and intended strategies?
5. What might interfere with the realization of an intended strategy?
6. How might you manage the balance between design and emergence strategizing processes in an organization?
7. What is the difference between strategy formulation and strategy implementation?
8. What is the difference between business strategy and corporate strategy?
9. What are some of the forms of diversification, and what do they mean?
10. What do you learn from a SWOT analysis?
11. In SWOT analysis, what are some of the tools you might use to understand the internal environment (identify strengths and weaknesses)?
12. In SWOT analysis, what are some of the tools you might use to understand the external environment (identify opportunities and threats)?

Essential Unit Vocabulary

Abandoned Strategy – A thought-out plan that is no longer used because it is not profitable or not effective for the company. An abandoned strategy is something a company walks away from in order to pursue strategies that are more worth the company's time and resources.

Above Average Returns (AAR) – refers to profit from the revenue of a firm that is above the average for all competitors within an industry. Investors seek returns equal to or above what they can earn from other investments with a similar amount of risk and reward firms that provide AAR with stronger stock values and willingness to loan capital.

Average Returns – A percentage figure used when reporting the historical return, such as the three-, five- and 10-year average returns of a mutual fund. The average annual return is stated net of a fund's operating expense ratio, which does not include sales charges, if applicable, or portfolio transaction brokerage commissions.

Broad Differentiation – One of the five generic business-level strategies. A unique quality, perceived or real, of a good or service that distinguish it from a competing good or service; if you cannot be the best then you must be unique. Michael Porter, the grandfather of strategic management, suggested the only sustainable BLS is based on uniqueness because it grows the market; he suggested the alternative, competing on price, is a race to the bottom.

Business Model – A business model is the means by which a company promises to deliver value to its customers, who then pay for the goods and services, and then allows the firm to convert those payments into a profit.

Capital Market – A financial market that channels the flow of money provided by investors (banks, credit unions, insurance companies and individuals) to borrowers through a variety of financial instruments (long term bonds, short term notes and stock shares) called securities. Capital markets play an important role in job creation, innovation and financial security by enabling business to raise the funds they need in order to grow or operate their business.

Competitive Advantage (CA) – The benefit a firm receives by offering a greater value to its customers than its rivals can offer. In order to gain this value, a strategy that is hard to replicate is used so the firm can sustain its advantage over its competitors. A sustainable competitive advantage can be achieved by developing and exploiting core competencies – capabilities that are valuable, rare, costly to imitate and non-substitutable.

Customer Value Proposition – A company uses a customer value proposition to let their

customers, and potential customers, know why they should buy that company's particular product. It lets potential customers know why the specific product is special and why it is different than anything else on the market.

Industrial Organizational (I/O) Model for AAR – Industrial Organizational (I/O) Model for AAR: It starts with an assumption that forces external to the company represent the dominant influences on a company's strategic actions. This model presumes that the characteristics of and conditions present in the external environment determine the appropriateness of strategies that are formulated and implemented in order for a company to earn above-average returns. The I/O model specifies that the choice of industries in which to compete has more influence on company performance than the decisions made by managers inside their firm. Research shows that 20% of profitability can be directly attributed to this model.

Product Market – The marketplace in which a final good or service is bought and sold. It consists of customers, suppliers, unions, host communities.

Resource-based Model for AAR – Starts with an assumption that internal uniqueness is what the company uses as its dominant influences on implementing a strategic action. This model presumes that the characteristics of and conditions present in the internal environment determine the appropriateness of strategies that are formulated and implemented in order for a company to earn above-average returns. The resource model specifies that the manner in which a firm manages its resources (people and assets) has more influence on the company's overall performance than the pressure by outside forces. Research shows that 36% of profitability can be directly attributed to this model.

Risk – The degree of uncertainty about the future economic gains or losses that could deviate from the expected outcome of a particular financial investment. Risk includes losing some or all of the investment.

Stakeholder – A person, organization or group that has a stake or significant interest in a business. Even though stakeholders can negatively or positively influence a business with their decisions, they can also be negatively or positively affected by a business's decisions. Stakeholders typically have ownership, legal and property interests, legal obligations, and/or ethical rights.

Strategic Management Process (SMP) – Involves the planning and execution of a plan of action to create a competitive advantage (CA) and generate above average returns (AAR). The SMP assumes that both planning and execution are essential to success. The process can be broken into four steps including: 1) UNDERSTAND the environment in which the company is operating in order to 2) PLAN the best course of action given its unique strengths, weaknesses and capabilities. Next, the firm must 3) EXECUTE the strategic plan

and regularly and systematically conduct a study to 4) EVALUATE the plan to ensure the firm's long term success.

Strategic Plan – A document used to communicate with the organization about the organization management's goals, the actions needed to achieve those goals and all of the other essential questions such as answer to questions like who are we, where do we want to go, how will we get there and how will we know when we have arrived?

PART 2. CORPORATE GOVERNANCE

Part Contents

- What's in it for Me?
- What Is Corporate Governance?
- The Evolution of the Modern Corporation
- The U.S. Corporate Governance System
- Corporate Governance in America: A Brief History
- Purpose and Direction of the Firm
- KEY TAKEAWAY
- Essential Unit Vocabulary

What's in it for Me?

Reading these chapters will help you do the following:

1. Describe the evolution of governance and regulation within the modern corporation.
2. Distinguish the interests and priorities of owners as distinct from those of managers.
3. Identify the key components of a vision and mission.

What Is Corporate Governance?

The tug of war between individual freedom and institutional power is a continuing theme of history. Early on, the focus was on the church; more recently, it is on the civil state. Today, the debate is about making corporate power compatible with the needs of a democratic society. The modern corporation has not only created untold wealth and given individuals the opportunity to express their genius and develop their talents but also has imposed costs on individuals and society. How to encourage the liberation of individual energy without inflicting unacceptable costs on individuals and society, therefore, has emerged as a key challenge.

Example 2.1 – Corporate Governance in Action

In February 2019 Amazon announced the appointment of its fourth woman, Rosalind Brewer, to its board of directors. She is currently the only person of color on Amazon's 10-person board. Like other companies, Amazon is responding to demands from shareholders and activist groups to diversify its board of directors. In 2018, BlackRock, the world's biggest asset manager, asked all companies in its investment portfolio with less than two women board members to report on their efforts to diversify. Amazon was also responding to criticism from shareholders who passed an internal resolution to formalize its board member selection process in order to achieve greater diversification on its board.

Source: Forbes, Amazon Diversifies Its All-White Board With Addition Of Starbucks Exec, Bunga Azalea Putri, 2019Wi

Corporate governance lies at the heart of this challenge. It deals with the systems, rules, and processes by which corporate activity is directed. Narrow definitions focus on the relationships between corporate managers, a company's board of directors, and its shareholders. Broader descriptions encompass the relationship of the corporation to all of its stakeholders and society, and cover the sets of laws, regulations, listing rules, and voluntary private-sector practices that enable corporations to attract capital, perform efficiently, generate profit, and meet both legal obligations and general societal expectations. The wide variety of definitions and descriptions that have been advanced over the years also reflect their origin: lawyers tend to focus on the contractual and fiduciary aspects of the governance function; finance scholars and economists think about decision-making objectives, the potential for conflict of interest, and the alignment

of incentives, while management consultants tend to adopt a more task-oriented or behavioral perspective.

Complicating matters, different definitions also reflect two fundamentally different views about a corporation's purpose and responsibilities. Often referred to as the "shareholder versus stakeholder" perspectives, they define a debate about whether managers should run a corporation primarily or solely in the interests of its legal owners—the shareholders (the shareholder perspective)—or whether they should actively concern themselves with the needs of other constituencies (the stakeholder perspective).

This question is answered differently in different parts of the world. In Continental Europe and Asia, for example, managers and boards are expected to concern themselves with the interests of employees and the other stakeholders, such as suppliers, creditors, tax authorities, and the communities in which they operate. Reflecting this perspective, the Centre of European Policy Studies (CEPS) defines corporate governance as "the whole system of rights, processes and controls established internally and externally over the management of a business entity with the objective of protecting the interests of all stakeholders."[1]

In contrast, the Anglo-American approach to corporate governance emphasizes the primacy of ownership and property rights and is primarily focused on creating "shareholder" value. In this view, employees, suppliers, and other creditors have rights in the form of contractual claims on the company, but as owners with property rights, shareholders come first:

> *Corporate governance is the system by which companies are directed and controlled. Boards of directors are responsible for the governance of their companies. The shareholders' role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place.*[2]

Example 2.2 – Shareholder Value Creation

Enerflex, a Canadian-based energy services company that provides turnkey solutions for the global natural gas industry, announced a new president and Chief Executive Officer (CEO), Marc Rossiter, during the company's annual shareholder meeting. The appointment was touted as a reflection of the firm's commitment

1. Centre of European Policy Studies (CEPS; 1995), as reported in Shleifer and Vishny (1997).
2. European Corporate Governance Institute (1992).

to executive succession planning. Mr. Rossiter had worked for more than 22 years in numerous operational and administrative roles, starting as a project engineer. Additionally, the smooth transition of power is expected to create shareholder value by ensuring continuity and continued growth as Mr. Rossiter takes over the reins of the company from Enerflex's previous CEO of 15-years, J. Blair Goertzen.

Source: MarketWatch, Enerflex Announces President and Chief Executive Officer Succession, (inactive link as of 08/07/2020) Tatog Sasono, 2019Wi

Perhaps the broadest, and most neutral, definition is provided by the Organization for Economic Cooperation and Development (OECD), an international organization that brings together the governments of countries committed to democracy and the market economy to support sustainable economic growth, boost employment, raise living standards, maintain financial stability, assist other countries' economic development, and contribute to growth in world trade:

> *Corporate governance is the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as, the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance.*[3]

3. Organization for Economic Cooperation and Development (OECD; 1999).

The Evolution of the Modern Corporation

Corporations have existed since the beginning of trade. From small beginnings they assumed their modern form in the 17th and 18th centuries with the emergence of large, European-based enterprises, such as the British East India Company. During this period of colonization, multinational companies were seen as agents of civilization and played a pivotal role in the economic development of Asia, South America, and Africa. By the end of the 19th century, advances in communications had linked world markets more closely, and multinational corporations were widely regarded as instruments of global relations through commercial ties. While international trade was interrupted by two world wars in the first half of the twentieth century, an even more closely bound world economy emerged in the aftermath of this period of conflict.

Over the last 20 years, the perception of corporations has changed. As they grew in power and visibility, they came to be viewed in more ambivalent terms by both governments and consumers. Almost everywhere in the world, there is a growing suspicion that they are not sufficiently attuned to the economic well-being of the communities and regions they operate in and that they seek to exploit their growing power in relation to national government agencies, international trade federations and organizations, and local, national, and international labor organizations.

The rising awareness of the changing balance between corporate power and society is one factor explaining the growing interest in the subject of corporate governance. Once largely ignored or viewed as a legal formality of interest mainly to top executives, boards, and lawyers, corporate governance for some time now has been a subject of growing concern to social reformers, shareholder activists, legislators and regulatory agencies, business leaders, and the popular press.

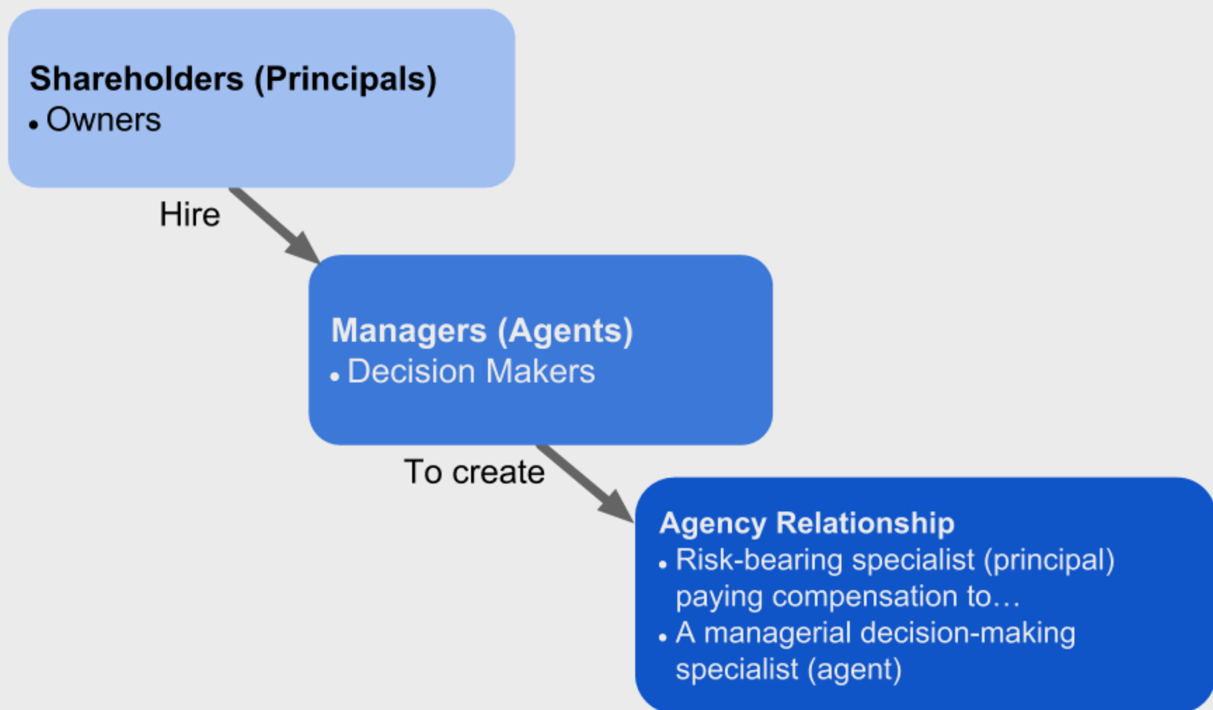


Figure 2.1 Separation of Ownership and Management

Shareholders, increasingly upset about outsized executive compensation deals and other governance issues, argue that too many boards are beholden to management and neglect shareholder interests. CEOs complain that having to play the "Wall Street expectations" game distracts them from the "real" strategic issues and erodes their company's' long-term competitiveness. Employees worry about the impact of management practices, such as offshoring and outsourcing on pay, advancement opportunity, and job security. Meanwhile, outside stakeholders, focused on issues such as global warming and sustainability, are pressing for limits on corporate activity in areas like the harvesting of natural resources, energy use, and waste disposal. Increasingly, they are joined by civic leaders concerned by the continuing erosion of key societal values or threats to the health of their communities.

Example 2.3 – Governance and Executive Compensation

During the 2008 financial crisis American International Group (AIG) received a $180B taxpayer bailout while paying its executives tens of millions and raising attention through costly client events. voting against large compensation packages for top executives. Recent reports by a pair of institutional investment industry watchdog organizations called attention to a continued "unmitigated pay-for-performance misalignment" between AIG's performance and executive compensation. In 2018 AIG reported a -32% total shareholder return

compared to a -0.8% while CEO Brian Duperreault received a pay package of $21M compared with typical comparable CEO pay of $10-17M. The two firms recommended AIG's shareholder reject the upcoming pay package but they were approved by a smaller-than-usual margin.

Source: The New York Times, Advisory Firms Say AIG Shareholders Should Vote 'No' on Executive Pay (inactive link as of 08/07/2020) , Charles N. Hatch, 2019Sp

Behind these concerns lie a number of fundamental questions. Who "owns" a corporation? What constitutes "good" governance? What are a company's responsibilities? To shareholders? To other stakeholders, such as employees, suppliers, creditors, and society at large? How did Wall Street acquire so much power? And, critically, what are the roles and responsibilities of boards of directors?

Example 2.4 – Governance and the Board of Directors

Earn credit, add your own example!

The U.S. Corporate Governance System

Today's U.S. corporate governance system is best understood as the set of fiduciary and managerial responsibilities that binds a company's management, shareholders, and the board within a larger, societal context defined by legal, regulatory, competitive, economic, democratic, ethical, and other societal forces.

Shareholders

Although shareholders own corporations, they usually do not run them. Shareholders elect directors, who appoint managers who, in turn, run corporations. Since managers and directors have a fiduciary obligation to act in the best interests of shareholders, this structure implies that shareholders face two separate so-called principal-agent problems—with management whose behavior will likely be concerned with its own welfare, and with the board, which may be beholden to particular interest groups, including management.[1] Many of the mechanisms that define today's corporate governance system are designed to mitigate these potential problems and align the behavior of all parties with the best interests of shareholders broadly construed.

The notion that the welfare of shareholders should be the primary goal of the corporation stems from shareholders' legal status as residual claimants. Other stakeholders in the corporation, such as creditors and employees, have specific claims on the cash flows of the corporation. In contrast, shareholders get their return on investment from the residual only after all other stakeholders have been paid. Theoretically, making shareholders residual claimants creates the strongest incentive to maximize the company's value and generates the greatest benefits for society at large.

Not all shareholders are alike and share the same goals—at one extreme, the interests of small (minority) investors are often in conflict with large shareholders (including those

1. Agency theory explains the relationship between principals, such as shareholders and agents, like a company's executives. In this relationship, the principal delegates or hires an agent to perform work. The theory attempts to deal with two specific problems: first, that the goals of the principal and agent are in conflict (agency problem) and second, that the principal and agent have different tolerances for risk.

holding a controlling block of shares and institutional investors) at the other. Small investors with just a few shares, have little power to influence the board of the corporation. Moreover, with only a small share of their personal portfolios invested in the corporation, these investors have little motivation to exercise control over the corporation. As a consequence, small investors are usually passive and interested only in favorable returns. Often they do not bother to vote and simply sell their shares if they are not satisfied.

Example 2.5 – Shareholder Activism

After years of poor sales and amidst rumors of a potential acquisition, 7% shareholder, billionaire Daniel Loeb is leading an initiative to replace five of the 12 board members at Campbell's Soup through a proxy vote. Loeb faces a difficult battle, investors will get the opportunity to vote on the company's future at the annual meeting. Loeb will appeal to other investors who are also upset with the performance and management direction that Campbell's has taken in the past, and offer fresh blood and a conversation about whether to sell the company.

Source: CNN, Activist investor tries new tactic in Campbell Soup fight, 2018Fa

In contrast, shareholders who own a sufficiently large stake in the corporation can easily justify the time and expense necessary to monitor management actively. They may hold a controlling block of shares or be institutional investors, such as mutual funds, pension plans, employee stock ownership plans. Or—outside the United States—they may be banks whose stake in the corporation may not qualify as majority ownership but is large enough to motivate active engagement with management. It should be noted that the term "institutional investor" covers a wide variety of managed investment funds, including banks, trust funds, pension funds, mutual funds, and similar "delegated investors." All have different investment objectives, portfolio management disciplines, and investment horizons. As a consequence, institutional investors represent both another layer of agency problems and an opportunity for oversight.

To identify the potential for an additional layer of agency problems, ask why we should expect that a bank or pension fund will look out for minority shareholder interests any better than corporate management. On the one hand, institutional investors may have "purer" motives than management— principally a favorable investment return. On the other hand, they often make for passive, indifferent monitors, partly out of preference and partly because active monitoring may be prohibited by regulations or by their own internal investment rules. Indeed, a major tenet of the recent governance debate is focused on whether it is useful and desirable to create ways for institutional investors to take a more

active role in monitoring and disciplining corporate behavior. In theory, as large owners, institutional investors have a greater incentive to monitor corporations. Yet, the reality is that institutions failed to protect their own investors from managerial misconduct in firms like Enron, Tyco, Global Crossing, and WorldCom, even though they held large positions in these firms.

The latest development in the capital markets is the rise of private equity. Private equity funds differ from other types of investment funds mainly in the larger size of their holdings in individual investee companies, their longer investment horizons, and the relatively fewer number of companies in individual fund portfolios. Private equity managers typically have a greater degree of involvement in their investee companies compared to other investment professionals, such as mutual fund or hedge fund managers. As a result, these private equity managers are likely to play a greater role in influencing the corporate governance practices of their investee companies. By virtue of their longer investment horizon, direct participation on the board, and continuous engagement with management, private equity managers play an important role in shaping governance practices. That role is even stronger in a buyout or majority stake acquisition, where a private equity manager exercises substantial control—not just influence as in minority stake investments—over a company's governance. Not surprisingly, scholars and regulators are keeping a close watch on the impact of private equity on corporate performance and governance.

Example 2.6 – Private Equity in Action

Earn credit, add your own example!

State and Federal Law

Until recently, the U.S. government relied on the states to be the primary legislators for corporations. Corporate law primarily deals with the relationship between the officers, board of directors, and shareholders, and therefore traditionally is considered part of private law. It rests on four key premises that define the modern corporation: (a) indefinite life, (b) legal personhood, (c) limited liability, and (d) freely transferable shares. A corporation is a legal entity consisting of a group of persons—its shareholders—created

under the authority of the laws of a state. The entity's existence is considered separate and distinct from that of its members. Like a real person, a corporation can enter into contracts, sue and be sued, and must pay tax separately from its owners. As an entity in its own right, it is liable for its own debts and obligations. Providing it complies with applicable laws, the corporation's owners (shareholders) typically enjoy limited liability and are legally shielded from the corporation's liabilities and debts.[2]

Example 2.7 – Dissolution of a Corporation

Jenkins & Gilchrist was a large law firm consisting of 600 attorneys in 2012. After hiring a handful of debatable employees and adopting several unethical company policies, the IRS began a search on the law firm. After four years, and a $76 million dollar fine given to the company, the firm ultimately decided to dissolve.

Source: Business Insider, 10 Huge Law Firm Collapses Of The Decade, Ments Haugen, 2018Fa

The existence of a corporation is not dependent upon whom the owners or investors are at any one time. Once formed, a corporation continues to exist as a separate entity, even when shareholders die or sell their shares. A corporation continues to exist until the shareholders decide to dissolve it or merge it with another business. Corporations are subject to the laws of the state of incorporation and to the laws of any other state in which the corporation conducts business. Corporations may therefore be subject to the law of more than one state. All states have corporation statutes that set forth the ground rules as to how corporations are formed and maintained.

A key question that has helped shape today's patchwork of corporate laws asks, "What is or should be the role of law in regulating what is essentially a private relationship?" Legal scholars typically adopt either a "contract-based" or "public interest" approach to this question. Free-market advocates tend to see the corporation as a contract, a voluntary economic relationship between shareholders and management, and see little need for government regulation other than the necessity of providing a judicial forum for civil suits alleging breach of contract. Public interest advocates, on the other hand are concerned by the growing impact of large corporations on society and tend to have little faith in market solutions, and argue that government must force firms to behave in a manner that advances the public interest. Proponents of this point of view focus on how corporate

2. This section is based on Kenneth Holland's May 2005 review of the book Corporate Governance: Law, Theory and Policy.

behavior affects multiple stakeholders, including customers, employees, creditors, the local community, and protectors of the environment.

The stock market crash of 1929 brought the federal government into the regulation of corporate governance for the first time. President Franklin Roosevelt believed that public confidence in the equity market needed to be restored. Fearing that individual investors would shy away from stocks and, by doing so, reduce the pool of capital available to fuel economic growth in the private sector, Congress enacted the Securities Act in 1933 and the Securities Exchange Act in the following year, which established the Securities and Exchange Commission (SEC). This landmark legislation shifted the balance between the roles of federal and state law in governing corporate behavior in America and sparked the growth of federal regulation of corporations at the expense of the states and, for the first time, exposed corporate officers to federal criminal penalties. In 2002, as a result of the revelations of accounting and financial misconduct in the Enron and WorldCom scandals, Congress enacted the Accounting Reform and Investor Protection Act, better known as the Sarbanes-Oxley Act (and often referred to as SOX).

The Securities and Exchange Commission

The SEC—created to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation—is charged with implementing and enforcing the legal framework that governs security transactions in the United States. This framework is based on a simple and straightforward concept: All investors, whether large institutions or private individuals, should have access to certain basic facts about an investment prior to buying it, so long as they hold it. To achieve this, the SEC requires public companies to disclose meaningful financial and other information to the public. This promotes efficiency and transparency in the capital market, which, in turn, stimulates capital formation. To ensure efficiency and transparency, the SEC monitors the key participants in the securities trade, including securities exchanges, securities brokers and dealers, investment advisers, and mutual funds.[3]

3. http://www.sec.gov/about/whatwedo.shtml

The Exchanges

The NYSE (New York Stock Exchange) and NASDAQ (National Association of Securities Dealers Automated Quotations) which is operated by the National Association of Stock Dealers account for the trading of a major portion of equities in North America and the world. While similar in mission, they are different in the ways they operate and in the types of equities that are traded on them.[4]

The origination of the NYSE dates to 1792. Its listing standards are among the highest of any market in the world. Meeting these requirements signifies that a company has achieved leadership in its industry in terms of business and investor interest and acceptance. Today, the NYSE has about 2,800 listed companies that represent almost $30 trillion (2017) in total global capitalization.

The NASDAQ, the other major U.S. stock exchange, is the largest U.S. electronic stock market. With approximately 3,300 companies, it lists more companies and, on average, trades more shares per day than any other U.S. market. The total market capitalization of its listed companies is smaller than NYSE at around $10 trillion (2017). It is home to companies that are leaders across all areas of business, including technology, retail, communications, financial services, transportation, media, and biotechnology. The NASDAQ is typically known as a high-tech market, attracting many of the firms dealing with the Internet or electronics. Accordingly, the stocks on this exchange are considered to be more volatile and growth oriented.

The Gatekeepers: Auditors, Security Analysts, Bankers, and Credit Rating Agencies

The integrity of our financial markets greatly depends on the role played by a number of "gatekeepers"– external auditors, analysts, and credit rating agencies–in detecting and exposing the kinds of questionable financial and accounting decisions that led to the collapse of Enron, WorldCom, and other "misreporting" or accounting frauds.[5] A key question is whether we can (or should) rely on these gatekeepers to perform their roles diligently. It can be argued that we can and should because their business success depends

4. http://www.investopedia.com
5. This section draws on Edwards (2003).

on their credibility and reputation with the ultimate users of their information– investors and creditors–and if they provide fraudulent or reckless opinions, they are subject to private damage suits. The problem with this view is that the interests of gatekeepers are often more closely aligned with those of corporate managers than with investors and shareholders.

Gatekeepers, after all, are typically hired and paid (and fired) by the very firms that they evaluate or rate, and not by creditors or investors. Auditors are hired and paid by the firms they audit; credit rating agencies are typically retained and paid by the firms they rate; lawyers are paid by the firms that retain them; and, as we learned in the aftermath of the 2001 governance scandals, until recently the compensation of security analysts (who work primarily for investment banks) was closely tied to the amount of related investments banking business that their employers (the investment banks) do with the firms that their analysts evaluate.[6]

Example 2.8 – Auditors as Gatekeepers

Public companies everywhere must submit to audits in order to certify to shareholders that their financial and strategic results are accurate. London Biscuits Bhd received a qualified opinion on their financial statements for the year ended September 30, 2018. The auditor was "unable to determine whether adjustments might have been necessary in respect of the profit for the year"; concerns over net cash flows, misstatements related to opening balances, material transactions within the firm, and errors in account receivables records were also cited as causes of concern. London Biscuits shares closed down 5.26% on the news and the Board determined it would conduct an interim re-audit before the next fiscal year close.

Source: The Edge Markets, London Biscuits' auditor issues qualified opinion on FY18 results, Tatog Sasono, 2019Wi

A contrasting view, therefore, holds that most gatekeepers are inherently conflicted and cannot be expected to act in the interests of investors and shareholders. Advocates of this perspective also argue that gatekeeper conflict of interest worsened during the 1990s because of the increased cross-selling of consulting services by auditors and credit rating agencies and by the cross-selling of investment banking services.

Both issues are addressed by recent regulatory reforms; new rules address the

6. Citigroup paid $400 million to settle government charges that it issued fraudulent research reports; and Merrill Lynch agreed to pay $200 million for issuing fraudulent research in a settlement with securities regulators and also agreed that, in the future, its securities analysts would no longer be paid on the basis of the firm's related investment-banking work.

restoration of the “wall” between investment banks and security analysts, and mandate the separation of audit and consulting services for accounting firms.

Corporate Governance in America: A Brief History

Entrepreneurial, Managerial, and Fiduciary Capitalism

In the first part of the twentieth century, large U.S. corporations were controlled by a small number of wealthy entrepreneurs—Morgan, Rockefeller, Carnegie, Ford, and DuPont, to name a few. These "captains of industry" not only owned the majority of the stock in companies, such as Standard Oil and U.S. Steel, but they also exercised their rights to run these companies.

By the 1930s, however, the ownership of U.S. corporations had become much more widespread. Capitalism in the United States had made a transition from **entrepreneurial capitalism**, the model in which ownership and control had been synonymous, to **managerial capitalism**, a model in which ownership and control were effectively separated—that is, in which effective control of the corporation was no longer exercised by the legal owners of equity (the shareholders) but by hired, professional managers.

With the rise of institutional investing in the 1970s, primarily through private and public pension funds, the responsibility of ownership became once again concentrated in the hands of a relatively small number of institutional investors who act as fiduciaries on behalf of individuals. This large-scale institutionalization of equity brought further changes to the corporate governance landscape. Because of their size, institutional investors effectively own a major fraction of many large companies. And because this can restrict their liquidity, the de facto may have to rely on active monitoring (usually by other, smaller activist investors) than trading. This model of corporate governance, in which monitoring has become as or more important than trading, is sometimes referred to as **fiduciary capitalism**.[1]

1. This section is based on the essay by Hawley and Williams (2001).

The 1980s: Takeovers and Restructuring

As the ownership of American companies changed, so did the board-management relationship. For the greater part of the 20th century, when managerial capitalism prevailed, executives had a relatively free rein in interpreting their responsibilities toward the various corporate stakeholders and, as long as the corporation made money and its operations were conducted within the confines of the law, they enjoyed great autonomy. Boards of directors, mostly selected and controlled by management, intervened only infrequently, if at all. Indeed, for the first half of the last century, corporate executives of many publicly held companies managed with little or no outside control.

Example 2.9 – Modern Takeovers

In a recent takeover case, Walt Disney Co. announced it would take over 21st Century Fox at the price of $71.3 billion. The deal unites both companies Marvel franchises and adds Fox's Deadpool to Disney's Star Wars in addition to Fox television, FX Networks, and National Geographic. The now smaller Fox Corp. will operate as a stand alone company and retain ownership of a broadcast network and its affiliates as well as Fox News, Fox Business, and Fox Sports. Disney hopes to position itself against increasing competition from Netflix, Amazon, and possibly Apple. Unfortunately, as Disney consolidates its properties thousands of people are likely to lose their jobs.

Source: NPR.org, Disney Officially Owns 21st Century Fox, Zeqing Liu, 2019Sp

In the 1970s and 1980s, however, serious problems began to surface, such as exorbitant executive payouts, disappointing corporate earnings, and ill-considered acquisitions that amounted to little more than empire building, and depressed shareholder value. Led by a small number of wealthy, activist shareholders seeking to take advantage of the opportunity to capture underutilized assets, takeovers surged in popularity. Terms, such as leveraged buyout, dawn raids, poison pills, and junk bonds, became household words, and individual corporate raiders, including Carl Icahn, Irwin Jacobs, and T. Boone Pickens, became well known. The resulting takeover boom exposed underperforming companies and demonstrated the power of unlocking shareholder value.

Of lasting importance from this era was the emergence of institutional investors who knew the value of ownership rights, had fiduciary responsibilities to use them, and were

big enough to make a difference.[2] And with the implicit assent of institutional investors, boards substantially increased the use of stock option plans that allowed managers to share in the value created by restructuring their own companies. Shareholder value, therefore, became an ally rather than a threat.[3]

The Meltdown of 2001

The year 2001 will be remembered as the year of corporate scandals. The most dramatic of these occurred in the United States—in companies such as Enron, WorldCom, Tyco, and others—but Europe also had its share, with debacles at France's Vivendi, the Netherlands' Ahold, Italy's Parmalat, and ABB, a Swiss-Swedish multinational company. Even before these events fully unfolded, a rising number of complaints about executive pay, concerns about the displacement of private-sector jobs to other countries through offshoring, and issues of corporate social responsibility had begun to fuel emotional and political reactions to corporate news in the United States and abroad.

Most of these scandals involved deliberately inflating financial results, either by overstating revenues or understating costs, or diverting company funds to the private pockets of managers. Two of the most prominent examples of fraudulent "earnings management" include Enron's creation of off–balance sheet partnerships to hide the company's deteriorating financial position and to enrich Enron executives and WorldCom's intentional misclassification of as much as $11 billion in expenses as capital investments—perhaps the largest accounting fraud in history.

The Enron scandal came to symbolize the excesses of corporations during the long economic boom of the 1990s.[4] Hailed by Fortune magazine as "America's Most Innovative Company" for six straight years from 1996 to 2001, Enron became one of the largest bankruptcies in U.S. history. Its collapse in December 2001 followed the disclosure that it had reported false profits, using accounting methods that failed to follow generally accepted procedures. Both internal and external controls failed to detect the financial losses disguised as profits for a number of years. At first, Enron's senior executives, whose activities brought the company to the brink of ruin, escaped with millions of dollars as they retired or sold their company stock before its price plummeted. Enron employees

2. Romano (1994).
3. Holmstrom and Kaplan (2003).
4. Lindstrom (2008).

were not so lucky. Many lost their jobs and a hefty portion of retirement savings invested in Enron stock. Because the company was able to hide its losses for nearly five years, the Enron scandal shook the confidence of investors in American governance around the world.

Outside agencies, such as accounting firms, credit rating businesses, and stock market analysts had failed to warn the public about Enron's business losses until they were obvious to all. Internal controls had not functioned, either. And Enron's board of directors, especially its audit committee, apparently did not understand the full extent of the financial activities undertaken by the firm and, consequently, had failed in providing adequate oversight. Some experts believed that the federal government also bore some responsibility. Politicians in both the legislative and executive branches received millions of dollars in campaign donations from Enron during the period when the federal government decided to deregulate the energy industry, removing virtually all government controls. Deregulation was the critical act that made Enron's rise as a $100 billion company possible.

In June 2002, shortly after the Enron debacle, WorldCom admitted that it had falsely reported $3.85 billion in expenses over 5 quarterly periods to make the company appear profitable when it had actually lost $1.2 billion during that period.[5] Experts said it was one of the biggest accounting frauds ever. In its aftermath, the company was forced to lay off about 17,000 workers, more than 20% of its workforce. Its stock price plummeted from a high of $64.50 in 1999 to 9 cents in late July 2002 when it filed for bankruptcy protection. In March 2004, in a formal filing with the SEC, the company detailed the full extent of its fraudulent accounting. The new statement showed the actual fraud amounted to $11 billion and was accomplished mainly by artificially reducing expenses to make earnings appear larger. After restructuring its debt and meeting other requirements imposed by a federal court, the company emerged from bankruptcy protection in April 2004 and formally changed its name to MCI Inc.

Even as it emerged from bankruptcy, industry observers anticipated that MCI would need to merge with another telecommunications firm to compete against larger companies that offered a broader range of telecommunications services. The merger materialized less than a year later, in February 2005, when Verizon Communications Inc. announced its acquisition of MCI for about $6.7 billion in cash, stocks, and dividend payments. MCI ceased to exist as an independent company under the terms of the merger, which was completed in 2006.

As Edwards (2003) notes, these scandals raised fundamental questions about the

5. "MCI, Inc.," Microsoft® Encarta® Online Encyclopedia (2008).

motivations and incentives of executives and about the effectiveness of existing corporate governance practices, not just in the United States, but globally. What motivated executives to engage in fraud and earnings mismanagement? Why did boards either condone or fail to recognize and stop managerial misconduct and allow managers to deceive shareholders and investors? Why did external gatekeepers, for example, auditors, credit rating agencies, and securities analysts, fail to uncover the financial fraud and earnings manipulation, and alert investors to potential discrepancies and problems? Why were shareholders themselves not more vigilant in protecting their interests, especially large institutional investors? What does this say about the motivations and incentives of money managers?[6]

Because of the significance of these questions and their influence on the welfare of the U.S. economy, the government, regulatory authorities, stock exchanges, investors, ordinary citizens, and the press all started to scrutinize the behavior of corporate boards much more carefully than they had before. The result was a wave of structural and procedural reforms aimed at making boards more responsive, more proactive, and more accountable, and at restoring public confidence in our business institutions. The major stock exchanges adopted new standards to strengthen corporate governance requirements for listed companies; then Congress passed the Sarbanes-Oxley Act of 2002, which imposes significant new disclosure and corporate governance requirements for public companies, and also provides for substantially increased liability under the federal securities laws for public companies and their executives and directors; and the SEC adopted a number of significant reforms.

The Financial Crisis of 2008

Just as investor confidence had (somewhat) been restored and the avalanche of regulatory reform that followed the 2001 meltdown digested, a new, even more damaging crisis, global in scale and scope, emerged. While it has not (yet) been labeled as a “corporate governance” crisis, the “financial crisis of 2008” once again raises important questions about the efficacy of our economic and financial systems, board oversight, and executive behavior.

Specifically, as the economic news worsened—rising inflation and unemployment, falling house prices, record bank losses, a ballooning federal deficit culminating in a

6. Edwards (2003).

$10 trillion national debt, millions of Americans losing their homes, a growing number of failures of banks and other financial institutions—CEOs, investors, and creditors are walking away with billions of dollars, while American taxpayers are being asked to pick up the tab (Freddie Mac's chairman earned $14.5 million in 2007; Fannie Mae's CEO earned $14.2 million that same year). Ordinary citizens who had seen the value of their 401K investment plans shrink by 40% or more.

Example 2.10 – Financial Regulation

Since 2002, companies in the United States have had to comply with the Sarbanes Oxley Act which requires that executives personally certify their company's accounts. If the executive misrepresents something they are subject to criminal penalties. External auditors – companies other than ones that maintain record of accounts – must certify the validity of the books.

Source: The Balance, Do Regulations Keep Your Money Safer?, 2019Wi

Certainly, the 2008 crisis was complicated and even ten years later, answers remain evasive. Many believe bankers, central banks, and regulators did indeed mishandle the crisis by failing to foresee the coming disaster and for failing to impose checks and balances on financial institutions. Following the repeal of Glass-Steagall (a rule that separated commercial and investment banking) in 1999, banks needed to find ever more risky vehicles for growth. Many gave risky mortgage loans to people who could not afford them. The central bank ignored warnings signs as the emerging disaster was building up. Regulators were understaffed and overwhelmed to the point where they could not read what was available to them.

While the causes of the crisis will be debated for some time—Did we rely too much on free markets or not enough? Did special interests shape public policy? Did greed rule once again? Where were the boards of Bear Stearns, Lehman Brothers, and AIG? Were regulators asleep at the wheel? Incompetent? One thing is for sure, another wave of regulatory reform—this time possibly global in reach—is around the corner. And once again we will be asking those familiar questions: What will be the impact on investor confidence? On corporate behavior? On boards of directors? On society?

Purpose and Direction of the Firm

Whether for-profit or not-for-profit, a key issue within any organization is aligning the behavior of all members to serve the purpose of the organization. Mission defines this purpose in words that are commonly understandable; the mission defines why the organization exists. Vision creates a picture of what the firm wants to be in broad terms; where the firm is headed. Where mission is abstract and intangible, vision is concrete and tangible.

What Makes a Good Vision:[1]

- Graphic – paints a picture
- Directional – is forward looking
- Focused – is specific enough to provide guidance in decision making and allocating resources
- Flexible – not SO focused it makes it difficult to make mid-course adjustments based on dynamic circumstances
- Feasible – within the realm of the company's expertise and resources
- Desirable – why the path makes good sense
- Ease of Communication – can be explained in 5-10 minutes, memorable

Common Vision Shortcomings:

- Vague or incomplete
- Not forward looking
- Too broad
- Bland or uninspiring
- Not distinctive
- Too reliant on superlatives

1. Based on Essentials of Strategic Management, 3e, 2012 by Gamble, Thompson, and Peteraf, pg 17.

KEY TAKEAWAY

Like the government of any country where rule-of-law provides structure and order so the society can function effectively, corporate governance provides a framework by which modern corporations can operate. Agency theory provides the basis for corporate governance and is largely responsible for the current state of publicly traded companies and their access to vital capital through the equity market. But sometimes, things can go wrong. Because the interests of shareholders (owners) and decision makers (managers) can sometimes be at odds, owner representatives (board members) must take care to ensure proper controls are in place to both motivate the behavior of managers while at the same time guarding against potential abuse by those same leaders. Strong, and complex, rules dictate how the various actors in modern corporations behave, but they sometimes go wrong with devastating consequences for all stakeholders.

Essential Unit Vocabulary

Agent – Any manager or executive within a firm with the control and authority to make business decisions for the good of the company as if he or she were the owner. Agents prefer higher levels of corporate diversification that maximize firm size and their compensation while reducing employment risk.

Agency Cost – Those costs incurred by the Principals of a firm related to maintaining an agency relationship with its managers. Typically comprised of incentives, monitoring and enforcement costs, these expenses are incurred to prevent conflicts between shareholders and managers by aligning the interests of both parties and increase shareholder value.

Agency Relationship – A fiduciary relationship consisting of a risk bearing owner (principal) and a decision making manger (agent) wherein the agent (person or business) is appointed by the principal (person or business) to make sound business decisions for the company.

Balanced Scorecard – A planning and management system that is used to carry out a company's strategy and vision. It was created as a way to measure financial metrics against non-financial measurements in order to get a more balanced view of an organization's performance and it is an excellent complement to a SWOT analysis when looking at an organization from the inside. The four key areas of a balanced scorecard include: finance, customers, internal processes, and knowledge & growth. This YouTube video is a good explanation of the balanced scorecard.

Board of Directors – A group of individuals elected as representatives of its owners (stockholders) to establish corporate management oversight related to decision making in major company issues such as strategy, hiring and firing of executives, dividend policies, and executive compensation. The Board of Directors makes sure the business is being run in a way that benefits the shareholders and looks out for the long term financial well being of the company.

Centralization – Describes the concentration or restriction of decision making power to the upper management of an organization. The opposite of centralized is decentralized; together these terms describe a continuum of decision making authority within a firm's organization structure.

Culture – The shared value of beliefs, customs, practices and purpose of a company's employees in a business setting. Culture of a company could be described by the interactions of employees with each other and with their customers.

Executive Compensation – Refers to the financial compensation package awarded to a firm's executives by the Board of Directors within the restraints of Federal Law. Executive compensation is explicitly designed to create an incentive for the executive team to perform in the best interests of the owners and to increase stockholder profits. Typical packages include: salary, annual bonuses, future incentives or stock options, benefits and severance agreements (golden parachutes) with the majority of the compensation coming in the form of company stock contingent on the company achieving specific strategic or financial goals.

Formalization – The extent to which work roles are structured in an organization, and the activities of the employees are governed by rules and procedures. When designing an organizational structure, formalization is considered against its opposite, informalization.

Market for Corporate Control – When a company is undervalued due to the underwhelming performance of its governance or board of directors, which creates a competition for its control rights. The lower the stock price, the more attractive the company could be if it were under better management. So, investors will buy the controlling interest in the targeted company's equity and effectively purchase the company from the original owners without their permission, and replace the board of directors and top management. The ultimate plan being to revitalize the company and allow it to reach its full revenue potential. This possibility of hostile takeover or leveraged buyout can force current management and board of directors to be held accountable for their choices and enforce greater corporate governance rules.

Mission Statement – A short statement outlining a company's core values and business philosophy; used to communicate the purpose of the company.

Objective Setting – The process of identifying a goal or set of goals that will help the organization achieve competitive advantage and earn above average returns. Objective setting happens at all levels of an organization from the overall strategic plan to individual functions and their employees. In general, objectives should be "SMART"; this includes Specific, Measurable, Achievable, Related and Time-bound.

Organization Structure – The way an organization distributes its power and who makes decisions (Centralized/Decentralized), the type and number of jobs (Specialized/Generalized) and degree of rules to govern work practices (Formalized/Informal). Adam Chandler discovered a predictable pattern of evolution of organizations from simple (where the staff act as an extension of the owner) to functional (where a limited corporate staff controls unique operations of the firm) to multidivisional (where autonomous divisions act as profit centers).

Risk Profile – A risk profile is a measure across all points of the company to determine

what and how risks may affect the company. It helps to locate and thus address the area of operations that is associated with the largest risk.

Specialization – The practice within the design of an organization of limiting the scope of duties each job performs in order to gain greater degrees of expertise, productivity or efficiency within the entire system of businesses or areas. This practice contrasts with that of expanding the scope of job duties, called generalization, where employees are expected to perform a broad range of duties.

Three P's (profit, people and planet) – Also called "the triple bottom line" and consisting of three separate areas, a company should have (profit, people, planet). With focusing on all three of these aspects, it allows the company to "measure the financial, social and environmental performance of the company over a period of time." The first P stands for Profit, which focuses on the profit and loss accounts. The main aspect of the "people account" is to ensure the firm measures its social responsibility the people in the firm, the people in the community in which the firm operates and the people impacted by its products or service. Last is the "planet account" which measures a firm's environmental responsibility to the earth and the condition in which the earth is left for following generations.

Vision – The concrete companion to a firm's mission statement, the vision statement defines where the firm is headed and is used as a compass to guide the business towards its goals. It is future focused and is typically so lofty as to be unachievable. Nevertheless, it is graphic, directional, focused, flexible, feasible, desirable and easy to communicate.

PART 3. THE EXTERNAL ENVIRONMENT

Part Contents

- What's in it for Me?
- The General Environment (PESTEL)
- Analyzing the Organization's Microenvironment
- KEY TAKEAWAY
- EXERCISES
- Essential Unit Vocabulary

What's in it for Me?

Reading these chapters will help you do the following:

1. Describe the general external environment of an industry using the PESTEL model.
2. Apply Porter’s Five Forces model to describe any industry and determine the attractiveness of that industry through the opportunity for a firm to make a profit.
3. Describe activities that allow a firm to understand the external environment of an industry.

The General Environment (PESTEL)

When appraising the external environment of the organization you will typically start with its general environment. But what does this mean? The general environment is composed of dimensions in the broader society that influence an industry and the firms within it. We group these dimensions into six segments: political, economic, social, technical or technological, environmental, and legal. You can use the simple acronym, PESTEL, to help remind you of these six general environment segments. Examples of elements analyzed in each of these segments are shown in Table 3.1.

Table 3.1 PESTEL Analysis

Political	Economic
How stable is the political environment?	What are current and forecasted interest rates?
What are local taxation policies, and how do these affect your business?	What is the level of inflation, what is it forecast to be, and how does this affect the growth of your market?
Does the government have trade agreements such as EU, NAFTA, ASEAN, or others?	What are local employment levels per capita and how are they changing?
What are the foreign trade regulations?	What are the long-term prospects for the economy gross domestic product (GDP) per capita, and so on?
What are the social welfare policies?	What are exchange rates between critical markets and how will they affect production and distribution of your goods?
Social or Socio-cultural	**Technical or Technological**
What are local lifestyle trends?	What is the level of research funding in government and the industry, and are those levels changing?
What are the current demographics, and how are they changing?	What is the government and industry's level of interest and focus on technology?
What is the level and distribution of education and income?	How mature is the technology?
What are the dominant local religions and what influence do they have on consumer attitudes and opinions?	What is the status of intellectual property issues in the local environment?
What is the level of consumerism and popular attitudes toward it?	Are potentially disruptive technologies in adjacent industries creeping in at the edges of the focal industry?
What pending legislation is there that affects corporate social policies (e.g., domestic partner benefits, maternity/paternity leave)?	How fast is technology changing? How is its pace impacting the industry?
What are the attitudes toward work and leisure?	What role does technology play in competitive advantage?
Environmental	**Legal**
What are local environmental issues?	What are the regulations regarding monopolies and private property?
Are there any ecological or environmental issues relevant to your industry that are pending?	Does intellectual property have legal protections?

How do the activities of international pressure groups affect your business (e.g., Greenpeace, Earth First, PETA)?	Are there relevant consumer laws?
Are there environmental protection laws? What are the regulations regarding waste disposal and energy consumption?	What is the status of employment, health and safety, and product safety laws?

Firms cannot directly control the general environment segments and elements. Accordingly, successful companies gather the information required to understand each segment and its implications for the selection and implementation of the appropriate strategies. For example, the terrorist attacks in the United States on September 11, 2001, surprised businesses throughout the world. This single set of events had substantial effects on the U.S. economy. Although individual firms were affected differently, none of them could control the U.S. economy. Instead, companies around the globe were challenged to understand the effects of this economy's decline on their current and future strategies. A similar set of events and relationships was seen around the world as financial markets began to struggle one after the other starting in late 2008.

Example 3.1 Impact of PESTEL Factors on an Entire Industry

Management consulting services allow businesses to focus on their unique business plan while considering broader external information. Consulting firms gather information from an outsider's persepctive and alert businesses how they're seen by the larger society and the general public. By reflecting this information generically, they can sell their services to a variety of related businesses. They reflect the kind of impact those firms are making and how they can adjust accordingly, to implement beneficial changes. The idea is that one factor in the external environment can create a competitive advantage that makes the company more profitable than a competitor. As demand for such information has risen, so have the profits of the entire management consulting industry, with an estimate of $343B by 2025 in Europe according to this report. Expect to see further consolidation in the industry as it continues to get bigger.

Source: EIN Newsdesk, Management Consulting Services Market to Hit $343.52 Billion by 2025, 2019Sp

Although the degree of impact varies, these environmental segments affect each industry and its firms. The challenge to the firm is to evaluate those elements in each segment that are of the greatest importance. Resulting from these efforts should be a recognition of environmental changes, trends, opportunities, and threats.

Analyzing the Organization's Microenvironment

When we say microenvironment (or alternatively, Competitor Environment) we are referring primarily to an organization's industry, and the upstream and downstream markets related to it. An industry is a group of firms producing products that are close substitutes. In the course of competition, these firms influence one another. Typically, industries include a rich mix of competitive strategies that companies use in pursuing strategic competitiveness and above-average returns. In part, these strategies are chosen because of the influence of an industry's characteristics.[1] Upstream markets are the industries that provide the raw material or inputs for the focal industry, while downstream markets are the industries (sometimes consumer segments) that consume the industry outputs. For example, the oil production market is upstream of the oil-refining market (and, conversely, the oil refiners are downstream of the oil producers), which in turn is upstream of the gasoline sales market. Instead of upstream and downstream, the terms wholesale and retail are often used. Accordingly, the industry microenvironment consists of stakeholder groups that a firm has regular dealings with. The way these relationships develop can affect the costs, quality, and overall success of a business.

Porter's Five-Forces Analysis of Market Structure

You can distill the results of PESTEL and microenvironment analysis to view the competitive structure of an industry using Michael Porter's five forces, see **Figure 3.1**. Here you will find that your understanding of the microenvironment is particularly helpful. Porter's model attempts to analyze the attractiveness of an industry by considering five forces within a market. According to Porter, the likelihood of firms making profits in a given industry depends on five factors: (1) barriers to entry and new

1. Spanos, Y. E., & Lioukas, S. (2001). An examination into the causal logic of rent generation: Contrasting Porter's competitive strategy framework and the resource-based perspective. Strategic Management Journal, 22, 907–934.

entry threats, (2) buyer and (3) supplier bargaining power, (4) threat from substitutes, and (5) the degree of rivalry of competitors in the industry.[2]

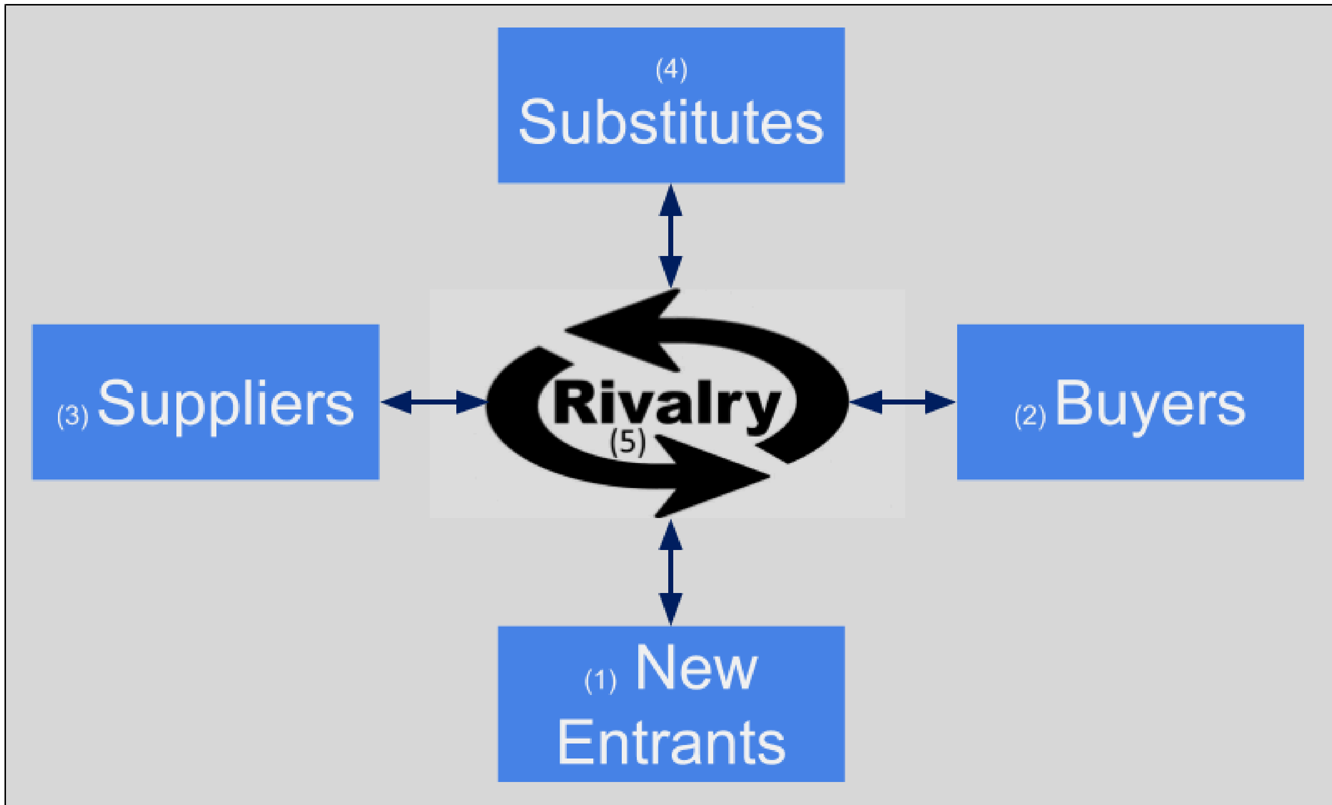


Figure 3.1 Porter's Five Forces

The industry environment has a more direct effect on the firm's strategic competitiveness and above-average returns than the general environment. The intensity of industry competition and an industry's profit potential (as measured by the long-run return on invested capital) are a function of these five forces of competition: the threats posed by new entrants, the power of suppliers, the power of buyers, product substitutes, and the intensity of rivalry among competitors.

Porter's five-forces model of competition expands the arena for competitive analysis. Historically, when studying the competitive environment, firms concentrated on companies with which they competed directly (competitor groups). However, firms must search more broadly to identify current and potential competitors by identifying potential customers as well as the firms serving them. Competing for the same customers and thus

2. Porter, M. E. (1980). Competitive strategy. New York: Free Press.

being influenced by how customers value location and firm capabilities in their decisions is referred to as the market microstructure.[3]

Example 3.2 Understanding an Industry Using Porter's Five Forces

Looking at JPMorgan Chase, Porter's Five Forces Analysis shows that the company's strongest force is rivalry, as there is a huge variety of banking companies to compete with JPM. Bargaining power of buyers is important too, because of the various competitors the buyers could switch to, and so JPM combats this with special offers that attract consumers. Substitutions are a large factor in the banking industry as well, and like with buyers, consumers have a great level of bargaining power as a whole. New entrants, on the other hand, are a relatively low threat to JPMorgan Chase.

Source: Investopedia, Analyzing Porter's Five Forces on JPMorgan (JPM), 2018Fa

Understanding this area is particularly important because, in recent years, industry boundaries have become blurred. For example, in the electrical utilities industry, cogenerators (firms that also produce power) are competing with regional utility companies. Moreover, telecommunications companies now compete with broadcasters, software manufacturers provide personal financial services, airlines sell mutual funds, and automakers sell insurance and provide financing.[4] In addition to focusing on customers rather than specific industry boundaries to define markets, geographic boundaries are also relevant. Research suggests that different geographic markets for the same product can have considerably different competitive conditions.[5]

Example 3.3 Forward or Backward Integration

In August 2017, the e-commerce giant Amazon acquired Whole Foods Market Inc. for $13.7 Billion. This acquisition allowed Amazon to gain 400 physical stores and get access to large data of consumers' grocery buying habits, patterns, and preferences.

3. Zaheer, S., & Zaheer, A. (2001). Market microstructure in a global b2b network, Strategic Management Journal, 22, 859–873.
4. Hitt, M. A., Ricart I Costa, J., & Nixon, R. D. (1999). New managerial mindsets. New York: Wiley.
5. Pan, Y., & Chi, P. S. K. (1999). Financial performance and survival of multinational corporations in China. Strategic Management Journal, 20, 359–374; Brooks, G. R. (1995). Defining market boundaries Strategic Management Journal, 16, 535–549.

Source: Doctor Vidya Hattangadi, What is a business integration strategy?, 2018Fa

The five-forces model recognizes that suppliers can become a firm's competitors (by integrating forward), as can buyers (by integrating backward). Several firms have integrated forward in the pharmaceutical industry by acquiring distributors or wholesalers. In addition, firms choosing to enter a new market and those producing products that are adequate substitutes for existing products can become competitors of a company.

Another way to think about industry market structure is that these five sets of stakeholders are competing for profits in the given industry. For instance, if a supplier to an industry is powerful, they can charge higher prices. If the industry can't pass its higher costs onto their buyers in the form of higher prices, industry members make less profit. For example, if you have a jewelry store, but are dependent on a monopolist like De Beers for diamonds, then De Beers actually is extracting more relative value from your industry (i.e., the retail jewelry business).

Threat of New Entrants

The likelihood of new entry is a function of the extent to which barriers to entry exist. Evidence suggests that companies often find it difficult to identify new competitors.[6] Identifying new entrants is important because they can threaten the market share of existing competitors. One reason new entrants pose such a threat is that they bring additional production capacity. Unless the demand for a good or service is increasing, additional capacity holds consumers' costs down, resulting in less revenue and lower returns for competing firms. Often, new entrants have a keen interest in gaining a large market share. As a result, new competitors may force existing firms to be more effective and efficient and to learn how to compete on new dimensions (for example, using an Internet-based distribution channel).

6. Geroski, P. A. (1999). Early warning of new rivals. Sloan Management Review, 40(3), 107–116.

Example 3.4 New Entrant

Amazon's recent acquisition of PillPack is threatening pharmaceutical market share, potentially altering the landscape of medication home delivery. Amazon serves as a threat due to its power and capacity to provide service. Existing local pharmaceutical companies now competing with home delivery will have to add tools to keep customers satisfied and to maintain trust.

Source: Pharmacy Today, Will recent announcements alter medication home delivery?, Sarah Cushing, 2018Fa

The more difficult it is for other firms to enter a market, the more likely it is that existing firms can make relatively high profits. The likelihood that firms will enter an industry is a function of two factors: barriers to entry and the retaliation expected from current industry participants. Entry barriers make it difficult for new firms to enter an industry and often place them at a competitive disadvantage even when they are able to enter. As such, high-entry barriers increase the returns for existing firms in the industry.[7]

The threat of new entrants is high when:

- Barriers to entry are low (initial capital costs, costs to scale efficiently.)
- There are no network effects (a good or service is more valuable when more people use it, e.g., the internet was of little value until more people started to use it.)
- Customer switching costs are low.
- Incumbents do not possess brand loyalty, proprietary technology, preferential access to raw materials or distribution channels, favorable geographic location, or cumulative experience.
- There are no restrictive government regulations.
- A low expectation that incumbents in the industry cannot or will not retaliate.

Buyer Bargaining Power

The stronger the power of buyers in an industry, the more likely it is that they will be able to force down prices and reduce the profits of firms that provide the product. Firms seek to maximize the return on their invested capital. Alternatively, buyers (customers of an

7. Robinson, K. C., & McDougall, P. P. (2001). Entry barriers and new venture performance: A comparison of universal and contingency approaches. Strategic Management Journal, 22, 659–685.

industry or firm) want to buy products at the lowest possible price—the point at which the industry earns the lowest acceptable rate of return on its invested capital. To reduce their costs, buyers bargain for higher-quality, greater levels of service, and lower prices. These outcomes are achieved by encouraging competitive battles among the industry's firms.

Example 3.5 Buyer Bargaining Power

Tenants and buyer of real estate in Abu Dhabi are experiencing greater bargaining power due to the oversupply of apartments and villas in the city and driving down purchase prices by 9% and rental prices by 12% overall. With more units coming on the market in 2019, this trend is expected to remain for the foreseeable future. Meanwhile, buyers and tenants are expected to move to bigger and better apartments as property owners seek their investments.

Source: Khaleej Times, Tenants, buyers have more bargaining power in Abu Dhabi, 2019Wi

The bargaining power of buyers is high when:

- Only a few buyers exist and those buyers purchase relatively large quantities relative to the size of any single seller.
- When the industry's products are commodities or standardized.
- Switching costs are low or non-existent.
- Buyers can reasonably threaten backward integration into the industry.

Supplier Bargaining Power

The stronger the power of suppliers in an industry, the more difficult it is for firms within that sector to make a profit because suppliers can determine the terms and conditions on which business is conducted. Increasing prices and reducing the quality of its products are potential means used by suppliers to exert power over firms competing within an industry. If a firm is unable to recover cost increases by its suppliers through its pricing structure, its profitability is reduced by its suppliers' actions.

Example 3.6 Supplier Bargaining Power

Apple plans to move away from its Liquid Crystal Polymer (LCP) antenna technology toward a newer modified polyimide (MPI) for all phones built starting in 2019. The newer material is performs as well as the older one but has a much higher yield rate, making it more effective. The older LCP process was complicated to manufacture, prone to defects, and could be accomplished by a limited number of suppliers. Because there will be five new suppliers of the MPI antennae, Apple has greater bargaining power, will get comparable performance with fewer failures, and expects to pay lower prices.

Source: 9to5Mac, 2019 iPhones to use new combination of antenna technology, Ziqi Cao, 2018Fa

The bargaining power of suppliers is high when:

- The industry of the suppliers is more concentrated than that of the industry to which it sells.
- Suppliers do not rely on the industry as their sole source of revenue.
- Switching costs are high.
- The products offered by the supplier is highly differentiated.
- No readily available substitutes are available.
- The threat of forward integration into the industry by suppliers is reasonable.

Threat of Substitutes

This measures the ease with which buyers can switch to another product that does the same thing, such as using aluminum cans rather than glass or plastic bottles to package a beverage. The ease of switching depends on what costs would be involved (e.g., while it may be easy to sell Coke or Pepsi in bottles or cans, transferring all your data to a new database system and retraining staff could be expensive) and how similar customers perceive the alternatives to be. Substitute products are goods or services from outside a given industry that perform similar or the same functions as a product that the industry produces. For example, as a sugar substitute, NutraSweet places an upper limit on sugar manufacturers' prices—NutraSweet and sugar perform the same function but with different characteristics.

Example 3.7 Substitution

Boxed is a new online, membership-free wholesale retailer that allows you to buy in bulk from the comfort of your home without any membership fees. They have a curated range of products that allow them to be the low cost leader which makes for direct competition with other wholesalers such as Costco or Sam's club. As switching costs are minimal to almost non-existent, it is very easy for customers to switch to Boxed as they not only offer the best prices, but also offer free shipping on orders over 49 dollars.

Source: Fox 4 News, On Your Side: 'Boxed' Bulk Delivery Service, Ariadna Archibald, 2018Fa

Other product substitutes include fax machines instead of overnight deliveries, plastic containers rather than glass jars, and tea substituted for coffee. Recently, firms have introduced to the market several low-alcohol fruit-flavored drinks that many customers substitute for beer. For example, Smirnoff Ice was introduced with substantial advertising of the type often used for beer. Other firms have introduced lemonade with 5% alcohol (e.g., Doc Otis Hard Lemon) and tea and lemon combinations with alcohol (e.g., BoDean's Twisted Tea). These products are increasing in popularity, especially among younger people, and, as product substitutes, have the potential to reduce overall sales of beer.[8] In general, differentiating a product along dimensions that customers value (such as price, quality, service after the sale, and location) reduces a substitute's attractiveness.

The threat of substitute products is high when:

- The substitute offers an attractive price-to-performance trade-off.
- The substitute product's price is lower or its quality and performance capabilities are equal to or greater than those of the competing product.
- Customers face few, if any, switching costs.

Degree of Rivalry

This measures the degree of competition between existing firms. The higher the degree of rivalry, the more difficult it is for existing firms to generate high profits.

The degree of rivalry is highest when:

8. Khermouch, G. (2001, March 5). Grown-up drinks for tender taste buds. Business Week, p. 96.

- There are numerous competitors or competitors are equally balanced.
- The industry is experiencing slow growth.
- Fixed costs are high in the industry.
- The industry's products lack differentiation
- Rivals in the industry have high strategic stakes.
- Leaving the industry comes with high exit barriers.

Numerous or Equally Balanced Competitors

Example 3.8 Numerous or Balanced Rivalry

Coca-Cola and Pepsi have been in the "Cola Wars" for a long time. Although their portfolios are no longer limited to soft drinks, their continuing battle on a full spectrum of growth and earnings measures shows the intensity of rivalry that continues between the two. Pepsi seems to currently lead in consumer demand, showing a 43% higher return over the last five years. And while consumers are shifting their preferences to healthier options, so are these two rivals as they attempt to modify consumer perceptions of their brands. Pepsi acquired Naked, Kevita and Soda Stream. Meanwhile Coca-Cola acquired Honest Tea, Costa Coffee, MOJO Kombucha, and a minority stake in the growing Gatorade competitor Body Armor.

Source: Yahoo Finance, The Cola Wars: Pepsi vs. Coke, 2019Sp

Intense rivalries are common in industries with many companies. With multiple competitors, it is common for a few firms to believe that they can act without eliciting a response. However, evidence suggests that other firms generally are aware of competitors' actions, often choosing to respond to them. At the other extreme, industries with only a few firms of equivalent size and power also tend to have strong rivalries. The large and often similar-sized resource bases of these firms permit vigorous actions and responses. The Fuji/Kodak and Airbus/Boeing competitive battles exemplify intense rivalries between pairs of relatively equivalent competitors.

Example 3.9 Slow Growing Industry

With the growing concern of vehicle carbon emissions, the advent of electric cars for consumer use has become inevitable. While the need for a change is clear, the market is clearly developing slowly because there isn't the proper infrastructure for the charging of electric vehicles like the network of gas stations that

currently exist. Until companies can differentiate through an increased range and charging options, the industry will continue to develop slowly.

Source: Phys.org, 'Not right away': Electric cars still have long road ahead, 2018Fa

Slow Industry Growth

When a market is growing, firms try to use resources effectively to serve an expanding customer base. Growing markets reduce the pressure to take customers from competitors. However, rivalry in non-growth or slow-growth markets becomes more intense as firms battle to increase their market shares by attracting their competitors' customers.

Typically, battles to protect market shares are fierce. Certainly, this has been the case with Fuji and Kodak. The instability in the market that results from these competitive engagements reduce profitability for firms throughout the industry, as is demonstrated by the commercial aircraft industry. The market for large aircraft is expected to decline or grow only slightly over the next few years. To expand market share, Boeing and Airbus will compete aggressively in terms of the introduction of new products, and product and service differentiation; both firms are likely to win and lose battles; however, as of this writing Boeing is the current leader.

High Fixed Costs or High Storage Costs

Example 3.10 High Fixed Costs

Approach Resources, an independent oil and gas company, is an example of a company hindered by high fixed costs in 2018. G&A and interest costs are the main reason these fixed costs are so high, and need to be reduced if the company wants to remain competitive. It is likely that in the future they will use some sort of debt restructuring to try and drive down these costs compared to other companies in their industry.

Source: Seeking Alpha, Approach Resources: Hindered By High Fixed Costs, 2018Fa

When fixed costs account for a large part of total costs, companies try to maximize the use of their productive capacity. Doing so allows the firm to spread costs across a

larger volume of output. However, when many firms attempt to maximize their productive capacity, excess capacity is created on an industry-wide basis. To then reduce inventories, individual companies typically cut the price of their product and offer rebates and other special discounts to customers. These practices, however, often intensify competition. The pattern of excess capacity at the industry level followed by intense rivalry at the firm level is observed frequently in industries with high storage costs. Perishable products, for example, lose their value rapidly with the passage of time. As their inventories grow, producers of perishable goods often use pricing strategies to sell products quickly.

Lack of Differentiation or Low Switching Costs

When buyers find a differentiated product that satisfies their needs, they frequently purchase the product faithfully over time. Industries with many companies that have successfully differentiated their products have less rivalry, resulting in lower competition for individual firms.[9] However, when buyers view products as commodities (as products with few differentiated features or capabilities), rivalry intensifies. In these instances, buyers' purchasing decisions are based primarily on price and, to a lesser degree, service. Film for cameras is an example of a commodity. Thus, the competition between Fuji and Kodak is expected to be strong.

Example 3.11 Commodities

Commodities are grouped into three main categories – agriculture, energy, and metals. The term "agriculture" leads one to think about this category as items such as lumber or fibers that we create clothes out of, but it also pertains to drinks, grains, and animals that are specifically raised for food. Low product differentiation and low prices are both characteristics of commodities.

Based on this definition, buying a soft drink at grocery store presents two options — to buy a commodity or a branded item. If the customer perceives Pepsi or Coca-Cola as providing a higher quality than the generic store brand (also known as a dealer brand) of "cola", they will pay a premium for the product. However, if the customer doesn't perceive a value distinction then the cola is simply a commodity and they will purchase the lowest cost alternative.

Source: The Balance, What Commodities Are and How Its Trading Market Works, 2019Wi

9. Deephouse, D. L. (1999). To be different, or to be the same? It's a question (and theory) of strategic balance. Strategic Management Journal, 20, 147–166.

The effect of switching costs is identical to that described for differentiated products. The lower the buyer's' switching costs, the easier it is for competitors to attract buyers through pricing and service offerings. High switching costs, however, at least partially insulate the firm from rivals' efforts to attract customers. Interestingly, the switching costs—such as pilot and mechanic training—are high in aircraft purchases, yet, the rivalry between Boeing and Airbus remains intense because the stakes for both are extremely high.

High Strategic Stakes

Competitive rivalry is likely to be high when it is important for several of the competitors to perform well in the market. For example, although it is diversified and is a market leader in other businesses, Samsung has targeted market leadership in the consumer electronics market. This market is quite important to Sony and other major competitors such as Hitachi, Matsushita, NEC, and Mitsubishi. Thus, we can expect substantial rivalry in this market over the next few years.

Example 3.12 High Stakes Rivalry

After acquiring Uber's local business in Indonesia, Grab, a top ride-hailing firm based in South East Asia, formed a joint venture with ZhongAn International and insurance company to add insurance and loan financing products for its drivers. This action by Grab is part of their ambition to become the leading South East Asia irval to Go-Jek (an Indonesian ride-hailing firm).

In recent years, these two companies have battled to provide services beyond ride-hailing. For its part, Go-Jek is expanding its business to Vietnam and Thailand compete with Grab. This rivalry has escalated since 2018 as Grab has raised $3 billion of a $5 billion capital goal while Go-Jek is close to raising $2 billion to strengthen their balance sheet.

Source: TechCrunch, Grab moves to Offer Digital Insurance Services in Southeast Asia, 2019Wi

High strategic stakes can also exist in terms of geographic locations. For example, Japanese automobile manufacturers are committed to a significant presence in the U.S. marketplace. A key reason for this is that the United States is the world's single largest market for auto manufacturers' products. Because of the stakes involved in this country for Japanese and U.S. manufacturers, rivalry among firms in the U.S. and global automobile industry is highly intense. While close proximity tends to promote greater rivalry, physically proximate competition has potentially positive benefits as well. For example,

when competitors are located near one another, it is easier for suppliers to serve them and they can develop economies of scale that lead to lower production costs. Additionally, communications with key industry stakeholders such as suppliers are facilitated and more efficient when they are close to the firm.[10]

High Exit Barriers

Sometimes companies continue competing in an industry even though the returns on their invested capital are low or negative. Firms making this choice likely face high exit barriers, which include economic, strategic, and emotional factors, causing companies to remain in an industry when the profitability of doing so is questionable.

Example 3.13 Exit Barriers to Rivalry

Earn credit, add your own example!

Attractiveness and Profitability

Using Porter's analysis, firms are likely to generate higher profits (and be considered attractive) if the industry:

- Is difficult to enter
- There is limited rivalry
- Buyers are relatively weak
- Suppliers are relatively weak
- There are few substitutes

Profits are likely to be low (and the industry considered unattractive) if:

10. Chung, W., & Kalnins, A. (2001). Agglomeration effects and performance: Test of the Texas lodging industry Strategic Management Journal, 22, 969–988.

- The industry is easy to enter
- There is a high degree of rivalry between firms within the industry
- Buyers are strong
- Suppliers are strong
- It is easy to switch to alternatives

Effective industry analyses are products of careful study and interpretation of data and information from multiple sources. A wealth of industry-specific data is available to be analyzed. Because of globalization, international markets and rivalries must be included in the firm's analyses. In fact, research shows that in some industries, international variables are more important than domestic ones as determinants of strategic competitiveness. Furthermore, because of the development of global markets, a country's borders no longer restrict industry structures. In fact, movement into international markets enhances the chances of success for new ventures as well as more established firms.[11]

Following a study of the five forces of competition, the firm can develop the insights required to determine an industry's attractiveness in terms of its potential to earn adequate or superior returns on its invested capital. In general, the stronger competitive forces are, the lower the profit potential for an industry's firms. An unattractive industry has low entry barriers, suppliers and buyers with strong bargaining positions, strong competitive threats from product substitutes, and intense rivalry among competitors. These industry characteristics make it very difficult for firms to achieve strategic competitiveness and earn above-average returns. Alternatively, an attractive industry has high entry barriers, suppliers and buyers with little bargaining power, few competitive threats from product substitutes, and relatively moderate rivalry.[12]

11. Kuemmerle, W. (2001). Home base and knowledge management in international ventures. Journal of Business Venturing, 17, 99–122; Lorenzoni, G., & Lipparini, A. (1999). The leveraging of interfirm relationships as a distinctive organizational capability: A longitudinal study. Strategic Management Journal, 20, 317–338.
12. Porter, M. E. (1980). Competitive strategy. New York: Free Press.

KEY TAKEAWAY

External environment analysis is a key input into strategy formulation. PESTEL is an external environment analysis framework that helps guide your prospecting in the political, economic, social, technological, environmental, and legal spheres of an organization's external environment. Working inward to the focal organization, we discussed the broad dimensions of the stakeholders feeding into the firm. Porter's five forces analysis considers (1) barriers to entry and new entry threats, (2) buyer power, (3) supplier power, (4) threat from substitutes, and (5) rivalry as key external environmental forces in developing strategy. The ultimate goal of a Porter's five forces analysis is to determine the attractiveness or profit potential for the industry.

EXERCISES

1. What are the six dimensions of the environment that are of broad concern when you conduct a PESTEL analysis?
2. Which of the PESTEL dimensions do you believe to be most important, and why?
3. What are the key dimensions of a firm's microenvironment?
4. What are the five forces referred to in the Porter framework?
5. Is there a dimension of industry structure that Porter's model appears to omit?

Essential Unit Vocabulary

Assessing – In the competitive assessment process, firms are advised to follow four specific activities to understand their external environment: scanning, monitoring, forecasting and assessing. This final step of assessment defines the likelihood a trend will become an opportunity or a threat.

Attractiveness of an Industry – The attractiveness of an industry influences the decision to enter that industry. An "attractive industry" is one that offers high potential profit yields. Determining the attractiveness of an industry is the primary goal of conducting the analysis of an industry using Michael Porter's 5-Forces of Competition. For example, an industry is more likely to be labeled as attractive when more of the following conditions exist: Low threat of substitute products; high barriers to enter the industry; rivalry among existing competitors is low or when existing industry rivals have high bargaining power with its suppliers.

Bargaining Power of Buyer – The bargaining power of customers (buyers) directly affects the market as a whole when they expect lower prices or special services. When the buyer's bargaining power is high it forces rivals to cut prices or improve the product's offering in terms of quality, features or service. High buyer bargaining power reduces operating profits and make the industry less attractive for new entrants.

Bargaining Power of Suppliers – A party that supplies goods or services is a Supplier. A supplier may be distinguished from a contractor or subcontractor, who commonly adds specialized input to deliverables. Also called vendor. The bargaining power of suppliers is strong when there is a steep price for switching to alternate suppliers, when needed inputs are in short supply, when the particular supplier has a differentiated input in terms of quality, performance or image, when the supply is critical to seller's production or when there are few suppliers from which to choose. When a supplier has high bargaining power it forces members of the industry to accept its price and terms.

Competitive Intelligence – Scanning, monitoring, forecasting, and assessing information about competitors in order to better understand them and enhance business decision making. There are two different types, Tactical and Strategic. Tactical competitive intelligence is short term and seeks to provide input into issues such as capturing market share or increasing revenue. Strategic competitive intelligence focuses on longer term issues such as key risk and opportunities.

Competitor Environment – The competitive environment describes the dynamic external structure in which a company/business operates. The level of competition

depends on how many sellers are in the market currently. The higher the number of competing businesses , the more competitive the industry/market will be.

Degree of Rivalry – Occurs when two or more companies compete with each other in similar markets and/or with similar resources. In Porter's Five Forces of Competition, the degree of rivalry among competing sellers in an industry will be great when members are active in making fresh moves to improve their standing or performance, when buyer demand is growing slowly or falling, when sellers have excess capacity or inventory, the number of rivals increases and they are of comparable size, the industry is selling a commodity and switching costs for buyers are low.

Forecasting – A planning tool that helps management create projections in its attempt to cope with the uncertainty of the future, relying mainly on data from the past and present, and analysis of trends.

General Macro Environment – The major external and uncontrollable factors that influence an organization's decision making and affect its performance and strategies. These factors include: economic factors, demographics, legal, political and social conditions, technological changes, as well as natural forces.

Industry Analysis – A market assessment tool designed to provide a business with an idea of the complexity and profit potential of a particular industry. Industry analysis involves reviewing the economic, political and market factors that influence the way the industry develops. Major factors can include the power wielded by suppliers and buyers, the condition of rivals, and the likelihood of new market entrants or substitute products.

Industry's Driving Forces – An industry's driving forces that are outside a firm, forces that are external to an organization, but still trigger changes in the strategy of that firm.

Industry Environment – The factors directly influencing a firm's competitive actions/ responses and is typically defined by Porter's Five Factors of Competition — the bargaining power of Buyers and Suppliers, the threat of New Entrants and Substitute products and the degree of Rivalry within the industry. In comparison to the general environment, the industry environment has more likely effect on a firm's strategic competitiveness and above-average returns.

Industry Life Cycle – Describes the evolutionary timeline of an industry including: Introduction featuring slow sales growth and nonexistent profits; Growth phase in which market acceptance accelerates and profits increase; Maturity when sales slow down and profits level off or decline; and Decline when sales fall off dramatically and profits drop, typically irrecoverably.

Key Success Factors – Those competitive factors that most affect industry members' ability to prosper in the marketplace. It may include particular strategy elements, product

attributes, resources, competitive capabilities, or intangible assets with the greatest impact on the future success in the marketplace.

Market Segmentation – The process of defining and subdividing a large homogenous market into clearly identifiable segments having similar needs, wants or demand characteristics.

Porter's Five Forces Model of Competition – This model is used as an analytical tool for identifying the profit potential of an industry. The five forces consist of the threat of new entrants, threat of substitute products, the bargaining power of suppliers and buyers and the intensity of rivalry by existing industry participants. The model is universal in its applicability but does not yield precise, quantified data about the industry. Instead, it produces a framework for understanding the relative strength or weakness of each of the five forces and helps the analyst ultimately determine the attractiveness of the industry relative to profit potential.

SWOT Analysis – Stands for strength, weakness, opportunities and threats. Each of the four factors is typically examined anecdotally and using quantified information to assess both the internal capabilities of a firm (strengths and weaknesses) and the external conditions within which the firm operates (opportunities and threats). It is typically used as a preliminary tool to provide qualitative information that can be used to focus quantitative investigation.

Threat of New Entrants – In the context of Porter's Five Forces of Competition, the threat of New Entrants is increased when there is a large pool of entry candidates, when barriers to entry are low or are easy to hurdle, there is profit to be made in the industry, buyer demand is increasing and existing industry members are unable or unwilling to contest new entrants.

Threat of Substitution – In Porter's Five Forces model, a substitute is defined as a product that meets the essential needs of an industry's buyers at a lower price. The threat of substitution is increased when buyers have multiple options, when those options are attractively priced, when the alternative has comparable or better performance features, when buyers have low switching costs and when end users grow more comfortable using the alternative.

PART 4. INTERNAL CAPABILITY

Part Contents

- What's in it for Me?
- Operational Excellence
- Internal Analysis
- VRIO Analysis
- Organizational Control
- KEY TAKEAWAY
- EXERCISES
- Essential Unit Vocabulary

What's in it for Me?

Reading these chapters will help you do the following:

1. Conduct an analysis to understand the ability of an organization to develop sustainable competencies.
2. Distinguish between capabilities and core competencies using VRIO analysis.
3. Explain the process of Value Chain analysis.
4. Describe the balanced scorecard and explain how it is used in a firm to facilitate the implementation of strategy.

Operational Excellence

In the late twentieth century a growing awareness of the importance of management in the performance of the modern firm began to emerge as governments and cross-industry groups introduced official awards for the highest levels of management practice.[1] Awards such as Japan's Deming Prize (established in 1950), the United States's Malcolm Baldrige National Award (established in 1987), the European Quality Awards (established in 1990), and the AKAO Prize (established in 1996 by the Quality Function Deployment Institute) publicly recognize either individual or whole organization-level performance.

Example 4.1 Baldrige Quality Award Recipient

This year, one of the Baldrige Quality Award recipients was Donor Alliance; they were one of five winners to attain this award for their organizational excellence and sustainability impact within the healthcare industry. For Donor Alliance, winning the award is a motivational accomplishment, but they also aspire to inspire other organizations and become role models for them.

Source: Market Watch, Donor Alliance Wins 2018 Baldrige National Quality Award (inactive link as of 08/07/2020), Abraham Diaz, 2018

While many firms take great pride in winning such popular recognitions and incorporate them into their marketing, others eschew them and instead pursue operational excellence for its own benefit, greater profitability. Ultimately, management is responsible for making the decisions and leading the actions that define a firm's values and create the culture that will impact the quality of execution of all operational aspects.[2]

World-class firms concern themselves with whether all of their various operational systems have the ability to be competitive and lead in their industry. These firms recognize that such quality is created before and during the process of implementation, not after-the-fact. Additionally, all decisions big and small incur a cost, create a benefit, or both. The simple equation, Profit = Price − Cost, captures the essence of this wisdom.

1. Victor, David A., et al. "Management Awards." Encyclopedia of Management, edited by Marilyn M. Helms, 5th ed., Gale, 2006, pp. 483-490. Gale Virtual Reference Library. Accessed 12 Dec. 2016.
2. Inman, R. Anthony. "World-Class Manufacturer." Encyclopedia of Management, edited by Marilyn M. Helms, 5th ed., Gale, 2006, pp. 980-983. Gale Virtual Reference Library. Accessed 12 Dec. 2016.

Therefore, the world-class firm acts as if every single action impacts every other action whether within the firm or with its suppliers and partners. Additionally, these decisions impact the firm's ability to charge a competitive price while incurring a best-of-class cost in order to generate above average returns.

Internal Analysis

By exploiting internal resources and capabilities and meeting the demanding standards of global competition, firms create value for customers.[1] Value is measured by a product's performance characteristics and by its attributes for which customers are willing to pay.[2] Those particular bundles of resources and capabilities that provide unique advantages to the firm are considered core competencies.[3] Core competencies are resources and capabilities that serve as a source of a firm's competitive advantage over rivals. Core competencies distinguish a company competitively and reflect its personality. Core competencies emerge over time through an organizational process of accumulating and learning how to deploy different resources and capabilities. As the capacity to take action, core competencies are "crown jewels of a company," the activities the company performs especially well compared to competitors and through which the firm adds unique value to its goods or services over a long period of time.[4]

Example 4.2 Core Competency

Sometimes consistency and predictability provide value to customers, such as the type of value Walgreens drugstores provides. As a Fortune magazine writer noted, "Do you realize that from 1975 to today, Walgreens beat Intel? It beat Intel nearly two to one, GE almost five to one. It beat 3M, Coke, Boeing, Motorola." Walgreens was able to do this by using its core competencies to offer value desired by its target customer group. Instead of responding to the trends of the day, "During the Internet scare of 1998 and 1999, when slogans of 'Change or Die!' were all but graffitied on the subway, Walgreens obstinately stuck to its corporate credo of 'Crawl, walk,

1. McEvily, S. K., & Chakravarthy, B. (2002). The persistence of knowledge-based advantage: An empirical test for product performance and technological knowledge. Strategic Management Journal, 23, 285–305; Buckley, P. J., & Carter, M. J. (2000). Knowledge management in global technology markets: Applying theory to practice. Long Range Planning, 33(1), 55–71.
2. Pocket Strategy. (1998). Value (p. 165). London: The Economist Books.
3. Prahalad, C. K., and Hamel, G. (1990). The core competence of the organization. Harvard Business Review, 90, 79–93.
4. Hafeez, K., Zhang, Y. B., & Malak, N. (2002). Core competence for sustainable competitive advantage: A structured methodology for identifying core competence. IEEE Transactions on Engineering Management, 49(1), 28–35; Prahalad, C. K., & Hamel, G. (1990). The core competence of the corporation. Harvard Business Review, 68(3), 79–93.

run.' Its refusal to act until it thoroughly understood the implications of e-commerce was deeply unfashionable, but…Walgreens is the epitome of the inner-directed company." Thus, Walgreens creates value by focusing on the unique capabilities it has built, nurtured, and continues to improve across time.

Earn credit, add your own example!

During the past several decades, the strategic management process was concerned largely with understanding the characteristics of the industry in which the firm competes and, in light of those characteristics, determining how the firm should position itself relative to competitors. This emphasis on industry characteristics and competitive strategy may have understated the role of the firm's resources and capabilities in developing competitive advantage. In the current competitive landscape, core competencies, in combination with product-market positions, are the firm's most important sources of competitive advantage.[5] The core competencies of a firm, in addition to its analysis of its general, industry, and competitor environments, should drive its selection of strategies. As Clayton Christensen noted, "Successful strategists need to cultivate a deep understanding of the processes of competition and progress and of the factors that undergird each advantage. Only thus will they be able to see when old advantages are poised to disappear and how new advantages can be built in their stead."[6] By drawing on internal analysis and emphasizing core competencies when formulating strategies, companies learn to compete primarily on the basis of firm-specific differences, but they must be aware of how things are changing as well.

Example 4.3 Leveraging Resources

For example, Amazon.com has combined service and distribution resources to develop its competitive advantages. The firm started as an online bookseller, directly shipping orders to customers. It quickly grew large and established a distribution network through which it could ship "millions of different items to millions of different customers." Compared with Amazon's use of combined resources, traditional bricks-and-mortar companies, such as Toys "R" Us and Borders, found it hard to establish an effective online presence. These

5. Hitt, M. A., Nixon, R. D., Clifford, P. G., & Coyne, K. P. (1999). The development and use of strategic resources. In M. A. Hitt, P. G. Clifford, R. D. Nixon, & K. P. Coyne (Eds.), Dynamic Strategic Resources (pp. 1–14). Chichester: Wiley.
6. Christensen, C. M. (2001). The past and future of competitive advantage. Sloan Management Review, 42(2), 105–109.

difficulties led them to develop partnerships with Amazon. Through these arrangements, Amazon now handles the online presence and shipping of goods for several firms, including Toys "R" Us and Borders, which now can focus on sales in their stores. Arrangements such as these are useful to the bricks-and-mortar companies because they are not accustomed to shipping so much diverse merchandise directly to individuals.

Earn credit, add your own example!

Resources and Capabilities

Resources

Broad in scope, the term resources covers a spectrum of individual, social, and organizational phenomena.[7] Typically, resources alone do not yield a competitive advantage.[8] In fact, the core competencies that yield a competitive advantage are created through the unique bundling of several resources.[9]

Some of a firm's resources are tangible while others are intangible. Tangible resources are assets that can be seen and quantified. Production equipment, manufacturing plants, and formal reporting structures are examples of tangible resources. Intangible resources typically include assets that are rooted deeply in the firm's history and have accumulated over time. Because they are embedded in unique patterns of routines, intangible resources are relatively difficult for competitors to analyze and imitate. Knowledge, trust

7. Eisenhardt, K., & Martin, J. (2000). Dynamic capabilities: What are they? Strategic Management Journal, 21, 1105–1121; Michalisin, M. D., Kline, D. M., & Smith. R. D. (2000). Intangible strategic assets and firm performance: A multi-industry study of the resource-based view, Journal of Business Strategies, 17(2), 91–117.
8. West, G. P., & DeCastro, J. (2001). The Achilles heel of firm strategy: Resource weaknesses and distinctive inadequacies. Journal of Management Studies, 38(3), 26–45.; Deeds, D. L., DeCarolis, D., & J. Coombs. (2000). Dynamic capabilities and new product development in high technology ventures: An empirical analysis of new biotechnology firms. Journal of Business Venturing, 15, 211–229; Chi, T. (1994). Trading in strategic resources: Necessary conditions, transaction cost problems, and choice of exchange structure. Strategic Management Journal, 15, 271–290.
9. Berman, S., Down, J., & Hill, C. (2002). Tacit knowledge as a source of competitive advantage in the National Basketball Association. Academy of Management Journal, 45, 13–31.

between managers and employees, ideas, the capacity for innovation, managerial capabilities, organizational routines (the unique ways people work together), scientific capabilities, and the firm's reputation for its goods or services and how it interacts with people (such as employees, customers, and suppliers) are all examples of intangible resources.[10] The four types of tangible resources are financial, organizational, physical, and technological. The three types of intangible resources are human, innovation, and reputational.

As a manager or entrepreneur, you will be challenged to understand the strategic value of your firm's tangible and intangible resources. The strategic value of resources is indicated by the degree to which they can contribute to the development of core competencies, and, ultimately, competitive advantage. For example, as a tangible resource, a distribution facility is assigned a monetary value on the firm's balance sheet. The real value of the facility, however, is grounded in a variety of factors, such as its proximity to raw materials and customers, but also in intangible factors such as the manner in which workers integrate their actions internally and with other stakeholders, such as suppliers and customers.[11]

Capabilities

Capabilities are the firm's capacity to deploy resources that have been purposely integrated to achieve a desired end state.[12] As the glue that holds an organization together, capabilities emerge over time through complex interactions among tangible and intangible resources. They can be tangible, like a business process that is automated, but most of them tend to be tacit and intangible. Critical to forming competitive advantages,

10. Feldman, M. S. (2000). Organizational routines as a source of continuous change, Organization Science, 11, 611–629; Knott, A. M., & McKelvey, B. (1999). Nirvana efficiency: A comparative test of residual claims and routines. Journal of Economic Behavior & Organization, 38, 365–383.
11. Gavetti, G., & Levinthal, D. (2000). Looking forward and looking backward: Cognitive and experiential search. Administrative Science Quarterly, 45, 113–137; Coff, R. W. (1999). How buyers cope with uncertainty when acquiring firms in knowledge-intensive industries: Caveat emptor. Organization Science, 10, 144–161; Marsh, S. J., & Ranft, A. L. (1999). Why resources matter: An empirical study of knowledge-based resources on new market entry. In M. A. Hitt, P. G. Clifford, R. D. Nixon, & K. P. Coyne (Eds.), Dynamic strategic resources (pp. 43–66). Chichester: Wiley.
12. Helfat, C. E., & Raubitschek, R. S. (2000). Product sequencing: Co-evolution of knowledge, capabilities, and products. Strategic Management Journal, 21, 961–979.

capabilities are often based on developing, carrying, and exchanging information and knowledge through the firm's human capital.[13] Because a knowledge base is grounded in organizational actions that may not be explicitly understood by all employees, repetition and practice increase the value of a firm's capabilities.

The foundation of many capabilities lies in the skills and knowledge of a firm's employees and, often, their functional expertise. Hence, the value of human capital in developing and using capabilities and, ultimately, core competencies cannot be overstated. Firms committed to continuously developing their people's capabilities seem to accept the adage that "the person who knows how will always have a job. The person who knows why will always be his boss."[14]

Example 4.4 Advantage through the Value Chain

With a combined total export revenue of around US$5.2 million in the past 3 years, Myanmar's local coffee industry has experienced tremendous growth. Up to this point, Myanmar's smallholder coffee farmers sold their raw green coffee beans in a commodity like market. Their roasting processes were traditional and low efficiency, they produced a poor quality product. But all of that changed in 2015 thanks to a collaborative between U.S.-funded Value Chain for Rural Areas and the Myanmar Coffee Association. The Ywangan Coffee Cluster now consists of more than 10,000 coffee growers producing high quality Arabica beans and exports in the most recent year exceeded 477 metric tons to Europe, the U.S., and numerous Asian markets.

Improved techniques led to better quality product which in turn led to greater demand. Coffee producers have had to modernize their methods to keep up. One coffee producer Daw Su Su Ang, known as "the Coffee Lady" and owner of Amara Coffee, said that the Value Chain program has helped the factory to host training sessions to improve bean taste and pass down knowledge of natural processing methods while generating better wages for 300 families in 20 villages. Their output doubled in the past year.

Source: Irrawaddy, Shan State's "Coffee Lady" Moves up the Value Chain, 2019Wi

Global business leaders increasingly support the view that the knowledge possessed by human capital is among the most significant of an organization's capabilities and may

13. Hitt, M. A., Bierman, L., Shimizu, K., & Kochhar, R. (2001) Direct and moderating effects of human capital on strategy and performance in professional service firms: A resource-based perspective. Academy of Management Journal, 44(1), 13–28; Hitt, M. A., Ireland, R. D., & Lee, H. (2000). Technological learning, knowledge management, firm growth and performance: An introductory essay. Journal of Engineering and Technology Management, 17, 231–246; Hoopes, D. G., & Postrel, S. (1999). Shared knowledge: "Glitches," and product development performance. Strategic Management Journal, 20, 837–865; Quinn, J. B. (1994).The Intelligent Enterprise. New York: Free Press.
14. Thoughts on the business of life. (1999, May 17). Forbes, p. 352.

ultimately be at the root of all competitive advantages. But firms must also be able to use the knowledge that they have and transfer it among their operating businesses.[15] For example, researchers have suggested that "in the information age, things are ancillary, knowledge is central. A company's value derives not from things, but from knowledge, know-how, intellectual assets, and competencies—all of it embedded in people."[16] Given this reality, the firm's challenge is to create an environment that allows people to fit their individual pieces of knowledge together so that, collectively, employees possess as much organizational knowledge as possible.[17]

To help them develop an environment in which knowledge is widely spread across all employees, some organizations have created a new upper-level managerial position of chief learning officer (CLO). Establishing a CLO position highlights a firm's belief that "future success will depend on competencies that traditionally have not been actively managed or measured—including creativity and the speed with which new ideas are learned and shared."[18] In general, these firm should manage knowledge in ways that

15. Argote, L., & Ingram, P. (2000). Knowledge transfer: A basis for competitive advantage in firms. Organizational Behavior and Human Decision Processes, 82, 150–169.
16. Dess, G. G., & Picken, J. C. (1999). Beyond productivity. New York: AMACOM. 26.
17. Coy, P. (2002, Spring). High turnover, high risk [Special Issue]. Business Week, p. 24.
18. Baldwin, T. T., & Danielson, C. C. (2000). Building a learning strategy at the top: Interviews with ten of America's CLOs. Business Horizons, 43(6), 5–14.

will support its efforts to create value for customers.[19]

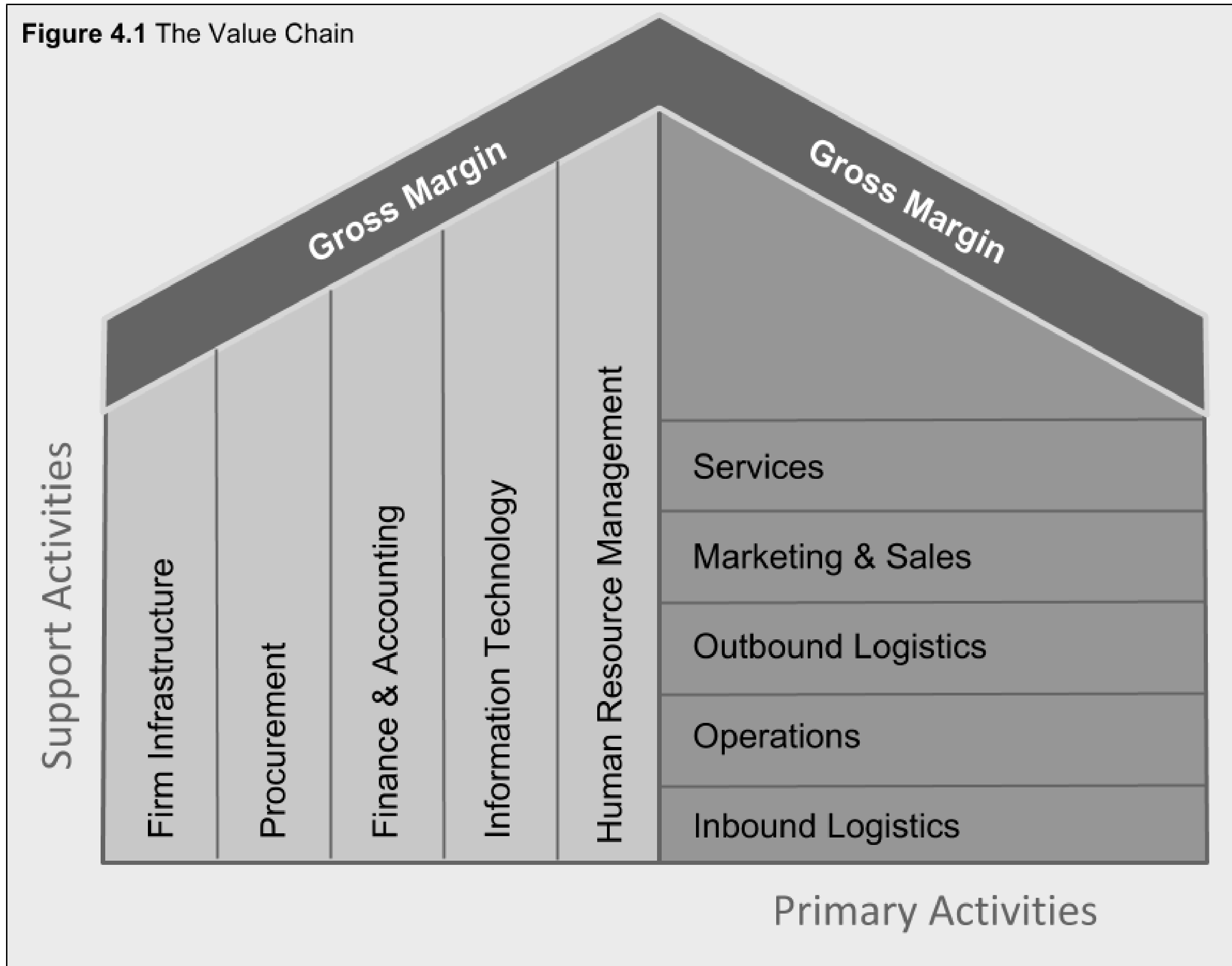


Figure 4.1 The Value Chain

Capabilities are often developed in specific functional areas (such as manufacturing, R&D, and marketing) or in a part of a functional area (for example, advertising). The value chain, popularized by Michael Porter's book, Competitive Advantage, is a useful tool for taking stock of organizational capabilities. A value chain is a chain of activities. In the value chain, some of the activities are deemed to be primary, in the sense that these activities add direct value. In the preceding figure, primary activities are logistics (inbound and outbound), marketing, and service. Support activities include how the firm is organized (infrastructure), human resources, technology, and procurement. Products pass through all activities of the chain in order, and at each activity, the product gains some value. A firm

19. Kuratko, D. F., Ireland, R. D., & Hornsby, J. S. (2001). Improving firm performance through entrepreneurial actions: Acordia's corporate entrepreneurship strategy. Academy of Management Executive, 15(4), 60–71; Hansen, M. T., Nhoria, N., & Tierney, T. (1999). What's your strategy for managing knowledge? Harvard Business

is effective to the extent that the chain of activities gives the products more added value than the sum of the costs at each step. While both primary and support activities add to a firm's cost structure, due to their enabling nature, support activities are often candidates for outsourcing. Distinguishing between the two types of activities is a critical first step in understanding the firm's value chain. Firms do not outsource primary activities if they are a source of competitive advantage.

It is important not to mix the concept of the value chain with the costs occurring throughout the value chain activities. A diamond cutter can be used as an example of the difference. The cutting activity may have a low cost, but the activity adds to much of the value of the end product, since a rough diamond is significantly less valuable than a cut, polished diamond. Research suggests a relationship between capabilities developed in particular functional areas and the firm's financial performance at both the corporate and business-unit levels,[20] suggesting the need to develop capabilities at both levels.

20. Hitt, M. A., & Ireland, R. D. (1986). Relationships among corporate level distinctive competencies, diversification strategy, corporate structure, and performance. Journal of Management Studies, 23, 401–416; Hitt, M. A., & Ireland, R. D. (1985). Corporate distinctive competence, strategy, industry, and performance. Strategic Management Journal, 6, 273–293; Hitt, M. A., Ireland, R. D., & Palia, K. A. (1982). Industrial firms' grand strategy and functional importance. Academy of Management Journal, 25, 265–298; Hitt, M. A., Ireland, R. D., & Stadter, G. (1982). Functional importance and company performance: Moderating effects of grand strategy and industry type. Strategic Management Journal, 3, 315–330; Snow, C. C., & Hrebiniak, E. G. (1980). Strategy, distinctive competence, and organizational performance. Administrative Science Quarterly, 25, 317–336.

VRIO Analysis

Figure 4.2 VRIO and Relative Firm Performance

Valuable?	Rare?	Difficult to Imitate?	Supported by Organization?	Competitive Implications	Perfor-mance
No	--	--	Yes	Competitive Disadvantage	Below Normal
Yes	No	--		Competitive Parity	Normal
Yes	Yes	No		Temporary Competitive Advantage	Above Normal
Yes	Yes	Yes		Sustained Competitive Advantage	Above Normal

Given that almost anything a firm possesses can be considered a resource or capability, how should you attempt to narrow down the ones that are core competencies, and explain why firm performance differs? To lead to a sustainable competitive advantage, a resource or capability should be valuable, rare, inimitable (there are no substitutes), and possessed by the organization despite it being costly to imitate in terms of time or money or both. This VRIO framework is the foundation for internal analysis.[1] VRIO is an acronym for valuable, rare, inimitable, and organization (as in *owned* by the organization).

If you ask managers why their firms do well while others do poorly, a common answer is likely to be "our people." But this is really not a complete answer. It may be the start of an answer, but you need to probe more deeply—what is it about "our people" that is especially valuable? Why don't competitors have similar people? Why haven't competitors hired our people away? Or is it that there is something special about the organization that brings out the best in people? These kinds of questions form the basis of VRIO and get to the heart of why some resources help firms more than others.

Moreover, your ability to identify whether an organization has VRIO resources will also likely explain their competitive position. In the figure, you can see that a firm's

1. VRIO analysis is at the core of the resource-based view of the firm. Wernerfelt, B. (1984). A resource-based view of the firm. Strategic Management Journal, 5, 171–180. Barney, J. B. (1991). Firm resources and sustained competitive advantage. Journal of Management, 19, 99–120.

performance relative to industry peers is likely to vary according to the level to which resources, capabilities, and ultimately core competences satisfy VRIO criteria. The four criteria are explored next.

Valuable

A resource or capability is said to be valuable if it allows the firm to exploit opportunities or negate threats in the environment. If a resource does not allow a firm to minimize threats or exploit opportunities, it does not enhance the competitive position of the firm. In fact, some scholars suggest that owning resources that do not meet the VRIO test of value actually puts the firm at a competitive disadvantage.[2]

Example 4.5 Creating Value

Union Pacific's extensive network of rail-line property and equipment in the Gulf Coast of the United States is valuable because it allows the company to provide a cost-effective way to transport chemicals. Because the Gulf Coast is the gateway for the majority of chemical production in the United States, the rail network allows the firm to exploit a market opportunity. Delta's control of the majority of gates at the Cincinnati / Northern Kentucky International Airport (CVG) gives it a significant advantage in many markets. Travelers worldwide have rated CVG one of the best airports for service and convenience 10 years running. The possession of this resource allows Delta to minimize the threat of competition in this city. Delta controls air travel in this desirable hub city, which means that this asset (resource) has significant value.

Earn credit, add your own example!

Rare

A resource is rare simply if it is not widely possessed by other competitors. Of all of the VRIO criteria this is probably the easiest to judge. For example, Coke's brand name is valuable but most of Coke's competitors (Pepsi, 7Up, RC) also have widely recognized

2. Barney, J. B. (1991). Firm resources and sustained competitive advantage. Journal of Management, 17, 99–120.

brand names, making it not that rare. Of course, Coke's brand may be the most recognized, but that makes it more valuable, not more rare, in this case.

A firm that possesses valuable resources that are not rare is not in a position of advantage relative to competitors. Rather, valuable resources that are commonly held by many competitors simply allow firms to be at par with competitors. However, when a firm maintains possession of valuable resources that are rare in the industry they are in a position of competitive advantage over firms that do not possess the resource. They may be able to exploit opportunities or negate threats in ways that those lacking the resource will not be able to do. Delta's virtual control of air traffic through Cincinnati gives it a valuable and rare resource in that market.

How rare do the resources need to be for a firm to have a competitive advantage? In practice, this is a difficult question to answer unequivocally. At the two extremes (i.e., one firm possesses the resource or all firms possess it), the concept is intuitive. If only one firm possesses the resource, it has significant advantage over all other competitors. However, meeting the condition of rarity does not always require exclusive ownership. When only a few firms possess the resource, they will have an advantage over the remaining competitors. For instance, Toyota and Honda both have the capabilities to build cars of high quality at relatively low cost.[3] Their products regularly beat rival firms' products in both short-term and long-term quality ratings.[4] Thus, the criterion of rarity requires that the resource not be widely possessed in the industry. It also suggests that the more exclusive a firm's access to a particularly valuable resource, the greater the benefit for having it.

Example 4.6 Rare Resource

In the race to be first with 5G technology competitors are scrambling to win bids in a new wireless high-band spectrum. The Federal Communications Commission in April 2019 announced its third and largest auction for fifth generation networks that promise a major speed increase for downloading data over cellular networks. The White House considers service in rural areas and security for 5G to be essential to keep the country competitive for billions of Internet of Things (IoT) devices like autonomous cars and industrial sensors. In recent months the U.S. and China have imposed tariffs against each other and with no American companies

3. Dyer, J. H., Kale, P., & Singh, H. (2004, July–August). When to ally and when to acquire. Harvard Business Review, 109–115.
4. Dyer, J. H., & Hatch, N. (2004). Using Supplier Networks to Learn Faster. Sloan Management Review, 45(3), 57–63.

manufacturing the main switch networks, the new network will rely on European companies Nokia and Ericsson.

Source: New York Times, Trump Announces 5G Plan as White House Weighs Banning Huawei, Zeqing Liu, 2019Sp

Inimitable

An inimitable (the opposite of imitable) resource is difficult to imitate or to create ready substitutes for. A resource is inimitable and non-substitutable if it is difficult for another firm to acquire it or to substitute something else in its place. A valuable and rare resource or capability will grant a competitive advantage as long as other firms do not gain subsequent possession of the resource or a close substitute. If a resource is valuable and rare and responsible for a market leader competitive advantage, it is likely that competitors lacking the resource or capability will do all that they can to obtain the resource or capability themselves. This leads us to the third criterion—inimitability. The concept of imitation includes any form of acquiring the lacking resource or substituting a similar resource that provides equivalent benefits. The criterion important to be addressed is whether competitors face a cost disadvantage in acquiring or substituting the resource that is lacking. There are numerous ways that firms may acquire resources or capabilities that they lack.

Example 4.7 Inimitable

A tablet computer has been around for years but it wasn't until the iPad when the market finally took off. Apple has designed something that is hard to imitate successfully and this can be proven by the number of knockoffs and imitation products of the iPod, iPad and MacBook that have failed to gain a large portion of market share.

Source: Christopher S Penn, What Is Your Business Core Competency?, 2018Fa

As strategy researcher Scott Gallagher notes:

This is probably the toughest criterion to examine because given enough time and money almost any resource can be imitated. Even patents only last 17 years and can be invented around in even less time. Therefore, one way to think about this is to compare

how long you think it will take for competitors to imitate or substitute something else for that resource and compare it to the useful life of the product. Another way to help determine if a resource is inimitable is why/how it came about. Inimitable resources are often a result of historical, ambiguous, or socially complex causes. For example, the U.S. Army paid for Coke to build bottling plants around the world during World War II. This is an example of history creating an inimitable asset. Generally, intangible (also called tacit) resources or capabilities, like corporate culture or reputation, are very hard to imitate and therefore inimitable.[5]

Organization

The fourth and final VRIO criterion that determines whether a resource or capability is the source of competitive advantage recognizes that mere possession or control is necessary but not sufficient to gain an advantage. The firm must likewise have the organizational capability to exploit the resources. Think of it in terms of whether the organization owns the capability. Alternatively, think of organization ownership in terms of how much it would cost to copy the capability in terms of time or money or both.

Example 4.8 Organization

A critical part of Apple's success is their organizational structure. They take advantage of a hierarchical organizational structure, which is a traditional structure seen in many organizations. The three main characteristics of this structure are spoke-and-wheel hierarchy, product-based divisions, and a weak functional matrix. While this gives them strong organizational control, it also limits organizational flexibility, and is something other corporations should consider when choosing an organizational structure.

Source: Seeking Alpha, Approach Resources: Hindered By High Fixed Costs, 2018Fa

The question of organization is broad and encompasses many facets of a firm but essentially means that the firm is able to capture any value that the resource or capability might generate. Organization, essentially the same form as that taken in the P-O-L-C framework, spans such firm characteristics as control systems, reporting relationships,

5. Retrieved January 30, 2009, from http://falcon.jmu.edu/~gallagsr/WDFPD-Internal.pdf.

compensation policies, and management interface with both customers and value-adding functions in the firm.

A valuable but widely held resource only leads to competitive parity for a firm if they also possess the capabilities to exploit the resource. Likewise, a firm that possesses a valuable and rare resource will not gain a competitive advantage unless it can actually put that resource to effective use.

Many firms have valuable and rare resources that they fail to exploit (the question of imitation is not relevant until the firm exploits valuable and rare resources). For instance, for many years Novell had a significant competitive advantage in computer networking based on its core NetWare product. In high-technology industries, remaining at the top requires continuous innovation. Novell's decline during the mid- to late 1990s led many to speculate that Novell was unable to innovate in the face of changing markets and technology. However, shortly after new CEO Eric Schmidt arrived from Sun Microsystems to attempt to turnaround the firm, he arrived at a different conclusion. Schmidt commented: "I walk down Novell hallways and marvel at the incredible potential of innovation here. But, Novell has had a difficult time in the past turning innovation into products in the marketplace."[6] He later commented to a few key executives that it appeared the company was suffering from "organizational constipation."[7] Novell appeared to still have innovative resources and capabilities, but they lacked the organizational capability (e.g., product development and marketing) to get those new products to market in a timely manner.

Example 4.9 Example of a Core Competency (VRIO)

The company now known as RTW Retailwinds has began implementing celebrity brands, including Kate Hudson, which is now part of their core competency as they continue to expand. The Kate Hudson line of products as well as any future celebrity brands are all valuable, rare and imitable within the same quality standards and can be difficult for other retailers to copy through the same celebrity partners. RTW is one of the largest omni-channel retailers for women and will only continue to grow.

Source: Dayton Daily News, Women's clothing retailer with local presence moving forward with name change, Ariadna Archibald, 2018Fa

6. Personal communication by Saylor.org with Margaret Haddox. (2003). Novell Corporate Librarian.
7. Personal communication by Saylor.org with former executives.

SWOT and VRIO

As you already know, many scholars refer to core competencies. A core competency is simply a resource, capability, or bundle of resources and capabilities that is VRIO. While VRIO resources are the best, they are quite rare, and it is not uncommon for successful firms to simply be combinations of a large number of VR _ O or even V _ _ O resources and capabilities. Recall that even a V _ _ O resource can be considered a strength under a traditional SWOT analysis.

Organizational Control

Up to this point you should have become familiar with the planning, organizing, and leading components of the P-O-L-C framework. This section addresses the controlling component, often taking the form of internal systems and process, to complete your understanding of P-O-L-C. As you know, planning comprises all the activities associated with the formulation of your strategy, including the establishment of near- and long-term goals and objectives. Organizing and leading are the choices made about the way people work together and are motivated to achieve individual and group goals and objectives.

What Is Organizational Control?

The fourth facet of P-O-L-C, organizational control, refers to the process by which an organization influences its subunits and members to behave in ways that lead to the attainment of organizational goals and objectives. When properly designed, such controls should lead to better performance because an organization is able to execute its strategy better.[1] As shown in the P-O-L-C framework figure (Unit 1), we typically think of or talk about control in a sequential sense, where controls (systems and processes) are put in place to make sure everything is on track and stays on track. Controls can be as simple as a checklist, such as that used by pilots, flight crews, and some doctors. Increasingly, however, organizations manage the various levels, types, and forms of control through systems called Balanced Scorecards. We will discuss these in detail later in the unit.

Example 4.10 Balanced Scorecard

Earn credit, add your own example!

1. Kuratko, D. F., Ireland, R. D., & Hornsby. J. S. (2001). Improving firm performance through entrepreneurial actions: Acordia's corporate entrepreneurship strategy. Academy of Management Executive, 15(4), 60–71.

Organizational control typically involves four steps: (1) establish standards, (2) measure performance, (3) compare performance to standards, and then (4) take corrective action as needed. Corrective action can include changes made to the performance standards—setting them higher or lower or identifying new or additional standards. Sometimes we think of organizational controls only when they seem to be absent, as in the 2008 meltdown of U.S. financial markets, the crisis in the U.S. auto industry, or the much earlier demise of Enron and MCI/WorldCom due to fraud and inadequate controls. However, as shown in the P-O-L-C Framework in Unit 1, good controls are relevant to a large spectrum of firms beyond Wall Street and big industry.

The Costs and Benefits of Organizational Controls

Organizational controls provide significant benefits, particularly when they help the firm stay on track with respect to its strategy. External stakeholders, too, such as government, investors, and public interest groups have an interest in seeing certain types or levels of control are in place. However, controls also come at a cost. It is useful to know that there are trade-offs between having and not having organizational controls, and even among the different forms of control. Let's look at some of the predominant costs and benefits of organizational controls, which are summarized in the following figure.

Example 4.11 Costs of Organizational Controls

Earn credit, add your own example!

Costs

Controls can cost the organization in several areas, including (1) financial, (2) damage to culture and reputation, (3) decreased responsiveness, and (4) botched implementation. An example of financial cost is the fact that organizations are often required to perform and report the results of a financial audit. These audits are typically undertaken by external accounting firms, which charge a substantial fee for their services; the auditor may be a large firm like Accenture or KPMG, or a smaller local accounting office. Such audits are

a way for banks, investors, and other key stakeholders to understand how financially fit the organization is. Thus, if an organization needs to borrow money from banks or has investors, it can only obtain these benefits if it incurs the monetary and staffing costs of the financial audit.

Example 4.12 Organizational Control Gone Wrong

Less theoretical are practical examples such as Hewlett-Packard's (HP) indictment on charges of spying on its own board of directors. In a letter to HP's board, director Tom Perkins said his accounts were "hacked" and attached a letter from AT&T explaining how the breach occurred. Records of calls made from Perkins's home phone were obtained simply with his home phone number and the last four digits of his Social Security number. His long-distance account records were obtained when someone called AT&T and pretended to be Perkins, according to the letter from AT&T. HP Chairman Patricia Dunn defended this rather extreme form of control as legal, but the amount of damage to the firm's reputation from these charges led the firm to discontinue the practice. It also prompted the resignation of several directors and corporate officers.

Earn credit, add your own example!

Controls also can have costs in terms of organization culture and reputation. While you can imagine that organizations might want to keep track of employee behavior, or otherwise put forms of strict monitoring in place, these efforts can have undesirable cultural consequences in the form of reduced employee loyalty, greater turnover, or damage to the organization's external reputation. Management researchers such as the late London Business School professor Sumantra Ghoshal have criticized theories that focus on the economic aspects of man (i.e., assumes that individuals are always opportunistic). According to Ghoshal, "A theory that assumes that managers cannot be relied upon by shareholders can make managers less reliable."[2] Such theory, he warned, would become a self-fulfilling prophecy.

The third potential cost of having controls is that they can afford less organizational flexibility and responsiveness. Typically, controls are put in place to prevent problems, but controls can also create problems. For instance, the Federal Emergency Management Agency (FEMA) is responsible for helping people and business cope with the consequences of natural disasters, such as hurricanes. After Hurricane Katrina devastated communities

2. Ghoshal S., & Moran, P. (1996). Bad for practice: A critique of the transaction cost theory. Academy of Management Review. 21(1), 13–47.

along the U.S. Gulf Coast in 2005, FEMA found that it could not provide prompt relief to the hurricane victims because of the many levels of financial controls that it had in place.[3]

The fourth area of cost, botched implementation, may seem obvious, but it is more common than you might think (or than managers might hope). Sometimes the controls are just poorly understood, so that their launch creates significant unintended, negative consequences. For example, when Hershey Foods put a new computer-based control system in place in 1999, there were so many problems with its installation that it was not able to fulfill a large percentage of its Halloween season chocolate sales that year. It did finally get the controls in working order, but the downtime created huge costs for the company in terms of inefficiencies and lost sales.[4] Some added controls may also interfere with others. For instance, a new quality control system may improve product performance but also delay product deliveries to customers.

Benefits

Although organizational controls come at some cost, most controls are valid and valuable management tools. When they are well designed and implemented, they provide at least five possible areas of benefits, including (1) improved cost and productivity control, (2) improved quality control, (3) opportunity recognition, (4) better ability to manage uncertainty and complexity, and (5) better ability to decentralize decision making. Let's look at each one of these benefits in turn.

3. U.S. Government Printing Office. (2006, February 15). Executive summary. Select Bipartisan Committee to Investigate the Preparation for and Response to Hurricane Katrina.
4. Retrieved January 30, 2009, from Hershey profits for 4Q 1999 down 11% due to SAP implementation problem. http://www.greenspun.com/bboard/q-and-a-fetch-msg.tcl?msg_id=002SUM

Figure 4.3 Summary of Organization Control Costs and Benefits

- Key Costs
  - Financial costs—direct (i.e., paying for an accountant for an audit) and indirect (i.e., people such as internal quality control the organization employs whose primary function is related to control).
  - Culture and reputation costs—the intangible costs associated with any form of control. Examples include damaged relationships with employees, or tarnished reputation with investors or government.
  - Responsiveness costs—downtime between a decision and the actions required to implement it due to compliance with controls.
  - Poorly implemented controls—implementation is botched or the implementation of a new control conflicts with other controls.
- Key Benefits
  - Cost and productivity control—ensures that the firm functions effectively and efficiently.
  - Quality control—contributes to cost control (i.e., fewer defects, less waste), customer satisfaction (i.e., fewer returns), and greater sales (i.e., repeat customers and new customers).
  - Opportunity recognition—helps managers identify and isolate the source of positive surprises, such as a new growth market. Though opportunities can also be found in internal comparisons of cost control and productivity across units.
  - Manage uncertainty and complexity—keeps the organization focused on its strategy, and helps managers anticipate and detect negative surprises and respond opportunistically to positive surprises.
  - Decentralized decision making—allows the organization to be more responsive by moving decision making to those closest to customers and areas of uncertainty.

First, good controls help the organization to be efficient and effective by helping managers to control costs and productivity levels. Cost can be controlled using budgets, where managers compare actual expenses to forecasted ones. Similarly, productivity can be controlled by comparing how much each person can produce, in terms of service or products. For instance, you can imagine that the productivity of a fast-food restaurant like McDonald's depends on the speed of its order takers and meal preparers. McDonald's can look across all its restaurants to identify the target speed for taking an order or wrapping a burger, then measure each store's performance on these dimensions.

Quality control is a second benefit of controls. Increasingly, quality can be quantified in terms of response time (i.e., How long did it take you to get that burger?) or accuracy (Did the burger weigh one-quarter pound?). Similarly, Toyota tracks the quality of its cars according to hundreds of quantified dimensions, including the number of defects per car. Some measures of quality are qualitative, however. For instance, Toyota also tries to gauge how "delighted" each customer is with its vehicles and dealer service. You also may be familiar with quality control through the Malcolm Baldrige National Quality Program Award. The Baldrige award is given by the president of the United States to businesses—manufacturing and service, small and large—and to education, healthcare, and nonprofit organizations that apply and are judged to be outstanding in seven areas: leadership; strategic planning; customer and market focus; measurement, analysis, and knowledge management; human resource focus; process management; and results. Controlling—how well the organization measures and analyzes its processes—is a key criterion for winning the award. The Baldrige award is given to organizations in a wide range of categories and industries, from education to ethics to manufacturing.

The third area by which organizations can benefit from controls is opportunity recognition. Opportunities can come from outside of the organization and typically are the result of a surprise. For instance, when Nestlé purchased the Carnation Company for its ice cream business, it had also planned to sell off Carnation's pet food line of products. However, through its financial controls, Nestlé found that the pet food business was even more profitable than the ice cream, and kept both. Opportunities can come from inside the organization too, as would be the case if McDonald's finds that one of its restaurants is exceptionally good at managing costs or productivity. It can then take this learned ability and transfer it to other restaurants through training and other means.

Example 4.13 Effective Organizational Controls

Earn credit, add your own example!

Controls also help organizations manage uncertainty and complexity. This is a fourth area of benefit from well-designed and implemented controls. Perhaps the most easily understood example of this type of benefit is how financial controls help an organization navigate economic downturns. Without budgets and productivity controls in place, the organization might not know it has lost sales, or if expenses are out of control until it is too late.

The fifth area of benefit in organizational control is related to decentralized decision making. Organization researchers have long argued that performance is best when those people and areas of the organization that are closest to customers and pockets of uncertainty also have the ability (i.e., the information and authority) to respond to them.[5] Going back to our McDonald's example, you can imagine that it would be hard to give a store manager information about her store's performance and possible choices if information about performance were only compiled at the city, region, or corporate

5. Galbraith, J. R. (1974). Organization design: An information processing view. Interfaces, 4, 28–36. Galbraith believes that "the greater the uncertainty of the task, the greater the amount of information that must be processed between decision makers during the execution of the task to get a given level of performance." Firms can reduce uncertainty through better planning and coordination, often by rules, hierarchy, or goals. Galbraith states that "the critical limiting factor of an organizational form is the ability to handle the non-routine events that cannot be anticipated or planned for."

level. With store-level performance tracking (or, even better, tracking of performance by the hour within a store), McDonald's gives store managers the information they need to respond to changes in local demand. Similarly, it equips McDonald's to give those managers the authority to make local decisions, track that decision-making performance, and feed it back into the control and reward systems.

KEY TAKEAWAY

We examined the importance of keeping our focus on profitability as the ultimate key to understanding an organization's strengths and weaknesses. Remembering that all internal decisions and actions have a cost, a benefit, or both is critical to understanding the operational excellence of a firm.

Internal analysis begins with the identification of resources and capabilities. Resources can be tangible and intangible; capabilities may have such characteristics as well. VRIO analysis is a way to distinguish resources and capabilities from core competencies. Specifically, VRIO analysis should show you the importance of value, rarity, inimitability, and organization as building blocks of competitive advantage.

Finally, this unit introduced the basics of controls, the process by which an organization influences its subunits and members to behave in ways that lead to attaining organizational goals and objectives. When properly designed, controls lead to better performance by enabling the organization to execute its strategy better. Managers must weigh the costs and benefits of control, but some minimum level of control is essential for organizational survival and success.

EXERCISES

1. What is the objective of internal analysis?
2. What is the difference between a resource and a capability?
3. What is the difference between a tangible and an intangible resource or capability?
4. What is a core competency?
5. What framework helps you identify those resources, capabilities, or core competencies that provide competitive advantage?
6. Why might competitive advantage for a firm be fleeting?
7. What do properly conceived and implemented controls allow an organization to do?
8. What are three common steps in organizational control?
9. What are some of the costs of organizational controls?
10. What are some of the benefits of organizational controls?
11. How do managers determine when benefits outweigh costs?

Essential Unit Vocabulary

Benchmarking – The comparing of a business's performance to industry leaders and rival competitors. Areas of a business to benchmark include quality, profitability, customer satisfaction, and operations. By benchmarking, businesses can have a greater idea of where they stand against rivals and what it takes to match high-performing industry leaders.

Capabilities – An integrated and coordinated set of actions taken to deploy resources to achieve a specific task or a desired end state. Capabilities are the source of a firm's core competencies; when capabilities are valuable, rare, costly to imitate, and non-substitutable they are considered a core competency. When capabilities meet the conditions of a core competency, they are a potential source of competitive advantage.

Complexity – Companies today are faced with growing complexity with respect to environmental, political and competitive changes. In response to such pressures, companies often reflect external complexity within their internal environments. They may address increasing cost pressures and accelerating innovation by building a matrix organization structure or add new processes to address evolving market needs. In isolation, each of these responses makes sense, but in combination, they create significant problems. Complexity leads to uncertainty and vice-versa creating a devolving downward cycle impacting organizational performance and decision making.

Core Competency – A set of capabilities that are capable of leading to a sustainable competitive advantage through exhibiting all characteristics of valuable, rare, costly to imitate and non-substitutable. Core competencies can be technical skills, knowledge, and even resources; anything that is unique and which the company controls or gives it an advantage in the market. Typically, a company does not outsource core competencies.

Distinctive Competency – A unique competency or capability that distinguishes a company from its competitors. It is also a firm-specific strength that allows a company to gain competitive advantage by differentiating its products and/or achieving lower costs than its rivals. This YouTube video may help understand the concept.

Operational Excellence – The practice by which a firm operates where all operational decisions are integrated and coordinated and allow the firm to charge a competitive price while incurring a best-of-class cost in order to generate above average returns.

Sustainable Competitive Advantage – when a company has a competitive advantage over its competitors in terms of assets, product or service attributes, or corporate abilities for an extended period of time making it extremely hard for competitors to meet or

surpass. Most advantages related to price, features, and similar attributes are short lived because they are easy to imitate. A competitive advantage is more likely to be sustainable when it incorporates some difficult to copy attributes such as outstanding people, culture, brand, intellectual property, business property and unique and difficult to find resources.

Tangible vs. Intangible Resources – Tangible Resource include those concrete physical assets such as cash, inventory, machinery that can be touched or seen or counted. Intangible Resource are those nonphysical assets such as patents, website domains, manuscripts and intellectual property that cannot be seen or counted. When a firm employs tangible and intangible resources through a concentration on strategy, it generates capabilities.

Uncertainty – Uncertainty can exist in the internal environment which in turn can affect the external environment. In the company, you can plan for the firm in regards to the industry they are in and try to predict what customers want but there is no guarantee it will pay off. This can lead to uncertainty in decisions, never knowing 100% if your managerial decision will be successful for the company. Decisions start from within with planning strategically hoping they will pay off in the external environment and drive profits.

Value Chain – A set of activities that an organization carries out to create value for its customers. The value chain includes the full range of activities that a business goes through to bring a product from conception to delivery. Through value chain analysis organizations can ensure that they are positioned to earn above average profits.

Value Chain Activities (Primary) – The activities performed within an organization that directly add value to the firm's product or service. Examples will vary based upon the firm and its value chain, but these activities might include logistics, procurement, operations, marketing, sales, customer support and others.

Value Chain Activities (Support) – The activities that the organization performs to assist the primary activities to gain the competitive advantages. In other words, firm activities that add value indirectly, but are necessary to sustain primary activities. Examples will vary based upon the firm and its value chain, but these activities might include research and development (R&D), information systems, operating management, human resources, finance, accounting, general management and others.

Value Chain Analysis – A process where a firm identifies the primary and support activities that add value to its product or service and then analyze these activities to reduce costs through outsourcing or to increase product differentiation. VCA identifies core competencies by determining those primary activities that are valuable, rare, costly to imitate and non-substitutable.

Vertical Integration – Vertical integration occurs when a company expands its

business into areas that are at different points on the same production value chain. Therefore, complete vertical integration would dictate that a company controls all steps of the value chain forward to the end product as well as backward to the most raw materials; e.g. such as when a manufacturer owns its suppliers and distributors.

PART 5. BUSINESS-LEVEL STRATEGY

Part Contents

- What's in it for Me?
- What Is Strategic Focus?
- Strategy as Trade-Offs
- Strategy as Discipline
- Generating Advantage
- KEY TAKEAWAY
- EXERCISES
- Essential Unit Vocabulary

What's in it for Me?

Reading these chapters will help you do the following:

1. Describe the trade-off of strategy as a discipline.
2. Distinguish the advantages and disadvantages of the generic business-level strategies defined by Michael Porter and describe when each is best deployed.
3. Describe the four rules competing companies must obey with regard to strategy formulation.
4. Distinguish between operational excellence, product leadership, and customer intimacy.

What is Strategic Focus?

While there are different schools of thought about how strategy comes about, researchers generally agree that strategic focus is a common characteristic across successful organizations. Strategic focus is seen when an organization is very clear about its mission and vision and has a coherent, well-articulated strategy for achieving those. When a once high-flying firm encounters performance problems, it is not uncommon to hear business analysts say that the firm's managers have lost focus on their customers or markets.

Example 5.1 Strategic Focus

Dell Computer's strategy is highly focused around the efficient sale and manufacture of computers and computer peripheral devices. However, during the mid-2000s, Dell started branching out into other products such as digital cameras, DVD players, and flat-screen televisions. As a result, it lost focus on its core sales and manufacturing business, and its performance flagged. As recently as mid-2008, however, Dell has realized a tremendous turnaround: "We are executing on all points of our strategy to drive growth in every product category and in every part of the world," said a press release from Michael Dell, chairman and CEO. "These results are early signs of our progress against our five strategic priorities. Through a continued focus, we expect to continue growing faster than the industry and increase our revenue, profitability and cash flow for greater shareholder value."

Earn credit, add your own example!

The spirit of focus is echoed in the following two sections where we introduce you to the complementary notions of strategy as trade-offs and strategy as discipline.

Strategy as Trade-Offs

Three of the most widely read books on competitive analysis in the 1980s were Michael Porter's Competitive Strategy, Competitive Advantage, and Competitive Advantage of Nations. In his various books, Porter developed three generic strategies that, he argues, can be used singly or in combination to create a defendable position and to outperform competitors, whether they are within an industry or across nations. The strategies are (1) overall cost leadership, (2) differentiation, and (3) focus on a particular market niche.

Cost Leadership, Differentiation, and Scope

These strategies are termed generic because they can be applied to any size or form of business. We refer to them as trade-off strategies because Porter argues that a firm must choose to embrace one strategy or risk not having a strategy at all. Overall lower cost or cost leadership refers to the strategy where a firm's competitive advantage is based on the bet that it can develop, manufacture, and distribute products more efficiently than competitors. Differentiation refers to competitive advantage based on superior products or service; superiority arises from factors other than low cost, such as customer service, product quality, or unique style. To put these strategies into context, you might think about Wal-Mart as pursuing a cost-leadership strategy and Harley Davidson as pursuing a differentiation strategy.

Porter suggests another factor affecting a company's competitive position is its competitive scope. Competitive scope defines the breadth of a company's target market. A company can have a broad (mass market) competitive scope or a narrow (niche market) competitive scope. A firm following the focus strategy concentrates on meeting the specialized needs of its customers. Products and services can be designed to meet the needs of buyers. One approach to focusing is to service either industrial buyers or consumers but not both.

Firms using a narrow focus strategy can also tailor advertising and promotional efforts to a particular market niche. Many automobile dealers advertise that they are the largest volume dealer for a specific geographic area. Other car dealers advertise that they have the highest customer satisfaction scores within their defined market or the most awards for their service department.

Another differentiation strategy is to design products specifically for a customer. Such customization may range from individually designing a product for a single customer to offering a menu from which customers can select options for the finished product. Tailor-made clothing and custom-built houses include the customer in all aspects of production, from product design to final acceptance, and involve customer input in all key decisions. However, providing such individualized attention to customers may not be feasible for firms with an industry-wide orientation. At the other end of the customization scale, customers buying a new car, even in the budget price category, can often choose not only the exterior and interior colors but also accessories such as navigation, rooftop racks, and upgraded tires.

By positioning itself in either broad scope or narrow scope and a low-cost strategy or differentiation strategy, an organization will fall into one of the following generic competitive strategies: cost leadership, cost focus, differentiation, and focused differentiation.

Example 5.2 Broad Scope

Amazon, online retailer, is difficult to compete with due to its wide variety of product offerings and low cost products. Amazon has just about anything a person could want from apparel, electronics, and office products. If a person wants product choice, they will shop at Amazon. Companies such as Rent the Runway are forced to not compete on selection and scope, but rather by using another business level strategy.

Source: CNBC, Beating Bezos: Top online retailers like Rent the Runway are winning shoppers by offering what Amazon can't, Sarah Cushing, 2018Fa

Example 5.3 Narrow Scope

Nvidia is known for producing some of the best graphics processing unit (GPU) cards in the consumer electronics industry. Its market share is also the highest within the industry. Now, many personal computers come installed with a Nvidia graphics card. By focusing narrowly on GPU, rather than the larger category of CPU or even consumer electronics, Nvidia has carved out a niche for itself that has allowed it to become a dominate force without competing more broadly with much larger firms.

Source: Rocket, Paper, Shotgun PC Gaming, Best Graphics card 2019: Top GPUs, Shuang Liang, 2019Sp

Cost Leadership/Low Cost

Cost leadership is a low-cost market strategy. Firms pursuing this type of strategy must be particularly efficient in engineering tasks, production operations, and physical distribution; they must also be able to minimize costs in marketing and research and development (R&D). A low-cost leader can gain significant market share enabling it to procure a more powerful position relative to both suppliers and competitors. A firm employing this strategy uses product price as its primary competitive edge, minimizing its cost to enable it to provide an acceptable product at the lowest possible price while still maintaining a positive margin. This strategy is particularly effective for organizations in industries where there is limited possibility of product differentiation and where buyers are very price sensitive as with commodities and similar products or services.

Overall cost leadership is not without potential problems. Two or more firms competing for cost leadership may engage in price wars (a race to the bottom) that drive profits to very low levels. Ideally, a firm using a cost-leader strategy will develop an advantage that others cannot easily copy. Cost leaders also must maintain their investment in state-of-the-art equipment or face the possible entry of more cost-effective competitors. Major changes in technology may drastically change production processes so that previous investments in production technology are no longer advantageous. Finally, firms may become so concerned with maintaining low costs that they overlook needed changes in the product, production, or marketing.

The cost-leadership strategy may be more difficult in a dynamic environment because some of the expenses that firms may seek to minimize are research and development costs or marketing research costs—expenses the firm may need to incur to remain competitive.

Example 5.4 Broad Cost Leadership

Three examples relating to Flat Fee Realtor Services, Cookie-cutter Home Renovations, and Oil Change Services provide an illustration of broad cost leadership as a business-level strategy. By identifying the primary activity served in these different industries, these three companies have targeted the largest part of the market, reduced the cost of delivering services and its related price, and found profitability through small gross margins and high unit volume.

Source: Small Business Chron, Examples of Cost Leadership & Strategy Marketing, Charles N. Hatch, 2019Sp

Focused Low-Cost

A cost-focus strategy is a low-cost, narrowly focused market strategy. Firms employing this strategy may focus on a particular buyer segment or a particular geographic segment and must locate a niche market that wants or needs an efficient product and is willing to forgo extras to pay a lower price for the product. A company's costs can be reduced by providing little or no service, providing a low-cost method of distribution, or producing a no-frills product.

Example 5.5 Narrow Cost Leadership

Earn credit, add your own example!

Differentiation

A differentiation strategy involves marketing a unique product in a market; because this type of strategy involves a unique product, price is not the significant factor. In fact, consumers may be willing to pay a high price for a product that they perceive as different. The product difference may be based on product design, method of distribution, or any aspect of the product (other than price) that is significant to the consumer. A company choosing this strategy must develop and maintain a product perceived as different enough from the competitors' products to warrant the asking price.

Example 5.6 Broad Differentiation

Earn credit, add your own example!

Example 5.7 Narrow Differentiation

Earn credit, add your own example!

Several studies have shown that a differentiation strategy is more likely to generate higher profits than a cost-leadership strategy, because differentiation creates stronger entry barriers. However, a cost-leadership strategy is more likely to generate increases in market share.

Example 5.8 Using Brand to Differentiate

Increasing market share, brand loyalty, and consumer trust are integral to maintaining and increasing profitability. Nike is an example of a company that invests a significant amount of money and resources into developing strong connections with their customers through product personalization, loyalty apps, and state-of-the-art retail shopping experiences. Nike also differentiates their brand through advocacy initiatives, most recently advocating for social justice through the Colin Kaepernick saga in the NFL. This brand differentiation strategy appeals to customers for reasons other than the expertise in footwear and sportswear.

Source: Forbes, How Foot Locker, Nike, North Face And Starbucks Created A Culture Of Customer Loyalty, 2018Fa

Focused Differentiation

A differentiation-focus strategy is the marketing of a differentiated product to a narrow market, often involving a unique product and a unique market. This strategy is viable for a company that can convince consumers that its narrow focus allows it to provide better goods and services than its competitors.

Example 5.9 Private-label Product

Amazon is now finding new ways to entice potential consumers. With new retail stores Amazon is now giving customers a new way to experience their private label products. Although shopping with Amazon and buying

their private label products is not something foreign to current customers, the idea of being able to hold, feel, and try these products is something customers are willing to participate in. For example, Wag, Amazon's private label dog food is being displayed at these new stores alongside popular reviews in order to give the customer a cohesive experience.

Source: Forbes, Amazon Tries To Find A Home For Its Private Label Products With New '4-Star' Store, 2018Fa

Differentiation does not allow a firm to ignore costs; it makes a firm's products less susceptible to cost pressures from competitors because customers see the product as unique and are willing to pay extra to have the product with the desirable features. Differentiation can be achieved through real product features or through advertising that causes the customer to perceive that the product is unique.

Differentiation may lead to customer brand loyalty and result in reduced price elasticity. It may also lead to higher profit margins and reduce the need to be a low-cost producer. Since customers see the product as different from competing products and they like the product features, customers are willing to pay a premium for these features. As long as the firm can increase the selling price by more than the marginal cost of adding the features, the profit margin is increased. Firms must be able to charge more for their differentiated product than it costs them to make it distinct, or else they may be better off making generic, undifferentiated products. Firms must remain sensitive to cost differences. They must carefully monitor the incremental costs of differentiating their product and make certain the difference is reflected in the price.

Example 5.10 Best Cost Provider Success

Southwest Airlines has combined cost-cutting measures with differentiation. The company has been able to reduce costs by not assigning seating and by eliminating meals on its planes. It has also been able to promote in its advertising that its fares are so low that checked bags fly free, in contrast to the fees that competitors such as American and United charge for checked luggage. Southwest's consistent low-fare strategy has attracted a significant number of passengers, allowing the airline to succeed.

Earn credit, add your own example!

Firms pursuing a differentiation strategy are vulnerable to different competitive threats than firms pursuing a cost-leader strategy. Customers may sacrifice features, service, or image for cost savings. Price-sensitive customers may be willing to forgo desirable features in favor of a less costly alternative. This can be seen in the growth in popularity of

store brands and private labels. Often, the same firms that produce name-brand products produce the private-label products. The two products may be physically identical, but stores are able to sell the private-label products for a lower price because very little money was put into advertising to differentiate the private-label product.

Imitation may also reduce the perceived differences between products when competitors copy product features. Thus, for firms to be able to recover the cost of marketing research or R&D, they may need to add a product feature that is not easily copied by a competitor.

A final risk for firms pursuing a differentiation strategy is changing consumer tastes. The feature that customers like and find attractive about a product this year may not make the product popular next year. Changes in customer tastes are especially obvious in the fashion industry. For example, although Ralph Lauren's Polo has been a very successful brand of apparel, some younger consumers have shifted to Tommy Hilfiger and other youth-oriented brands.

For a variety of reasons, including the differences between intended versus realized strategies discussed in an earlier section, none of these competitive strategies is guaranteed to achieve success. Some companies that have successfully implemented one of Porter's generic strategies have found that they could not sustain the strategy. Several risks associated with these strategies are based on evolved market conditions (buyer perceptions, competitors, etc.).

Straddling Positions or Stuck in the Middle?

Can forms of competitive advantage be combined? That is, can a firm straddle strategies so that it is simultaneously the low-cost leader and a differentiator? Porter asserts that a successful strategy requires a firm to stake out a market position aggressively and that different strategies involve distinctly different approaches to competing and operating the business. Some research suggests that straddling strategies – also known as a Best Cost Provider strategy – is a recipe for below-average profitability compared to the industry. Porter also argues that straddling strategies is an indication that the firm's managers have not made necessary choices about the business and its strategy. A straddling strategy may be especially dangerous for narrow scope firms that have been successful in the past, but then start neglecting their focus.

Example 5.11 Stuck in the Middle

Earn credit, add your own example!

An organization pursuing a differentiation strategy seeks competitive advantage by offering products or services that are unique from those offered by rivals, either through design, brand image, technology, features, or customer service. Alternatively, an organization pursuing a cost-leadership strategy attempts to gain competitive advantage based on being the overall low-cost provider of a product or service. To be "all things to all people" can mean becoming "stuck in the middle" with no distinct competitive advantage. The difference between being "stuck in the middle" and successfully pursuing a combination best cost provider strategy merits discussion. Although Porter describes the dangers of not being successful in either cost control or differentiation, some firms have been able to succeed using combination strategies and research suggests that, in some limited cases, it is possible to be a cost leader while maintaining a differentiated product.

Some industries may actually call for such combination strategies. Trends suggest that highly complex environments do not have the luxury of choosing exclusively one strategy over another. The hospital industry may represent such an environment, as hospitals must compete on a variety of fronts. Combination (i.e., more complicated) strategies are both feasible and necessary to compete successfully. For instance, reimbursement to diagnosis-related groups, and the continual lowering of reimbursement ceilings have forced hospitals to compete on the basis of cost. At the same time, many of them jockey for position with differentiation based on such features as technology and birthing rooms. Thus, many hospitals may need to adopt some form of hybrid strategy to compete successfully.[1]

1. Walters, B. A., & Bhuian, S. (2004). Complexity absorption and performance: A structural analysis of acute-care hospitals. Journal of Management, 30, 97–121.

Strategy as Discipline

While Michael Porter's generic strategies were introduced in the 1980s and still dominate much of the dialogue about strategy and strategizing, a complementary approach was offered more recently by CSC Index consultants Michael Treacy and Fred Wiersema. Their value disciplines model is quite similar to the three generic strategies from Porter (cost leadership, differentiation, focus). However, there is at least one major difference. According to the value disciplines model, no discipline may be neglected: threshold levels on the two disciplines that are not selected must be maintained.

Example 5.12 Operational Excellence

AT&T's introduced the Universal Card, a combined long-distance calling card and general purpose credit card, featuring low annual fees and customer-friendly service. At the time, mobile phones and free long distance calling were unheard of. AT&T combined the scale of its telecommunications network to provide a unique offer to relatively interchangeable credit cards. TO be successful, AT&T had to provide both with industry leading performance levels.

Earn credit, add your own example!

In their book, The Discipline of Market Leaders, they offered four rules that competing companies must obey with regard to strategy formulation:[1]

1. Provide the best offer in the marketplace, by excelling in one specific dimension of value. Market leaders first develop a value proposition, one that is compelling and unmatched.
2. Maintain threshold standards on other dimensions of value. You can't allow performance in other dimensions to slip so much that it impairs the attractiveness of your company's unmatched value.
3. Dominate your market by improving the value year after year. When a company focuses all its assets, energies, and attention on delivering and improving one type of customer value, it can nearly always deliver better performance in that dimension

1. Treacy, M., & Wiersema, F. (1997). The discipline of market leaders: Choose your customers, narrow your focus, dominate your market. Reading, M Addison-Wesley.

than another company that divides its attention among more than one.

4. Build a well-tuned operating model dedicated to delivering unmatched value. In a competitive marketplace, the customer value must be improved. This is the imperative of the market leader. The operating model is the key to raising and resetting customer expectation.

What Are Value Disciplines?

Treacy and Wiersema describe three generic value disciplines: operational excellence, product leadership, and customer intimacy. As with Porter's perspective about the importance of making trade-offs, any company must choose one of these value disciplines and consistently and vigorously act on it, as indicated by the four rules mentioned earlier.

Example 5.13 Product Leadership

Just like product leadership can create a competitive advantage, it can also harm a company's performance when it becomes vulnerable. Boeing had a reputation in the airplane market for innovative products, rapid development of new products, and safety. However, the Boeing 737 Max came under fire for not being as safe as expected when questionable practices were exposed following the fatal crash of two of the airplanes. Boeing had rushed this product to market to protect their innovative brand and failed to ask key safety question. Its actions may have encouraged employees to overlook crucial safety features and requirements. Boeing's board and management are under immense pressure from external authorities including the FAA and foreign safety regulators, industry investment watchdogs, and even criminal investigations to reevaluate its business-level strategy in light of this recent crisis.

Source: CNN, Boeing has a 'crisis of confidence.' It's time for the board to step up, 2019Sp

Operational Excellence

Key characteristics of the strategy are superb operations and execution, often by providing a reasonable quality at a very low price, and task-oriented vision toward personnel. The focus is on efficiency, streamlined operations, supply chain management, no frills, and high volume. Most large international corporations strive to operate

according to this discipline but circumstances impact their degree of success. Measuring systems are important, as is extremely limited variation in product assortment.

Example 5.14 Customer Intimacy

The partnership of Airborne Express with IBM and Xerox is a great example of an effective customer intimacy strategy. Airborne provides centralized control to IBM and Xerox part-distribution networks. Airborne provides Xerox and IBM with a central source of shipment data and performance metrics. The air-express carrier also manages a single, same-day delivery contract for both companies. In addition, Airborne examines same-day or special-delivery requirements and recommends a lower-priced alternative where appropriate.

Earn credit, add your own example!

Product Leadership

Firms executing this strategy well are very strong in innovation and brand marketing. Organization leaders demonstrate a recognition that the company's current success and future prospects lie in its talented product design people and those who support them. The company operates in dynamic markets. The focus is on development, innovation, design, time to market, and high margins in a short time frame. Company cultures are flexible to encourage innovation. Structure also encourages innovation through small ad hoc working groups, an experimentation-is-good mindset, and compensation systems that reward success.

Customer Intimacy

Companies pursuing this strategy excel in customer attention and customer service. They tailor their products and services to individual or almost individual customers. There is large variation in product assortment. The focus is on: customer relationship management (CRM), delivery of products and services on time and above customer expectations, lifetime value concepts, reliability, and being close to the customer. Decision authority is given to employees who are close to the customer. The operating principles of this value discipline include having a full range of services available to serve customers upon demand—this may involve running what the authors call a "hollow company," where a

variety of goods or services are available quickly through contract arrangements, rather than the supplier business having everything in stock all the time.

Only One Discipline

Treacy and Wiersema maintain that, because of the focus of management time and resources that is required, a firm can realistically choose only one of these three value disciplines in which to specialize. This logic is similar to Porter's in that firms that mix different strategies run the risk of being "stuck in the middle." Most companies, in fact, do not specialize in any of the three, and thus they realize only mediocre or average levels of achievement in each area.

Example 5.15 Cult of the Customer

Amazon is the shining example of of how to create a cult customer following. The CEO Jeff Bezos has built Amazon on three pillars, Amazon Prime, Amazon Marketplace, and Amazon Web Services. The culmination of these services has created a wide range of customer types, from the average prime user doing their daily online shopping, to multinational corporations using Amazon Web Services.

Source: Motley Fool, Why Customer Loyalty Is So Important to Investors, Aden Eilers, 2018Fa

The companies that do not make the hard choices associated with focus are in no sense market leaders. In today's business environment of increased competition and competitive differentiation, their complacency will not lead to increased market share, sales, or profits.

"When we look at these managers' businesses [complacent firms], we invariably find companies that don't excel, but are merely mediocre on the three disciplines…What they haven't done is create a breakthrough on any one dimension to reach new heights of performance. They have not traveled past operational competence to reach operational excellence, past customer responsiveness to achieve customer intimacy, or beyond product differentiation to establish product leadership. To these managers we say that if you decide to play an average game, to dabble in all areas, don't expect to become a market leader."[2]

2. Treacy, M., & Wiersema, F. (1997). The discipline of market leaders: Choose your customers, narrow your focus, dominate your market (p. 40). Reading, M Addison-Wesley.

Within the context of redesigning the operating model of a company to focus on a particular value discipline, Treacy and Wiersema discuss creating "the cult of the customer." This is a mindset that is oriented toward making customer's needs the key priority throughout the company, at all levels. They also review some of the challenges involved in sustaining market leadership once it is attained (i.e., avoiding the natural complacency that tends to creep into an operation once dominance of the market is achieved).

Generating Advantage

A company's competitive strategy deals exclusively with the specifics of management's game plan for competing successfully—its specific efforts to please customers, its offensive and defensive moves to counter the maneuvers of rivals, its responses to whatever market conditions prevail at the moment, and its approach to securing a competitive advantage relative to rivals. There are countless variations in the competitive strategies that companies employ, mainly because each company's strategic approach entails custom-designed actions to fit its own circumstances and industry environment. The custom-tailored nature of each company's strategy is also the result of management's efforts to uniquely position the company in its market.

Example 5.16 A Unique Value Proposition

The iPod's attractive styling, easy-to-use controls, attention-grabbing ads, and extensive collection of music available at Apple's iTunes Store have given Apple a competitive advantage in the digital media player industry. Microsoft has attempted to imitate Apple's competitive strategy with the introduction of its Zune music player and store, but Microsoft has fared no better in its attack on the iPod than any of the other makers of digital media players.

Earn credit, add your own example!

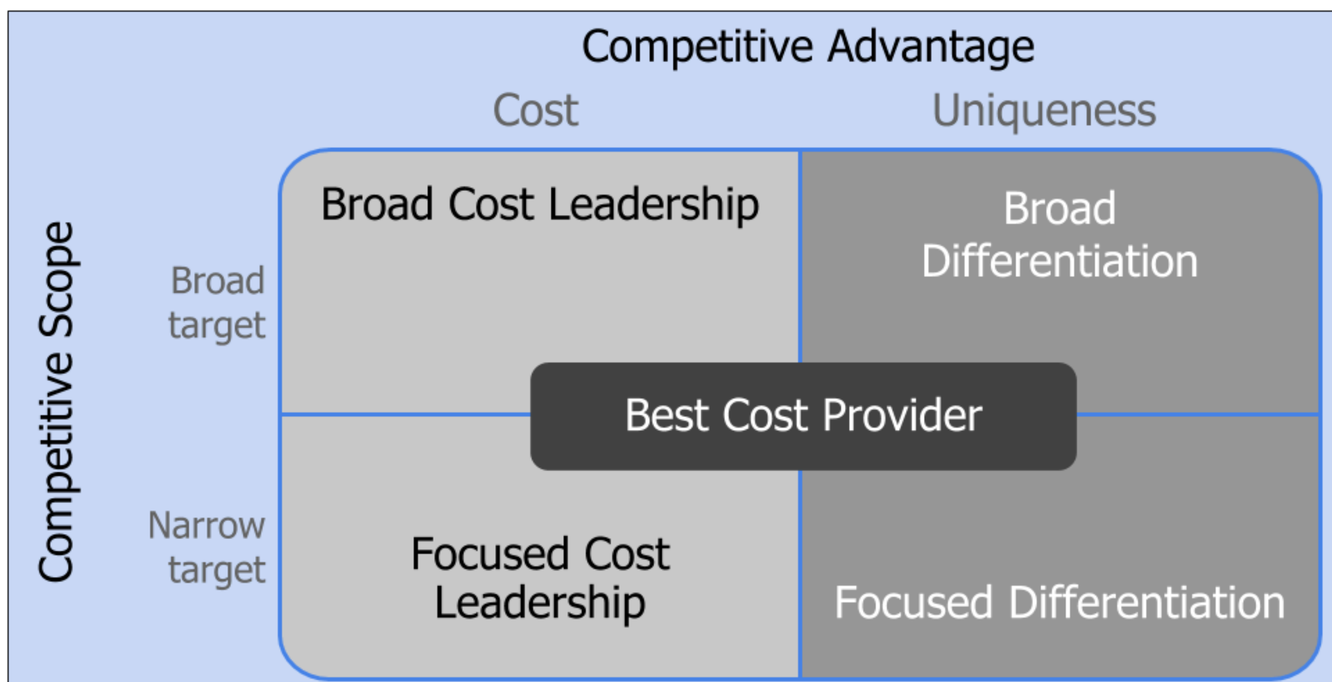
Companies are much more likely to achieve competitive advantage and earn above-average profits if they find a unique way of delivering superior value to customers.

By choosing a unique approach to providing value to customers, a firm achieves an enduring brand loyalty that makes it difficult for others to triumph by merely copying its strategic approach. "Me too" strategies can rarely be expected to deliver competitive advantage and stellar performance unless the imitator possesses resources or competencies that allow it to provide greater value to customers than that offered by firms with similar strategic approaches.

Competitive strategies that provide distinctive industry positioning and competitive advantage in the marketplace involve choosing between a market target that is either broad or narrow, and whether the company should pursue a competitive advantage linked to low costs or product differentiation. These two factors give rise to five competitive strategy options:

1. A *low-cost provider strategy* – striving to achieve lower overall costs than rivals and appealing to a broad spectrum of customers, usually by under-pricing rivals.
2. A *broad differentiation strategy* – seeking to differentiate the company's product or service from rivals' in ways that will appeal to a broad spectrum of buyers.
3. A *focused low-cost strategy* – concentrating on a narrow buyer segment (or market niche) and outcompeting rivals by having lower costs than rivals and thus being able to serve niche members at a lower price.
4. A *focused differentiation strategy* – concentrating on a narrow buyer segment (or market niche) and outcompeting rivals by offering niche members customized attributes that meet their tastes and requirements better than rivals' products.
5. A *best-cost provider strategy* – giving customers more value for the money by satisfying buyers' expectations on key product attributes (e.g., quality, features, performance, or service) while beating their price expectations. Alternatively, it may provide a product with better attributes as a comparable price to competitors. This option is a hybrid strategy that blends elements of low-cost provider and differentiation strategies.

Figure 5.1 Porter's Generic Strategies



When a Low-cost Provider Strategy Works Best

A competitive strategy predicated on low-cost leadership is particularly powerful when:

1. *Price competition among rival sellers is especially vigorous.* Low-cost providers are in the best position to compete offensively on the basis of price and to survive price wars.
2. *The products of rival sellers are essentially identical and are readily available from several sellers.* Commodity-like products and/or ample supplies set the stage for lively price competition; in such markets, it is the less efficient, higher-cost companies that are most vulnerable.
3. *There are few ways to achieve product differentiation that have value to buyers.* When the product or service differences between brands do not matter much to buyers, buyers nearly always shop the market for the best price.
4. *Buyers incur low costs in switching their purchases from one seller to another.* Low switching costs give buyers the flexibility to shift purchases to lower-priced sellers having equally good products. A low-cost leader is well positioned to use low price to induce its customers not to switch to rival brands.
5. *The majority of industry sales are made to a few, large-volume buyers*. Low-cost providers are in the best position among sellers in bargaining with high-volume buyers because they are able to beat rivals' pricing to land a high-volume sale while maintaining an acceptable profit margin.
6. *Industry newcomers use introductory low prices to attract buyers and build a customer base*. The low-cost leader can use price cuts of its own to make it harder for a new rival to win customers.

As a rule, the more price-sensitive buyers are, the more appealing a low-cost strategy becomes. A low-cost company's ability to set the industry's price floor and still earn a profit erects protective barriers around its market position.

Pitfalls to Avoid in Pursuing a Low-Cost Provider Strategy

Perhaps the biggest pitfall of a low-cost provider strategy is getting carried away with overly aggressive price cutting and ending up with lower, rather than higher, profitability. A low-cost / low-price advantage results in superior profitability only if (1) prices are cut

by less than the size of the cost advantage or (2) the added volume is large enough to bring in a bigger total profit despite lower margins per unit sold. Thus, a company with a 5 percent cost advantage cannot cut prices 20 percent, end up with a volume gain of only 10 percent, and still expect to earn higher profits!

A second big pitfall is relying on an approach to reduce costs that can be easily copied by rivals. The value of a cost advantage depends on its sustainability. Sustainability, in turn, hinges on whether the company achieves its cost advantage in ways difficult for rivals to replicate or match. If rivals find it relatively easy or inexpensive to imitate the leader's low-cost methods, then the leader's advantage will be too short-lived to yield a valuable edge in the marketplace.

A third pitfall is becoming too fixated on cost reduction. Low costs cannot be pursued so zealously that a firm's offering ends up being too features-poor to gain the interest of buyers. Furthermore, a company driving hard to push its costs down has to guard against misreading or ignoring increased buyer preferences for added features or declining buyer price sensitivity. Even if these mistakes are avoided, a low-cost competitive approach still carries risk. Cost-saving technological breakthroughs or process improvements by rival firms can nullify a low-cost leader's hard-won position.

When a Differentiation Strategy Works Best

Differentiation strategies tend to work best in market circumstances where:

1. *Buyer needs and uses of the product are diverse*. Diverse buyer preferences allow industry rivals to set themselves apart with product attributes that appeal to particular buyers. For instance, the diversity of consumer preferences for menu selection, ambience, pricing, and customer service gives restaurants exceptionally wide latitude in creating differentiated concepts. Other industries offering opportunities for differentiation based upon diverse buyer needs and uses include magazine publishing, automobile manufacturing, footwear, kitchen appliances, and computers.
2. *There are many ways to differentiate the product or service that have value to buyers*. Industries that allow competitors to add features to product attributes are well suited for differentiation strategies. For example, hotel chains can differentiate on such features as location, size of room, range of guest services, in-hotel dining, and the quality and luxuriousness of bedding and furnishings. Similarly, cosmetics

producers are able to differentiate based upon prestige and image, formulations that fight the signs of aging, UV light protection, exclusivity of retail locations, the inclusion of antioxidants and natural ingredients, or prohibitions against animal testing.

3. *Few rival firms are following a similar differentiation approach*. The best differentiation approaches involve trying to appeal to buyers on the basis of attributes that rivals are not emphasizing. A differentiator encounters less head-to-head rivalry when it goes its own separate way to create uniqueness and does not try to out-differentiate rivals on the very same attributes. When many rivals are all claiming "ours tastes better than theirs" or "ours gets your clothes cleaner than theirs," competitors tend to end up chasing the same buyers with very similar product offerings.
4. *Technological change is fast-paced and competition revolves around rapidly evolving product features*. Rapid product innovation and frequent introductions of next-version products heighten buyer interest and provide space for companies to pursue distinct differentiating paths. In video game hardware and video games, golf equipment, PCs, mobile phones, and automobile navigation systems, competitors are locked into an ongoing battle to set themselves apart by introducing the best next-generation products; companies that fail to come up with new and improved products and distinctive performance features quickly lose out in the marketplace.

Pitfalls to Avoid in Pursuing a Differentiation Strategy

Differentiation strategies can fail for any of several reasons. A differentiation strategy keyed to product or service attributes that are easily and quickly copied is always suspect. Rapid imitation means that no rival achieves meaningful differentiation, because whatever new feature one firm introduces that strikes the fancy of buyers is almost immediately added by rivals. This is why a firm must search out sources of uniqueness that are time-consuming or burdensome for rivals to match if it hopes to use differentiation to win a sustainable competitive edge over rivals.

Differentiation strategies can also falter when buyers see little value in the unique attributes of a company's product. Thus even if a company sets the attributes of its brand apart from its rivals' brands, its strategy can fail because of trying to differentiate on the basis of something that does not deliver adequate value to buyers. Any time many potential buyers look at a company's differentiated product offering and conclude "so

what," the company's differentiation strategy is in deep trouble; buyers will likely decide the product is not worth the extra price and sales will be disappointingly low.

Overspending on efforts to differentiate is a strategy flaw that can erode profitability. Company efforts to achieve differentiation nearly always raise costs. The trick to profitable differentiation is either to keep the costs of achieving differentiation below the price premium the differentiating attributes can command in the marketplace or to offset thinner profit margins by selling enough additional units to increase total profits. If a company goes overboard in pursuing costly differentiation, it could be saddled with unacceptably thin profit margins or even losses. The need to contain differentiation costs is why many companies add little touches of differentiation that add to buyer satisfaction but are inexpensive to institute.

Other common pitfalls and mistakes in crafting a differentiation strategy include:

- *Over-differentiating so that product quality or service levels exceed buyers' needs.* Buyers are unlikely to pay extra for features and attributes that will go unused. For example, consumers are unlikely to purchase programmable large appliances such as washers, dryers, and ovens if they are satisfied with manually controlled appliances.
- *Trying to charge too high of a price premium.* Even if buyers view certain extras or deluxe features as "nice to have," they may still conclude that the added benefit or luxury is not worth the price differential over that of lesser differentiated products.
- *Being timid and not striving to open up meaningful gaps in quality or service or performance features vis-à-vis the products of rivals.* Tiny differences between rivals' product offerings may not be visible or important to buyers.

A low-cost provider strategy can always defeat a differentiation strategy when buyers are satisfied with a basic product and don't think "extra" attributes are worth a higher price.

Focused (or Market Niche) Strategies

What sets focused strategies apart from low-cost leadership or broad differentiation strategies is a concentration on a narrow piece of the total market. The targeted segment, or niche, can be defined by geographic uniqueness or by special product attributes that appeal only to niche members. The advantages of focusing a company's entire competitive effort on a single market niche are considerable, especially for smaller and medium-sized companies that may lack the breadth and depth of resources to tackle going after

a national customer base with a "something for everyone" lineup of models, styles, and product selection.

Example 5.17 Niche Success

Community Coffee, the largest family-owned specialty coffee retailer in the United States, has a geographic focus on the state of Louisiana and communities across the Gulf of Mexico. Community holds only a 1.1 percent share of the national coffee market, but has recorded sales in excess of $100 million and has won a 50 percent share of the coffee business in the 11-state region where it is distributed.

Earn credit, add your own example!

Examples of firms that concentrate on a well-defined market niche keyed to a particular product or buyer segment include Discovery Channel and Comedy Central (in cable TV), Google (in Internet search engines), Porsche (in sports cars), and CGA, Inc. (a specialist in providing insurance to cover the cost of lucrative hole-in-one prizes at golf tournaments). Microbreweries, local bakeries, bed-and-breakfast inns, and local owner-managed retail boutiques are all good examples of enterprises that have scaled their operations to serve narrow or local customer segments.

When a Market Niche Strategy Is Viable

A focused strategy aimed at securing a competitive edge based either on low cost or differentiation becomes increasingly attractive as more of the following conditions are met:

- The target market niche is big enough to be profitable and offers good growth potential.
- Industry leaders have chosen not to compete in the niche—focusers can avoid battling head-to-head against the industry's biggest and strongest competitors.
- It is costly or difficult for multi-segment competitors to meet the specialized needs of niche buyers and at the same time satisfy the expectations of mainstream customers.
- The industry has many different niches and segments, thereby allowing a focuser to pick a niche suited to its resource strengths and capabilities.
- Few, if any, rivals are attempting to specialize in the same target segment.

The Risks of a Market Niche Strategy

Focusing carries several risks. The first major risk is the chance that competitors will find effective ways to match the focused firm's capabilities in serving the target niche. In the lodging business, large chains such as Marriott and Hilton have launched multi-brand strategies that allow them to compete effectively in several lodging segments simultaneously. Marriott has flagship hotels with a full complement of services and amenities that allow it to attract travelers and vacationers going to major resorts; it has J.W. Marriott and Ritz-Carlton hotels that provide deluxe comfort and service to business and leisure travelers; it has Courtyard by Marriott and SpringHill Suites brands for business travelers looking for moderately priced lodging; it has Marriott Residence Inns and TownePlace Suites designed as a "home away from home" for travelers staying five or more nights; and it has more than 650 Fairfield Inn locations that cater to travelers looking for quality lodging at an "affordable" price.

Similarly, Hilton has a lineup of brands (Waldorf Astoria, Conrad Hotels, Doubletree Hotels, Embassy Suites Hotels, Hampton Inns, Hilton Hotels, Hilton Garden Inns, and Homewood Suites) that enable it to compete in multiple segments and compete head-to-head against lodging chains that operate only in a single segment. Multi-brand strategies are attractive to large companies such as Marriott and Hilton precisely because they enable a company to enter a market niche and siphon business away from companies that employ a focus strategy.

Example 5.18 Shifting Market Focus

The popular Campbell Soup Company is shifting its marketing focus from "Millennials" to "Generation X." To do this, it will begin focusing on snacks and simple meals and beverages. Their marketing will emphasize easy, affordable, and tasty meal solutions. They will make package re-designs to make the products more convenient and add unique and adventurous flavors. To support their existing chunky soup franchise, new marketing efforts will focus on the convenience of these products as well.

Source: Media Post, Campbell Soup Brand To Shift Focus From Millennials To Gen X, 2018Fa

A second risk of employing a focus strategy is the potential for the preferences and needs of niche members to shift over time toward the product attributes desired by the majority of buyers. An erosion of the differences across buyer segments lowers entry barriers into a focused market niche and provides an open invitation for rivals in adjacent segments to begin competing for the focuser's customers. A third risk is that the segment may become

so attractive it is soon inundated with competitors, intensifying rivalry and splintering segment profits.

Best-cost Provider Strategy

Best-cost provider strategies are a hybrid of low-cost provider and differentiation strategies that aim at satisfying buyer expectations on key quality/features/performance/service attributes and beating customer expectations on price. Companies pursuing best-cost strategies aim squarely at the sometimes great mass of value-conscious buyers looking for a good-to-very-good product or service at an economical price. The essence of a best-cost provider strategy is giving customers more value for the money by satisfying buyer desires for appealing product attributes in terms of features, performance, quality, service, or related characteristics and charging a lower price for these attributes compared to rivals with similar caliber product offerings. Alternatively, the firm could provide a superior product at a comparable price. Either approach yields a comparable best-cost product.

When a Best-Cost Provider Strategy Works Best

A best-cost provider strategy works best in markets where product differentiation is the norm and attractively large numbers of value-conscious buyers can be induced to purchase midrange products rather than the basic products of low-cost producers or the expensive products of top-of-the-line differentiators. A best-cost provider usually needs to position itself in the middle of the market with either a medium-quality product at a below-average price or a high-quality product at an average or slightly higher-than-average price. Best-cost provider strategies also work well in recessionary times when great masses of buyers become value-conscious and are attracted to economically priced products and services with especially appealing attributes.

The Danger of an Unsound Best-Cost Provider Strategy

A company's biggest vulnerability in employing a best-cost provider strategy is not having

the requisite core competencies and efficiencies in managing value chain activities to support the addition of differentiating features without significantly increasing costs. A company with a modest degree of differentiation and no real cost advantage will most likely find itself squeezed between the firms using low-cost strategies and those using differentiation strategies. Low-cost providers may be able to siphon customers away with the appeal of a lower price (despite having marginally less appealing product attributes). High-end differentiators may be able to steal customers away with the appeal of appreciably better product attributes (even though their products carry a somewhat higher price tag). Thus, a successful best-cost provider must offer buyers significantly better product attributes to justify a price above what low-cost leaders are charging. Likewise, it has to achieve significantly lower costs in providing upscale features so that it can outcompete high-end differentiators on the basis of a significantly lower price.

Successful Strategies are Resource-based

For a company's competitive strategy to succeed in delivering good performance and the intended competitive edge over rivals, it has to be well-matched to a company's internal situation and underpinned by an appropriate set of resources, know-how, and competitive capabilities. To succeed in employing a **low-cost provider** strategy, a company has to have the resources and capabilities to keep its costs below those of its competitors; this means having the expertise to cost-effectively manage value chain activities better than rivals and/or the innovative capability to bypass certain value chain activities being performed by rivals.

To succeed in strongly **differentiating** its product in ways that are appealing to buyers, a company must have the resources and capabilities (such as better technology, strong skills in product innovation, expertise in customer service) to incorporate unique attributes into its product offering that a broad range of buyers will find appealing and worth paying for.

Strategies focusing on a **narrow segment** of the market require the capability to do an outstanding job of satisfying the needs and expectations of niche buyers. Success in employing a strategy keyed to a best value offering requires the resources and capabilities to incorporate upscale product or service attributes at a lower cost than rivals.

KEY TAKEAWAY

Strategic focus is a common element in the strategies across successful firms. Two prevalent views of strategy are strategy as trade-offs and strategy as discipline. Michael Porter identifies three flavors of strategy: (1) cost leadership, (2) differentiation, or (3) focus of cost leadership or differentiation on a particular market niche; the combination of these flavors creates his five generic business-level strategies, see **Figure 5.1**. Firms can straddle these strategies, but such straddling is likely to dilute strategic focus. Strategy also provides discipline. Treacy and Wiersema's three strategic disciplines are (1) operational excellence, (2) product leadership, and (3) customer intimacy. In the strategy as discipline mindset successful firms focus on one of these disciplines only creating a cult of the customer.

EXERCISES

1. What is strategic focus and why is it important?
2. What are Porter's three generic strategies?
3. Can a firm simultaneously pursue a low-cost and a differentiation strategy?
4. What are the three value disciplines?
5. What four rules underlie the three value disciplines?
6. How do Porter's generic strategies differ from, and relate to, the Treacy and Wiersema approaches?

Essential Unit Vocabulary

Best Cost Provider – The best cost provider strategy has the goal of providing the customer with more value for the money on a product by having low cost and upscale differences. This strategy either provides lower prices for a product with comparable attributes (e.g., level of quality or features) or better product attributes at the same price as competitors. See YouTube.

Broad Cost Leader – One of the five business level strategies. Where the strategy's competitive advantage is the cost of goods sold and its competitive scope is broad in target. Broad cost leaders must provide an acceptable level of service, quality, and features at a low price and sell to a broad market segment.

Business Level Strategy (BLS) – An organization's core competencies should be focused on satisfying customer needs or preferences in order to achieve above average returns, which is done through Business-level strategies. Business level strategies detail actions taken to provide value to customers and gain a competitive advantage by exploiting core competencies in specific, individual product or service markets. Business-level strategy is concerned with a firm's position in an industry. Five generic BLS were identified by Michael Porter (Broad Cost leadership, Broad Differentiation, Focused Cost Leadership, Focused Differentiation, Best Cost Provider).

Focused Cost Leadership – One of the five generic business level strategies. This strategy competes based on price in a narrow, "targeted" market. This strategy does not necessarily charge the lowest prices in the industry, instead, it strives to charge low prices relative to other firms competing within the smaller target market.

Focused Differentiation – One of the five generic business level strategies. This strategy restricts marketing to a narrow segment of the industry — or niche — while promoting the unique qualities of the product. Differentiation may be based on geography, quality, features, or service. This type of strategy works best when a market has been "over served". For example, when a product becomes bloated with features, buyers of the product become unwilling to pay the price needed to make a profit. In this situation a focused differentiator will reduce features in order to lower the price and sell a "stripped down" version of a unique product.

Niche Strategies – Niche Strategies are marketing approaches for a good or service with attractive features that focus on one particular minority market subgroup. A typical product marketed using a niche strategy will be easily distinguished from other products,

and it will also be produced and sold for fulfilling the Identifiable and unique needs within the niche market.

Perceived Value – The value a person associates with a given object or service based on their own judgements and usually influenced by previous experiences with the same or similar products. Brand marketing assumes consumers will pay extra for a higher perceived value related to their brand.

Race to the Bottom – A competitive strategy where companies are forced to continue to cut prices in order to compete with their competitors and continue to get customers in their stores and generate sales. This can be seen in the retailing industry where Wal-Mart, Amazon and others are all competing on the lowest prices. The issue with this strategy is that companies can start cutting prices so low that they are making little to no profit and in some cases losing profit.

Zero-sum game – When one person's gain is equivalent to another's loss such that the net change in wealth or benefit is zero. A zero-sum game is not necessarily between two players, there can be millions of participants, but the end result is the same – the net change in wealth or benefit is equal to zero.

PART 6. FORMULATING STRATEGY

Part Contents

- What's in it for Me?
- The Strategy Diamond
- Competitor Analysis Framework
- Types of Rivalry
- KEY TAKEAWAY
- EXERCISES
- Essential Unit Vocabulary

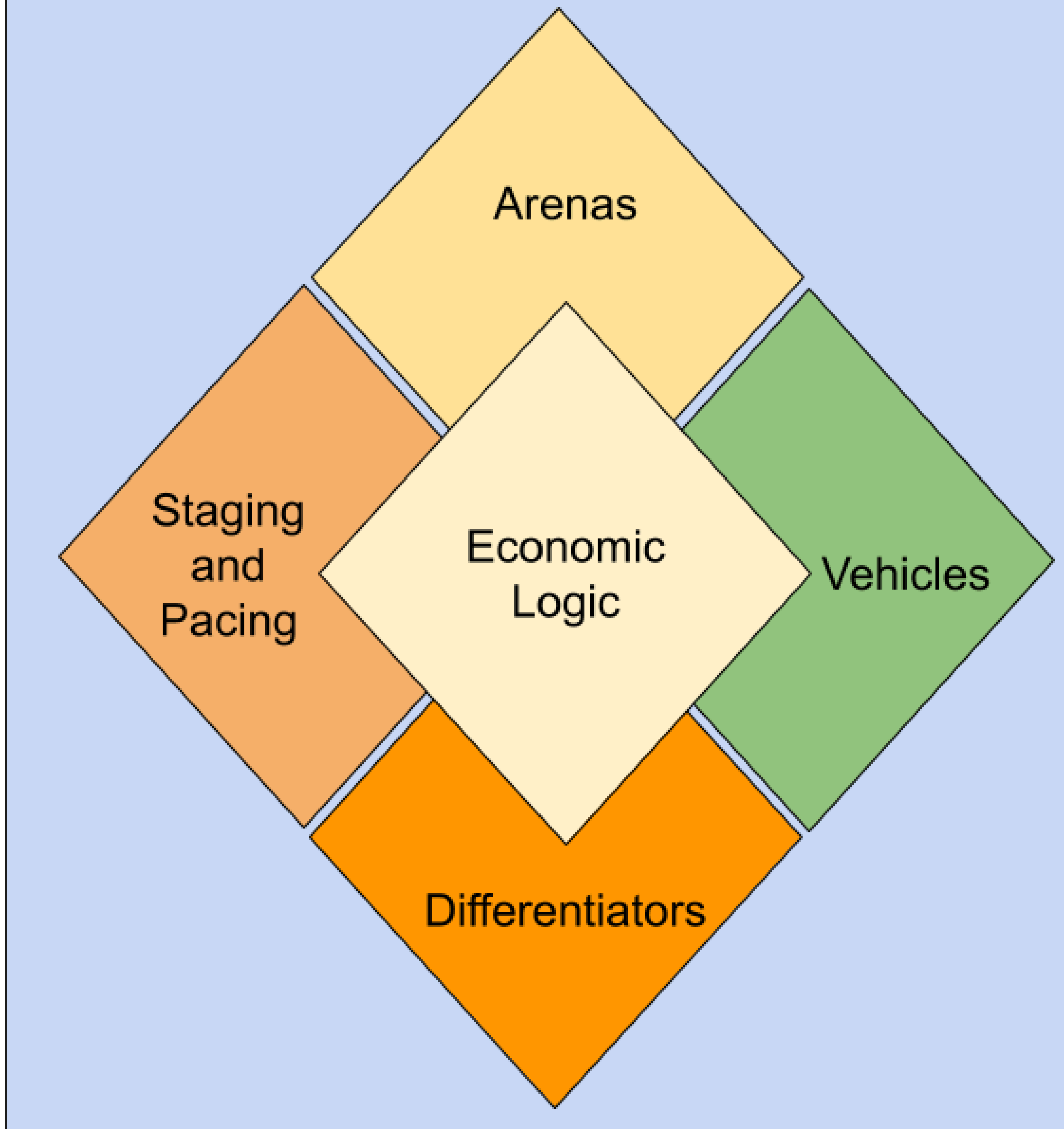
What's in it for Me?

Reading these chapters will help you do the following:

1. Describe the Strategy Diamond and predict when a firm’s strategy will be successful using this model.
2. Describe the three types of rivalry in the context of competitive markets for goods and services.

The Strategy Diamond

All organizations have strategies. The real question for a business is not whether it has a strategy but rather whether its strategy is effective or ineffective, and whether the elements of the strategy are chosen by managers, luck, or by default. You have probably heard the saying, "luck is a matter of being in the right place at the right time"—well, the key to making sure you are in the right place at the right time is preparation, and in many ways, strategizing provides that type of preparation. Luck is not a bad thing. The challenge is to recognize luck when you see it, capitalize on luck, and put the organization repeatedly in luck's path.



The strategy diamond (**Figure 6.1**) was developed by strategy researchers Don Hambrick and Jim Fredrickson as a framework for checking and communicating a strategy.[1] Unit 5 discussed the need for focus and choice with strategy, but you might also have noticed that generic strategies and value disciplines do not spell out a strategy's ingredients. In

1. Hambrick, D. C., & Fredrickson, J. W. (2001). Are you sure you have a strategy? Academy of Management Executive, 19(4), 51–62.

critiquing the field of strategy, these researchers noted that “after more than 30 years of hard thinking about strategy, consultants and scholars have provided executives with an abundance of frameworks for analyzing strategic situations. Missing, however, has been any guidance as to what the product of these tools should be—or what actually constitutes a strategy.”

Because of their critique and analysis, they concluded that if an organization must have a strategy, then the strategy must necessarily have parts. **Figure 6.1** identifies the parts of their diamond model. The diamond model does not presuppose that any particular theory should dictate the contents of each facet. Instead, a strategy consists of an integrated set of choices, but it isn’t a catchall for every important choice a manager faces. In this section, we will tell you a bit about each facet, addressing first the traditional strategy facets of arenas, differentiators, and economic logic; then we will discuss vehicles and finally the staging and pacing facet.

We refer to the first three facets of the strategy diamond—arenas, differentiators, and economic logic—as traditional in the sense that they address three longstanding hallmarks of strategizing. Specifically, strategy matches up market needs and opportunities (located in arenas) with unique features of the firm (shown by its differentiators) to yield positive performance (economic logic). While performance is typically viewed in financial terms, it can have social or environmental components as well.

Arenas

Strategy questions about arenas tell managers and employees where the firm will be active and with how much emphasis.

- Which product categories?
- Which channels?
- Which market segments?
- Which geographic areas?
- Which core technologies?
- Which value-creation strategies?

Beyond geographic-market and product-market arenas, an organization can also make choices about the value-chain arenas in its strategy. To emphasize the choice part of this value-chain arena, Nike’s competitor New Balance manufactures nearly all the athletic

shoes that it sells in the United States. Thus, these two sports-shoe companies compete in similar geographic- and product-market arenas but differ greatly in terms of their choice of value-chain arenas.

Example 6.1 Arenas

Nike is headquartered near Beaverton, Oregon. Today, Nike's geographic market arenas are most major markets around the globe, but in the early 1960s, Nike's arenas were limited to Pacific Northwest track meets accessible by founder Phil Knight's car. In terms of product markets (another part of where), the young Nike company (previously Blue Ribbon Sports) sold only track shoes and not even shoes it manufactured.

Earn credit, add your own example!

Differentiators

These are the things that are unique to the firm such that they give it a competitive advantage in its current and future arenas. Differentiators are concerned with the question, how will the firm win?

- Image?
- Customization?
- Price?
- Styling?
- Product reliability?
- Speed to market?

A differentiator could be asset based, that is, it could be something related to an organization's tangible or intangible assets. A tangible asset has a value and physically exists. Land, machines, equipment, automobiles, and even currencies, are examples of tangible assets. For instance, the oceanfront land on California's Monterey Peninsula, where the Pebble Beach Golf Course and Resort is located, is a differentiator for it in the premium golf-course market. An intangible asset is a nonphysical resource that provides gainful advantages in the marketplace. Brands, copyrights, software, logos, patents, goodwill, and other intangible factors afford name recognition for products and services.

Differentiators can also be found in capabilities, that is, how the organization does something. Walmart, for instance, is very good at keeping its costs low.

Example 6.2 Differentiators

Nike brand has become a valuable intangible asset because of the broad awareness and reputation for quality and high performance that it has built. Nike focuses on developing leading-edge, high-performance athletic technologies, as well as up-to-the-minute fashion in active sportswear.

Earn credit, add your own example!

Economic Logic

This explains how the firm makes money above its cost of capital.

- Lowest costs through scale advantages?
- Lowest costs through scope and replication advantages?
- Premium prices due to unmatchable service?
- Premium prices due to proprietary product features?

While economic logic can include environmental and social profits (benefits reaped by society), the strategy must earn enough financial profits to keep investors (owners, taxpayers, governments, and so on) willing to continue to fund the organization's costs of doing business. A firm performs well (i.e., has a strong, positive economic logic) when its differentiators are well-aligned with its chosen arenas.

Example 6.3 Economic Logic

The collapse in the late 1990s of stock market valuations for Internet companies lacking in profits—or any prospect of profits—marked a return to economic reality. Profits above the firm's cost of capital are required to yield sustained or longer-term shareholder returns.

Earn credit, add your own example!

Vehicles

You can see why the first three facets of the strategy diamond—arenas, differentiators, and economic logic—might be considered the traditional facets of strategizing in that they cover the basics: (1) external environment, (2) internal organizational characteristics, and (3) some fit between them that has positive performance consequences. The fourth facet of the strategy diamond is called vehicles. If arenas and differentiators show where you want to go, then vehicles communicate how the strategy will get you there.

- Internal development?
- Joint ventures?
- Licensing/franchising?
- Alliances?
- Acquisitions?

Example 6.4 Vehicles – Joint Venture

Toyota and Mazda have established a new joint venture company. The companies will jointly open an assembly plant in Alabama, each company will contribute equal funding (50/50 joint venture). Because of the need to adapt quickly market conditions, Toyota and Mazda want to increase plant flexibility. The new plant in Alabama can produce 300,000 vehicles per year; Mazda plans to produce 150,000 crossover models and Toyota will manufacture 150,000 Toyota Corollas. Both models will share drivetrains. The collaboration is expected to help the companies reduce their cost of manufacturing and maintaining sustainable growth in “the future of mobility.”

Source: Automotive News, Toyota, Mazda will launch $1.6 billion Alabama plant construction next month, Kim Duong, 2018Fa

Specifically, vehicles refer to how you might pursue a new arena through internal means, through help from a new partner or some other outside source, or even through acquisition. In the context of vehicles, this is where you determine whether your organization is going to grow organically, through acquisition, or a combination of both. Organic growth is the growth rate of a company excluding any growth from takeovers, acquisitions, or mergers. Acquisitive growth, in contrast, refers precisely to any growth from takeovers, acquisitions, or mergers.

Example 6.5 Vehicles – Coopetition

LinkedIn cooperates with employment recruiters because their presence increases the attractiveness of the professional-oriented social network even though it denies LinkedIn a potential source of revenue. This relationship works – even though each would arguably like to control the entire market themselves – because their working together creates a bigger market than working in competition.

Earn credit, add your own example!

A third type of growth can occur through partnership-based relationships, referred to as co-opetition. The term co-opetition is the reference to an organization cooperating with others, even some competitors, in order to grow together.

Vehicles are considered part of the strategy because there are different skills and competencies associated with different vehicles. For instance, acquisitions fuel rapid growth, but they are challenging to negotiate and put into place. Similarly, alliances are a great way to spread the risk and let each partner focus on what it does best. But at the same time, to grow through alliances also means that you must be really good at managing relationships in which you are dependent on another organization over which you do not have direct control. Organic growth, particularly for firms that have grown primarily through partnering or acquisition, has its own distinct challenges, such as the fact that the organization is on its own to put together everything it needs to fuel its growth.

Example 6.6 Vehicles – Acquisition

The software company, SAP, will acquire Qualtrics for $8 billion in cash. Importantly, the chief executive of Qualtrics, Ryan Smith, will continue his position after the acquisition. This indicates that SAP wants to maintain Qualtrics' organizational culture to avoid the risk of upsetting employees and to avoid the cost of hiring or training new employees. The acquisition will also help SAP gain Qualtrics' core competency, experienced employees, and market share without the risk of entering a new market. Qualtrics possesses experience data which can benefit SAP by accelerating its market position.

Source: New York Times, Why SAP's Purchase of Qualtrics May Be Mutually Beneficial, Kim Duong, 2018Fa

Staging and Pacing

Staging and pacing constitute the fifth and final facet of the strategy diamond and answer what will be our speed and sequence of moves?

Staging and pacing reflect the sequence and speed of strategic moves. This powerful facet of strategizing helps you think about timing and next steps, instead of creating a strategy that is a static, monolithic plan. Remember, strategizing is about making choices, and sequencing and speed should be key choices along with the other facets of the strategy. The staging and pacing facet also helps to reconcile the designed and emergent portions of your strategy.

Example 6.7 Staging and Pacing

The management of Chuy's, a chain of Austin, Texas-based Tex-Mex restaurants, wanted to grow the business outside of Austin, but at the same time, they knew it would be hard to manage these restaurants that were farther away. How should they identify in which cities to experiment with new outlets? Their creative solution was to choose cities that were connected to Austin by Southwest Airlines. Since Southwest is inexpensive and its point-to-point system means that cities are never much more than an hour apart, the Austin managers could easily and regularly visit their new ventures out of town.

Earn credit, add your own example!

Competitor Analysis Framework

Keep in mind that competition can come in multiple forms and be both strategic and tactical. Tactical actions (small or temporary moves like price promotions or coupons) tend to draw competitive responses quicker than than strategic actions (large moves that change a company's business model or mix of businesses). Market leaders are more likely to attract responses to their competitive actions than are smaller firms.

Example 6.8 – Multi-market Competition

Two of the most well known multinational Western coffee firms, Starbuck and Costa Coffee are facing intense competition from local trendy cafes in Shanghai, China. Beijing-based Luckin Coffee is undergoing on the of the fastest retail expansion in history. To leverage its international reputation and 20-year presence in China, Starbucks is responding with all-day dining featuring fresh Italian food, Starbucks Reserve Bakery Cafe. But Starbucks is being pressured by Luckin low prices. Starbucks is attempting to innovate its product and service instead of getting into an unwanted and intense price war.

Source: Forbes, New Cafes Won't Solve Starbucks China Problem, Bunga Azalea Putri, 2019Wi

The aggressiveness of a rivalry is commonly a result of overlaps in interests between multiple firms and their resource and market similarity. Resource similarity occurs when one firm's tangible and intangible resources look like a competitor's in both types and amounts. Market commonality happens when a firm and its competitor operate in the same market. For example, in the financial industry, firms compete for access to capital (resource similarity) and in the food industry, firms compete over access to customer groups (market similarity). The more important these resources or markets are to success in the industry, the more likely one firm is to respond when another acts. The more important the resource or market to either firm, the more aggressive the response.

Companies expose themselves to, or mitigate losses from, overlapping interests using multi-market competition – that is, through the number of product or geographic markets in which they compete head-to-head. Greater multi-market contact means a firm is less likely to initiate an attack but is more likely to respond when attacked. A greater similarity of resources means a greater similarity in strengths and weaknesses and therefore, in business strategies.

Types of Rivalry

We mostly think about rivalry in the context of competitive markets for goods and services. Discussions of competitiveness often focus on high-level measures such as sales growth and market share. However, these are not factors over which we can have any direct effect, but are the results of success in winning, developing, and retaining important resources.

Example 6.9 Rivalry among Nonprofits

Nonprofits face competition just like any other business. The first step in combating this is for executives to really get to know their nonprofit and pay attention to their social return on investment. Another way nonprofits can avoid competition is to engage in partnerships and join together to improve their overall mission.

Source: Nonprofit Hub, Understanding Competition and Partnerships in the Nonprofit Sector | Ft. Derrick Feldmann, 2018Fa

Since most of what we know about rivalry comes from studies of price- and value-based markets, it is perhaps not surprising that customer markets grab all the attention. This focus has a most unfortunate consequence: competitive strategy seems to have little relevance for nonprofit sectors such as public services, the voluntary sector, and nongovernmental organizations (NGOs). Yet nothing could be further from the truth; these organizations constantly compete for resources. Skilled staff are the obvious example, but supporters, cash, and other resources require the organization to compete.

Nevertheless, customers are still the most obvious resource that must be won and retained against rivals, so this is where we will focus first. However, most of the principles explained here are readily applicable to rivalry for staff and some other resources as well.

There are three main forms of rivalry, which sometimes operate alone but more often play out alongside each other:

- Type 1: The battle to win new customers who do not yet buy your kind of product from anyone (potential customers).
- Type 2: The struggle to capture existing customers from rivals while keeping your own customers from switching to rivals.
- Type 3: The fight for the best possible share of business from customers who are not

exclusively with you or anyone else.

Type 1 Rivalry: Competing for Potential Customers

Example 6.10 Type 1 Rivalry

T-Mobile is rebranding its prepaid carrier Metro-PCS to Metro by T-Mobile. This is a way to draw in new customers to the prepaid market that have shunned it in the past as being inferior to postpaid service despite operating on the same T-Mobile Network as its flagship brand.

Source: Fortune, Why T-Mobile Is Rebranding MetroPCS to 'Metro by T-Mobile', 2018Fa

As new potential customers develop, rivals fight to win them and develop this potential pool of resources for their own. The challenge for organizations that are developing potential customers is to understand what is driving customers' choice for which "pipe" to flow through. That is, what motivates their buying behavior? Their choices will be driven by competitors' decisions and actions, especially marketing and sales activities, relative price, relative perceived performance of competing products, and mechanisms such as word of mouth reinforcing growth.

Type 2 Rivalry: Competing for Rivals' Customers

Example 6.11 Type 2 Rivalry

Verizon and T-Mobile compete to steal away each other's existing customers. They employ different strategies in order to try and do this, with Verizon offering the best choice for network and coverage and T-Mobile offering the best in price and customer service. The switching rates in this industry are generally quite low which means the companies have stiff competition between one another.

Source: Whistle Out, Verizon vs. T-Mobile: Which Carrier is Better?, 2018Fa

Competitors battle to steal resources that have been developed and controlled by their

rivals at the same time as they fight to prevent their own resources from being lured away. The rate at which customers choose to leave one firm for another reflects the comparison of price and benefits (value for money) between the rivals. This flow of customers between competing suppliers may, however, be moderated by switching costs.

Type 2 rivalry has certain features that can be understood only by tracking and understanding what is driving these switch rates. First, switching rates accelerate as the customer benefits move further ahead of the cost of switching. In other cases, switching costs can be considerable. Owners of game consoles accumulate expensive libraries of game titles, plus networks of friends with whom they share enthusiasm for their platform. Persuading these consumers to switch is much tougher than keeping them or winning them as they get started in gaming.

Many markets feature a group of hard-to-persuade customers who fail to move despite strong inducements, either because of emotional reasons, such as loyalty or comfort, or because of simple inertia. The deregulation of utility markets was supposed to encourage the mass migration of customers from inefficient incumbent suppliers to the many new entrants who would offer competitive prices. In practice, many customers failed to switch despite the prospect of considerable savings.

Example 6.12 Reluctance to Switching

Earn credit, add your own example!

Type 2 rivalry increases in importance as markets develop. Firms are fighting to pull customers out of their rivals' resource systems and into their own, so the more customers are in that state (rather than in an undeveloped potential pool), the more intense Type 2 rivalry becomes. Customers benefit from a range of incentives to stay or join, which is why regulatory competition policies focus so strongly on eliminating switching costs.

As with the race to develop potential customers, it is often necessary to understand customer switching between multiple competitors. This can be achieved by grouping competitors and tracking the few most likely to attack your firm or most vulnerable to attack from you.

Type 3 Rivalry: Competing for Sales to Shared Customers

In Type 1 and Type 2 rivalry, we have assumed that all customers purchase exclusively from one firm or another. This is true only in certain markets. Mobile phone subscribers hardly ever use two services, for example, and most households purchase electricity from a single supplier.

Example 6.13 Type 3 Rivalry

Chipotle Mexican Grill Inc. is a popular fast food chain that specializes in tacos and burritos in the U.S. They currently operate on a walk-in basis only, as opposed to most of their fast food rivals. In February 2019, Chipotle announced an initiative called "Chipotlanes" where customers can order on their mobile devices and drive to the store at a specific time to pick-up their order without leaving their vehicle. This contrasts with a traditional drive through where customers arrive randomly and wait in line in their vehicles. Because they are competing for sales of shared customers in this rivalry, they must adopt similar capabilities that companies such as McDonalds are utilizing.

Source: Business Insider, Chains like Chipotle, Starbucks, and Cava are revolutionizing the drive-thru to compete with fast-food giants, Christopher Burke, 2019Sp

In many markets, however, customers tend to allocate buying between two or more suppliers. In these cases, rivals are fighting for a larger share of sales to customers who purchase from several suppliers. Since these customers already buy from more than one source, the cost of switching for any single buying decision is generally low. Share of sales can therefore swing quickly between rivals. One market where competition for sales to shared customers takes place is fast-moving consumer goods such as food and drink.

Figure 6.2 Action Checklist: Understanding and Managing Competition Over Time

Here are some tips for understanding what is happening in the battle between you and your competitors:

- Start with a chart of what has happened, and is likely to happen, to your own customer base, not just how many there are in each period, but also how many are won and lost.
- For customers you win, identify the rate at which some of them are won from a potential population of previously inactive customers and how many are won from rivals. If you have more than one competitor, focus attention first on those that offer the biggest threat—or biggest opportunity.
- Try to estimate or research the same information for your rivals.
- Do not forget to include the pool of shared customers who are not loyal to either you or a competitor. Together with the previous steps, this will give you a complete view of which customers and potential customers are moving at what rate among the alternatives.
- Identify what affect your, and your competitors' decisions, have to drive customers to move at the rates they do, between the alternative available states.

If you sell through intermediaries, such as a consumer goods company selling through retailers, you will need to do the same work for those intermediaries as well as for final customers.

This may all seem a big effort, and a big change from how you currently do things, but remember, this is how the world works. So if you try making decisions without this insight, you will struggle to make the right choices. And remember, your competitors may be ahead of you in this thinking.

KEY TAKEAWAY

In this section, we discussed how to put together a strategy diamond. The first step involves identifying the organization's arenas, differentiators, and economic logic. This step involves a basic understanding of strategy and summarizes many of the traditional views in strategic management. The second step involves contemplating how the organization would compete or grow in existing or new arenas, and this is where the vehicles came into play. Finally, you considered the sequencing and speed of strategic initiatives by learning about the strategy diamond facet of staging and pacing.

Together, these five facets (i.e., arenas, differentiators, economic logic, vehicles, staging, and pacing) constitute the strategy diamond. They get expressed through three types of rivalry over customers – competing for potential customers, competing for rivals' customers, and competing for sales to shared customers.

EXERCISES

1. What are the five facets of Hambrick and Fredrickson's strategy diamond?
2. What is the relationship between arenas and differentiators if the strategy yields a positive economic logic?
3. If a firm is performing poorly financially, what might this say about the differentiators, arenas, or both?
4. Why is it important to consider vehicles as part of an organization's strategy?
5. What is the difference between staging and pacing in terms of the strategy diamond?
6. What are some ways that you might apply staging and pacing to an organization's strategy?

Essential Unit Vocabulary

Acquisition – Acquisition is the act of a company buying most/all of the assets of another company. It is a growth strategy where one company uses their excess capital to take over another company instead of expanding its own product line or operation. The acquirer earns full profit from both operations after the acquisition. Companies often use this strategy to avoid risk of failure when entering a new industry. Moreover, they use this strategy to gain market share within an existing industry when expanding an existing product or service may not be sufficient to create a big impact in market share.

Backward and Forward Integration – Refers to the type of integration within a firm's value chain. In Backward Integration, the company purchases or develops the expertise currently performed by suppliers or firms "earlier" in the value chain in order to control the inputs to their production. In Forward Integration, the company purchases or develops expertise currently performed by the firm's distributors or retailers in order to gain control of the activities that are closer to their end customer.

Blue Ocean Strategy – Refers to a business theory describing new, uncontested market space and expanding market boundaries which avoids direct market competition and rivalry; the strategy creates new value while decreasing costs. This theory often suggests companies are better off choosing a brand new market by innovating rather than engaging in traditional competition. Blue Ocean Strategy is often contrasted with Red Ocean Strategy, which is the portion of the market where rivalry is most intense and there is much "blood in the water".

Competitive Rivalry – Firms that are competing in an industry and the extent to which they put pressure on one another to gain market share and profit. Not all competitors are necessarily rivals; primary rivals are usually those who are offering products/services at a similar price and/or going after the same consumer market and are most likely to affect the firm's market share or profit.

First Mover Advantage – The advantages of being the first Business in a given Segment of the market. To be the First Mover the company must be a pioneer in a given industry. A few advantages to being the first mover are industry leadership, capturing uncontested market share, gaining early knowledge and experience to adapt products as the market shifts, and preemptively acquiring scarce resources to protect the firm from competition. Unfortunately, being a first-mover can also entail a great deal of risk if the pioneering effort is not well received.

Joint Venture – Combining and/or pooling of two or more organizations in which they

take part in a single project. The two or more parties retain their separate legal identities as businesses/organizations aside from the one-time shared project.

Late Mover Advantage – Describes a firm that waits for a market to mature before deciding to enter. The Advantages of being a late mover include lower risk, learning from your predecessors' mistakes, copying what they have done and offering the product at a lower price because the late mover's Cost of Goods Sold does not need to cover development costs. Additionally, because they have no stakes in maintaining the status quo, late movers can often reinvent the product in ways not considered by earlier movers and gain a market advantage.

Merger – The combination of two or more companies in which one company remains after the action is completed. Typically, this is done through an exchange of cash or stock between the owners of the various companies. This typically takes place in a "friendly" arrangement in which both firms expect to retain some identity in the new organization.

Outsourcing – An effective cost-saving strategy when used properly. It is the practice used to reduce costs by transferring non-core activities or functions to external specialists or suppliers rather than performing the tasks internally.

Strategic Alliance – When two or more companies combine their efforts to generate more sales than otherwise would have been possible. In a strategic alliance both partners retain their independent corporate identities but they have the opportunity to enjoy shortened development times, increased target market, and most importantly, using the strengths (core competencies) of each company involved to create a venture neither could create on their own.

PART 7. CORPORATE-LEVEL STRATEGY

Part Contents

- What's in it for Me?
- Business- vs. Corporate-level Strategy
- Concentration Strategies
- Horizontal Integration: Mergers and Acquisitions
- Vertical Integration Strategies
- Diversification Strategies
- Strategies for Getting Smaller
- Portfolio Planning and CLS
- KEY TAKEAWAY
- EXERCISES
- Essential Unit Vocabulary

What's in it for Me?

Reading these chapters will help you do the following:

1. Describe the difference between business- and corporate-level strategy.
2. Apply Ansoff's Matrix in explaining the four primary concentration strategies.
3. Discuss the pros and cons of horizontal and vertical integration.
4. Describe options for companies when strategy goes awry.

Business- vs. Corporate-level Strategy

While business-level strategy focused on how an organization generates value by positioning products and services relative to the offerings of other firms in the same industry, corporate-level strategy deals with a portfolio of distinct products and services. When dealing at the business-level, managers ask, “How can we be successful in this business?” When dealing with corporate-level strategy, executives ask, “In what industry or industries should our firm compete?”

The executives in charge of a firm such as The Walt Disney Company must decide whether to remain within their present domains or venture into new ones. In Disney’s case, the firm has expanded from its original business (films) and into television, theme parks, and several others. In contrast, many firms never expand beyond their initial choice of industry.

Concentration Strategies

Figure 7.1 Ansoff's Product-Market Matrix

Product / Market	Existing Products	New Products
Existing Markets	Consolidation, Penetration, Withdrawal	Product Development
New Markets	Market Development	Diversification

For many firms, concentration strategies are very sensible. These strategies involve trying to compete successfully only within a single, broad industry. There are three concentration strategies: (1) market penetration, (2) market development, and (3) product development. A firm can use one, two, or all three as part of their efforts to excel within an industry.[1] Ansoff described these strategies in a matrix, see **Figure 7.1**. Ansoff's matrix is a tool for understanding at a high-level, the general direction of growth. It helps a firm match products and markets. The firm must decide whether to prioritize increasing profit or growth and how the firm will achieve it. No one strategy is appropriate for all companies at all times! Markets are defined as customer groups, and products are items sold to customers.

Example 7.1 Market Penetration

Advance Micro Devices (AMD) has steadily increased its market penetration year over year after it began shipping its Ryzen CPUs taking market share from its rival Intel. On average they are currently taking around 5% of market share per year from Intel due to a superior product. The Ryzen CPUs are outselling Intel's offerings due to an industry best performance per dollar, which is important in the home PC market as well as server markets. AMD is beginning to chip away at Intel's market share because its offerings are cheaper, better performing, and more innovative resulting in an improvement of market penetration.

1. Ansoff, H. I. 1957. Strategies for diversification. Harvard Business Review, 35(5), 113–124.

Source: Extreme Tech, AMD Gains Market Share in Desktop and Laptop, Slips in Servers, Christopher Burke, 2019Sp

Market Penetration

Market penetration involves increasing the firm's share within existing markets using existing products. Often firms will rely on advertising to attract new customers within existing markets using loyalty program, coupons, and sales promotions. Nike, for example, features famous athletes in print and television ads designed to take market share within the athletic shoes business from Adidas and other rivals.

Market Development

Example 7.2 Market Development

This article discusses the importance of stock and how it differentiates a company based on how high or low their stock evaluation is. Companies that defy the social norm, such as Amazon and Netflix have a high stock and are growing at an annual rate of 99 and 93 percent, respectively.

Source: Investor's Business Daily, Who Joins Canada Goose, Square On This List Of Today's Fastest-Growing Companies?, Carolyn Hoard, 2018Fa

Market development involves selling existing products within new markets. One way to reach a new market is to enter a new retail channel. Starbucks has stepped beyond selling only coffee beans in its stores and now sells beans in grocery stores. This enables Starbucks to reach consumers that do not visit its coffee houses. Entering new geographic areas and adding new sales or distribution channels are other ways to pursue market development.

Product Development

Example 7.3 Product Development

Big brand name companies such as Coke, Pepsi, and Nestle are expanding their product market to add flavored sparkling water. In doing this, they are making a new product that serves an existing market. These new products are aimed to compete with others on the market such as La Croix. A specific example is Pepsico's new line called Bubly, which already has over $61 million in sales according to market research group IRI.

Source: Bevnet, Big Guys Pursue the Bubbles: Coco-Cola, PepsiCo and Nestle Take Aim at La Croix, 2018Fa

Product development involves creating new products to serve existing markets. In the 1940s, for example, Disney expanded its offerings within the film business by going beyond cartoons and creating movies featuring real actors. More recently, McDonald's has gradually moved more and more of its menu toward healthy items to appeal beyond its existing base and to attract customers who are concerned about nutrition.

In 2009, Starbucks introduced VIA, an instant coffee variety that executives hoped would appeal to their customers when they do not have easy access to a Starbucks store or a coffee pot. The soft drink industry is a frequent location of product development efforts. Coca-Cola and Pepsi regularly introduce new varieties—such as Coke Zero and Pepsi Cherry Vanilla—in an attempt to take market share from each other and from their smaller rivals.

Horizontal Integration: Mergers and Acquisitions

Rather than rely on their own efforts, some firms try to expand their presence in an industry by acquiring or merging with one of their rivals. This strategic move is known as horizontal integration. An acquisition takes place when one company purchases another company. Generally, the acquired company is smaller than the firm that purchases it. A merger joins two companies into one; mergers typically involve similarly sized companies. Disney was much bigger than Miramax and Pixar when it joined with these firms in 1993 and 2006, respectively. Thus, these two horizontal integration moves are considered to be acquisitions.

Example 7.4 Purchasing Market Share

Part of the motivation behind Southwest Airlines' purchase of AirTran was that AirTran had a significant share of the airline business in cities—especially Atlanta, home of the world's busiest airport—that Southwest had not yet entered. Rather than build a presence from nothing in Atlanta, Southwest executives believed that buying a position was prudent.

Earn credit, add your own example!

Horizontal integration can be attractive for several reasons. In many cases, horizontal integration is aimed at lowering costs by achieving greater economies of scale. This was the reasoning behind several mergers of large oil companies including BP and Amoco in 1998, Exxon and Mobil in 1999, and Chevron and Texaco in 2001. Oil exploration and refining are expensive. Executives in charge of each of these six corporations believed that greater efficiency could be achieved by combining forces with a former rival. Considering horizontal integration alongside Porter's five forces model highlights that such moves also reduce the intensity of rivalry in an industry and thereby make the industry more profitable.

Some purchased firms are attractive because they own strategic resources such as valuable brand names. Acquiring Tasty Baking was appealing to Flowers Foods, for example, because the name Tastykake is well known for quality in heavily populated

areas of the northeastern United States. Some purchased firms have market share that is attractive.

Horizontal integration can also provide access to new distribution channels. Some observers were puzzled when Zuffa, the parent company of the Ultimate Fighting Championship (UFC), purchased rival mixed martial arts (MMA) promotion Strikeforce. UFC had such a dominant position within MMA that Strikeforce seemed to add very little for Zuffa. Unlike UFC, Strikeforce had gained exposure on network television through broadcasts on CBS and its partner Showtime. Thus acquiring Strikeforce might help Zuffa gain mainstream exposure for its product.[1]

Despite the potential benefits of mergers and acquisitions, their financial results often are very disappointing. One study found that more than 60 percent of mergers and acquisitions erodes, while fewer than one in six increases, shareholder wealth.[2] Some of these moves struggle because the cultures of the two companies cannot be meshed. This chapter's opening vignette suggests that Disney and Pixar may be experiencing this problem. Other acquisitions fail because the buyer pays more for a target company than that company is worth and the buyer never earns back the premium it paid.

In the end, between 30 and 45 percent of mergers and acquisitions are undone, often at huge losses.[3] For example, Mattel purchased The Learning Company in 1999 for $3.6 billion and sold it a year later for $430 million—12 percent of the original purchase price. Similarly, Daimler-Benz bought Chrysler in 1998 for $37 billion. When the acquisition was undone in 2007, Daimler recouped only $1.5 billion worth of value—a mere 4 percent of what it paid. Thus, executives need to be cautious when considering using horizontal integration.

1. Wagenheim, J. 2011, March 12. UFC buys out Strikeforce in another step toward global domination. SI.com.
2. Henry, D. 2002, October 14. Mergers: Why most big deals don't pay off. Businessweek, 60–70.
3. Hitt, M. A., Harrison, J. S., & Ireland, R. D. 2001. Mergers and acquisitions: A guide to creating value for stakeholders. New York, NY: Oxford University Press.

Vertical Integration Strategies

When pursuing a vertical integration strategy, a firm gets involved in new portions of the value chain. This approach can be very attractive when a firm's suppliers or buyers have too much power over the firm and are becoming increasingly profitable at the firm's expense. By entering the domain of a supplier or a buyer, executives can reduce or eliminate the leverage that the supplier or buyer has over the firm. Considering vertical integration alongside Porter's five forces model highlights that such moves can create greater profit potential. Firms can pursue vertical integration on their own, such as when Apple opened stores bearing its brand, or through a merger or acquisition, such as when eBay purchased PayPal.

Example 7.5 Vertical Integration

In the late 1800s, Carnegie Steel Company was a pioneer in the use of vertical integration. The firm controlled the iron mines that provided the key ingredient in steel, the coal mines that provided the fuel for steelmaking, the railroads that transported raw material to steel mills, and the steel mills themselves. By having control over all elements of the production process, they ensured the stability and quality of key inputs. By using vertical integration, Carnegie Steel achieved levels of efficiency never before seen in the steel industry.

Earn credit, add your own example!

Today, oil companies are among the most vertically integrated firms. Firms such as ExxonMobil and ConocoPhillips can be involved in all stages of the value chain including crude oil exploration, drilling for oil, shipping oil to refineries, refining crude oil into products such as gasoline, distributing fuel to gas stations, and operating gas stations.

Vertical integration also creates risks. Venturing into new portions of the value chain can take a firm into very different businesses. A lumberyard that started building houses, for example, would find that the skills it developed in the lumber business have very limited value to home construction. Such a firm would be better off selling just lumber to contractors.

Example 7.6 Safety through Vertical Integration

The risk of not being vertically integrated is illustrated by the 2010 Deepwater Horizon oil spill in the Gulf of Mexico. Although the US government held BP responsible for the disaster, BP cast at least some of the blame on drilling rig owner Transocean and two other suppliers: Halliburton Energy Services (which created the cement casing for the rig on the ocean floor) and Cameron International Corporation (which had sold Transocean blowout prevention equipment that failed to prevent the disaster). In April 2011, BP sued these three firms for what it viewed as their roles in the oil spill.

Earn credit, add your own example!

Vertical integration can also create complacency. For example, a situation in which an aluminum company is purchased by a can company. People within the aluminum company may believe that they do not need to worry about doing a good job because the can company is guaranteed to use their products. Some companies try to avoid this problem by forcing their subsidiary to compete with outside suppliers, but this undermines the reason for purchasing the subsidiary in the first place.

A **backward vertical integration** strategy involves a firm moving back along the value chain and entering a supplier's business. Some firms use this strategy when executives are concerned that a supplier has too much power over their firm. In the early days of the automobile business, Ford Motor Company created subsidiaries that provided key inputs to vehicles such as rubber, glass, and metal. This approach ensured that Ford would not be hurt by suppliers holding out for higher prices or providing materials of inferior quality.

A **forward vertical integration** strategy involves a firm moving further down the value chain to enter a buyer's business. Disney has pursued forward vertical integration by operating more than three hundred retail stores that sell merchandise based on Disney's characters and movies. This allows Disney to capture profits that would otherwise be enjoyed by another store. Each time a Hannah Montana book bag is sold through a Disney store, the firm makes more profit than it would if the same book bag were sold by a retailer such as Target.

Diversification Strategies

Firms using diversification strategies enter entirely new industries. While vertical integration involves a firm moving into a new part of a value chain that it is already in, diversification requires moving into new value chains. Many firms accomplish this through a merger or an acquisition, while others expand into new industries without the involvement of another firm.

Three Tests for Diversification

A proposed diversification move should pass these three tests or it should be rejected.[1]

1. **Attractiveness Test** – How attractive is the industry that a firm is considering entering? Unless the industry has strong profit potential, entering it may be very risky.
2. **Cost-of-Entry Test** – How much will it cost to enter the industry? Executives need to be sure that their firm can recoup the expenses that it absorbs in order to diversify.
3. **Better Off Test** – Will the new unit and the firm be better off? Unless one side or the other gains a competitive advantage, diversification should be avoided.

Related Diversification

Because it leverages strategic fit, companies that engage in related diversification are more likely to achieve gains in shareholder value. **Related diversification** occurs when a firm moves into a new industry that has important similarities with the firm's existing industry or industries. Because films and television are both aspects of entertainment, Disney's purchase of ABC is an example of related diversification. Some firms that engage

1. Porter, M. E. 1987. From competitive advantage to corporate strategy. Harvard Business Review, 65(3), 102–121.

in related diversification aim to develop and exploit a core competency to become more successful. A core competency is a skill set that is difficult for competitors to imitate, can be leveraged in different businesses, and contributes to the benefits enjoyed by customers within each business.[2] For example, Newell Rubbermaid is skilled at identifying underperforming brands and integrating them into their three business groups: (1) home and family, (2) office products, and (3) tools, hardware, and commercial products.

Example 7.7 Related Diversification

Honda Motor Company provides a good example of leveraging a core competency through related diversification. Although Honda is best known for its cars and trucks, the company started out in the motorcycle business. Through competing in this business, Honda developed a unique ability to build small and reliable engines. When executives decided to diversify into the automobile industry, Honda was successful in part because it leveraged this ability within its new business. Honda also applied its engine-building skills in the all-terrain vehicle, lawn mower, and boat motor industries.

Earn credit, add your own example!

Sometimes the benefits of related diversification that executives hope to enjoy are never achieved. For example, both soft drinks and cigarettes are products that consumers do not need. Companies must convince consumers to buy these products through marketing activities such as branding and advertising. Thus, on the surface, the acquisition of 7Up by Philip Morris seemed to offer the potential for Philip Morris to take its existing marketing skills and apply them within a new industry. Unfortunately, the possible benefits to 7Up never materialized.

Unrelated Diversification

Why would a soft-drink company buy a movie studio? It's hard to imagine the logic behind such a move, but Coca-Cola did just this when it purchased Columbia Pictures in 1982 for $750 million. This is a good example of **unrelated diversification**, which occurs when a firm enters an industry that lacks any important similarities with the firm's existing

2. Prahalad, C. K., & Hamel, G. 1990. The core competencies of the corporation. Harvard Business Review, 86(1), 79–91.

industry or industries. Luckily for Coca-Cola, its investment paid off—Columbia was sold to Sony for $3.4 billion just seven years later.

Example 7.8 Unrelated Diversification

Lighter firm Zippo is currently trying to avoid this scenario. According to CEO Geoffrey Booth, the Zippo is viewed by consumers as a "rugged, durable, made in America, iconic" brand. This brand has fueled eighty years of success for the firm. But the future of the lighter business is bleak. Zippo executives expect to sell about 12 million lighters this year, which is a 50 percent decline from Zippo's sales levels in the 1990s. This downward trend is likely to continue as smoking becomes less and less attractive in many countries. To save their company, Zippo executives want to diversify. As of March 2011, Zippo was examining a wide variety of markets where their brand could be leveraged, including watches, clothing, wallets, pens, liquor flasks, outdoor hand warmers, playing cards, gas grills, and cologne.

Earn credit, add your own example!

Most unrelated diversification efforts, however, do not have happy endings. Harley-Davidson, for example, once tried to sell Harley-branded bottled water. Starbucks tried to diversify into offering Starbucks-branded furniture. Both efforts were disasters. Although Harley-Davidson and Starbucks both enjoy iconic brands, these strategic resources simply did not transfer effectively to the bottled water and furniture businesses.

Strategies for Getting Smaller

"In what industry or industries should our firm compete?" is the central question addressed by corporate-level strategy. In some cases, the answer that executives arrive at involves exiting one or more industries.

Retrenchment

In the early twentieth century, many military battles were fought in series of parallel trenches. If an attacking army advanced enough to force a defending army to abandon a trench, the defenders would move back to the next trench and try to refortify their position. This small retreat was preferable to losing the battle entirely. Trench warfare inspired the business term **retrenchment**. Firms following a retrenchment strategy shrink one or more of their business units. Much like an army under attack, firms using this strategy hope to make just a small retreat rather than losing a battle for survival. Retrenchment is often accomplished through laying off employees.

Example 7.9 Retrenchment

In January 2019, Buzzfeed, announced it would cut 15 percent of its jobs following an evaluation of the "evolving economics of digital platforms." This was just one of several announced media layoffs in a short period of time. Earlier Verizon Communications announced it would cut 7% of its digital-media operations including operations involving its AOL, Yahoo, and Huffington Post operations. In a separate announcement Gannett, Inc. announced it would reduce staff in several of its newspaper companies. In its announcement, Buzzfeed pointed to the need to "reduce our costs and improve our operating model so we can thrive and control our own destiny."

Source: Bloomberg, BuzzFeed to Cut 15% of Jobs in Latest Digital-Media Retrenchment, 2019Wi

This is a common rationale for retrenchment—by shrinking the size of a firm, executives hope that the firm can survive as a profitable enterprise.

Restructuring

Executives sometimes decide that bolder moves than retrenchment are needed for their firms to be successful in the future. **Divestment** refers to selling off part of a firm's operations. In some cases, divestment reverses a forward vertical integration strategy, such as when Ford sold Hertz. Divestment can also be used to reverse backward vertical integration. General Motors (GM), for example, turned a parts supplier called Delphi Automotive Systems Corporation from a GM subsidiary into an independent firm. This was done via a **spin-off**, which involves creating a new company whose stock is owned by investors. GM stockholders received 0.69893 shares of Delphi for every share of stock they owned in GM. A stockholder who owned 100 shares of GM received 69 shares of the new company plus a small cash payment in lieu of a fractional share.

Example 7.10 Divestment

General Electric divested by disposing of a unit of GE Aviation, called MRA Systems LLC, to ST Engineering. By doing this, GE will earn about $630 million in cash by the first quarter of 2019 if all goes as planned. The company made many plans in June of 2018 to restructure their company, and this is just one example of how they're using divestment to try and increase shareholder value.

Source: Zachs, General Electric's GE Aviation Unit to Divest MRA Systems, 2018Fa

Divestment also serves as a means to undo diversification strategies. Divestment can be especially appealing to executives in charge of firms that have engaged in unrelated diversification. Investors often struggle to understand the complexity of diversified firms, and this can result in relatively poor performance by the stocks of such firms. This is known as a **diversification discount**. Executives sometimes attempt to unlock hidden shareholder value by breaking up diversified companies.

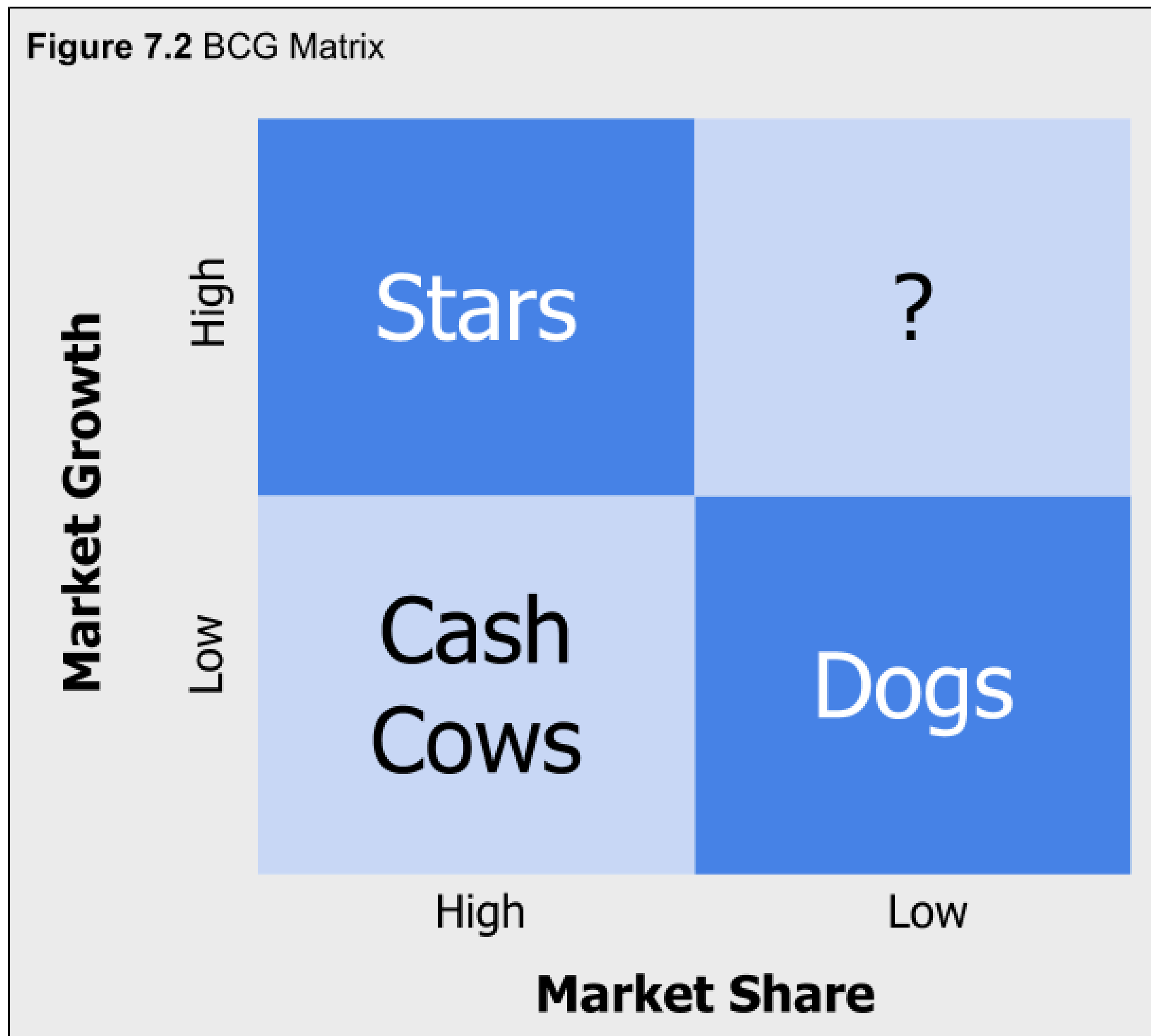
Executives are sometimes forced to admit that the operations that they want to abandon have no value. If selling off part of a business is not possible, the best option may be **liquidation**. This involves simply shutting down portions of a firm's operations, often at a tremendous financial loss. GM has done this by scrapping its Geo, Saturn, Oldsmobile, and Pontiac brands. Ford recently followed this approach by shutting down its Mercury brand. Such moves are painful because massive investments are written off, but becoming "leaner and meaner" may save a company from total ruin.

Portfolio Planning and CLS

Executives in charge of firms involved in many different businesses must figure out how to manage such portfolios. General Electric (GE), for example, competes in a very wide variety of industries, including financial services, insurance, television, theme parks, electricity generation, light bulbs, robotics, medical equipment, railroad locomotives, and aircraft jet engines. When leading a company such as GE, executives must decide which units to grow, which ones to shrink, and which ones to abandon.

Portfolio planning can be a useful tool. Portfolio planning is a process that helps executives assess their firms' prospects for success within each of its industries, offers suggestions about what to do within each industry, and provides ideas for how to allocate resources across industries. Portfolio planning first gained widespread attention in the 1970s, and it remains a popular tool among executives today.

The Boston Consulting Group (BCG) Matrix



The Boston Consulting Group (BCG) matrix is the best-known approach to portfolio planning. Using the matrix requires a firm's businesses to be categorized as high or low along two dimensions: its share of the market and the growth rate of its industry. High market share units within slow-growing industries are called **cash cows**. Because their industries have bleak prospects, profits from cash cows should not be invested back into cash cows but rather diverted to more promising businesses. Low market share units within slow-growing industries are called **dogs**. These units are good candidates for divestment. High market share units within fast-growing industries are called **stars**. These units have bright prospects and thus are good candidates for growth. Finally, low-market-share units within fast-growing industries are called **question marks**. Executives must decide whether to build these units into stars or to divest them.

The BCG matrix is a popular portfolio planning technique. With the help of a leading consulting firm, GE developed the attractiveness-strength matrix to examine its diverse activities. This planning approach involves rating each of a firm's businesses in terms of the attractiveness of the industry and the firm's strength within the industry. See **Figure 7.2**.

Limitations to Portfolio Planning

Although portfolio planning is a useful tool, this tool has important limitations. First, portfolio planning oversimplifies the reality of competition by focusing on just two dimensions when analyzing a company's operations within an industry. Many dimensions are important to consider when making strategic decisions. Second, portfolio planning can create motivational problems among employees. For example, if workers know that their firm's executives believe in the BCG matrix and that their subsidiary is classified as a dog, then they may give up any hope for the future. Similarly, workers within cash cow units could become dismayed once they realize that the profits that they help create will be diverted to boost other areas of the firm. Third, portfolio planning does not help identify new opportunities. Because this tool only addresses existing businesses, it cannot reveal what new industries a firm should consider entering.

KEY TAKEAWAY

This chapter explains corporate-level strategy. Executives grappling with corporate-level strategy must decide in what industry or industries their firms will compete. Many of the possible answers to this question involve growth. Concentration strategies involve competing within existing domains to expand within those domains. This can take the form of market penetration, market development, or product development. Integration involves expanding into new stages of the value chain. Backward integration occurs when a firm enters a supplier's business while forward vertical integration occurs when a firm enters a customer's business. Diversification involves entering entirely new industries; this can be an industry that is related or unrelated to a firm's existing activities. Sometimes being smart about corporate-level strategy requires shrinking the firm through retrenchment or restructuring. Finally, portfolio planning can be useful for analyzing firms that participate in a wide variety of industries.

EXERCISES

1. Suppose the president of your college or university decided to merge with or acquire another school. What schools would be good candidates for this horizontal integration move? Would the move be a success?
2. Given that so many mergers and acquisitions fail, why do you think that executives keep making horizontal integration moves?
3. Can you identify a struggling company that could benefit from market penetration, market development, or product development? What might you advise this company's executives to do differently?
4. Should Disney consider using retrenchment or restructuring? Why or why not?
5. Given how much information is readily available about companies, why do you think investors still struggle to analyze diversified companies?
6. Is market share a good dimension to use when analyzing the prospects of a business? Why or why not?
7. What might executives do to keep employees within dog units motivated and focused on their jobs?

Essential Unit Vocabulary

Cash Cow – A business or asset that once paid off, provides a steady stream of income. In the Boston Consulting Group's (BCG) growth share matrix, the bottom left quadrant is the cash cow quadrant which means that it demonstrates high market share in a low growth industry.

Cash Hog – Relates to the financial strength of different business units. A cash hog is a business unit that generates too little cash flow to completely fund its own operation. Such a business often requires cash from other sources or other business units to survive. For example, if a cash hog needs to purchase new equipment or upgrade its computer system to keep up with orders, the parent company will need to provide the capital – it would be unable to make the investment otherwise. If a cash hog continues to be a financial drain on the company with little outlook for improvement, management may have to consider selling, spinning off or otherwise dismantling the operation. Corporations are less likely to unload a cash hog if its products or services provide greater value than will the freed up capital.

Corporate Restructuring – The process involved in changing the organization of a business. Corporate restructuring can involve making dramatic changes to a business by cutting out or merging departments that often has the effect of displacing staff members.

Dominant Business – A Dominant Business can be looked at as a firm/business that controls at least half the market in which it operates and has no significant competition. The dominant firm/businesses competitors are mostly small firms that compete against each other for the remaining market share. Dominant firms/businesses have a competitive advantage by virtue of their size, name recognition, and resources. They usually hold onto their dominance through various strategies, including innovation, brand extension, and price wars, that trailing firms do not have the resources to compete against. See this video explaining Dominant Business.

Economies of Scope – A theory in economics that explains achievable savings in resource costs as a byproduct of increasing the number of goods that use similar resources. For example, Kleenex Corporation has diversified its product line by offering paper products for a variety of users (i.e. sanitation wipes for hospitals, paper towels for schools and businesses, etc.) All of these require a similar input (paper) and Kleenex is able to experience cost saving by spreading these inputs through a number of different products.

Horizontal Integration – A type of diversification that leverages the corporate

relatedness of the firm's various value chains. In horizontal diversification, the firm develops or acquires products or services that will appeal to its current customers in an effort to expand their offerings without competing with existing offerings. Also known as horizontal integration, this is a move that leverages existing competencies such as marketing, warehousing or logistics to benefit multiple products.

Market Power – Reflects a company's ability to manipulate the price of its product by influencing the item's supply, its demand or both. Firms with market power are said to be "price makers" as they are able to set a premium price for the product while maintaining market share.

Reasons to Diversify – Firms diversify to gain market power in terms of reducing overall costs of operation, create synergy between existing products or services, and to expand competition to multiple markets. They also diversify to leverage the operational or corporate relatedness of their value chains and to obtain technologies or competencies needed to remain competitive.

Strategic Fit – An integrated and systematic matching of a company's resources and capabilities to the opportunities at hand within the external environment. As resources and capabilities differ it is important that resources can be classified as two different groups, as tangible (Financial, Physical) or intangible (Technology, Human Resources, Reputation, Culture).

Vertical Integration – An arrangement in which a firm absorbs activities or functions earlier or later in the industry value chain either through acquisition, through expansion of existing capabilities or by developing the capability organically. By integrating vertically, the firm gains more control over its product and may reduce the threat of competition.

Unrelated Diversification – When a company enters a new field of business that is not related to its previous business in anyway at all. On the continuum of diversification, unrelated bears the greatest levels of risk and has historically proven to provide the least likely path to profitability.

PART 8. ANALYSIS AND REPORTING

Part Contents

- What's in it for Me?
- Strategy Analysis Framework (SAF)
- Sample Client Report

What's in it for Me?

Reading these chapters will help you do the following:

1. Have a framework for analyzing a client company (strategy analysis framework).
2. Employ the Rules of Analysis to thoroughly analyze a client company.

Strategy Analysis Framework (SAF)

As with all such models, the details in this framework are provided to stimulate thinking, not all points or questions will be relevant in all situations. Use the models (called out in bullets at the top of each section) if appropriate and the questions in the section content themselves as a start only. Your situation will dictate the "right" questions to ask and the "right" models to use for analysis.

Step 1. Current Company Situation

- BLS Analysis
- BCG Matrix
- BEP Analysis

Analyze the industry's history, development, and growth. A useful way to investigate how an industry has evolved is to chart the critical incidents in its history – that is, those events that were the most unusual, pivotal, or essential for development of the industry into what it is now. Some of the events have to do with geographical variations, which business-level strategies dominated at various times, whether broad or focused strategies worked better, decisions relating to marketing choices, and what apparent functional or operational competencies were necessary for success. Shifts in industry leadership are also important considerations. It may be useful to create an industry timeline – using a monthly, quarterly, or annual timeframe to organize such critical events.

Analyze business-level strategy (BLS). Next, identify the company's BLS – is it differentiation or low-cost leader, broad or focused or integrated? Given its relative competitive position, how well has the company invested its resources? Has the company used different BLS in its various regions? For example, it may offer a low-cost product in one region and differentiated products in others. Be sure to give a full account of a company's BLS to show how it competes.

Once completed, this first step will provide a broad picture of how the company is operating and puts you in a position to evaluate the profit potential of its strategy. Thus, you can make conclusions about the past or make recommendations concerning future

actions. However, first consider the company's strategic context, or the environment within which the company is competing to achieve its strategy.

Break-Even Point (BEP) Analysis

A break-even point is that volume of sales in which the contribution from each unit sold covers the firm's fixed costs and its incremental variable costs. To calculate the BEP, first calculate contribution margin, CM = P – VC, where contribution margin is the unit price less a single unit variable cost. Then, BEP = FC / CM, where breakeven point is the firm's fixed cost divided by the contribution margin per unit.

From Investopedia:[1]

An analysis to determine the point at which revenue received equals the costs associated with receiving the revenue. Break-even analysis calculates what is known as a margin of safety, the amount that revenues exceed the break-even point. This is the amount that revenues can fall while still staying above the break-even point.

Step 2. External Environment

- PESTEL Analysis
- Porter's Five Forces
- Stages of Lifecycle
- SW**OT** Analysis (emphasis added)

Analyze the external environment. This includes the *competitor* (i.e., competitive groups), *industry* (supplier, buyer, substitute, new entrant, rivalry), and *general* (physical, sociocultural, global, technological, political/legal, demographic, economic) *environment*. To identify environmental opportunities and threats that exist, consider all the concepts of competitive groups, industry, and macro-environments. Of particular importance at the industry level are Porter's Five Forces model and the Stages of Lifecycle model (birth, growth, maturity, revitalization, death). Importantly, when conducting a Porter's Five

1. Investopedia, Break-Even Analysis, accessed November 2018.

Forces analysis, be sure to identify the attractiveness of the industry as determined by the overall ability of an existing firm in the industry to make a profit.

The first part of the SWOT (Strengths and Weaknesses) analysis will provide the information on the company's functional competencies. It requires to investigate all aspects of the firm's operations including supply chain, marketing, research and development, and finance to further to gain a picture of where the company is going. For example, successfully pursuing a low-cost leader or a differentiation strategy requires very different sets of competencies. What are their competencies? Has the company demonstrated evidence of developing the right ones? If it has, how can it exploit them further? Can it pursue both a low-cost leader and a differentiation strategy simultaneously?

A SWOT analysis is especially important at this point in the industry analysis, particularly if Porter's model has revealed threats to the company from the environment. How can the company deal with these threats? How should it change its BLS to counter them?

Example 8.1 SWOT Analysis

No company is too big or too small to conduct a SWOT analysis! Take for example, Starbucks Coffee Company and their SWOT analysis. Among their strengths is a strong brand image that includes Ethos Water, Seattle's Best Coffee, and Teavana. Conversely, their product can be imitated and the company must constantly battle its price points to remain competitive. Through its SWOT analyses Starbucks can leverage its strengths and opportunities by analyzing its weaknesses and threats.

Source: Panmore Institute, Starbucks Coffee Company SWOT Analysis & Recommendations, Charissa Roberts, 2019Wi

Not sure what an industry analysis should look like? See your school library's copy of S&P's NetAdvantage Industry Reports. Alternatively, see the Sample Client Report (below).

Step 3. Internal Capabilities

- VRIO Analysis
- P-O-L-C
- Balanced Scorecard

- Governance Mechanisms
- Organization Structure Characteristics
- Value Chain Analysis
- **SW**OT Analysis (emphasis added)

Value Chain and SWOT Analysis. As you consider the second part of your SWOT (Opportunities and Threats) analysis you are considering the company's internal strengths and weaknesses relative to environmental threats and opportunities. Use the incidents you charted for the industry in a timeline to develop an account of the company's strengths and weaknesses as they emerged over time. Examine each of the value creation functions (i.e., value chain) of the company and identify the activities in which the company is currently strong and weak. For example, a company might be weak in marketing and strong in research and development. Whenever possible, use data to support your observations. Make lists of these strengths and weaknesses. To get ideas about what you might consider in this analysis, see the Business Writing Style Guide for a SWOT checklist.

Consider what your findings mean – balance strengths and weaknesses against opportunities and threats. Is the company in an overall strong competitive position? Can the firm continue to pursue its current BLS profitably? What can the company do to turn weaknesses into strengths and threats into opportunities? Can it develop new functional, business, or corporate strategies to accomplish this change? Never merely generate the SWOT analysis and then put it aside. Because it provides a succinct summary of the company's condition, a good SWOT analysis can serve as a launching point for all analyses that follow.

Analyze structure and control systems. What structure and control systems are the company using to implement its strategy and to evaluate whether that structure is the appropriate one? How effectively does the management team operate? Are employees being appropriately rewarded and recognized for their efforts? Are the right rewards in place for encouraging cooperation among divisions without generating unhealthy internal competition? Does the client use a balanced scorecard approach to assess their performance to key financial and strategic (customer, business process, and people) controls?

If you have access to the executives who ran this company, what can you learn about their decision making culture and the degree of organization around making decisions? Gear the analysis toward its most salient issues. For example, organizational conflict, power, and politics will be important issues for some companies. Try to analyze why problems in these areas are occurring. Do they occur because of bad strategy formulation

or bad strategy implementation? As part of your analysis, suggest an action plan that the company could use to achieve its goals. For example, you might create a list of logical steps they need to follow in order to alter their BLS from a focused to a broad one.

Step 4. Identify Key Problems and Opportunities

- Price – Cost = Profit
- SWOT Analysis
- Organization Controls
- Type 1, 2, 3 Rivalry
- Strategy Diamond
- Action Checklist: Understanding and Managing Competition Over Time

Identifying the focus of the report is critical at this point. You should already have a good understanding of the opportunities and threats that exist in the external environment and be well aware of the strengths and weaknesses of the firm's capabilities. Now you need to summarize and prioritize all of what you know. Decide among these options, which are most salient? Regardless of their success, no firm has unlimited resources nor do they operate without opportunity for improvement; they can't do everything and there is always something that can improve. Limit the focus of your analysis to those things that will make a difference; prioritize your findings so that your most important one is first.

The models identified in the bulleted list above for this step should help you organize and prioritize your efforts for the next step.

Step 5. Make Actionable Recommendations

- Rules of Analysis

The quality of your recommendations is a direct result of the thoroughness with which you prepared the analysis. Recommendations are directed at solving whatever strategic problems the company is facing and increasing its future profitability. Your recommendations should be in line with your analysis; that is, they should follow logically from the observations and data you provide in the report. Making your recommendations

actionable means that you provide specific, measurable, and detailed instructions that are likely to produce positive results for the client.

Actionable recommendations convey credibility because they are specific, measurable, and contain enough detail to facilitate implementation. Provided they are in line with your analysis, there should be a clear line-of-sight between cause and corrective action. Your recommendations should direct the action of your reader in such a way they know precisely what is required, when it is needed, for how long, and who will be held accountable.

A set of recommendations will be specific to each subject of analysis. Such recommendations might include an increase in spending on specific research and development projects or the divesting of a region. Make sure your recommendations are mutually consistent and written in an actionable format – who does what by when? Ask yourself, will my client be able to implement these proposed recommendations or will they just scratch their heads – how and how much? Make your proposal as complete as possible given the time and information constraints. Your plan of action might contain a prioritized timetable that sequences the actions in chronological order and flows from the business to the functional level.

For additional information, see Actionable Recommendations in the Business Writing Style Guide.

Rules of Analysis. To check your final list of recommendations, consider the following five rules of analysis. Given, these five questions may have more relevance in an academic setting, they can still be useful in an application setting as well.

1. **Understand the Question** – Go back to the original assignment and connect the question(s), or what you were asked to produce, with the course subject. If you were given an assignment while studying Chapter 5, is there a model in Chapter 5 that, if applied, would yield a logical result? In a business setting, this question would translate into checking your client's request to be sure you are understanding what they are paying you to do.
2. **Essential Vocabulary** – In academia, courses introduce students to specialized vocabulary. Often, as is the case here, the course textbook includes a listing of essential vocabulary and their meaning. Use terminology and concepts emphasized by the course or its instructor accurately and appropriately to demonstrate mastery. Similarly, in a business environment, pay attention to the language your client uses so that you sound better informed about their specific environment and circumstance.
3. **Use Evidence** – Usually if you have done your job well, the recommendations you

make to your client will be critical of what they did and could be potentially confrontive. By using the specific evidence you uncovered or created in your analysis, you can be both critical and palatable at the same time. Using data to support your conclusions and your recommendations will favorably impress your professor (in academia) and will be more acceptable to your client or boss (in business).

4. **Be Complete** – An executive summary is the first section of a business report, typically one or two paragraphs but rarely more than one page. It is not background or an introduction; it provides a quick overview of what is contained in the report. Sometimes, the executive summary is the only thing a busy executive (or professor) reads. On the occasions they dive deeper, however, they'll be looking for your calculations and reference citations. Know and report your assumptions.
5. **Be Precise** – Just like Mark Twain famously said, "It usually takes me more than three weeks to prepare an impromptu speech", you will need time and editing to be precise. Neither your university professor nor your future boss will be impressed if what you write wanders around without getting to the point. Answer the research question fully but omit everything that is unnecessary. Once you think you are done, reread what you wrote and ask yourself "Did I answer the question?"

Sample Client Report

Business relies heavily on effective analysis and reporting. Although there is no such thing as a business report template – the format of the report always depends on the nature of the organization and the context in which it operates – the underlying principles for what makes a good business report translates nicely from business school to the business world. Because of this, I have provided a Sample Client Report from an archived assignment with extensive comments in Google Docs. This sample demonstrates the following and was representative of a "B-" project. Use this sample to understand what good critical thinking (analysis) and writing (reporting) looks like.

- There are a lot of comments in the margin. You may need to click on the highlighted text to see the actual comment. You may also need to click on the "Show more" link to see all of the specific comment.
- The report generally follows the framework laid out in the "Report Outline" of the assignment instructions. All required elements are addressed in the appropriate sequence. While you will rarely have a boss that will specify what sections to write about, doing so makes evaluation easier for the Instructor.
- While the report makes periodic use of passive voice, is overly wordy in places, and underdeveloped in others, it is generally well written with only minor grammar mistakes that do not significantly impair the reader's ability to understand what is written.
- The author fully grasps the syntax for writing "actionable" recommendations, but the report does not provide sufficient supporting analysis to document "why" the client should heed her advice.
- The Executive summary is written better than the introduction. It appears more effort was put into the former than the latter. The paper misses opportunities to use graphs or charts to illustrate observations in the introduction that would otherwise make the report much more persuasive.
- Analysis is underdeveloped. Little reference is made to the textbook or lectures. No models are cited from the student's business education. The space devoted to analysis is reflective of a cursory look at the data to generate recommendations rather than a deep dive. I favor narrow-and-deep analysis over broad-and-shallow when I evaluate a client report.

Index to Tools and Models Used in the Textbook

Use this index to quickly navigate within the textbook to the tool that will work best for your situation. Each heading is linked to the top of its respective chapter.

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- Unrelated Diversification
- Vertical Integration

Business Writing Style Guide

Initially, Unit 8 of this textbook including a couple of sections about writing for business. Eventually, that material grew sufficiently that I and a co-author, Julie Zwart, published the Business Writing Style Guide (BWSG). This new document remains an important element of preparing a report for Strategic Management.

Publication History

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- Said, Edward W. *Culture and Imperialism.* Knopf, 1994.

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Examples

- Davidson, Donald, *Essays on Actions and Events*. Oxford: Clarendon, 2001. https://bibliotecamathom.files.wordpress.com/2012/10/essays-on-actions-and-events.pdf.
- Kerouac, Jack. *The Dharma Bums.* New York: Viking Press, 1958.

Versioning

This page provides a record of changes made to this guide. Each set of edits is acknowledged with a 0.01 increase in the version number. The exported files for this toolkit reflect the most recent version.

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Version	Date	Change Made	Location in text
0.1	**MM/DD/YYYY**		
0.11	**08/07/2020**	**Links to external sources updated**	**All**