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BHARATHIDASAN UNIVERSITY

TIRUCHIRAPPALLI - 620 024.

CENTRE FOR DISTANCE EDUCATION



**M
B
A**

STRATEGIC MANAGEMENT
CORE PAPER
III SEMESTER (FULL PACKAGE)

Code Number : MBA

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STRATEGIC MANAGEMENT

(Full Package)

STRATEGIC MANAGEMENT

Unit - I

Corporate Strategic planning - Mission - Vision of the firm - Development, maintenance & the role of leader - Hierarchical levels of planning - Strategic planning process. Merits and limitations of Corporate Strategic Planning, Strategic management in Practice.

Unit - II

ENVIRONMENT ANALYSIS & INTERNAL ANALYSIS OF FIRM:

General environment scanning, competitive environment analysis - to identify opportunities & threat - Assessing internal environment through functional approach and value chain - identifying critical success factors - to identify the strength & weakness - SWOT audit - swot matrix - implications core competencies - Portfolio analysis - Stakeholder's expectations, Scenario-planning.

Unit - III

STRATEGY FORMULATION:

Generic strategies - Grand strategies - Strategies of leading Indian companies - The role of diversification - limits - means and forms. Strategic management at Corporate level, at Business level and at Functional level with special reference to companies operating in India.

Unit - IV

CONCEPTS AND TOOLS OF STRATEGY EVALUATION:

Competitive cost dynamics - experience curve - BCG approach - cashflow implication - I.A. - B.S. matrix A.D. Little's Life-cycle approach to strategic planning - Assessment of economic contribution of strategy - Cost of equity capital - M/B model with stationary growth - Assessing market value of a Business - Profitability matrix - divestiture decision - cash flows and selection of proper discount rates.

Unit - V

STRATEGY IMPLEMENTATION & CONTROL:

Various approaches to implementation of strategy - Commander approach - Org. - change approach, collaborative approach, Cultural approach, creative approach - Matching organization structure with strategy - 76 model - Strategic control process - Du Pont's control model and other Quantitative and Qualitative tools - steps - M. Porter's approach for Globalisation - Future of Strategic Management.

REFERENCE BOOKS:

1. Strategic Management - Pearce & Robinson. All Indian Travellers N.D. 1988.



MANAGEMENT (IN A NUTSHELL)

Organizational Mission:

a description of an organization's domain, in terms of its product(s), target market(s), differentiating feature(s)

External Assessment- "What might we do?"

(industrial-organizational economics)

- identification of basic industry facts
- general environment trend analysis
- analysis of Porter's "five forces of competition"
- strategic group mapping
- competitive intelligence
- "key success factors"

Internal Assessment-"What can we do?"

(resource-based view of the firm)

- value chain analysis; in-depth assessment of resources, functional skills, organizational capabilities
- "distinctive competence" - valuable? rare? difficult to imitate? organizationally accessible?

SWOT analysis

strengths and weaknesses of the organization; opportunities and threats in the environment

Strategic options

"What do we want to do?"

"What should we do?"

Generic Strategies

Corporate Level:

- single business
- dominant business
- vertical integration
- related diversification
- unrelated diversification

Business Level:

- cost leadership
- differentiation
- focus (niche); with either low-cost or differentiation approach
- integrated low-cost/differentiation

Tactics

Strategy Implementation:

organizational structure, processes, behaviors, leadership, resource allocation, functional skill development, "cross-cutting" organizational capabilities

Sustainable Competitive Advantage and Above-Average Profits through External Strategic Fit and Internal Strategic Fit

INTRODUCTION TO STRATEGIC MANAGEMENT

This chapter provides an overview of the Strategic Management Process. Each of the stages in the process are explained in detail in subsequent chapters.

Defining Strategic Management

Strategic management can be defined as the art and science of formulating, implementing, and evaluating cross-functional decisions that enable an organization to achieve its objectives. As this definition implies, strategic management focuses on integrating management, marketing, finance/accounting, production/operations, research and development, and computer information systems to achieve organizational success. The term strategic management in this text is used synonymously with the term strategic planning. The latter term is more often used in the business world, whereas the former is often used in academia. Sometimes the term strategic management is used to refer to strategy formulation, implementation, and evaluation, with strategic planning referring only to strategy formulation. The purpose of strategic management is to exploit and create new and different opportunities for tomorrow; long-range planning, in contrast, tries to optimize for tomorrow the trends of today.

The term strategic planning originated in the 1950s and was very popular between the mid-1960s to mid-1970s. During these years, strategic planning was widely believed to be the answer for all problems. At the time, much of corporate world was "obsessed" with strategic planning. Following that "boom" however, strategic planning was cast aside during the 1980s as various planning models did not yield higher returns. The 1990s however brought the revival of strategic planning, and the process is widely practiced today in the business world.

The term strategic management is used at many colleges and universities as the subtitle for the capstone course in business administration, Business Policy, which integrates material from all business courses.

Stages of Strategic Management (or) Strategic Management Process

The strategic management process consists of three stages: strategy formulation, strategy implementation, and strategy evaluation. Strategy formulation includes developing a vision and mission, identifying an organization's external opportunities and threats, determining internal strengths and weaknesses, establishing long-term objectives, generating alternative strategies, and choosing particular strategies to pursue. Strategy-formulation issues include deciding what new businesses to enter, what businesses to abandon, how to allocate resources, whether to expand operations or diversify, whether to enter international markets, whether to merge or form a joint venture, and how to avoid a hostile takeover.

Because no organization has unlimited resources, strategists must decide which alternative strategies will benefit the firm most. Strategy formulation decisions commit an organization to specific products, markets, resources, and technologies over an extended period of time. Strategies determine long-term competitive advantages. For better or worse, strategic decisions have major multifunctional consequences and enduring effects on an organization. Top managers have the best perspective to understand fully the ramifications of formulation decisions; they have the authority to commit the resources necessary for implementation.

Strategy implementation requires a firm to establish annual objectives, devise policies, motivate employees, and allocate resources so that formulated strategies can be executed; strategy implementation includes developing a strategy-supportive culture, creating an effective organizational structure, redirecting marketing efforts, preparing budgets, developing and utilizing information systems, and linking employee compensation to organizational performance.

Strategy implementation often is called the action stage of strategic management. Implementing strategy means mobilizing employees and managers to put formulated strategies into action. Often considered to be the most difficult stage in strategic management, strategy implementation requires personal discipline, commitment, and sacrifice. Successful strategy implementation hinges upon managers' ability to motivate employees, which is more an art than a science. Strategies formulated but not implemented serve no useful purpose.

Interpersonal skills are especially critical for successful strategy implementation. Strategy-implementation activities affect all employees and managers in an organization. Every division and department must decide on answers to questions such as "What must we do to implement our part of the organization's strategy?" and "How best can we get the job done?" The challenge of implementation is to stimulate managers and employees throughout an organization to work with pride and enthusiasm toward achieving stated objectives.

Strategy evaluation is the final stage in strategic management. Managers desperately need to know when particular strategies are not working well; strategy evaluation is the primary means for obtaining this information. All strategies are subject to future modification because external and internal factors are constantly changing. Three fundamental strategy-evaluation activities are (1) reviewing external and internal factors that are the bases for current strategies, (2) measuring performance, and (3) taking corrective actions. Strategy evaluation is needed because success today is no guarantee of success tomorrow! Success always creates new and different problems; complacent organizations experience demise.

Strategy formulation, implementation, and evaluation activities occur at three hierarchical levels in a large organization: corporate, divisional or strategic business unit, and functional. By fostering communication and interaction among managers and employees across hierarchical levels, strategic management helps a firm function as a competitive team. Most small businesses and some large businesses do not have divisions or strategic business units; they have only the corporate and functional levels. Nevertheless, managers and employees at these two levels should be actively involved in strategic-management activities.

Peter Drucker says the prime task of strategic management is thinking through the overall mission of a business:

"... that is, of asking the question, 'What is our Business?' This leads to the setting of objectives, the development of strategies, and the making of today's decisions for tomorrow's results. This clearly must be done by a part of the organization that can see the entire business; that can balance objectives and the needs of today against the needs of tomorrow; and that can allocate resources of men and money to key results."

Integrating Intuition and Analysis

The strategic-management process can be described as an objective, logical, systematic approach for making major decisions in an organization. It attempts to organize qualitative and quantitative information in a way that allows effective decisions to be made under conditions of uncertainty. Yet, strategic management is not a pure science that lends itself to a nice, neat, one-two-three approach.

Based on past experiences, judgment, and feelings, intuition is essential to making good strategic decisions. Intuition is particularly useful for making decisions in situations of great uncertainty or little precedent. It is also helpful when highly interrelated variables exist, or when it is necessary to choose from several plausible alternatives. Some managers and owners of businesses profess to have extraordinary abilities for using intuition alone in devising brilliant strategies. For example, Will Durant, who organized General Motors Corporation, was described by Alfred Sloan as "a man who would proceed on a course of action guided solely, as far as I could tell, by some intuitive flash of brilliance. He never felt obliged to make an engineering hunt for the facts. Yet at times, he was astoundingly correct in his judgment."³ Albert Einstein acknowledged the importance of intuition when he said, "I believe in intuition and inspiration. At times I feel certain that I am right while not knowing the reason. Imagination is more important than knowledge, because knowledge is limited, whereas imagination embraces the entire world."

Although some organizations today may survive and prosper because they have intuitive geniuses managing them, most are not so fortunate. Most organizations can benefit from strategic management, which is based upon integrating intuition and analysis in decision making. Choosing an intuitive or analytic approach to decision making is not an either-or proposition. Managers at all levels in an organization inject their intuition and judgment into strategic-management analyses. Analytical thinking and intuitive thinking complement each other.

Operating from the I've-already-made-up-my-mind-don't-bother-me-with-the-facts mode is not management by intuition; it is management by ignorance. Drucker says, "I believe in intuition only if you discipline it. 'Hunch' artists, who make a diagnosis but don't check it out with the facts, are the ones in medicine who kill people, and in management kill businesses." As Henderson notes:

"The accelerating rate of change today is producing a business world in which customary managerial habits in organizations are increasingly inadequate. Experience alone was an adequate guide when changes could be made in small increments. But intuitive and experience-based management philosophies are grossly inadequate when decisions are strategic and have major, irreversible consequences."

In a sense, the strategic-management process is an attempt to duplicate what goes on in the mind of a brilliant, intuitive person who knows the business and hinge it with analysis.

Adapting to Change

The strategic management process is based on the belief that organizations should continually monitor internal and external events and trends so that timely changes can be made as needed. The rate and magnitude of changes that affect organizations are increasing dramatically. Consider, for example, e-commerce, laser medicine, laser weapons, the aging population, and merger mania. To survive, all organizations must be capable of astutely identifying and adapting to change. The strategic-management process is aimed at allowing organizations to adapt effectively to change over the long run.

In today's business environment, more than any preceding era, the only constant is change. Successful organizations effectively manage change, continuously adapting their bureaucracies, strategies, systems, products, and cultures to survive the shocks and prosper from the forces that decimate the competition.

Information technology and globalization are external changes that are transforming business and society today. On a political map, the boundaries between countries may be clear, but on a competitive map showing the real flow of financial and industrial activity, the boundaries have largely disappeared. Speedy flow of information has eaten away at national boundaries so that people worldwide readily see for themselves how other people live. People are traveling abroad more; ten million Japanese travel abroad annually. People are emigrating more; Germans to England and Mexicans to the United States are examples. We are becoming a borderless world with global citizens, global competitors, global customers, global suppliers, and global distributors!

The need to adapt to change leads organizations to key strategic-management questions, such as, What kind of business should we become? Are we in the right fields? Should we reshape our business? What new competitors are entering our industry? What strategies should we pursue? How are our customers changing? Are new technologies being developed that could put us out of business?

Key Terms in Strategic Management

Before we further discuss strategic management, we should define eight key terms: strategists, mission statements, external opportunities and threats, internal strengths and weaknesses, long-term objectives, strategies, annual objectives, and policies.

Strategists

Strategists are individuals who are most responsible for the success or failure of an organization. Strategists have various job titles, such as chief executive officer, president, owner, chair of the board, executive director, chancellor, dean, or entrepreneur. Regarding entrepreneurs, there are now 9.1 million businesses owned by women. This represents 38 percent of all firms in the United States. More than thirty million people nationwide are employed at female-owned firms.

Strategists help an organization gather, analyze, and organize information. They track industry and competitive trends, develop forecasting models and scenario analyses, evaluate corporate and divisional performance, spot emerging market opportunities, identify business threats, and develop creative action plans. Strategic planners usually serve in a support or staff role. Usually found in higher levels of management, they typically have considerable authority for decision making in the firm. The CEO is the most visible and critical strategic manager. Any manager who has responsibility for a unit or division, responsibility for profit and loss outcomes, or direct authority over a major piece of the business is a strategic manager (strategist).

Strategists differ as much as organizations themselves and these differences must be considered in the formulation, implementation, and evaluation of strategies. Some strategists will not consider some types of strategies because of their personal philosophies. Strategists differ in their attitudes, values, ethics, willingness to take risks, concern for social responsibility, concern for profitability, concern for short-run versus long-run aims, and management style. The founder of Hershey Foods, Milton Hershey, built the company to manage an orphanage. From corporate profits, Hershey Foods today cares for over one thousand boys and girls in its School for Orphans.

Some strategists agree with Ralph Nader, who proclaims that organizations have tremendous social obligations. Others agree with Milton Friedman, an economist, who maintains that organizations have no obligation to do any more for society than is legally required. Most strategists agree that the first social responsibility of any business must be to make enough profit to cover the costs of the future, because if this is not achieved, no other social responsibility can be met. Strategists should examine social problems in terms of potential costs and benefits to the firm, and address social issues that could benefit the firm most.

Vision and Mission Statements

Many organizations today develop a "vision statement" which answers the question, What do we want to become? Developing a vision statement is often considered the first step in strategic planning, preceding even development of a mission statement. Many vision statements are a single sentence. For example the vision statement of Stokes Eye Clinic in Florence, South Carolina, is "Our vision is to take care of your vision." The vision of the Institute of Management Accountants is "Global leadership in education, certification, and practice of management accounting and financial management."

Mission

Mission is the description of an organization's reasons for existence, its fundamental purpose. It is the guiding principle that drives the processes of goal and action plan formulation, "a pervasive, although general, expression of the philosophical objectives of the enterprise." Mission should focus on "long-range economic potentials, attitudes toward customers, product and service quality, employee relations, and attitudes toward owners." It provides identity, continuity of purpose, and overall definition, and should convey the following categories of information:

1. Precisely why the organization exists, its purpose, in terms of (a) its basic product or service, (b) its primary markets, and (c) its major production technology.
2. The moral and ethical principles that will shape the philosophy and character of the organization.
3. The ethical climate within the organization.

Thus mission outlines the firm's identity and provides a guide for shaping strategies at all organizational levels. The role played by mission in guiding the organization is an important one. Specifically it

1. serves as a basis for consolidation around the organization's purpose.
2. provides impetus to and guidelines for resource allocation.
3. defines the internal atmosphere of the organization, its climate.
4. serves as a set of guidelines for the assignment of job responsibilities.
5. facilitates the design of key variables for a control system.

Deal and Kennedy claim that a strong culture is the key to long-term corporate success and that culture has five elements: business environment, values, heroes (people who personify values), rites and rituals (routines of day-to-day corporate life), and the cultural network (communication systems). The mission statement describes primarily the second of these cultural factors, corporate values. The strong cultural companies studied by Deal and Kennedy all had "a rich and complex system of values that were shared by the employees."

The mission statement must be believable in that the company's behavior should correspond to it over both the short and long term. In this way it can serve as the foundation for the development of respect for and pride in the firm by management, employees, owners, customers, suppliers, and others who interact with it.

Broad-based acceptance of the values represented by mission can lead to three characteristics of firms that accomplish this acceptance:

1. They stand for something--the way in which business is to be conducted is widely understood.
2. From the topmost levels of management down through the firm's organization structure to the lowest level of production jobs, the values are accepted by all employees.
3. "Employees feel special because of a sense of identity which distinguishes the firm from other firms."

Many examples of firms that have these characteristics as a result of a finely honed sense of cooperation and value acceptance are presented by Deal and Kennedy. A few of these are listed here, along with the slogans that have come to represent their value systems.

- Dupont: "Better things for better living through chemistry--a belief that product innovation, arising out of chemical engineering..."
- * Sears, Roebuck: "Quality at a good price--the mass merchandiser from Middle America."
- * Dana Corporation: "Productivity Through people-- enlisting the ideas and commitment of employees at every level in support of Dana's strategy of competing largely on cost and dependability rather than product differentiation..."
- * Chubb Insurance Company: "Underwriting excellence--an overriding commitment to excellence in a critical function."
- * Price Waterhouse and Company: "Strive for technical perfection" (in accounting).

Mission typically is not considered a part of a firm's strategy set. It reflects the essential preferences of owners and managers for what the firm will do. Strategy will accomplish the task of reducing mission to operational terms. As such mission is somewhat a personal choice of a firm's dominant group of actors and is an *input* to the strategy formulation process.

Mission statements are "enduring statements of purpose that distinguish one business from other similar firms. A mission statement identifies the scope of a firm's operations in product and market terms." It addresses the basic question that faces all strategists: What is our business? A clear mission statement describes the values and priorities of an organization. Developing a mission statement compels strategists to think about the nature and scope of present operations and to assess the potential attractiveness of future markets and activities. A mission statement broadly charts the future direction of an organization. An example mission statement is provided below for Microsoft.

Microsoft's mission is to create software for the personal computer that empowers and enriches people in the workplace, at school and at home. Microsoft's early vision of a computer on every desk and in every home is coupled today with a strong commitment to Internet-related technologies that expand the power and reach of the PC and its users. As the world's leading software provider, Microsoft strives to produce innovative products that meet our customers' evolving needs. At the same time, we understand that long-term success is about more than just making great products. Find out what we mean when we talk about Living Our Values.

External Opportunities and Threats

External opportunities and external threats refer to economic, social, cultural, demographic, environmental, political, legal, governmental, technological, and competitive trends and events that could significantly benefit or harm an organization in the future. Opportunities and threats are largely beyond the control of a single organization, thus the term external. The computer revolution, biotechnology, population shifts, changing work values and attitudes, space exploration, recyclable packages, and increased competition from foreign companies are examples of opportunities or threats for companies. These types of changes are creating a different type of consumer and consequently a need for different types of products, services, and strategies. Many companies in many industries face the severe external threat of online sales capturing increasing market share in their industry.

Other opportunities and threats may include the passage of a law, the introduction of a new product by a competitor, a national catastrophe, or the declining value of the dollar. A competitor's strength could be a threat. Unrest in the Balkans, rising interest rates, or the war against drugs could represent an opportunity or a threat.

A basic tenet of strategic management is that firms need to formulate strategies to take advantage of external opportunities and to avoid or reduce the impact of external threats. For this reason, identifying, monitoring, and evaluating external opportunities and threats is essential for success. This process of conducting research and gathering and assimilating external information is sometimes called environmental scanning or industry analysis. Lobbying is one activity that some organizations utilize to influence external opportunities and threats.

Internal Strengths and Weaknesses

Internal strengths and internal weaknesses are an organization's controllable activities that are performed especially well or poorly. They arise in the management, marketing, finance/accounting, production/operations, research and development, and computer information systems activities of a business. Identifying and evaluating organizational strengths and weaknesses in the functional areas of a business is an essential strategic-management activity. Organizations strive to pursue strategies that capitalize on internal strengths and improve on internal weaknesses.

Strengths and weaknesses are determined relative to competitors. Relative deficiency or superiority is important information. Also, strengths and weaknesses can be determined by elements of being rather than performance. For example, a strength may involve ownership of natural resources or an historic reputation for quality. Strengths and weaknesses may be determined relative to a firm's own objectives. For example, high levels of inventory turnover may not be a strength to a firm that seeks never to stock-out.

Internal factors can be determined in a number of ways that include computing ratios, measuring performance, and comparing to past periods and industry averages. Various types of surveys also can be developed and administered to examine internal factors such as employee morale, production efficiency, advertising effectiveness, and customer loyalty.

Long-Term Objectives

Objectives can be defined as specific results that an organization seeks to achieve in pursuing its basic mission. Long-term means more than one year. Objectives are essential for organizational success because they state direction; aid in evaluation; create synergy; reveal priorities; focus coordination; and provide a basis for effective planning, organizing, motivating, and controlling activities. Objectives should be challenging, measurable, consistent, reasonable, and clear. In a

multidimensional firm, objectives should be established for the overall company and for each division. Minnesota Power's long-term objectives are to achieve a 13 percent return on equity (ROE) in their core electric utility, 14 percent ROE on water resource operations, and 15 percent ROE on support businesses. Minnesota Power also strives to stay in the top 25 percent of electric utilities in the United States in terms of common stock's market-to-book ratio and to maintain an annual growth in earnings per share of 5 percent.

Strategies

Strategies are the means by which long-term objectives will be achieved. Business strategies may include geographic expansion, diversification, acquisition, product development, market penetration, retrenchment, divestiture, liquidation, and joint venture. Strategies currently being pursued by Barnes & Noble, Starbucks, and Royal Numico are described below:

Barnes & Noble

Barnes & Noble, the large bookseller, hesitated with an online strategy, while upstart Amazon.com captured huge market share in online bookselling. Despite huge capital expenditures and massive advertising in recent years, Barnes & Noble still remains barely more than one-tenth Amazon's size online. Barnes & Noble initially did not want to "cannibalize" its own core franchise. The lesson for other businesses may be that the Internet does not tolerate caution and hesitation. Many brick-and-mortar companies today "hesitate" with an online strategy because of perceived "cannibalism" with existing walk-in sales. Caution could spell disaster.

Starbucks

Headquartered in Seattle, Starbucks, the gourmet coffee company, is diversifying into noncoffee areas such as ice cream, candy, tea, specialty food, and even kitchen and home products. Starbucks is also expanding internationally by adding four hundred new stores in 1999 to its base of twenty-three hundred stores. The company has started selling products in supermarkets, as well as its own retail outlets, and this is causing discontent among some store managers. Starbucks has more than twenty-six thousand employees and annual sales of about \$1.5 billion. Company profitability and stock performance are faltering.

Royal Numico

This large Dutch nutritional-products manufacturer recently acquired General Nutrition Companies (GNC), the leading American retailer and maker of vitamins and other supplements. Numico paid \$1.7 billion for GNC creating the world's largest human nutrition company with annual sales over \$3 billion. GNC has 4,203 retail stores and will now offer more patented products and more scientific data on products it sells. Numico now has more than 27,000 employees worldwide and much better control over distribution of its products.

Strategies are potential actions that require top management decisions and large amounts of the firm's resources. In addition, strategies affect an organization's long-term prosperity, typically for at least five years, and thus are future-oriented. Strategies have multifunctional or multidivisional consequences and require consideration of both external and internal factors facing the firm.

Annual Objectives

Annual objectives are short-term milestones that organizations must achieve to reach long-term objectives. Like long-term objectives, annual objectives should be measurable, quantitative, challenging, realistic, consistent, and prioritized. They should be established at the corporate, divisional, and functional levels in a large organization. Annual objectives should be stated in terms of management, marketing, finance/accounting, production/operations, research and development, and information systems accomplishments. A set of annual objectives is needed for each long-term objective. Annual objectives are especially important in strategy implementation, whereas long-term objectives are particularly important in strategy formulation. Annual objectives represent the basis for allocating resources.

Campbell Soup Corporation has an annual objective to achieve 20 percent growth in earnings, a 20 percent ROE (Return on Equity), and a 20 percent return on invested cash. The company calls this ERC, for earnings, returns, and cash.

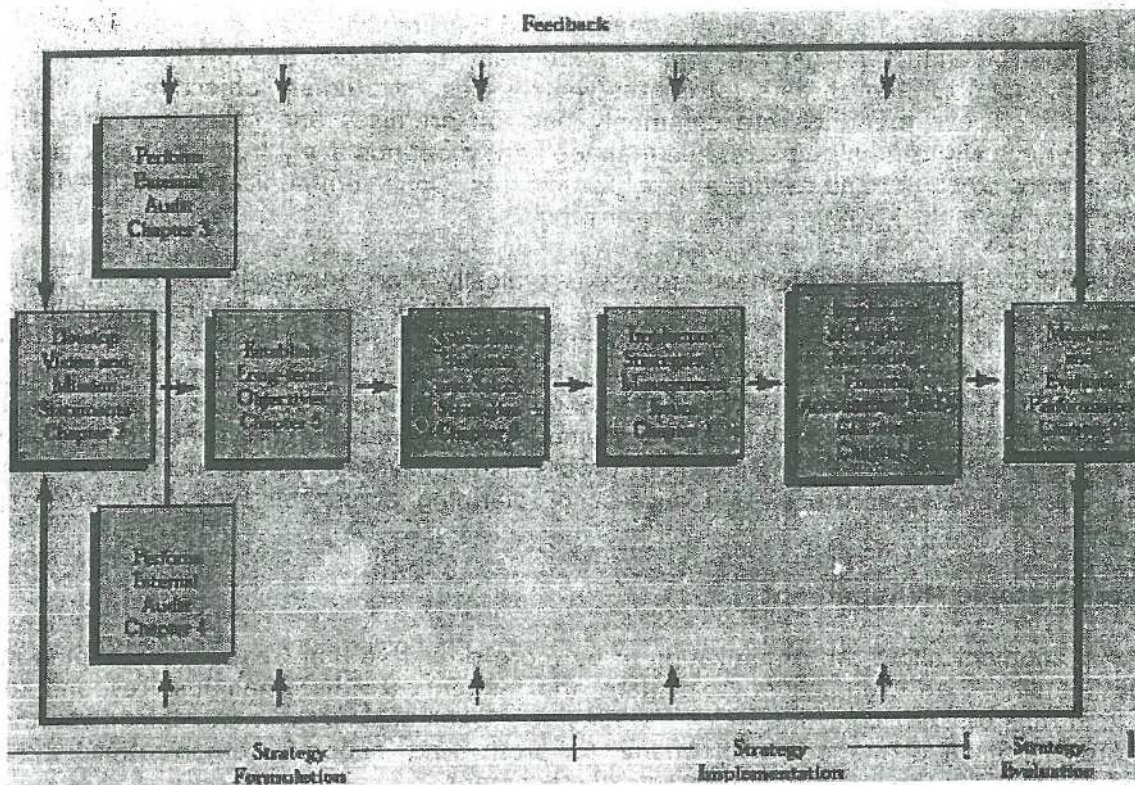
Policies

Policies are the means by which annual objectives will be achieved. Policies include guidelines, rules, and procedures established to support efforts to achieve stated objectives. Policies are guides to decision making and address repetitive or recurring situations.

Policies are most often stated in terms of management, marketing, finance/ accounting, production/operations, research and development, and computer information systems activities. Policies can be established at the corporate level and apply to an entire organization, at the divisional level and apply to a single division, or at the functional level and apply to particular operational activities or departments. Policies, like annual objectives, are especially important in strategy implementation because they outline an organization's expectations of its employees and managers. Policies allow consistency and coordination within and between organizational departments.

The strategic-management process best can be studied and applied using a model. Every model represents some kind of process. The framework illustrated in Figure 1-1 is a widely accepted, comprehensive model of the strategic-management process. This model does not guarantee success, but it does represent a clear and practical approach for formulating, implementing, and evaluating strategies. Relationships among major components of the strategic-management process are shown in the model, which appears in all subsequent chapters with appropriate areas shaped to show the particular focus of each chapter.

Figure 1-1 A Comprehensive Strategic-Management Model



Source: Fred R. David, "How Companies Define Their Mission," Long Range Planning 22, no. 3 (June 1988).

Identifying an organization's existing vision, mission, objectives, and strategies is the logical starting point for strategic management because a firm's present situation and condition may preclude certain strategies and may even dictate a particular course of action. Every organization has a vision, mission, objectives, and strategy, even if these elements are not consciously designed, written, or communicated. The answer to where an organization is going can be determined largely by where the organization has been!

The strategic-management process is dynamic and continuous. A change in any one of the major components in the model can necessitate a change in any or all of the other components. For instance, a shift in the economy could represent a major opportunity and require a change in long-term objectives and strategies; a failure to accomplish annual objectives could require a change in policy; or a major competitor's change in strategy could require a change in the firm's mission. Therefore, strategy formulation, implementation, and evaluation activities should be performed on a continual basis, not just at the end of the year or semiannually. The strategic-management process never really ends.

The strategic-management process is not as cleanly divided and neatly performed in practice as the strategic-management model suggests. Strategists do not go through the process in lockstep fashion. Generally, there is give-and-take among hierarchical levels of an organization. Many organizations conduct formal meetings semiannually to discuss and update the firm's vision, mission, opportunities/threats, strengths/weaknesses, strategies, objectives, policies, and performance. These meetings are commonly held off-premises and called retreats. The rationale for periodically conducting strategic-management meetings away from the work site is to encourage more creativity and candor among participants. Good communication and feedback are needed throughout the strategic-management process.

Application of the strategic-management process is typically more formal in larger and well-established organizations. Formality refers to the extent that participants, responsibilities, authority, duties, and approach are specified. Smaller businesses tend to be less formal. Firms that compete in complex, rapidly changing environments such as technology companies tend to be more formal in strategic planning. Firms that have many divisions, products, markets, and technologies also tend to be more formal in applying strategic-management concepts. Greater formality in applying the strategic-management process is usually positively associated with the cost, comprehensiveness, accuracy, and success of planning across all types and sizes of organizations.

Benefits of Strategic Management

Strategic management allows an organization to be more proactive than reactive in shaping its own future; it allows an organization to initiate and influence (rather than just respond to) activities, and thus to exert control over its own destiny. Small business owners, chief executive officers, presidents, and managers of many for-profit and nonprofit organizations have recognized and realized the benefits of strategic management.

Historically, the principal benefit of strategic management has been to help organizations formulate better strategies through the use of a more systematic, logical, and rational approach to strategic choice. This certainly continues to be a major benefit of strategic management, but research studies now indicate that the process, rather than the decision or document, is the more important contribution of strategic management.¹⁵ Communication is a key to successful strategic management. Through involvement in the process, managers and employees become committed to supporting the organization. Dialogue and participation are essential ingredients. The chief executive officer of Rockwell International explains, "We believe that fundamental to effective strategic management is fully informed employees at all organizational levels. We expect every business segment to inform every employee about the business objectives, the direction of the business, the progress towards achieving objectives, and our customers, competitors and product plans."

The manner in which strategic management is carried out is thus exceptionally important. A major aim of the process is to achieve understanding and commitment from all managers and employees. Understanding may be the most important benefit of strategic management, followed by commitment. When managers and employees understand what the organization is doing and why, they often feel a part of the firm and become committed to assisting it. This is especially true when employees also understand linkages between their own compensation and organizational performance. Managers and employees become surprisingly creative and innovative when they understand and support the firm's mission, objectives, and strategies. A great benefit of strategic management, then, is the opportunity that the process provides to empower individuals. Empowerment is the act of strengthening employees' sense of effectiveness by encouraging and rewarding them to participate in decision making and exercise initiative and imagination.

More and more organizations are decentralizing the strategic-management process, recognizing that planning must involve lower-level managers and employees. The notion of centralized staff planning is being replaced in organizations by decentralized line-manager planning. The process is a learning, helping, educating, and supporting activity, not merely a paper-shuffling activity among top executives. Strategic-management dialogue is more important than a nicely bound strategic-management document.¹⁶ The worst thing strategists can do is develop strategic plans themselves and then present them to operating managers to execute. Through involvement in the process, line managers become "owners" of the strategy. Ownership of strategies by the people who have to execute them is a key to success!

Although making good strategic decisions is the major responsibility of an organization's owner or chief executive officer, managers and employees both must also be involved in strategy formulation, implementation, and evaluation activities. Participation is a key to gaining commitment for needed changes.

An increasing number of corporations and institutions are using strategic management to make effective decisions. But strategic management is not a guarantee for success; it can be dysfunctional if conducted haphazardly.

Financial Benefits

Research indicates that organizations using strategic-management concepts are more profitable and successful than those that do not. Businesses using strategic-management concepts show significant improvement in sales, profitability, and productivity compared to firms without systematic planning activities. High-performing firms tend to do systematic planning to prepare for future fluctuations in their external and internal environments. Firms with planning systems more closely resembling strategic-management theory generally exhibit superior long-term financial performance relative to their industry.

High-performing firms seem to make more informed decisions with good anticipation of both short- and long-term consequences. On the other hand, firms that perform poorly often engage in activities that are shortsighted and do not reflect good forecasting of future conditions. Strategists of low-performing organizations are often preoccupied with solving internal problems and meeting paperwork deadlines. They typically underestimate their competitors' strengths and overestimate their own firm's strengths. They often attribute weak performance to uncontrollable factors such as poor economy, technological change, or foreign competition.

Dun & Bradstreet reports that more than 100,000 businesses in the United States fail annually. Business failures include bankruptcies, foreclosures, liquidations, and court-mandated receiverships. Although many factors besides a lack of effective strategic management can lead to business failure, the planning concepts and tools described in this text can yield substantial financial benefits for any organization.

Non-financial Benefits

Besides helping firms avoid financial demise, strategic management offers other tangible benefits, such as an enhanced awareness of external threats, an improved understanding of competitors' strategies, increased employee productivity, reduced resistance to change, and a clearer understanding of performance-reward relationships. Strategic management enhances the problem-prevention capabilities of organizations because it promotes interaction among managers at all divisional and functional levels. Interaction can enable firms to turn on their managers and employees by nurturing them, sharing organizational objectives with them, empowering them to help improve the product or service, and recognizing their contributions.

In addition to empowering managers and employees, strategic management often brings order and discipline to an otherwise floundering firm. It can be the beginning of an efficient and effective managerial system. Strategic management may renew confidence in the current business strategy or point to the need for corrective actions. The strategic-management process provides a basis for identifying and rationalizing the need for change to all managers and employees of a firm; it helps them view change as an opportunity rather than a threat.

Greenley stated that strategic management offers the following **benefits**:

1. It allows for identification, prioritization, and exploitation of opportunities.
2. It provides an objective view of management problems.
3. It represents a framework for improved coordination and control of activities.
4. It minimizes the effects of adverse conditions and changes.
5. It allows major decisions to better support established objectives.
6. It allows more effective allocation of time and resources to identified opportunities.
7. It allows fewer resources and less time to be devoted to correcting erroneous or adhoc decisions.
8. It creates a framework for internal communication among personnel.
9. It helps integrate the behavior of individuals into a total effort.
10. It provides a basis for clarifying individual responsibilities.
11. It encourages forward thinking.
12. It provides a cooperative, integrated, and enthusiastic approach to tackling problems and opportunities.
13. It encourages a favorable attitude toward change.
14. It gives a degree of discipline and formality to the management of a business.

Why Some Firms Do No Strategic Planning

Some firms do not engage in strategic planning and some firms do strategic planning but receive no support from managers and employees. Some reasons for poor or no strategic planning are as follows:

1. *Poor Reward Structures*—When an organization assumes success, it often fails to reward success. Where failure occurs, then the firm may punish. In this situation, it is better for an individual to do nothing (and not draw attention) than risk trying to achieve something, fail, and be punished.
2. *Fire-fighting*—An organization can be so deeply embroiled in crisis management and fire-fighting that it does not have time to plan.
3. *Waste of Time*—Some firms see planning as a waste of time since no marketable product is produced. Time spent on planning is an investment.
4. *Too Expensive*—Some organizations are culturally opposed to spending resources.
5. *Laziness*—People may not want to put forth the effort needed to formulate a plan.
6. *Content with Success*—Particularly if a firm is successful, individuals may feel there is no need to plan because things are fine as they stand. But success today does not guarantee success tomorrow.
7. *Fear of Failure*—By not taking action, there is little risk of failure unless a problem is urgent and pressing. Whenever something worthwhile is attempted, there is some risk of failure.
8. *Overconfidence*—As individuals amass experience, they may rely less on formalized planning. Rarely, however, is this appropriate. Being overconfident or overestimating experience can bring demise. Forethought is rarely wasted and is often the mark of professionalism.

9. *Prior Bad Experience*—People may have had a previous bad experience with planning, where plans have been long, cumbersome, impractical, or inflexible. Planning, like anything, can be done badly.
10. *Self-Interest*—When someone has achieved status, privilege, or self-esteem through effectively using an old system, they often see a new plan as a threat.
11. *Fear of the Unknown*—People may be uncertain of their abilities to learn new skills, their aptitude with new systems, or their ability to take on new roles.
12. *Honest Difference of Opinion*—People may sincerely believe the plan is wrong. They may view the situation from a different viewpoint, or may have aspirations for themselves or the organization that are different from the plan. Different people in different jobs have different perceptions of a situation.
13. *Suspicion*—Employees may not trust management.

Pitfalls in Strategic Planning

Strategic planning is an involved, intricate, and complex process that takes an organization into uncharted territory. It does not provide a ready-to-use prescription for success; instead, it takes the organization through a journey and offers a framework for addressing questions and solving problems. Being aware of potential pitfalls and prepared to address them is essential to success.

Some pitfalls to watch for and avoid in strategic planning are provided below:

1. Using strategic planning to gain control over decisions and resources
2. Doing strategic planning only to satisfy accreditation or regulatory requirements
3. Too hastily moving from mission development to strategy formulation
4. Failing to communicate the plan to employees, who continue working in the dark
5. Top managers making many intuitive decisions that conflict with the formal plan
6. Top managers not actively supporting the strategic-planning process
7. Failing to use plans as a standard for measuring performance
8. Delegating planning to a "planner" rather than involving all managers
9. Failing to involve key employees in all phases of planning
10. Failing to create a collaborative climate supportive of change
11. Viewing planning to be unnecessary or unimportant
12. Becoming so engrossed in current problems that insufficient or no planning is done
13. Being so formal in planning that flexibility and creativity are stifled

Problems with Strategic Planning

While most authors agree that a well-formulated strategy provides direction, helps focus efforts, and provides consistency to employees, and hence gives the organization advantages, another school of thought contends that a *deliberate absence* of strategy may promote creativity and flexibility in an organization (see for example, Inkpen and Choudhury 1995:313-323). Tightly controlled organizations with high reliance on formalized procedures and a passion for consistency may lose the ability to innovate and may hence become less successful. One example of the deliberate absence of strategy is the company Nucor, which has no written strategic plan, no written objectives, and no mission statement. Their absence is symbolic of the nonbureaucratic, flexible, learning organization Nucor has worked hard to become. So, at one end of the spectrum, some people believe strategy itself is deleterious to an organization's success. But focusing on strategy does not necessarily have to prevent creativity and flexibility. Hamel (2000) claims that developing an innovative strategic competency is the critical factor for ensuring future organizational success.

Although criticism has been directed at almost all theories or models of strategy development, most criticism has focused on the formalized, strategic planning processes that Mintzberg et al. classify as the "planning school" approach. These criticisms can be summarized as follows:

1. *Products of planning often are not used.* For example, a 1997 survey of 50 companies found that over 20 had developed a SWOT analysis, yet "no one subsequently used the outputs within the later stages of the strategy process".
2. *Planning processes can dominate the staff.* Methodologies can become very elaborate and time consuming, with too much emphasis on analysis and too little on true strategic insights.
3. *The implementers are often excluded from the process.* New organizations are sometimes created just to conduct the planning, often cutting executives out of the strategy development process.
4. *Planning processes often fail to develop true strategic choices.* Planners sometimes adopt the first strategy that meets certain basic conditions in an acceptable manner. They make no real effort to search for or analyze an array of strategy alternatives before making a decision.
5. *Forecasts are invariably wrong.* Strategic planning requires stability during, and predictability following, strategy making. However, disruptions and discontinuities are a fact of life. Planning cannot do much other than extrapolate the present trends and hope for the best.
6. *"Hard" data used in strategic planning lack the richness needed to make strategic decisions.* The strategic planning "system" is supposed to be detached and objective and relies on detailed "facts" about the organization and its context. But hard information is often limited in scope and fails to encompass important non-economic and non-quantitative factors. It can be too aggregated for effective use, often arrives too late to be of use, and is sometimes unreliable and subject to biases.
7. *Innovation cannot be institutionalized.* Strategic planning is not always viewed as an aid to strategic thinking or strategy making (as perhaps it should be), but as a replacement for intuition and creative thinking. The thinking of genius entrepreneurs is hard to replicate in a formalized, institutionalized process. Strategy making is "a complex process involving the most sophisticated, subtle, and at times subconscious of human cognitive and social processes".
8. *Strategic planning is not strategy making.* Mintzberg contends, "Planning, rather than providing new strategies, could not proceed without their prior existence. Strategic planning has been misnamed. It should have been called strategic programming."

Despite the pitfalls and constraints of detailed and routinized strategic planning, most academicians, industry analysts, and corporate executives believe that organizational strategy is important. The thing to keep in mind is that strategy cannot be reduced to strategic planning processes, especially at the upper levels of the organization. Strategic planning is better used to ensure strategic alignment and coordination across levels and groups, than to develop innovative strategy directions.

Guidelines for Effective Strategic Management

Failing to follow certain guidelines in conducting strategic management can foster criticisms of the process and create problems for the organization. An integral part of strategy evaluation must be to evaluate the quality of the strategic-management process. Issues such as "Is strategic management in our firm a people process or paper process?" should be addressed.

Even the most technically perfect strategic plan will serve little purpose if it is not implemented. Many organizations tend to spend an inordinate amount of time, money, and effort on developing the strategic plan, treating the means and circumstances under which it will be implemented as afterthoughts! Change comes through implementation and evaluation, not through the plan. A technically imperfect plan that is implemented well will achieve more than the perfect plan that never gets off the paper on which it is typed.

Strategic management must not become a self-perpetuating bureaucratic mechanism. Rather, it must be a self-reflective learning process that familiarizes managers and employees in the organization with key strategic issues and feasible alternatives for resolving those issues. Strategic management must not become ritualistic, stilted, orchestrated, or too formal, predictable, and rigid. Words supported by numbers, rather than numbers supported by words, should represent the medium for explaining strategic issues and organizational responses. A key role of strategists is to facilitate continuous organizational learning and change.

Successful companies know how to keep things moving. If they share a habit pattern, it's the habit of habit breaking. Sometimes they seem to like change for its own sake. IBM's chief executive John Akers says, "IBM never reorganizes except for a good business reason, but if they haven't reorganized in a while, that's a good business reason." Successful companies are deliberate bureaucracy-busters. They delight in smashing pettifogging encumbrances that Harry Quadracci calls "playing office." R.T. Lenz offered some important guidelines for effective strategic management:

Keep the strategic-management process as simple and nonroutine as possible. Eliminate jargon and arcane planning language. Remember, strategic management is a process for fostering learning and action, not merely a formal system for control. To avoid routinized behavior, vary assignments, team membership, meeting formats, and the planning calendar. The process should not be totally predictable, and settings must be changed to stimulate creativity. Emphasize word-oriented plans with numbers as back-up material. If managers cannot express their strategy in a paragraph or so, they either do not have one or do not understand it. Stimulate thinking and action that challenge the assumptions underlying current corporate strategy. Welcome bad news. If strategy is not working, managers desperately need to know it. Further, no pertinent information should be classified as inadmissible merely because it cannot be quantified. Build a corporate culture in which the role of strategic management and its essential purposes are understood. Do not permit "technicians" to co-opt the process. It is ultimately a process for learning and action. Speak of it in these terms. Attend to psychological, social, and political dimensions, as well as the information infrastructure and administrative procedures supporting it.

An important guideline for effective strategic management is open-mindedness. A willingness and eagerness to consider new information, new viewpoints, new ideas, and new possibilities is essential; all organizational members must share a spirit of inquiry and learning. Strategists such as chief executive officers, presidents, owners of small businesses, and heads of government agencies must commit themselves to listen to and understand managers' positions well enough to be able to restate those positions to the managers' satisfaction. In addition, managers and employees throughout the firm should be able to describe the strategists' positions to the satisfaction of the strategists. This degree of discipline will promote understanding and learning.

No organization has unlimited resources. No firm can take on an unlimited amount of debt or issue an unlimited amount of stock to raise capital. Therefore, no organization can pursue all the strategies that potentially could benefit the firm. Strategic decisions thus always have to be made to eliminate some courses of action and to allocate organizational resources among

others. Most organizations can afford to pursue only a few corporate-level strategies at any given time. It is a critical mistake for managers to pursue too many strategies at the same time, thereby spreading the firm's resources so thin that all strategies are jeopardized. Joseph Charyk, CEO of The Communication Satellite Corporation (Comsat), said, "We have to face the cold fact that Comsat may not be able to do all it wants. We must make hard choices on which ventures to keep and which to fold."

Strategic decisions require trade-offs such as long-range versus short-range considerations or maximizing profits versus increasing shareholders' wealth. There are ethics issues too. Strategy trade-offs require subjective judgments and preferences. In many cases, a lack of objectivity in formulating strategy results in a loss of competitive posture and profitability. Most organizations today recognize that strategic-management concepts and techniques can enhance the effectiveness of decisions. Subjective factors such as attitudes toward risk, concern for social responsibility, and organizational culture will always affect strategy-formulation decisions, but organizations need to be as objective as possible in considering qualitative factors.

EVOLUTION OF STRATEGIC MANAGEMENT

Strategic management is a way of running an organization that recognizes the complexity of its environment and seeks to establish competitive advantage at all levels. It is a process by which the manager can transform environmental factors, along with various internal, personal, and political considerations, into decisions that result in strategies (goals and plans of action for reaching them) to help guide the organization into the future in a dominant competitive position.

Over the past few decades, the nature of strategic management as a management technique has changed in two important ways with the changing environment. It has increased both in its level of detail and in its importance as the complexity of the environment has increased. Between World War II and the early 1960s, *business policy*, following the so-called prestrategy paradigm, addressed the problem of coordinating the operations of the various functional departments of the firm. Policies were established by top management to integrate activities that each department was to carry out. Thus policy served to standardize and specify behavior within functional departments. Strategy was usually viewed as an implicit concept reserved for the topmost managers. In the top manager's mind, this concept, environmental characteristics, certain organizational goals, and political circumstances, along with years of management experience, all came together to produce what was hoped would be the right collection of policies. Strategy was seldom analyzed, once it was decided on by top management, and rarely changed. When operations did not meet expectations, it was policy that typically was analyzed and modified. Most firms were single-line businesses; business policy making was conducted in large part at what is known today as the business level.

The rapid rise during the 1950s and early 1960s in the number of interest groups making demands on organizations of all kinds, along with the proliferation of mergers and acquisitions, began to strain the applicability of the relatively simple business-policy approach to management. Divisionalized firms no longer had a single line of business. Thus a different set of policies was needed for each subsidiary and managers sought a common thread that might bind them together. The internal complexity of firms had increased in an attempt to deal with the complexity of a pluralistic society. Davis and Blomstrom describe social pluralism as a society "in which diverse groups maintain autonomous participation and influence in the social system."³ Business is merely one such influence (interest group) and competes with many other groups for time, money, interest, allegiance, or attention. Increasingly organizations that were operated without an understanding of, or respect for, the various interest-group influences have been subjected to successful attacks by these groups. Electric utilities were forced by many interest

groups to cease or radically change the nature of nuclear power plant construction projects. Through the pressure of consumer groups, automobile manufacturers have been made to correct deficiencies in their products. Industrial polluters were required by environmental groups to clean up or stop harmful discharges. Product labeling requirements were tightened, Equal Employment Opportunity assurances became stricter and product safety standards were improved. These changes, and hundreds of others, were brought about largely by the political actions of interest groups. Their activities often resulted in enactment of legislation that today regulates the conduct of business.

In response to this growth in the dimensions of firms' environments, and also to the growth in the number of Divisionalized firms, strategy increasingly became interpreted as the link between an organization and its environment. All of the "policy" problems remained, but they were compounded by a baffling set of external claims, and also by the needs imposed by multiple product lines and business-level activities.

Because of its inability to deal with these factors, the business-policy model underwent several evolutionary changes and emerged as what was later called strategic planning. Dubbed the *initial strategy paradigm*, this view of corporate management focused heavily on the process of strategy formulation with emphasis on environmental pressures, yet it had four major shortcomings. First, it did not clearly differentiate between corporate-level strategy (questions related to the collection of business activities a divisionalized company owned) and business level strategy (how to compete within a particular business activity).

Second, the initial strategy paradigm was unclear about the nature of relationships between strategy and the operation of the various functional areas of business. How does the task of marketing management, for example, change with different strategic focuses⁷ and how can the functional areas be integrated into an effective whole? Such questions largely went unanswered.

Third, this paradigm was incomplete in its discussion of the role of general management. Some authors contended that strategic planning was the province of only top managers, whereas others claimed that all managers should be involved in strategic planning.

Finally, there was disagreement about whether strategy included both goals and action plans, or just action plans.

The *strategic management* paradigm, although still in its infancy, is the third step in the evolution of thought about strategy, and it addresses the shortcomings of strategic planning. As initially codified by Schendel and Hofer, strategic management is far from representing a consensus. Yet there is a perceptible movement toward consolidation around many of its principles. In particular, there is now a widely accepted distinction between corporate-level, business-level, and functional-level strategy. A fourth strategy level, enterprise strategy, has been proposed by Ansoff,⁸ but the concept has not endured (enterprise strategy was defined as describing the interaction of a firm with its environment--it is now felt by many that this interaction is best incorporated in each of the other strategy levels and not reserved only for a separate category of strategy.) In some ways related to Ansoff's concept of enterprise strategy, a more global strategic orientation is described by Magaziner and Reich; they call it international strategy. Here too, during the early 1990s the idea of isolating global issues and direction in a separate strategy level has given way to the practice of incorporating international competitive matters into all levels of strategic decision making.

The strategic management paradigm not only distinguishes among different levels of strategy but is sufficiently adaptable to accommodate the need for this expanded scope of strategic thinking.

Next, strategic management addresses the issue of functional integration by identifying various functional strategies. At the same time, responsibility for strategic thinking is viewed within this paradigm as the responsibility of all managers, not just top-level executives. Although there is much work to be done in learning how best to integrate functional strategy with other strategy levels, the strategic management paradigm lays the groundwork for the conduct of such research.

Finally, by separating the steps of goal formulation and strategy (action plan) formulation, this paradigm is more objective, more teachable, and less mysterious than earlier interpretations. It may help to continue the increase in popularity of strategy-focused management and thus expand the competitiveness of U.S. business in the international marketplace.

Levels of Strategy

There is wide diversity in the strategic management literature of labels attached to the different levels of strategy that may exist in a firm. For example, Thompson and Strickland propose four levels: corporate strategy, business strategy, functional area support strategy, and operating-level strategy. They go on to say, "Each layer [is]...progressively more detailed to provide strategic guidance of the next level of subordinate managers."

Lorange defines three levels for a typical divisionalized corporation: Portfolio strategy (corporate level), business strategy (division level), and strategic programs (functional level). He defines the focus of each as follows:

Portfolio strategy: Developing the desired risk/return balance among the businesses of the firm.

Business strategy: Source of competitive advantage of a particular business relative to its competition.

Strategic programs: Bringing to bear functional managers' specialized skills on the development of programs.

He notes that smaller firms may involve only the last two of these, but in any firm there rarely would be more than three. Hofer, et al list four levels of strategy for business organizations. First, strategy at the societal level is concerned with the definition of a firm's role in society. It would specify the nature of corporate governance, political involvement of the firm, and trade-offs sought between economic and social objectives. The second strategy level is corporate strategy which addresses (1) the nature of the firm's business and (2) management of the set of businesses necessary to achieve its goals. Third, business strategy addresses how the firm should be positioned and managed so as to compete in a given business or industry. Finally, functional area strategy is the lowest level of corporate strategy. It is concerned with their respective functional area environments.

Newman and Logan present two levels--business strategy and functional policy--for nondiversified firms, and a total of three (with the addition of corporate strategy) for diversified firms.

Higgins identifies four levels of strategy: societal response strategy (enterprise strategy), mission determination strategy (corporate level), primary mission strategy (business level), and mission supportive strategy (functional level). He defines their contents as follows:

Societal response strategy: how the firm relates to its societal constituents.

Mission determination strategy: the organization's field of endeavor.

Primary mission strategy: how the organization will achieve its primary mission.

Mission supportive strategies: how primary mission strategy will be supported.

Another model proposes five levels of strategy but the levels are not tied to organizational structure. Gluck suggest that the levels of planning activity consist of corporate, sector, shared

resource unit (SRU), natural business unit (NBU), and product market unit (PMU). The advantages of this system are (1) it separates the strategic management process from organization structure to a large degree and (2) pushes it farther down the organization than traditional systems do. These characteristics stem from focusing planning level selection on strategic issues or problems shared by the organization's activities rather than on the organization levels of its business activities.

Corporate level planning is that which involves identifying trends and formulating strategy in global, technical, and market arenas, responsibility for which rests with corporate headquarters in most cases. Sector level planning, where sectors represent national and technological boundaries, may involve several SBU's, product categories, or even product/service-based divisions of an organization. Shared resource unit planning calls for the development of strategies for activities of the business that are shared by SBU's or the various product-market focuses which the company might have.

Natural business units are largely self-contained businesses with control over the key factors that govern their success in the marketplace--their market position and cost structure. Finally, product-market unit planning is the lowest level at which planning takes place and those activities that directly relate the company's output to its markets.

There are many other interpretations of the levels of strategy. They differ primarily in terms of the organizational levels to which they apply. Those discussed above and most of the others have a number of commonalities. First, the uppermost levels in each scheme tend to concern the problem of fitting the organization to its environment; lower levels address the problem of integrating functional areas in ways consistent with upper-level strategy. Second, the topmost level tends to involve structuring the set of acquisitions of divisionalized firms and is usually called corporate-level strategy. Third, they contain a business or strategic business unit (SBU) level of strategy that applies almost equally to a firm comprised of only one line of business and to the individual subsidiaries of multi-business corporations.

Finally, the various schemes include a functional level of strategy that represents the ways in which functional departments are expected to respond to business-level and, in turn, corporate-level goals and action plans.

During the mid-1980s some authors began to include the fourth level: enterprise or societal goals and action plans. Societal strategy was intended to capture the essential ways in which the firm was expected to respond to goals related to the major social issues confronting it.

Interpreted fundamentally, then, there are four primary levels of strategy: societal-level, corporate-level, business-level, and functional-level. The concerns of societal-, corporate-, and business-level strategy are clearly cross-functional. That is, they contain implications for each of a firm's functional areas (although more distantly removed in the case of societal- and corporate-level strategy), whatever they may be and regardless of the type of firm. By contrast, functional area strategies are more operationally focused than the others. The process of determining how each functional area should be managed is a more specialized problem, defined largely by the practice and theory applicable to each functional (or operational) area. That is, the content of marketing strategy is the subject of marketing texts and courses, finance strategy can be found in finance texts and courses, personal strategy in personal texts and courses, and so on.

Societal Strategy

Societal strategy consists of goals and action plans of which the overall purpose is to guide the ways in which management intends the organization to respond to the major social demands placed on it. It is an explicit definition of the organization's social responsibilities: how it is expected to react to the demands of particular groups of external constituents. The recent emergence of this level deserves further explanation.

The idea of isolating social responsibility in a separate (from corporate, business, and functional) strategy level was introduced in 1979 by Ansoff and modified by Schendel and Hofer.

The original concept of product/market strategy appears as only one component of a much broader concept. We might call it *enterprise strategy*, which is needed to integrate and relate the new dimensions of the strategic problems.

The development of societal legitimacy (or enterprise) strategy is Ansoff's proposed solution to the increasing importance of socio-political variables in the life of the firm. Included in these variables are "new consumer attitudes, new dimensions of social control and, above all, a questioning of the firm's role in society." In other words, Ansoff suggests concentrating managers' attempts to deal with new liberal views about the social role of business, growing egalitarianism, and the proliferation of constrictive regulation, among other social demands, in a societal legitimacy strategy that specializes in matters of social responsibility. Actually Ansoff's proposal for enterprise strategy goes beyond social responsibility issues to include other substrategy areas. Schendel and Hofer limit its contents to social-legitimacy concerns because of their belief that the other strategy areas are effectively addressed within prevailing definitions of corporate-business-and functional-level strategies.

Enterprise strategy attempts to integrate the firm with its broader non-controllable environment, not in terms of product/market matches in a narrower economic sense, but in the sense of the overall role that business, as one of society's important institutions, should play in the everyday affairs of society. More explicit attention will have to be given to (societal legitimacy strategy) in the future, just as Ansoff suggests, just as it has been necessary to separate corporate and business strategy considerations from the problems of functional area interpretation, over the past two decades.

However, some strategists may prefer not to institute this new strategy level, for reasons explained by Dill: "There has been less turbulence in the environment for companies which have spent time over the years listening to and assessing what various internal and external constituencies have to say about the powers they are and are not willing to delegate to corporations and corporate management."

Stated differently, some managers may prefer to address *all* social legitimacy issues within the rubric of existing strategy levels. For them social responsibility concerns would be addressed within the fabric of goals and action plans at the corporate, business, and functional levels.

Our conclusion about the usefulness of enterprise strategy is that it should be employed by organizations that have particularly sensitive relationships with the environment. Firms such as utility companies, toy manufacturers, and educational institutions, for which an especially sharply focused public scrutiny has devolved, would be well suited for development of separate social-legitimacy goals and action plans. For others, whose society interaction is less controversial, matters of social responsibility might be handled more efficiently, and even effectively, within goals and action plans at the corporate, business, and functional levels alone.

However, the advisability of their formulation for a given firm as a distinct activity is intended to be a matter of judgment depending upon whether or not sufficiently poignant social issues either confront the firm at present, or are expected to do so in the future.

Corporate-Level Strategy

A corporation's portfolio of business units (SBUs) can vary in its desirability just as a financial manager's portfolio of investments can. The acceptability of a particular *business portfolio* is determined by assessing whether it reflects mission and expected strengths, weaknesses, threats, and opportunities (determined through environmental, industry, and internal analyses

of each business unit) as well as values and political exigencies. Additions to and deletions from the present portfolio would then be expressed in merger and/or divestment strategy. Finally, these strategies would be implemented by the appropriate organizational units and the machinery would thus be activated to adjust the present portfolio.

The content of corporate-level strategy is a set of action plans and corresponding corporate-level goals expressed in terms of the firm's collection of subsidiaries. By comparison, business strategy focuses on expected operational results of a business unit. However, it also consists of action plans that relate to goals (at the business level).

The substance of corporate-level goals and action plans can be summarized as follows:

Corporate-level goals: the desired portfolio of business units by the end of the firm's planning period.

Corporate-level action plans: how to get from the present portfolio to that targeted in (1) in terms of business unit strategies to be retained.

- * additions of business units expressed as either growth strategy parameters (for "home grown" units) or merger and acquisition strategy.
- * business units to be divested.

Business-Level Strategy

The content of business-level strategy is also a combination of goals and action plans. Business-level goals should be stated in such a way that for each one, the following four components are evident:

Identifying, characteristics of each objective or target.

Each target's *substantive threshold value*; that is, the hurdle value upon reaching which the target will be considered attained (often stated as a specific value of the evaluative criteria).

Evaluative criteria to be monitored in order to measure the firm's progress toward the target.

Time frame threshold value; that is, the date by which, or the elapsed time during which, the substantive threshold value would be reached.

Business-level action specifications should be devolved so that collectively they define the following elements:

The *strategic posture* represented by the strategy

The firm's *product market scope*; that is, the nature of the products or services provided and the markets served by the firm.

Input-output transformations in which the firm is engaged; that is, the nature of the activities with which the firm adds value to its labor and material inputs and what those inputs are.

What *synergies* are sought in the operation of the firm.

Whether a strategy is being analyzed from within or outside the firm, these characteristics should be present. The outside analyst may use them as dimensions along which a firm's strategy can be described. The inside analyst or strategist may use them as guidelines for determining the comprehensiveness of strategy.

When taken together, these elements of business-level strategy should combine uniquely to (1) define the business of the SBU or firm, and (2) describe its competitive edge. Thus strategy aligns the strategic business unit or firm relative to its competitors, distinguishes it from them, and hopefully propels it beyond them.

Functional-Level Strategy

In contrast with the other levels of strategy, functional strategies serve as guidelines for the employees of each of the firms' subdivisions. Which ones of these segments or functional areas are included in a firm's functional strategy set is itself a matter of strategy. For example, whether to have an R&D department or not in the first place is a strategic decision.

Functional goals and action plans are developed for each of the functional parts of the firm to guide the behavior of people in a way that would put the other strategies into motion. If part of a firm's business-level strategy were a target of a 10 percent increase in sales to be brought about by market penetration, for example, marketing strategy might include a change in compensation policy for salespersons and a specified increase in the advertising budget. In that way marketing strategy would provide some detail about how the marketing aspects of the market penetration action plan would be implemented. Similarly, financial strategy would consist of a set of guidelines on how the financial elements of the firm would be put into effect. Personal strategy, production strategy, research and development strategy, and appropriate other functional strategy areas would do the same.

The Nature of Strategic Decisions And Strategic Thinking

Although the process of creating strategy is often discussed as if it were an unconstrained design process, keep in mind that while strategists evaluate strategy, the firm is operating. This evaluation involves assessing the extent to which present strategy is meeting expectations. It may be the case that only a small part of, say, marketing strategy would have to be changed to correct a problem. In effect, then, such a change would constitute an acceptance of corporate- and business-level strategy, and also of the firm's functional strategy set. Marketing strategy would be all that was rejected. When a firm's performance is less than satisfactory, the reason often is a functional strategy shortcoming. One might say that a "good" business-level strategy would have been poorly implemented by part of its functional strategy set. For this simple example, a change in marketing strategy could improve performance while other levels of strategy would remain unchanged.

Alternatively, a problem with the nature of a firm's or SBU's business brought about by a major environmental opportunity or threat, a change in that level's goals set, or the development of some internal capability or weakness could necessitate a business-level strategy change. The new strategy would probably include vestiges of the old along with some unfamiliar elements. In most cases a whole new functional strategy set would likely have to be designed and put into effect to implement the new business-level strategy.

More generally, one could conceivably change parts of a firm's functional strategy set without changing business-level strategy. However, rarely would one expect to encounter the case in which a change in business-level strategy did not trigger the necessity to alter functional-level strategy in some way, at least not in a successfully managed business.

There is a risk of incorrectly identifying the strategy level at which a problem exists. A tendency exists in business to change functional-level strategies or organizational structure in an attempt to remedy any problem. Of course, if the problem existed within the firm's corporate- or business-level strategy, for example, changing functional-level strategy would not correct it. In fact, this move would most likely aggravate the situation. The reason for this tendency is probably that functional strategy changes are potentially less disruptive than changes in the other levels. They certainly would affect fewer people than modifications at the corporate or business levels.

The results of trying to solve a business-level strategic problem with a functional-level solution is well illustrated by the "big four" U.S. automobile companies. With overseas competitors exporting fuel-efficient automobiles to the United States, and with widely acknowledged shrinkages of fossil fuel supplies, they still stubbornly tried to retain their old business and corporate strategies, well into the 1970s, by changing market strategy only. A set of major

environmental threats; particularly at the business level, was met by minor model changes and increased efforts to convince the car-buying public that big autos were what we all really wanted. During the 1970s and early 1980s, these companies finally began to respond to their business strategy problems with business strategy changes--major philosophical alterations in the nature of their businesses. If U.S. auto firms were to rely on small cars instead of traditional American big cars as their primary sources of growth, far-reaching changes in their functional strategy sets were also necessary. New growth rates, profit targets, market-share goals, and the like, along with related broad action plans that centered around contraction in many forms, were implemented along with new functional strategy. They included such things as cash rebates, Chrysler's government-guaranteed loan, employee layoffs, close cooperation with UAW officials, R&D efforts focused on producing smaller, less powerful engines as a primary effort rather than as an inconvenience. The U.S. auto firms' strategy changes were finally implemented during a period of chaos. However, by then they were all in the red, and the doomsayers were having a heyday.

South claims that the key to successful strategic decisions is the creation of competitive advantage--selection of competitive areas within which success is clearly achievable. The Japanese have taught us that there are really two very different forms of competition: Reciprocal and strategic. Reciprocal competition is the traditional form in which companies in mature industries compete with other firms having similar strategic positions while attempting to distinguish themselves on the basis of operations. Many colleges and universities offer similar programs, with traditional facilities and are significantly different only in terms of the geographical areas within which they operate. Strategic competition, on the other hand, involves competing primarily by establishing superior strategic position. That is, the main concern of strategists is selection of a strategically advantageous posture which affords their organization a position of strength from which to do battle. Lincoln Electric Company has successfully differentiated itself on the basis of price and quality. Their industrial welding equipment is regarded as the top quality product of its kind and the firm has consistently passed along cost savings to customers in the form of low prices. As a result, Lincoln is very difficult to compete with because of its strong price position.

Following this set of ideas, then, strategic decisions are those which involve "clear and favorable differentiation from competitors," so that one's competitive advantage is tangible, measurable, and preservable.

Defining strategic thinking is made especially difficult by the absence of a consensus on what strategic management is. On the latter point, Gluck, et al commented, "hardly anyone yet fully understands what strategic management is, knows exactly how to do it, or can clearly define its benefits." Their explanation of strategic management is that it is an approach to management which fuses strategic planning (plan development through analysis of environment, competition, and strategy choices) and the firm's system of operational decision making. This process has five dimensions. First, strategic management requires a widely understood strategic planning process tightly interwoven with a strategically centered organization structure. Second, it requires widely discussed, analyzed and negotiated goal choices from which are culled out the ones that are not adoptable. Third, strategic management relies on the shared ability to think strategically by managers throughout the company. Fourth, a performance evaluation system is necessary that focuses top level evaluators' attention on critical positive and negative strategic factors. Finally, it requires a strategy supportive motivational system and value orientation among managers. These qualities, they say, define a strategically managed organization. Four of these qualities are readily understandable. But still subject to question is what is meant by the ability to think strategically.

Strategic thinking is that which generates (1) creative, environmentally relevant ideas and (2) concepts about how to turn them into systematically managed action plans. It has the following prerequisites:

- Input information is based on facts and logical data.
- Previously unquestioned assumptions are sought out and examined.
- A burning desire for resource conservation, and
- Indirect, spontaneous, and unexpected thought processes which are hard for competitors to predict.

These requirements of strategic thinking set it apart from other kinds of decision making. First, strategic thinking requires factual and logical input data because it is competitively dangerous to base strategy formulation on erroneous information. The stakes are too high to "hoof it." Second, long-held assumptions should be identified and analyzed to make sure they still apply. This is especially true about goals which are in force, understandings about the environment and competitors, market acceptance and image, etc. Third, the manager attempting to think strategically should be committed to conservation of the organization's resources rather than expecting that a good idea will precipitate a cornucopia of funds, people, and support. It is easy to be creative while assuming that most resource requirements can be taken care of. A greater degree of creativity is required when one must conserve resources.

Finally, strategic thinking must be done without setting patterns, which competitors can identify and anticipate. The problems of predictable strategic thinking are analogous to the football coach sending in plays to his quarterback using hand signals that are understood by the opposing team's coaches.

All firms have a strategy, even if it is informal, unstructured, and sporadic. All organizations are heading somewhere, but unfortunately some organizations do not know where. The old saying "If you do not know where you are going, then any road will lead you there!" accents the need for organizations to use strategic-management concepts and techniques. The strategic-management process is becoming more widely used by small firms, large companies, nonprofit institutions, governmental organizations, and multinational conglomerates alike. The process of empowering managers and employees has almost limitless benefits.

Organizations should take a proactive rather than a reactive approach in their industry, and should strive to influence, anticipate, and initiate rather than just respond to events. The strategic-management process embodies this approach to decision making. It represents a logical, systematic, and objective approach for determining an enterprise's future direction. The stakes are generally too high for strategists to use intuition alone in choosing among alternative courses of action. Successful strategists take the time to think about their businesses, where they are with the businesses, and what they want to be as organizations, and then implement programs and policies to get from where they are to where they want to be in a reasonable period of time.

It is a known and accepted fact that people and organizations that plan ahead are much more likely to become what they want to become than those who do not plan at all. A good strategist plans and controls his or her plans, while a bad strategist never plans and then tries to control people! This textbook is devoted to providing you with the tools necessary to be a good strategist.

Success in business increasingly depends upon offering products and services that are competitive on a world basis, not just on a local basis. If the price and quality of a firm's products and services are not competitive with those available elsewhere in the world, the firm may soon face extinction. Global markets have become a reality in all but the most remote areas of the world. Certainly throughout the United States, even in small towns, firms feel the pressure of world competitors. Nearly half of all the automobiles sold in the United States, for example, are made in Japan and Germany.

STRATEGIC MANAGEMENT PROCESS

The strategy-making/strategy-implementing process consists of five interrelated managerial tasks:

1. *Forming a strategic vision of where the organization is headed-so as to provide long-term direction, delineate what kind of enterprise the company is trying to become, and infuse the organization with a sense of purposeful action.*
2. *Setting objectives--converting the strategic vision into specific performance outcomes for the company to achieve.*
3. *Crafting a strategy to achieve the desired outcomes.*
4. *Implementing and executing the chosen strategy efficiently and effectively.*
5. *Evaluating performance and initiating corrective adjustments in vision, long-term direction, objectives, strategy, or execution in light of actual experience, changing conditions, new ideas, and new opportunities.*

Together, these five components define what we mean by the term strategic management. Let's examine this five-task framework in enough detail to set the stage for the forthcoming chapters.

Developing a Strategic Vision

Very early in the strategy-making process, company managers need to pose a set of questions: "What is our vision for the company-where should the company be headed, what should its future technology-product-customer focus be, what kind of enterprise do we want to become, what industry standing do we want to achieve in five years?" Drawing a carefully reasoned conclusion about what the company's long-term direction should be pushes managers to take a hard look at the company's external and internal environment and form a clearer sense of whether and how its present business needs will change over the next five years and beyond.

Management's views and conclusions about what the organization's long-term direction should be, the technology-product-customer focus it intends to pursue, and its future business scope constitute a strategic vision for the company. A strategic vision thus reflects management's aspirations for the organization and its business, providing a panoramic view of "where we are going" and giving specifics about its future business plans. It spells out long-term business purpose and molds organizational identity. A strategic vision points an organization in a particular direction and charts a strategic path for it to follow.

The Difference between a Strategic Vision and a Mission Statement: Whereas the chief concern of a strategic vision is with "where we are going," the term mission statement, as it is commonly used, tends to deal with a company's *present* business scope-"who we are and what we do." The mission statements that most companies include in their annual reports or post on their websites almost always stress what the company's present products and services are, what types of customers it serves, and what technological and business capabilities it has. They typically say precious little about where the company is headed and its future business scope and business plans. Hence the conceptual distinction between a strategic vision and a mission statement is fairly clear-cut: A strategic vision portrays a company's future business scope ("where we are going"), whereas a company's mission statement describes its present business scope ("who we are and what we do").

If a company's mission statement not only sets forth a clear definition of "who we are and what we do" but also indicates where the company is headed and what its business will become in the years ahead, then it has combined the concepts of company mission (or mission statement) and strategic vision into a single statement describing both where it is now and where it is going. In other words, a strategic vision and a future-oriented mission statement cover essentially the same ground. In practice, however, because the big majority of company mission statements say more about "what our business is now" than "what our business will be later," the distinction between company mission and strategic vision has pragmatic relevance.

Why a Strategic Vision Is Important

While there's a role for a mission statement that speaks to what a company is doing today, a strategic vision generally has much greater direction-setting and strategy-making value. There's an ever-present managerial imperative to look beyond today and think strategically about the impact of new technologies on the horizon, how customer needs and expectations are changing, what it will take to overtake or outrun competitors, which promising market opportunities ought to be aggressively pursued, and all the other external and internal factors that drive what the company needs to be doing to prepare for the future. Managers cannot succeed as organization leaders or strategy makers without first drawing soundly reasoned conclusions about the winds of change and then making some fundamental choices about which of several strategic paths to take. *There is no escaping the need for a strategic vision.* Armed with a clear, well-conceived business course for the organization to follow, managers have a beacon to guide resource allocation and a basis for crafting a strategy to get the company where it needs to go. Companies whose managers neglect the task of thinking strategically about the company's future business path or who are indecisive in committing the company to one direction instead of another are prone to drift aimlessly and lose any claim to being an industry leader.

Examples of Strategic Visions and Company Mission Statements

MICROSOFT CORPORATION

For years, one vision drove what Microsoft did: "A computer on every desk and in every home using great software as an empowering tool." But the emergence of the Internet and non-PC devices like handheld computers and TV-set-top boxes as increasingly integral parts of everyday life prompted Microsoft in 1999 to broaden its vision to "Empower people through great software anytime, anyplace, and on any device." Bill Gates observed: "We see a world where people can use any computing device to do whatever they want to do anytime, anywhere. The PC will continue to have a central role, . . . but it will be joined by an incredibly rich variety of digital devices accessing the power of the Internet"

INTEL

"Our vision: Getting to a billion connected computers worldwide, millions of servers, and trillions of dollars of e-commerce. Intel's core mission is being the building block supplier to the Internet economy and spurring efforts to make the Internet more useful. Being connected is now at the center of people's computing experience. We are helping to expand the capabilities of the PC platform and the Internet"

OTIS ELEVATOR

"Our mission is to provide any customer a means of moving people and things up, down, and sideways over short distances with higher reliability than any similar enterprise in the world."

AVIS RENT-A-CAR

"Our business is renting cars. Our mission is total customer satisfaction."

AMERICAN RED CROSS

"The mission of the American Red Cross is to improve the quality of human life; to enhance self-reliance and concern for others; and to help people avoid, prepare for, and cope with emergencies."

3COM

"3Com's mission is to connect more people and organizations to information in more innovative, simple, and reliable ways than any other networking company in the world. Our vision of pervasive networking is of a world where connections are simpler, more powerful, more affordable, more global, and more available to all."

EASTMAN KODAK

"We are in the picture business,"

RITZ-CARLTON HOTELS

"The Ritz-Carlton Hotel is a place where the genuine care and comfort of our guests is our highest mission. We pledge to provide the finest personal service and facilities for our guests who will always enjoy a warm, relaxed yet refined ambience." "The Ritz-Carlton experience enlivens the senses, instills well-being, and fulfills even the unexpressed wishes and needs of our guests."

Setting Objectives

The purpose of setting objectives is to convert managerial statements of strategic vision and business mission into specific performance targets--results and outcomes the organization wants to achieve. Setting objectives and then measuring whether they are achieved or not help managers track an organization's progress. Managers of the best performing companies tend to set objectives that require stretch and disciplined effort. The challenge of trying to achieve bold, aggressive performance targets pushes an organization to be more inventive, to exhibit some urgency in improving both its financial performance and its business position, and to be more intentional and focused in its actions. Setting objectives that require real organizational stretch helps build a firewall against complacent coasting and low-grade improvements in organizational performance. As Mitchell Leibovitz, CEO of automotive parts retailer The Pep Boys-Manny, Moe, & Jack, puts it, "If you want to have ho-hum results, have ho-hum objectives,"

Objective setting is required of all managers. Every unit in a company needs concrete, measurable performance targets that contribute meaningfully toward achieving company objectives. When company wide objectives are broken down into specific targets for each organizational unit and lower-level managers are held accountable for achieving them, a results-oriented climate builds throughout the enterprise. There's little if any internal confusion over what to accomplish. The ideal situation is a team effort where each organizational unit strives to produce results in its area of responsibility that contribute to the achievement of the company's performance targets and strategic vision.

From a company-wide perspective, two very distinct types of performance yardsticks are required: those relating to *financial performance* and those relating to *strategic performance*. Achieving acceptable financial results is crucial. Without adequate profitability, a company's pursuit of its vision, as well as its long-term health and ultimate survival, is jeopardized. Neither shareowners nor lenders will continue to sink additional funds into an enterprise that cannot deliver satisfactory financial results. Even so, the achievement of satisfactory financial performance, by itself, is not enough. Managers must also pay attention to the company's strategic well-being--its competitiveness and overall long-term business position. Unless a

company's performance reflects improving competitive strength and a stronger long-term market position, its progress is less than inspiring and its ability to continue delivering good financial performance is suspect.

The need for both good financial performance and good strategic performance calls for management to set financial objectives and strategic objectives. Financial objectives concern the financial results and outcomes that management wants the organization to achieve. They signal commitment to such outcomes as earnings growth, an acceptable return on investment (or economic value added-EVA), dividend growth, stock price appreciation (or market value added-MVA), good cash flow, creditworthiness. In contrast, strategic objectives aim at results that reflect increased competitiveness and a stronger business position--outcomes such as winning additional market share, overtaking key competitors on product quality or customer service or product innovation, achieving lower overall costs than rivals, boosting the company's reputation with customers, winning a stronger foothold in international markets, exercising technological leadership, gaining a sustainable competitive advantage, and capturing attractive growth opportunities. Strategic objectives serve notice that management intends not only to deliver good financial performance but also to improve the organization's competitive vitality, business position, and long-range business prospects.

Both financial and strategic objectives ought to involve both near-term and longer-term performance targets. Short-range objectives focus organizational attention on the need for immediate performance improvements and outcomes. Long-range objectives serve the valuable purpose of prompting managers to consider what to do now to put the company in position to perform well over the longer term. As a rule, when tradeoffs have to be made between achieving long-run objectives and achieving short-run objectives, long-run objectives should take precedence. A company rarely prospers from repeated management actions that put better short-term performance ahead of better long-run performance.

Crafting a Strategy

A company's strategy represents management's answers to such fundamental business questions as whether to concentrate on a single business or build a diversified group of businesses, whether to cater to a broad range of customers or focus on a particular market niche, whether to develop a wide or narrow product line, whether to pursue a competitive advantage based on low cost or product superiority or unique organizational capabilities, how to respond to changing buyer preferences, how big a geographic market to try to cover, how to react to newly emerging market and competitive conditions, and how to grow the enterprise over the long term. A strategy thus reflects managerial choices among alternatives and signals organizational commitment to particular products, markets, competitive approaches, and ways of operating the enterprise.

Strategy making brings into play the critical managerial issue of *how* to achieve the targeted results in light of the organization's situation and prospects. Objectives are the "ends," and strategy is the "means" of achieving them. The hows of a company's strategy are typically a blend of (1) deliberate and purposeful actions, (2) as-needed reactions to unanticipated developments and fresh market conditions and competitive pressures, and (3) the collective learning of the organization over time--not just the insights gained from its experiences but, more important, the internal activities it has learned to perform quite well and the competitive capabilities it has developed. As illustrated, strategy is typically more than what managers carefully plot out in advance and deliberately pursue as part of a visionary strategic plan. It is normal for management's planned strategy to take on a different face as new strategy features are added and others are subtracted in response to shifting market conditions, altered customer needs and preferences, the strategic maneuvering of rival firms, the experience of what is

working and what isn't, newly emerging opportunities and threats, unforeseen events, and fresh thinking about how to improve the strategy. Future business conditions are sufficiently uncertain and unpredictable to prevent managers from planning every strategic action in advance without experiencing any learning or seeing any possibilities for improvement. Furthermore, common sense instructs that a company's actions, both planned and reactive, ought to bear close relationship to its competencies and competitive capabilities.

The strategy-making task thus involves developing an *intended strategy*, adapting it as events unfold (*adaptive/reactive strategy*); and linking the firm's business approaches, actions, and competitive initiatives closely to its competencies and capabilities. In short, a company's actual strategy is something managers shape and reshape as events transpire outside the company and as the company's competitive assets and liabilities evolve in ways that enhance or diminish its competitiveness.

What Does a Company's Strategy Consist Of?

Company strategies concern how to grow the business, how to satisfy customers, how to outcompete rivals, how to respond to changing market conditions, how to manage each functional piece of the business and develop needed organizational capabilities, how to achieve strategic and financial objectives. The how of strategy tend to be company-specific, customized to a company's own situation and performance objectives. In the business world, companies have a wide degree of strategic freedom. They can diversify broadly or narrowly, into related or unrelated industries, via acquisition, joint venture, strategic alliances, or internal start-up. Insofar as a single business is concerned, prevailing market conditions usually offer enough strategy-making latitude that close competitors can easily avoid carbon copy strategies—some pursue low-cost leadership, others stress particular differentiating attributes of their product or service, and still others concentrate on serving narrow market segments and developing unique capabilities to meet the special needs and preferences of buyers comprising these segments. Some compete only locally or regionally, others compete nationally, and still others compete globally. Because there are numerous ways for a company to conduct its business internally and position itself in the markets where it elects to compete, descriptions of the content of company strategy necessarily have to be fairly detailed in order to portray the defining characteristics of its strategy.

A company's present strategy is typically a blend of holdover approaches and fresh actions and reactions, with perhaps some about-to-be-launched moves and changes that remain under wraps and in the planning stage. Because the holdover approaches and freshly initiated actions are usually visible and have been publicly discussed by company managers or explained in press releases, outside observers can deduce many key elements of a company's strategy. Still, there's an unrevealed portion of strategy that outsiders can only speculate about—the-as-yet-unrevealed strategic actions company managers are intending to launch. Managers often, for good reason, choose not to reveal certain elements of their strategy until the company's actions become public.

What to Look For in a Company's Strategy?

- Actions to diversify the company's revenue base and enter altogether new industries or businesses
- Planned actions and initiatives to outcompete rivals
- Moves to react and respond to changing external circumstances
- Actions to strengthen the company's resource base and competitive capabilities
- Actions to alter geographic coverage
- Actions and approaches that define how the company manages R&D, production, sales and marketing, finance, and other key functions

- Actions to capitalize on new opportunities or to defend against threats to the company's well-being
- Actions to form strategic alliances and collaborative partnerships
- Actions to merge with or acquire a rival company to strengthen the company's business position

Strategy and Entrepreneurship Crafting strategy is partly an exercise in astute entrepreneurship--actively searching for opportunities to do new things or to do existing things in new ways. The faster a company's business environment is changing, the more critical it becomes for its managers to be good entrepreneurs in making both predictions and timely strategic adjustments. Imagine, for instance, the implications for companies that downplay the potential impact of e-commerce or for retailers who ignore the exploding interest of consumers in shopping on the Internet. Managers are always under the gun to pick tip on happenings in the external environment that signal either new opportunities for the enterprise or threats to its present way of doing business. For a company to be successful, its strategy and business model have to be well matched to the company's present and future environment. That won't happen unless managers exhibit first-rate entrepreneurship in steering company activities in whatever new directions are dictated by market conditions and customer preferences. This entails studying market trends, listening to customers and anticipating their changing needs and expectations, scrutinizing the business possibilities that spring from technological developments, building the firm's market position via acquisitions or new-product introductions, and pursuing ways to strengthen the firm's competitive capabilities. Good strategy making is therefore inseparable from good business entrepreneurship. One cannot exist without the other.

How fast company managers adapt to changing market conditions, how boldly they pursue new business opportunities, how much they emphasize out-innovating the competition, and how often they champion actions to improve organizational performance are good barometers of a company's entrepreneurial spirit. Entrepreneurial strategy makers are inclined to be either first-movers or rapid followers, responding quickly and opportunistically to new avenues for building the enterprise and fortifying its market position and capabilities. They are willing to take prudent risks and initiate trailblazing strategies. Today's dot-com companies are examples of entrepreneurship in action. In contrast, entrepreneurially deficient companies are risk-averse, displaying a wariness of deviating very far from the company's tried-and-true business approaches unless absolutely forced to. They either dismiss impending developments as unimportant ("we don't think it will really affect us") or move so slowly that the company is habitually late in responding and adapting to shifting conditions in the marketplace. Entrepreneurially deficient companies often minimize the disadvantages of being late-movers, pointing instead to the cost-saving benefits of avoiding whatever "mistakes" they believe first-movers have made or might make. They prefer gradual strategic change to dramatic or sweeping strategic realignment. Companies still taking a wait-and-see approach to embracing use of the Internet and e-commerce is a classic example of entrepreneurial deficiency.

Why Company Strategies Evolve Plainly, every company encounters occasions in which it needs to adapt its strategy to shifting industry and competitive conditions, newly emerging buyer preferences and requirements, the initiatives of rival firms to grab increased market share, the appearance of fresh opportunities and threats, advancing technology, and other significant events that affect its business. On occasion, quantum changes in strategy are called for--when an opening appears to shift to a radically new strategy and drive market change, when a competitor makes a revolutionary move that demands a dramatic response, when technological breakthroughs occur, or when crisis strikes and major strategy adjustments are needed very quickly. The America Online-Time Warner merger represented a quantum strategy change for both companies. Just as plainly, ways open up to fine-tune a company's strategy, first in one department or functional area and then in another.

Because the march of external and internal events make it commonplace to initiate fresh strategic moves and business approaches of one kind or another in one part of the organization or another, an organization's strategy *re-forms over time as the number of changes and adaptations begin to mount*. It is thus normal, indeed necessary, for a company's strategy to change, sometimes gradually and sometimes rapidly, sometimes reactively (when new developments dictate a response) and sometimes proactively (when attractive new opportunities are spotted or new capabilities are acquired). Consequently, *strategy making is all ongoing process, not a one-time event*. Managers are obliged to reevaluate strategy regularly, refining and recasting it as often and as much as needed to match the organization's changing external and internal circumstances.

Another important facet of strategic change is *the need for actions to improve on how the company is competing today and the need for actions to prepare for tomorrow's markets and competitive conditions*. Whether a company takes a proactive or reactive posture in preparing for future market conditions shapes the character and speed of the adjustments it makes in its strategy over time.

The Following Figure illustrates the strategic postures a company can adopt in preparing for future market conditions and coping with the waves of change in the marketplace. In most industries, there are pioneering entrepreneurial companies that seek to be proactive leaders in reshaping their strategies and there are cautious, conservatively managed companies that end up as reactive followers. Indeed, it is typical for companies to adjust their strategies and prepare for future market conditions at varying speeds and in varying ways-the path each company takes is unique.

Figure - Strategic Approaches to Preparing for Future Market Conditions

COMPANY APPROACHES			
FUTURE MARKET CONDITIONS	Reactive/Follower		Proactive/leader
	Rapid Revolutionary Change	Rushing to catch up to keep from being swamped by the waves	Aggressively altering strategy to make waves and drive changes
	Gradual Evolutionary Change	Revising strategy (hopefully in time) to catch the waves	Anticipating change and initiating strategic actions to ride the crest of the waves

Source: Adapted from Derek F. Abell, "Competing Today While Preparing for Tomorrow," *Sloan Management Review* 40, no. 3 (Spring 1999), p. 75.

However, if managers decide to change strategy so fast and so fundamentally that their business model undergoes major overhaul every year, questions have to be asked. Is rapid strategy change being legitimately driven by rapid-fire technological change, swiftly changing market conditions, volatile buyer behavior, or other hard-to-foresee developments? Or is it the product of poor entrepreneurship, faulty situation analysis, and inept strategizing? As a general rule, frequent and fundamental strategy changes cannot be made repeatedly year after year without creating a zigzag market wake, generating undue confusion among customers and employees, and posing real profitability problems. In most situations, the core elements of well-crafted strategies ought to have a life of several years, even though they may have to undergo modest revision to keep them in tune with changing circumstances.

Strategy and Strategic Plans Developing a strategic vision and mission, establishing objectives, and deciding on a strategy are basic direction-setting tasks. They map out where the organization is headed, its short-range and long-range performance targets, and the competitive moves and internal action approaches to be used in achieving the targeted business results. Together, they constitute a strategic plan for coping with industry and competitive conditions, the expected actions of the industry's key players, and the challenges and issues that stand as obstacles to the company's success. In companies committed to regular strategy reviews and the development explicit strategic plans, the strategic plan may take the form of a written document describing the industry's economics, key success factors, and drivers of change along with the company's strategic plan I'm dealing with its external and internal environment.

Some companies circulate the strategic plan to most all managers (and perhaps selected employees), although some of the planned strategic initiatives may be expressed in general terms or omitted if they are too sensitive initiatives to reveal before they are actually undertaken. In other companies, the strategic plan is not put in writing for widespread distribution but exists only in the form of oral understandings and commitments among managers about where to head, what to accomplish, and how to proceed. Organizational objectives are the part of the strategic plan most often spelled out explicitly and communicated to managers and employees. A number of companies present key elements of their strategic plans in the company's annual report to shareholders or in statements provided to the business media, while others, perhaps for reasons of competitive sensitivity, make only vague general statements about their strategic plans that could apply to most any company.

However, as we noted earlier, formal, written strategic plans seldom anticipate all the strategically relevant events that will transpire in upcoming months and years. Unforeseen events, unexpected opportunities or threats, and the constant bubbling up of new proposals encourage managers to modify planned actions and forge "unplanned" reactions. Postponing the recrafting of strategy until it's time to work on next year's strategic plan is both foolish and unnecessary. Once-a-year strategizing under "have-to" conditions is not a prescription for managerial or business success, *Strategy is something that ought to be modified whenever it is propitious to do so and certainly whenever unfolding events dictate.* In the "Internet economy," developments have been occurring so rapidly that quarterly, monthly, or even weekly reviews of strategy have become essential and common--the notion of annual strategic plans has been abandoned almost entirely. Internet companies have found it essential to revise demand forecasts, update financial projections, and adjust key elements of their strategies at least quarterly and often more frequently.

At Ingram-Micro, a contract manufacturer and distributor of PCs, "rolling forecasts" of financial projections are devised for five quarters out and then updated every 60 days. Bluefly.com, a clothing e-tailer, makes budget revisions weekly to keep up with strategy changes and react to daily sales patterns. To help speed company reactions to fast-changing market conditions, a number of companies have resorted to developing strategic plans for each of several different market and competitive scenarios, enabling them to react more swiftly as one or another of the scenarios turns out to best approximate unfolding events. *Because of the speed of change in many of today's industries, strategy life cycles are increasingly measured in months and single years, not decades or even five year intervals.*

Implementing and Executing the Strategy

The managerial task of implementing and executing the chosen strategy entails assessing what it will take to develop the needed organizational capabilities and to reach the targeted objectives on schedule. The managerial skill here is figuring out what must be done to put the strategy in

place, carry it out proficiently, and produce good results. Managing the strategy execution process is primarily a hands-on, close-to-the-scene administrative task that includes the following principal aspects:

- Building an organization capable of carrying out the strategy successfully.
- Allocating company resources so that organizational units charged with performing strategy-critical activities and implementing new strategic initiatives have sufficient people and funds to do their work successfully.
- Establishing strategy-supportive policies and operating procedures.
- Putting a freshly chosen strategy into place.
- Motivating people in ways that induce them to pursue the target objectives energetically and, if need be, modifying their duties and job behavior to better fit the strategy requirements of successful execution.
- Tying the reward structure to the achievement of targeted results.
- Creating a company culture and work climate conducive to successful strategy implementation and execution.
- Installing information, communication, and operating systems that enable company personnel to carry out their strategic roles effectively day in, day out. Instituting best practices and programs for continuous improvement.
- Exerting the internal leadership needed to drive implementation forward and to keep improving on how the strategy is being executed.

Good strategy execution involves creating a strong "fit" between the way things are done internally and what it will take for the strategy to succeed. The stronger the methods of implementation fit the strategy's requirements, the better the odds that performance targets will be achieved. The most important fits are between strategy and organizational capabilities, between strategy and the reward structure, between strategy and internal support systems, and between strategy and the organization's culture. Fitting the organization's internal practices to what is needed for strategic success helps unite the organization behind the accomplishment of strategy.

The strategy-implementing/strategy-executing task is easily the most complicated and time-consuming part of strategic management. It cuts across virtually all facets of managing and must be initiated from many points inside the organization. The action agenda for executing strategy emerges from careful assessment of what the organization needs to do differently or better. Each manager has to answer the question "What has to be done in my area to execute my piece of the strategic plan, and how can I best get it done?" How much internal change is needed depends on how much of the strategy is new, how far internal practices and competencies deviate from what the strategy requires, and how well strategy and organizational culture already match. Depending on the amount of internal change involved, full implementation and proficient execution can take several months to several years.

Evaluating Performance, Monitoring New Developments, and Initiating Corrective Adjustments

It is always incumbent on management to evaluate the organization's performance and progress. It is management's duty to stay on top of the company's situation, deciding whether things are going well internally, and monitoring outside developments closely. Subpar performance or too little progress, as well as important new external circumstances, will require corrective actions and adjustments in a company's long-term direction, objectives, business model, and/or strategy.

Likewise, one or more aspects of executing the strategy may not be going as well as intended. Revising budgets, changing policies, reorganizing, making personnel changes, building new competencies and capabilities, revamping activities and work processes, making efforts to change the culture, and revising compensation practices are typical managerial actions that may have to be taken to hasten implementation or improve strategy execution. Proficient strategy execution is always the product of much organizational learning. It is achieved unevenly—coming quickly in some areas and proving nettlesome in others. Progress reviews, ongoing searches for ways to continuously improve, and corrective adjustments are thus normal.

WHY STRATEGIC MANAGEMENT IS AN ONGOING PROCESS, NOT A START-STOP EVENT

The choice of whether to continue or change the company's vision, objectives, strategy, and implementation approaches always presents itself. Strategic management is an ongoing, never-ending process, not a start-stop event that, once done, can be safely put aside for a while. Managers have an ever-present responsibility for detecting when new developments require a strategic response and when they don't. Their job is to track progress, spot problems and issues early, monitor the winds of market and customer change, and initiate adjustments as needed. This is why the task of evaluating performance and initiating corrective adjustments is both the end and the beginning of the strategic management cycle.

Characteristics of the Five-Task Process

Although forming a strategic vision, setting objectives, crafting a strategy, implementing and executing the strategic plan, and evaluating performance portray what strategic management involves, actually performing these five tasks is not so cleanly divided into separate, neatly sequenced compartments. First, there is much interplay and recycling among the five tasks, as was shown in Figure 1.1. For example, deciding on a company mission and vision shades into setting objectives (both involve directional priorities). Objective-setting entails considering current performance, the strategy options available to improve performance, and whether the organization has the resources and capabilities to achieve stretch objectives when pushed and challenged. Clearly, the direction-setting tasks of developing a mission, setting objectives, and crafting strategy need to be integrated and done as a package, not individually. Deciding on a strategy is entangled with whether the organization has what it takes to execute the strategy with sufficient proficiency—it is generally foolhardy to pursue a strategic course ill-suited to the company's competencies, capabilities, and resources.

Second, the five strategic management tasks have to be done alongside a manager's other duties and responsibilities—administering day-to-day operations, dealing with crises, going to meetings, reviewing information, handling people problems, and taking on special assignments and civic duties. Thus, while the job of managing strategy is the most important managerial function insofar as organizational success or failure is concerned, it certainly isn't all managers must do or be concerned about.

Third, crafting and implementing strategy make erratic demands on a manager's time. Change does not happen in an orderly or predictable way. Events can build quickly or gradually; they can emerge singly or in rapid-fire succession; and their implications for strategic change can be easy or hard to diagnose. Hence the task of reviewing and adjusting the strategic game plan can take up big chunks of management time in some months and little time in other months. As a practical matter, there is as much skill in knowing when to institute strategic changes as there is in knowing what to do.

Last, the most time-consuming aspect of strategic management involves a daily effort to get the best strategy-supportive performance out of every individual in the organization and trying to perfect the current strategy by refining its content and execution. Managers usually spend most of their efforts improving bits and pieces of the current strategy rather than developing and instituting radical or sweeping changes. Excessive changes in strategy can be disruptive to employees and confusing to customers, and they are usually unnecessary. Most of the time, there's more to be gained from improving execution of the present strategy. Persistence in making a basically sound strategy work better is often the key to successful strategy management.

WHO PERFORMS THE FIVE TASKS OF STRATEGIC MANAGEMENT?

An organization's chief executive officer, as captain of the ship, is the most visible and important strategy manager. The title of CEO carries with it the mantles of chief direction setter, chief objective setter, chief strategy maker, and chief strategy implementer for the total enterprise. Ultimate responsibility for *leading* the tasks of forming, implementing, and executing a strategic plan for the whole organization rests with the CEO, even though other senior managers normally have significant leadership roles also. What the CEO views as strategically important usually is reflected in the company's strategy, and the CEO customarily puts a personal stamp of approval on big strategic decisions and actions.

Vice presidents for production, marketing, finance, human resources, and other functional departments have important strategy-making and strategy-implementing responsibilities as well. Normally, the production VP has a lead role in developing and executing the company's production strategy, the marketing VP oversees the marketing strategy effort, the financial VP is in charge of devising and implementing an appropriate financial strategy, and so on. Usually, senior executives below the CEO are involved in proposing key elements of the overall company strategy and developing major new strategic initiatives, working closely with the CEO to hammer out a consensus strategy and coordinate various aspects of executing the strategy. Only in comparatively small companies is the strategy-making/strategy-implementing task orchestrated by a single executive.

But managerial positions with strategy-making and strategy-implementing responsibility are by no means restricted to CEOs, other senior executives, and owner-entrepreneurs. Every major organizational unit in a company—business unit, division, staff support group, plant, or district office—normally has a leading or supporting role in the company's strategic game plan. And the manager in charge of that organizational unit, with guidance from superiors, usually ends up doing some or most of the strategy making for the unit and deciding how to execute whatever strategic choices are made. While managers farther down in the managerial hierarchy obviously have a narrower, more specific strategy-making/strategy-implementing role than managers closer to the top, *every manager is a strategy maker and strategy implementer for the area he or she supervises.*

Toshiba is a \$45 billion corporation with 300 subsidiaries, thousands of products, and operations extending across the world. The notion that a few senior executives in Toshiba headquarters can orchestrate the crafting, implementing, and executing of all the thousands of pieces of Toshiba's strategy is absurd—it takes Toshiba's whole management team to pull off the strategy-making/strategy-executing process competently.

One of the primary reasons why middle- and lower-echelon managers are part of the strategy-making/strategy-implementing team is that the more geographically scattered and diversified an

organization's operations are, the more unwieldy it becomes for headquarters executives to personally craft and lead the implementation of all the necessary initiatives. Managers in the corporate office seldom know enough about the situation in every geographic area and operating unit to direct every strategic move made in the field. It is common practice for top-level managers to delegate strategy-making authority to subordinates who head the organizational subunits where specific strategic results must be achieved. Such delegation fixes accountability for strategic success or failure. When the managers who implement the strategy are also its architects, it is hard for them to shift blame or make excuses if they don't achieve the target results. And, having participated in developing the strategy they are trying to execute, they are likely to support it strongly, an essential condition for effective strategy execution.

In diversified companies where the strategies of several different businesses have to be managed, there are usually four distinct levels of strategy managers:

- The chief executive officer and other senior corporate-level executives who have primary responsibility and personal authority for big strategic decisions affecting the total enterprise and the collection of individual businesses into which the enterprise has diversified.
- Managers who have profit-and-loss responsibility for one specific business unit and who are delegated a major leadership role in crafting and executing a strategy for that business.
- Functional area managers within a given business unit who have direct authority over a major piece of the business (manufacturing, marketing and sales, finance, R&D, personnel) and whose role it is to support the business unit's overall strategy with strategic actions in their own areas.
- Managers of major operating units (plants, sales districts, local offices) who have on-the-scene responsibility for developing the details of strategic efforts in their areas and for executing their piece of the overall strategic plan at the grassroots level.

Single business enterprises need no more than three of these levels (a business level strategy manager, functional area strategy managers, and operating-level strategy managers). Proprietorships, partnerships, and owner-managed enterprises typically have only one or two strategy managers since in small-scale enterprises the whole strategy making/strategy-implementing function can be handled by just a few key people.

Managerial jobs involving crafting and executing strategy abound in not-for-profit organizations as well. In federal and state government, heads of local, district, and regional offices function as strategy managers in the areas they serve (a district manager in Portland may need a slightly different strategy than a district manager in Orlando). In municipal government, the heads of various departments (fire, police, water and sewer, parks and recreation, health, and so on) are strategy managers because they have line authority for the operations of their departments and thus can influence departmental objectives, the formation of a departmental strategy to achieve these objectives, and day-to-day execution of the strategy.

Managerial jobs with strategy-making/strategy-executing roles are thus the *norm* rather than the exception. The job of crafting and executing strategy touches virtually every managerial job in one way or another, at one time or another. Strategic management is basic to the task of managing; it is not something just top-level managers deal with.

How Strategies Get Crafted- What the Process Is Like and Who Participates

Companies and managers approach the task of crafting a strategy in a variety of ways. At one extreme, strategy emerges as chiefly the product of one person—the CEO, a visionary founder of the business, or an enterprise's current owner. At the other extreme, strategy making is a group or team exercise involving managers and perhaps select other key personnel throughout the whole organization. The process of crafting strategy at most companies tends to take one of the following four forms.

The Chief Architect Approach In some enterprises, a single person—the owner or CEO—assumes the role of chief strategist and chief entrepreneur, single-handedly shaping most or all of the major pieces of strategy. This does not mean that one person is the originator of all the ideas underlying the resulting strategy or does all the background data gathering and analysis; there may be much brainstorming with subordinates and considerable analysis by specific departments. But it does mean that one person functions as strategic visionary and chief architect of strategy, personally orchestrating the process and putting his or her imprint on what strategy to pursue. The chief architect approach to strategy formation is characteristic of companies that have been founded by the company's present CEO—Michael Dell at Dell Computer, Steve Case at America Online, Bill Gates at Microsoft, and Howard Schultz at Starbucks are prominent examples of corporate CEOs who exert a heavy hand in shaping their company's strategy. The strategies of small entrepreneurial companies, partnerships, and family-owned businesses almost always are primarily the product of the experiences, personal observations and assessments, strategic visions, and business judgments of the owner(s), with perhaps modest contributions from a few key employees or outside advisers.

The Delegation Approach Here the manager in charge delegates big chunks of the strategy-making task to trusted subordinates, down-the-line managers in charge of key business units and departments, a high-level task force of knowledgeable and talented people from many parts of the company, self-directed work teams with authority over a particular process or function, or, more rarely, a team of consultants brought in specifically to help develop new strategic initiatives. Delegating the brainstorming, analysis, and crafting of major strategy components and certainly most of the detailed pieces of an enterprise's strategy allows for broad participation from many managers and personnel with specialized expertise and on-the-scene knowledge of market and competitive conditions—a big advantage (if not a necessity) in multiproduct, multibusiness enterprises whose operations are far-flung or fast-moving. The more that a company's operations cut across different products, industries, and geographical areas, the more that headquarters executives are prone to delegate considerable strategy-making authority to personnel who have firsthand knowledge of customer requirements, can better evaluate market opportunities, and are better able to keep the strategy responsive to changing market and competitive conditions. The swifter the pace of market change, the more imperative it is to delegate strategy-making responsibility to down-the-line managers who can act quickly.

While strategy delegators have less of their own imprint on individual elements of strategy, they still typically play an influential role in shaping the major components of the strategy and in turning thumbs up or down on strategy particulars proposed by subordinates. The weakness of the delegation approach is that its success hinges on the business judgments and strategy-making skills of lower-echelon personnel. For instance, the strategizing efforts of subordinates may deal more with how to address today's problems than with positioning the enterprise and adapting its resources to capture tomorrow's opportunities. Subordinates may not have either the clout or the inclination to tackle changing major components of the present strategy. A second weakness is that delegation sends the wrong signal: that strategy development isn't

important enough to warrant a big claim on the boss's personal time and attention. Finally, it is a mistake for executives to be too detached from the strategy-making process in case the group's deliberations bog down in disagreement or go in ill-conceived directions.

The Collaborative or Team Approach This is a middle approach whereby a manager with strategy-making responsibility enlists the assistance and advice of key peers and subordinates in hammering out a consensus strategy. Strategy teams often include line and staff managers from different disciplines and departmental units, a few handpicked junior staffers known for their ability to think creatively, and near-retirement veterans noted for being keen observers, telling it like it is, and giving sage advice.

Electronic Data Systems conducted a year-long strategy review involving 2,500 of its 55,000 employees and coordinated by a core of 150 managers and staffers from all over the world. J. M. Smucker, a maker of jams and jellies, formed a team of 140 employees (7 percent of its 2,000-person workforce) who spent 25 percent of their time over a six-month period looking for ways to rejuvenate the company's growth; the team, which solicited input from all employees, came up with 12 initiatives to double the company's revenues over the next five years. Nokia Group, a Finland-based global leader in wireless telecommunications, involved 250 employees in a strategy review of how different communications technologies were converging, how this would affect the company's business, and what strategic responses were needed. It is increasingly common for strategy teams to involve customers and suppliers in assessing the future market situation and deliberating the various strategy options.

Collaborative efforts are usually led by the manager in charge, but the result is the joint product of all concerned. Such an approach is well suited to situations where strategic issues cut across departments, product lines, and businesses and there's a need to tap the strategic thinking of people with different expertise, experiences, and perspectives. Collaborative strategy making helps win participants' wholehearted commitment to implementation of the strategy that emerges. Involving teams of people to dissect complex situations and find market-driven, customer-driven solutions is becoming increasingly necessary in many businesses. Not only are many strategic issues too far-reaching or too involved for a single manager to handle but they often are cross-functional and cross departmental, thus requiring the contributions of many disciplinary experts and the collaboration of managers from different parts of the organization. Giving people an influential stake in crafting the strategy they must later help implement not only builds motivation and commitment but it also means they can be held accountable for putting the strategy into place and making it work--the excuse "It wasn't my idea to do this" won't fly.

The Corporate Intrapreneur Approach In the corporate intrapreneur approach, top management encourages individuals and teams to develop and champion proposals for new product lines and new business ventures. The idea is to unleash the talents and energies of promising corporate intrapreneurs, letting them try out business ideas and pursue new strategic initiatives. Executives serve as judges of which proposals merit support, give company intrapreneurs the needed organizational and budgetary support, and let them run with the ball. Thus, important pieces of company strategy originate with those intrapreneuring individuals and teams who succeed in championing a proposal through the approval stage and then end up being charged with the lead role in launching new products, overseeing the company's entry into new geographic markets, or heading up new business ventures.

Utilizing the corporate intrapreneur approach successfully requires having an organization populated with ambitious, entrepreneurial people who want the chance to take on strategic and managerial responsibility for a new product or business. With this approach, the total strategy of a company is the collective sum of all the championed initiatives. This approach works well in

enterprises where technological advances are coming at a fast and furious pace and/or compelling new opportunities are opening up in a variety of areas.

W. L. Gore & Associates, a privately owned company famous for its Gore-Tex waterproofing film, is an avid and highly successful practitioner of the corporate intrapreneur approach to strategy making. Gore expects all employees to initiate improvements and to display innovativeness. Each employee's intrapreneuring contributions are prime considerations in determining raises, stock option bonuses, and promotions. W. L. Gore's commitment to intrapreneuring has produced a stream of product innovations that has kept the company vibrant and growing for well over a decade.

Comparing the Approaches These four basic managerial approaches to forming a strategy illuminate several aspects of how strategies come into being. Highly centralized strategy making works fine when the strategy commander-in-chief has a powerful, insightful vision of where to head and how to get there. The primary weakness of the chief architect approach is that the caliber of the strategy depends so heavily on one person's entrepreneurial acumen and strategic judgments. It also breaks down in enterprises with diverse businesses and product lines where there are so many particulars to the strategy that one person cannot orchestrate the strategy-making process.

On the other hand, delegating strategic decisions to others and collaborating to build a consensus strategy have their risks too. The big weakness of delegating much of strategy making to down-the-line-managers is the potential lack of sufficient top-down direction and strategic leadership on the part of senior executives. Down-the-line managers don't always have the breadth of vision or experience to make strategic decisions that later could prove to have far-reaching impact on the enterprise. Furthermore, there may be occasions when lower-level managers elect to play it safe with conservative, middle-of-the-road strategies rather than bold, creative strategies. Delegation also runs the risk that the outcome will be shaped by influential subordinates, by powerful functional departments, or by majority coalitions that have a common interest in promoting their particular version of what the strategy ought to be. The collaborative approach is conducive to political strategic choices as well, since powerful departments and individuals have ample opportunity to try to build a consensus for their favored strategic approach. Politics and the exercise of power are most likely to come into play in situations where there is no consensus on what strategy to adopt. Collaborative strategy making can also suffer from slower reaction and response times, as group members meet to debate the merits of what to do.

The strength of the corporate intrapreneur approach is also its weakness. The value of corporate intrapreneuring is that it encourages people at lower organizational levels to be alert for profitable market opportunities, to propose innovative strategies to capture them, and to take on responsibility for new business ventures. Individuals with attractive strategic proposals are given the latitude and resources to try them out, thus helping renew an organization's capacity for innovation and growth. However, because they spring from many places in the organization and can fly off in many directions, the various championed actions are not likely to form a coherent pattern or result in a clear strategic direction for the company as a whole without some strong top-down leadership. With intrapreneuring, top-level executives have to work at nurturing proposals that add power to the overall organization strategy; otherwise, strategic initiatives may be launched in directions that have little or no integrating links or fits with the overall business. Another weakness of the corporate intrapreneuring approach is that top executives may be more prone to protect their reputations for prudence and risk avoidance than to support revolutionary strategies, in which case innovative ideas can be doused by corporate orthodoxy. It is not easy for a low-ranking employee to champion an out-of-the-ordinary proposal up the chain of command.

Thus, all four approaches to developing a strategy have strengths and weaknesses. All four can succeed or fail depending on the company's size and business makeup, on how well the approach is managed, and on the business judgments of the individuals involved.

The Role of the Board of Directors in Crafting and Executing Strategy

Since lead responsibility for crafting and executing strategy falls to key managers, the chief strategic role of an organization's board of directors is to exercise oversight and see that the five tasks of strategic management are done in a manner that benefits shareholders (in the case of investor-owned enterprises) or stakeholders (in the case of not-for-profit organizations). The specter of stockholder lawsuits and the escalating costs of liability insurance for directors underscore the responsibility that corporate board members have for overseeing a company's strategic actions. Moreover, holders of large blocks of shares (mutual funds and pension funds), regulatory authorities, and the financial press consistently urge that board members, especially outside directors, be active in their oversight of company strategy and the actions and capabilities of executives.

It is standard procedure for executives to brief board members on important strategic moves and to submit the company's strategic plans to the board for official approval. But directors rarely can or should play a direct, hands-on role in formulating or implementing strategy. Most outside directors lack industry-specific experience; their company-specific knowledge is limited (especially if they are relatively new board members). Boards of directors typically meet once a month (or less) for six to eight hours. Board members can scarcely be expected to have detailed command of all the strategic issues or know the ins and outs of the various strategic options. It is unreasonable to expect them to come up with compelling strategy proposals of their own to debate against those put forward by management. Such a hands-on role is unnecessary for good oversight. The immediate task of directors is to be *supportive critics*, exercising their own independent judgment about whether proposals have been adequately analyzed and whether proposed strategic actions appear to have greater promise than available alternatives. If executive management is bringing well-supported strategy proposals to the board, there's little reason for board members to aggressively challenge everything put before them. Asking perceptive and incisive questions is usually sufficient to test whether the case for the proposals is compelling and to exercise vigilant oversight. However, if the company is experiencing gradual erosion of profits and market share, and certainly when there is a precipitous collapse in profitability, board members have a duty to be proactive, expressing their concerns about the validity of the strategy, initiating debate about the company's strategic path, having one-on-one discussions with key executives and other board members, and perhaps directly intervening as a group to alter both the strategy and the company's executive leadership.

The real hands-on role of directors is to evaluate the caliber of senior executives' strategy-making and strategy-implementing skills. The board is always responsible for determining whether the current CEO is doing a good job of strategic management (as a basis for awarding salary increases and bonuses and deciding on retention or removal).¹⁴ Recently, at AT&T, Pacific Corp., Kmart, RiteAid, and Compaq Computer, company directors concluded that top executives were not adapting their company's strategy fast enough and fully enough to the changes sweeping their markets. They pressured the CEOs to resign and installed new leadership to provide the impetus for strategic renewal. Boards must also exercise due diligence in evaluating the strategic leadership skills of other senior executives in line to succeed the CEO. When the incumbent CEO retires, the board must elect a successor, either going with an insider (frequently, nominated by the retiring CEO) or deciding that an outsider is needed to perhaps radically change the company's strategic course. Board oversight and vigilance is therefore very much in play in the strategy arena.

THE BENEFITS OF A STRATEGIC APPROACH TO MANAGING

The message of this book is that doing a good job of managing inherently requires good strategic thinking. Today's managers have to think strategically about their company's position and about the impact of changing conditions. They have to monitor the company's external environment and internal capabilities closely enough to know when to institute strategy changes. They have to know the business well enough to determine what kinds of strategic changes to initiate. Simply said, the fundamentals of strategic management need to drive the whole approach to managing organizations. The chief executive officer of one successful company put it well when he said:

In the main, our competitors are acquainted with the same fundamental concepts and techniques and approaches that we follow, and they are as free to pursue them as we are. More often than not, the difference between their level of success and ours lies in the relative thoroughness and self-discipline with which we and they develop and execute our strategies for the future.

The advantages of first-rate strategic thinking and conscious strategy management (as opposed to freewheeling improvisation, gut feel, and hoping for good luck) include (1) providing better guidance to the entire organization on the crucial point of "what it is we are trying to do," (2) making managers and organizational members more alert to new opportunities and threatening developments, (3) helping to unify the organization, (4) creating a more proactive management posture, (5) promoting the development of a constantly evolving business model that will produce sustained bottom-line success for the enterprise, and (6) providing managers with a rationale for evaluating competing budget requests—a rationale that argues strongly for steering resources into strategy-supportive, results-producing areas.

Trailblazing strategies can be the key to better long-term performance. Business history shows that high-performing enterprises often initiate and lead, not just react and defend. They launch strategic offensives to out-innovate and out-maneuver rivals and secure sustainable competitive advantage, then use their market edge to achieve superior financial performance. Aggressive pursuit of a creative, opportunistic strategy can propel a firm into a leadership position, paving the way for its products and services to become the industry standard. High-achieving enterprises are nearly always the product of astute, proactive management, rather than the result of lucky breaks or a long run of good fortune.

In the chapters to come, we will probe the strategy-related tasks of managers and the methods of strategic analysis much more intensively. When you get to the end of the book, we think you will see that *two factors separate the best-managed organizations from the rest: (1) superior strategy making and entrepreneurship, and (2) competent implementation and execution of the chosen strategy.* There's no escaping the fact that the quality of managerial strategy making and strategy implementing has a significant impact on organization performance. A company that lacks clear-cut direction, has vague or undemanding objectives, has a muddled or flawed strategy, or can't seem to execute its strategy competently is a company whose performance is probably suffering, whose business is at long-term risk, and whose management is lacking. In short, the better conceived a company's strategy and the more proficient its execution, the greater the chances the company will be a leading performer in its markets and truly deserve a reputation for talented management.

DEVELOPING A STRATEGIC VISION, SETTING OBJECTIVES, AND CRAFTING A STRATEGY

In this chapter, we present a more in-depth look at the first three of the five strategic management tasks discussed in Chapter 2: developing a strategic vision and business mission, setting performance objectives, and crafting a strategy to produce the desired results. We will also examine which kinds of strategic decisions are made at which levels of management and the major factors that shape a company's strategy. The final two sections of the chapter discuss links between strategy making and ethics, and present some tests for determining whether a proposed strategy is a winner.

DEVELOPING A STRATEGIC VISION: THE FIRST DIRECTION-SETTING TASK

A clear and entrepreneurially astute strategic vision is a prerequisite to effective strategic leadership. Managers cannot function effectively as either leaders or strategy makers without a future-oriented concept of the business—what customer needs to work toward satisfying, what business activities to pursue, what kind of long-term market position to build vis-a-vis competitors, what kind of company to try to create. Charting a company's course begins with senior management looking at the road ahead and addressing the following questions: "Where do we go from here?" "What changes lie ahead in the business landscape?" and "What difference will these changes make to the company's present business?"

Forming a strategic vision is thus not merely a wordsmithing exercise designed to create a catchy company slogan; rather it is an exercise in thinking carefully about where a company needs to head to be successful. It involves selecting the market arenas in which to participate, putting the company on a strategic path, and making a commitment to follow that path.

See Illustration for an example of a strategic vision describing what course a company intends to follow.

The Three Elements of a Strategic Vision

Managers have three discernible tasks in forming a strategic vision and making it a useful direction-setting tool:

- Coming up with a *mission statement* that defines what business the company is *presently* in and conveys the essence of "who we are, what we do, and where we are now."
- Using the mission statement as a basis for deciding on a *long-term* course, making choices about "where we are going," and charting a strategic path for the company to pursue.
- Communicating the strategic vision in clear, exciting terms that arouse organizationwide commitment.

The Mission Statement: A Starting Point for Forming a Strategic Vision

Coming up with a mission statement is not as simple as it might seem. Is America Online in the Internet connection business, the online content business, the information business, or the entertainment business? Is Coca-Cola in the soft-drink business (in which case management's strategic attention can be concentrated on outselling and outcompeting Pepsi, 7UP, Dr Pepper, Canada Dry, and Schweppes), or is it in the beverage business (in which case management also

needs to think strategically about positioning Coca-Cola products to compete against fruit juices, ready-to-drink teas, bottled water, sports drinks, milk, and coffee)? Whether to take a soft-drink perspective or a beverage perspective is not a trivial question for Coca-Cola management only partly because Coca-Cola is also the parent of Minute Maid and Hi-C, which make juice products. With a beverage industry vision as opposed to a soft-drink focus, Coca-Cola management can better zero in on, say, how to convince young adults to get their morning caffeine fix by drinking Coca-Cola instead of coffee.

Illustration - Deere & Company's Strategic Vision

With revenues of more than \$14 billion, John Deere has been a truly international company for decades. Use of the company's agricultural equipment in many parts of the world has given the company a respected global brand name. The company has set forth in clear terms what it is, where it is going, and how it plans to get there. The following paragraphs, from Deere's website, spell out the company's strategic vision.

WHO ARE WE?

John Deere has grown and prospered through a longstanding partnership with the world's most productive farmers. Today, John Deere is a global company with several equipment operations and complementary service businesses. These businesses are closely interrelated, providing the company with significant growth opportunities and other synergistic benefits.

WHERE ARE WE GOING?

Deere is committed to providing genuine value to the company's stakeholders, including our customers, dealers, shareholders, employees, and communities. In support of that commitment, Deere aspires to:

- Grow and pursue leadership positions in each of our businesses.
- Extend our preeminent leadership position in the agricultural equipment market worldwide.
- Create new opportunities to leverage the John Deere brand globally.

HOW WILL WE GET THERE?

By pursuing the broader corporate goals of profitable growth and continuous improvement, each of the company's businesses is expected to:

- Achieve world-class performance by attaining a strong competitive position in target markets.
- Exceed customer expectations for quality and value.
- Earn in excess of the cost of capital over a business cycle.

By growing profitably and continuously improving, each of the company's businesses will benefit from and contribute to John Deere's unique intangible assets:

- Our distinguished brand.
- Our heritage of integrity and teamwork.
- Our advanced skills.
- The special relationships that have long existed between the company and our employees, customers, dealers, and other business partners around the world.

HOW WILL WE MEASURE OUR PERFORMANCE?

Each business will make a positive contribution to the corporation's objectives in the pursuit of creating genuine value for our stakeholders. Our "scorecard" includes:

- Human Resources-Employee Satisfaction, Training If Customer Focus-Loyalty, Market Leadership
- Business Processes-Productivity, Quality, Cost, Environment
- Business Results-Return on Assets, Sales Growth

Source: Deere & Company website (www.deere.com).

The Mission Is Not to Make a Profit

Sometimes companies couch their business mission in terms of making a profit. This is misguided--profit is more correctly an *objective* and a *result* of what the company does. The desire to make a profit says nothing about the business arena in which profits are to be sought. Missions based on making a profit do not allow us to distinguish one type of profit-seeking enterprise from another--the business of Amazon.com is plainly different from the business of Toyota, even though both endeavor to earn a profit. A company that says its mission is to make a profit begs the question "What win we do to make a profit?" To understand a company's business purpose, we must know management's real answer to that question. .

Incorporating What, Who, and How into the Mission Statement A strategically revealing mission statement incorporates three elements:

1. Customer needs, or *what* is being satisfied.
2. Customer groups, or *who* is being satisfied.
3. The company's activities, technologies, and competencies, or *how* the enterprise goes about creating and delivering value to customers and satisfying their needs.

Defining a business in terms of what to satisfy, whom to satisfy, and how to produce the satisfaction identifies the substance of what a company does to create value for its customers. Defining a business solely in terms of the products or services it provides is incomplete. A product or service becomes a business only when it satisfies a need or want; without demand for the product there is no business. Customer groups are relevant because they pinpoint the market to be served--the geographic domain to be covered and the types of buyers the firm hopes to attract.

Technology, competencies, and activities are important because they indicate how much of the industry's total production-distribution chain its operations will span. For instance, the business of a *fully integrated firm* extends across the entire range of industry activities that must be performed to get a product or service into the hands of end users. The business of major international oil companies like Exxon, Mobil, BP Amoco, and Royal Dutch/Shell covers all stages of the oil industry's production distributor, chain--these companies lease drilling sites, drill wells, pump oil, transport crude oil in their own ships and pipelines to their own refineries, and sell gasoline and other refined products through their own networks of branded distributors and service station outlets. A *partially integrated firm* participates in some but not all of the industry's stages--raw materials supply, components production, manufacturing and assembly, distribution, or retailing. General Motors is a partially integrated company that makes between 30 and 50 percent of the parts and components used in assembling GM vehicles; the remainder of the needed parts and systems components come from independent suppliers, and GM relies on a network of independent, franchised dealers, to handle retail sales and customer service functions. A *specialized firm* concentrates on just one stage of an industry's total production-distribution chain. Wal-Mart, The Home Depot, Toys"R"Us, Lands' End, and The Limited are essentially one-stage firms that focus on the retail end of the production-distribution chain; they don't manufacture the items they sell. Southwest Airlines is a one-stage enterprise that limits its business activities to moving travelers from one location to another via commercial jet aircraft. It doesn't manufacture the airplanes it flies or operate the airports where those planes land.

An example of a company that does a pretty good job of covering the three bases of what, who, and how in its business definition is Cardinal Health, a Fortune 100 company based in Dublin, Ohio:

Cardinal Health is a leading provider of services supporting health care worldwide. The company offers a broad array of services for health-care providers and manufacturers to help them improve the efficiency and quality of health care. These services include pharmaceutical distribution, health-care product manufacturing and distribution, drug delivery systems development, pharmaceutical packaging and repackaging, automated dispensing systems manufacturing, hospital pharmacy management, retail pharmacy franchising, and health-care information systems development.

JDS Uniphase, a Canada-based high-tech telecommunications components company, also has an explicit and comprehensive business definition:

JDS Uniphase is the leading provider of advanced fiber optic components and modules. These products are sold to the world's leading telecommunications and cable television system providers, which are commonly referred to as OEMs and include Alcatel, Ciena, General Instruments, Lucent, Nortel, Pirelli, Scientific Atlanta, Siemens, and Tyco. Our products perform both optical-only (commonly referred to as "passive") functions and optoelectronic (commonly referred to as "active") functions within fiber optic networks. Our products include semiconductor lasers, high-speed external modulators, transmitters, amplifiers, couplers, multiplexers, circulators, tunable filters, optical switches, and isolators for fiber optic applications. We also supply our OEM customers with test instruments for both system production applications and network installation. In addition, we design, manufacture, and market laser subsystems for a broad range of OEM applications, which include biotechnology, industrial process control and measurement, graphics and printing, and semiconductor equipment.

Russell Corporation, the largest U.S. manufacturer of athletic apparel and uniforms, is another company with a business definition that covers all the bases:

Russell Corporation is a vertically integrated international designer, manufacturer, and marketer of athletic uniforms, activewear, better knit shirts, leisure apparel, licensed sports apparel, sports and casual socks, and a comprehensive line of lightweight, yarn-dyed woven fabrics. The Company's manufacturing operations include the entire process of converting raw fibers into finished apparel and fabrics. Products are marketed to sporting goods dealers, department and specialty stores, mass merchandisers, golf pro shops, college bookstores, screen printers, distributors, mail-order houses, and other apparel manufacturers.

A Broad or Narrow Business Definition and Mission? Merck, one of the world's foremost pharmaceutical companies, states that its business mission is "to provide society with superior products and services-innovations and solutions that satisfy customer needs and improve the quality of life." There's nothing specific in this statement! that would allow anyone to actually identify Merck's true business; the broad, all-inclusive language Merck uses could just as easily apply to an enterprise engaged in developing innovative computer software, producing and marketing uniquely satisfying snack foods, manufacturing very appealing sports utility vehicles, or providing tax preparation services.

It is perfectly normal for companies in the same industry to have different missions and business definitions. For example, the current mission of a globally active New York bank like Citicorp (a Citigroup subsidiary) has little in common with that of a locally owned hometown bank, even though both are in the banking industry. To truly convey "who we are, what we do, and where we are now," a mission statement must be specific enough to pin down a company's real business arena. Broad-narrow definitions are relative to a company's business focus and intent, however. Consider the following business definitions:

Broad Definition	Narrow Definition
Furniture Business	Wrought-iron lawn furniture business
Telecommunications business	Long-distance telephone service
Beverage business	Soft-drink business
Global mail delivery business	Overnight package delivery business
Travel and tourism business	Caribbean cruise ship business

"We're in the furniture business" is probably too broad a definition for a company focused on being the largest manufacturer of wrought-iron lawn furniture in North America. In contrast, "We're a provider of long-distance telephone service" has proved too narrow a definition for AT&T, which, with its desire to capitalize on the convergence of computers and communications, has ventured into cable TV (acquiring TCI and MediaOne) and is launching efforts to become the telecommunications company of the future by bundling long-distance service, local telephone service, cable TV, and Internet access into package offerings to residential and business customers. The U.S. Postal Service successfully operates with a broad definition, providing global mail-delivery services to all types of senders. Federal Express, however, operates with a narrow business definition based on handling overnight package delivery for customers who have emergencies or tight deadlines. The risks of making an overly broad mission statement are lack of business focus and dilution of effort. *Few businesses fail because they are focused on a sharply targeted market opportunity. but many fail or do badly because managements attention is divided and resources are scattered across too many areas.*

Diversified firms, understandably, employ more sweeping business definitions than single-business enterprises. For example, the McGraw-Hill Companies describes itself broadly as a global publishing, financial, information, and media services company (which covers a lot of ground) but then goes on to pin down its business arenas in fairly explicit terms:

The McGraw-Hill Companies is a global publishing, financial, information and media services company with such renowned brands as Standard & Poor's, Business Week, and McGraw-Hill educational and professional materials. The Company provides information, via various media platforms: through books magazines and newsletters; online over the Internet and electronic networks; via television, satellite and FM sideband broadcast; and through software, videotape, facsimile and CD-ROM products. The McGraw-Hill Companies now creates more than 90 percent of its information on digital platforms and its business units are represented on more than 75 websites.

Federal Express (known formally as FDX Corporation)-also diversified-does a more precise job of laying out its targets of what, who, and how:

FDX is composed of a powerful family of companies: FedEx®, RPS®, Viking Freight, FDX Global Logistics, and Roberts Express®. These companies offer logistics and distribution solutions on a regional, national and global scale: fast, reliable, time-definite express delivery; expedited surface and air charter delivery of time-critical freight shipments; business-to-business ground small-package delivery; expedited same-day delivery; less-than-truckload (LTL) freight service in the Western U.S.; and integrated information and logistics solutions.

With all of this expertise under one umbrella, the FDX companies can provide businesses with the competitive advantage they need by providing streamlined solutions that are on the cutting edge of technology.

Mission Statements for Functional Departments There's also a place for mission statements for key functions and departments within a business-R&D, marketing, finance, human resources, customer service, information systems. Every department can help focus the efforts of its

personnel by developing its mission statement that sets forth its principal role and activities, the direction it is headed, and its contribution to the overall company mission. Functional and department managers who think through and debate with subordinates and higher-ups what their unit needs to focus on and do have a clearer view of how to lead the unit. Three examples from actual companies indicate how a functional mission statement puts the spotlight on a unit's organizational role and scope:

- The mission of the human resources department is to contribute to organizational success by developing effective leaders, creating high-performance teams, and maximizing the potential of individuals.
- The mission of the corporate claims department is to minimize the overall cost of liability, workers compensation, and property damage claims through competitive cost containment techniques and loss prevention and control programs.
- The mission of corporate security is to provide services for the protection of corporate personnel and assets through preventive measures and investigations.

From Mission Statement to Strategic Vision

A mission statement highlighting the boundaries of the company's current business is a logical vantage point from which to look down the road, decide what the enterprise's business makeup and customer focus need to be, and chart a strategic path for the company to take. As a rule, strategic visions should have a time horizon of five years or more unless the industry is very new or market conditions are so volatile and uncertain that it is difficult to see that far down the road with any degree of confidence. However, choosing a company's path is a daunting task that requires reasoned answers to the following questions:

1. What changes are occurring in the market arenas where we operate, and what implications do these changes have for the direction in which we need to move?
2. What new or different customer needs should we be moving to satisfy?
3. What new or different buyer segments should we be concentrating on?
4. What new geographic or product markets should we be pursuing?
5. What should the company's business makeup look like in five years?
6. What kind of company should we be trying to become?

The Crucial Role of Entrepreneurship in Forming a Strategic Vision There's no substitute for good entrepreneurship in addressing the above six questions and making choices about which forks in the road to take.² Charting a promising strategic course forces managers to think both creatively and realistically about changing market, competitive, technological, economic, regulatory, and societal conditions and about the company's resources and capabilities. Sometimes, the best clues about where to head come from alertness to users' problems and complaints and listening intently when a customer says, "If only. . ." Such information, if used creatively, points to valuable customer-market-technology opportunities. Moving early and quickly to pursue emerging opportunities can result in competitive advantage.³ A well-chosen strategic vision prepares a company for the future.

Recognizing Strategic Inflection Points Sometimes there's an order of magnitude change in a company's environment that dramatically alters its prospects and mandates radical revision of its strategic course. Intel's chairman Andrew Grove calls such occasions *strategic inflection points*. When H Company reaches a strategic inflection point, management has some tough decisions to make about the company's course. Often, it is a question of what to do to sustain company success, not just how to avoid possible disaster. Responding to the winds of change in

timely fashion lessens a company's chances of becoming trapped in a stagnant or declining business or letting attractive new growth opportunities slip away because of inaction.

Communicating the strategic vision

Communicating the strategic vision down the line to lower-level managers and employees is almost as important as setting the organization's long-term direction. People need to believe that the company's management knows where it's trying to take the company and what changes lie ahead both externally and internally. Ideally, executives should present their vision for the company in language that reaches out and grabs people, that creates a vivid image in their heads, and that provokes emotion and excitement. Expressing the strategic vision in engaging language has enormous motivational value—"building a cathedral," for example, is more inspiring than "laying stones."

Most organization members will rise to the challenge of pursuing a worthy organizational purpose and trying to be the world's best at something competitively significant and beneficial to customers. Presenting the vision as an endeavor that will please customers and perhaps benefit society is far more motivating than stressing the payoff for shareholders—it goes without saying that the company intends to profit shareholders. When management can paint an inspiring picture of the company's strategic vision it can arouse a committed organizational effort in which people live the business instead of just coming to work. The simple, clear mission statement of the International Red Cross is a good example: "to serve the most vulnerable." Bland language, platitudes, and dull motherhood-and-apple-pie-style verbiage must be scrupulously avoided—they can be a turn-off rather than a turn-on.

Breaking Down Resistance to a New Strategic Vision It is particularly important for executives to provide a compelling rationale for a new strategic vision. Failure to understand or accept the need for redirecting organizational efforts often produces resistance to change among employees and makes it harder to move the organization down a newly chosen path. Hence, inducing employee buy-in, lifting spirits, and calming fears are necessary steps in getting an organization ready to move along a new course. Just stating the case for a new direction once is not enough; the vision has to be repeated often and reinforced at every opportunity, until it gains organizationwide acceptance.

Putting the Vision Statement in Writing Many companies put the strategic visions of senior executives into written vision statements, using them as vehicles to communicate with employees, shareholders, and other constituencies. Usually it is best to keep such vision statements simple and clear, using no more words than it takes to convey unmistakable meaning. A slogan that helps generate enthusiasm for the firm's future course and inspires dedicated effort can be a strong plus. A crisp, clear, often-repeated, inspiring strategic vision has the power to turn heads in the intended direction and create a unified organizational march.

The Real Payoffs of a Well-Conceived, Well-Worded Vision Statement A well-conceived, well-stated strategic vision pays off in several respects: (1) it crystallizes senior executives' own views about the firm's long-term direction; (2) it reduces the risk of rudderless decision making; (3) it conveys organizational purpose in ways that motivate organization members to go all out; (4) it provides a beacon that lower-level managers can use to form departmental missions, set departmental objectives, and craft functional and departmental strategies that are in sync with the company's overall strategy; and (5) it helps an organization prepare for the future. When these five benefits have been realized the first step in organizational direction setting has been successfully completed.

ESTABLISHING OBJECTIVES: THE SECOND DIRECTION-SETTING TASK

Setting objectives converts the strategic vision into specific performance targets. Objectives represent a managerial commitment to achieving specific outcomes and results. Unless an organization's long-term direction is translated into specific performance targets and managers are pressured to show progress in reaching these targets, vision and mission statements are likely to end up as nice words, window dressing, and unrealized dreams. The experiences of countless companies and managers teach that *companies whose managers set objectives for each key result area and then press forward with actions aimed directly at achieving these performance outcomes typically outperform companies whose managers exhibit good intentions, try hard, and hope for the best.*

For objectives to function as yardsticks of organizational performance and progress, they must be stated in *quantifiable*, or measurable, terms and they must contain a *deadline for achievement*. They have to spell out *how much of what kind of performance by then*. This means avoiding generalities like "maximize profits," "reduce costs," "become more efficient," or "increase sales," which specify neither how much or when. As Bill Hewlett, co-founder of Hewlett-Packard, once observed, "You cannot manage what you cannot measure, , , And what gets measured gets done." Spelling out organization objectives in measurable terms and then holding managers accountable for reaching their assigned targets within a specified time frame (1) substitutes purposeful strategic decision making for aimless actions and confusion over what to accomplish and (2) provides a set of benchmarks for judging the organization's performance and progress.

What Kinds of Objectives to Set

Objectives are needed for each key result managers deem important to success. Two types of key result areas stand out: those relating to *financial performance* and those relating to *strategic performance*. Achieving acceptable financial performance is a must; otherwise the organization's financial standing can alarm creditors and shareholders, impair its ability to fund needed initiatives, and perhaps even put its very survival at risk. Achieving acceptable strategic performance is essential to sustaining and improving the company's long-term market position and competitiveness. Representative kinds of financial and strategic performance objectives are listed below:

Strategic Objectives versus Financial Objectives: Which Take Precedence? Even though an enterprise places high priority on achieving both financial and strategic objectives, situations arise where a trade-off has to be made. Should a company under pressure to pay down its debt elect to *kill* or postpone investments in strategic moves that *old* promise for strengthening the enterprise's future business and competitive position? Should a company under pressure to boost near-term profits cut back R&D programs that could help it achieve a competitive advantage over key rivals in the years ahead? The pressures on managers to opt for better near-term financial performance and to sacrifice or cut back on strategic initiatives aimed at building a stronger competitive position become especially pronounced when (1) an enterprise is struggling financially, (2) the resource commitments for strategically beneficial moves will materially detract from the bottom line for several years, and (3) the proposed strategic moves are risky and have an uncertain competitive or bottom-line payoff.

Yet there are dangers in management's succumbing time and again to the lure of immediate gains in profitability when it means forgoing strategic moves that would build a stronger business position. A company that consistently passes up opportunities to strengthen its long-term competitive position in order to realize better near-term financial gains risks diluting its

competitiveness, losing momentum in its markets, and impairing its ability to stave off market challenges from ambitious rivals. The danger of trading off long-term gains in market position for near-term gains in bottom-line performance is greatest when (1) there are lasting first-mover advantages in being a market pioneer (many Internet start-ups, for example, are incurring big short-term losses in their rush to stake out leadership positions in fast-emerging "industries of the future") and (2) a profit-conscious market leader has competitors who invest relentlessly in gaining market share, striving to become big and strong enough to outcompete the leader in a head-to-head market battle. The surest path to sustained future profitability quarter after quarter and year after year is to pursue strategic actions that strengthen a company's competitiveness and business position. Absent a strong position from which to compete, a company's profitability is at risk.

The Concept of Strategic Intent

A company's strategic objectives are important for another reason—they indicate **strategic intent** to stake out a particular business position. Strategic intent can be thought of as a "big, hairy, audacious goal," or BHAG (pronounced *bee-hag*), that generally takes a long time to achieve (maybe even as long as 20 or 30 years).¹ The strategic intent of a large company may be industry leadership on a national or global scale. The strategic intent of a small company may be to dominate a market niche. The strategic intent of an up-and-coming enterprise may be to overtake the market leaders. The strategic intent of a technologically innovative company may be to pioneer a promising discovery and create a whole new array of products that change the way people work and live—as many entrepreneurial companies are now trying to do via the Internet.

The time horizon underlying a company's strategic intent is *long term*. Ambitious companies almost invariably begin with strategic intents that are out of proportion to their immediate capabilities and market positions. But they set aggressive long-term strategic objectives and pursue them relentlessly, sometimes even obsessively. In the 1960s, Komatsu, Japan's leading earth-moving equipment company, was less than one-third the size of Caterpillar, had little market presence outside Japan, and depended on its small bulldozers for most of its revenue. But Komatsu's strategic intent was to eventually "encircle Caterpillar" with a broader product line and then compete globally against Caterpillar. By the late 1980s, Komatsu was the industry's second-ranking company, with a strong sales presence in North America, Europe, and Asia plus a product line that included industrial robots and semiconductors as well as a broad selection of earth-moving equipment.

The strategic intent of the U.S. government's Apollo space program was to land a person on the moon ahead of the Soviet Union. Throughout the 1980s, Wal-Mart's strategic intent was to "overtake Sears" as the largest U.S. retailer (a feat accomplished in 1991). America Online's strategic intent is to build the strongest, most recognized brand name on the Internet. Internet start-up companies like E-loan, Doubeclick, eBay, etoys, Mortgage.com, and E*Trade are exhibiting strategic intent in rushing to build what they hope will prove to be dominant positions in their target e-commerce niches.

Strategic intent signals a deep-seated commitment to winning—becoming the recognized industry leader, unseating the existing industry leader, remaining the industry leader (and becoming more dominant in the process)—sometimes against long odds. Small, capably managed enterprises determined to achieve ambitious strategic objectives exceeding their present reach and resources often prove to be more formidable competitors than larger, cash-rich companies with modest strategic intents.

Sometimes a company's strategic intent takes on a heroic character, serving as a rallying cry for managers and employees alike to go all out and do their very best. Canon's strategic intent in copying equipment was to "beat Xerox." Nike's strategic intent during the 1960s was to overtake Adidas (which connected nicely with its core purpose "to experience the emotion of competition, winning, and crushing competitors"). Komatsu's motivating battle cry was "Beat Caterpillar." When Yamaha overtook Honda in the motorcycle market, Honda responded with "Yamaha wo tsubusu" ("We will crush, squash, slaughter Yamaha"). It is plain that America Online, Amazon.com, and Yahoo are going all out to build globally dominant market positions in their parts of the mushrooming Internet economy.

The Need for Long-Range and Short-Range Objectives

Organizations need to establish both long-range and short-range objectives. A strong commitment to achieving long-range objectives forces managers to begin taking actions now to reach desired performance levels later. A company that has an objective of doubling its sales within five years can't wait until the third or fourth year of its five-year strategic plan to begin growing its sales and customer base. By spelling out the near-term results to be achieved, short-range objectives indicate the *speed* at which management wants the organization to progress as well as the level of performance being aimed for over the next two or three periods. Short-range objectives can be identical to long range objectives if an organization is already performing at the targeted long-term level. For instance, if a company has an ongoing objective of 15 percent profit growth every year and is currently achieving this objective, then the company's long-range and short-range objectives for increasing profits coincide. The most important situation where short-range objectives differ from long-range objectives occurs when managers are trying to elevate organizational performance and cannot reach the long-range target in just one year. Short-range objectives then serve as milestones.

How Much Stretch Should Objectives Entail?

As a starter, objectives should be set high enough to produce outcomes at least incrementally better than current performance. But incremental improvements are not necessarily sufficient, especially if current performance levels are subpar. At a minimum, a company's financial objectives must aim high enough to generate the resources to execute the chosen strategy proficiently. But an "enough-to-get-by" mentality is not appropriate in objective setting. Objectives need to be set high enough to generate period-to-period results that will not only please shareholders and Wall Street but also compare favorably with competitors' performance. Ideally, objectives ought to serve as a managerial tool for truly stretching an organization to reach its full potential; this means setting them high enough to be *challenging*---to energize the organization and its strategy.

One school of thought holds that objectives should be set boldly and aggressively high---above levels that many organizational members would consider realistic. The idea here is that more organizational creativity and energy is unleashed when stretch objectives call for achieving performance levels well beyond the reach of the enterprise's immediate resources and capabilities. One of the most avid practitioners of setting stretch objectives and challenging the organization to go all out to achieve them is General Electric, arguably the world's best-managed corporation. Jack Welch, GE's CEO from 1980 to 2001, believed in setting stretch targets that seemed "impossible" and then challenging the organization to go after them. Throughout the 1960s, 1970s, and 1980s, GE's operating margins hovered around 10 percent and its sales-to-inventory ratio averaged about 5 turns per year. In 1991, Welch set stretch targets for 1995 of at least a 16 percent operating margin and 10 inventory turns. Welch's letter to the shareholders in the company's 1995 annual report said:

1995 has come and gone, and despite a heroic effort by our 220,000 employees, we fell short on both measures, achieving a 14.4% operating margin and almost seven turns. But in stretching for these "impossible" targets, we learned to do things faster than we would have going after "doable" goals, and we have enough confidence now to set new stretch targets of at least 16% operating margin and more than 10 turns by 1998.

GE's philosophy is that setting very aggressive stretch targets pushes the organization to move beyond being only as good as what is deemed doable to being as good as it possibly can be. GE's management believes challenging the company to achieve the impossible improves the quality of the organization's effort, promotes a can-do spirit, and builds self-confidence. Hence, a case can be made that objectives ought to be set at levels *above* what is doable with a little extra effort; there's merit in setting stretch targets that require something approaching a heroic degree of organizational effort.

Objectives Are Needed at All Organizational Levels

Objective setting does not stop when company performance targets are agreed on. Company objectives must be broken down into performance targets for each of the organization's separate businesses, product lines, functional areas, and departments. Company objectives are unlikely to be reached without each area of the organization doing its part to contribute to the desired companywide outcomes and results. This means setting strategic and financial objectives for each organization unit that support rather than conflict with the achievement of companywide strategic and financial objectives. Consistency between company objectives and the objectives of organizational subunits signals that each part of the organization knows its strategic role and is on board in helping the company move down the chosen strategic path and produce the desired results.

The Need for Top-Down Objective Setting. To appreciate why a company's objective-setting process needs to be more top-down than bottom-up, consider the following example- Suppose the senior executives of a diversified corporation establish a corporate profit objective of \$500 million for next year. Suppose further that, after discussion between corporate management and the general managers of the firm's five different businesses, each business is given a stretch profit objective of \$100 million by year-end (i.e., if the five business divisions contribute \$100 million each in profit, the corporation can reach its \$500 million profit objective). A concrete result has thus been agreed on and translated into measurable action commitments at two levels in the managerial hierarchy. Next, suppose the general manager of business unit X, after some analysis and discussion with functional area managers, concludes that reaching the \$100 million profit objective will require selling 1 million units at an average price of \$500 and producing them at an average cost of \$400 (a \$100 profit margin times 1 million units equals \$100 million profit). Consequently, the general manager and the manufacturing manager settle on a production objective of 1 million units at a unit cost of \$400; and the general manager and the marketing manager agree on a sales objective of 1 million units and a target selling price of \$500. In turn, the marketing manager breaks the sales objective of 1 million units into unit sales targets for each sales territory, each item in the product line, and each salesperson. It is logical for organizationwide objectives and strategy to be established first so they can guide objective setting and strategy making at lower levels.

A top-down process of setting companywide performance targets first and then insisting that the financial and strategic performance targets established for business units, divisions, functional departments, and operating units be directly connected to the achievement of company objectives has two powerful advantages: One, it helps produce *cohesion* among the objectives and strategies of different parts of the organization. Two, it helps unify *internal* ((forts to move

the company along the chosen strategic course. If top management, in the interest of involving a broad spectrum of organizational members, allows objective setting to start at the bottom levels of an organization without the benefit of companywide performance targets as a guide, then lower-level organizational units have no basis for connecting their performance targets to the company. Bottomup objective setting, with little or no guidance from above, nearly always signals an absence of strategic leadership on the part of senior executives.

CRAFTING A STRATEGY: THE THIRD DIRECTION-SETTING TASK

Strategies represent management's answers to *how* to achieve objectives and *how* to pursue the organization's business mission and strategic vision. Strategy making is all about *flow-how* to achieve performance targets, how to outcompete rivals, how to achieve sustainable competitive advantage, how to strengthen the enterprise's longterm business position, how to make management's strategic vision for the company a reality. A strategy is needed for the company as a whole, for each business the company is in, and for each functional piece of each business.

Strategy making thus entails managerial choices. The *hows* that comprise the strategy represent organizational commitment to specific competitive approaches and ways of operating—in effect, strategy constitutes management's *business model* of producing good profitability and good business results. Furthermore, strategy is inherently action-oriented; it concerns what to do and when to do it. Unless there is action, unless something happens, unless somebody does something, strategic thinking and planning simply go to waste.

An organization's strategy evolves over time, emerging from the pattern of actions already initiated, the plans managers have for fresh moves, and the ongoing need to react to new or unforeseen developments. The future is too unknowable for management to plan a company's strategy in advance and encounter no reason for changing one piece or another of its intended strategy as time passes. In many of today's industries—especially those where technology is advancing rapidly and those involving the Internet the pace of industry change is intense and sometimes more than a bit chaotic. Industry environments characterized by high-velocity change require rapid strategy adaption.

Reacting to fresh developments in the surrounding environment is thus a normal and necessary part of the strategy-making process. There is always some new strategic window opening up—whether from advancing technology, new competitive developments, budding trends in buyer needs and expectations, unexpected increases or decreases in costs, mergers and acquisitions among major industry players, new regulations, the raising or lowering of trade barriers, or countless other events that make it desirable to alter first one and then another aspect of the present strategy. This is why the task of crafting strategy is never ending. And it is why a company's actual strategy turns out to be a blend of prior actions, managerial plans and intentions, and as-needed reactions to fresh developments.

While most of the time a company's strategy evolves incrementally, there are occasions when a company can function as an industry revolutionary by creating a *rule-breaking* strategy that redefines the industry or how it operates. A strategy can challenge fundamental conventions by reconceiving a product or service (like creating a single-use, disposable cameras or digital cameras), redefining the marketplace, or redrawing industry boundaries. Internet retailers are trying to become *rule-makers* by marketing their products anywhere at any time rather than being restricted to making their products available at particular locations during normal

shopping times. Consumers can now get their credit cards from Shell Oil or General Motors or AOL, or have their checking account at Charles Schwab, or get a home mortgage from Merrill Lynch or Mortgage.com, or shop on the Internet instead of going to the mall.

The Strategy-Making Pyramid

Strategy making is not just a task for senior executives. In large enterprises, decisions about what business approaches to take and what new moves to initiate involve senior executives in the corporate office, heads of business units and product divisions, the heads of major functional areas within a business or division (manufacturing, marketing and sales, finance, human resources, and the like), plant managers, product managers, district and regional sales managers, and lower-level supervisors. In diversified enterprises, strategies are initiated at four distinct organization levels. There's a strategy for the company and all of its businesses as a whole (*corporate strategy*). There's a strategy for each separate business the company has diversified into (*business strategy*). Then there is a strategy for each specific functional unit within a business (*functional strategy*). Each business usually has a production strategy, a marketing strategy, a finance strategy, and so on. And, finally, there are still narrower strategies for basic operating units—plants, sales districts and regions, and departments within functional areas (*operating strategy*). In single-business enterprises, there are only three levels of strategy making (business strategy, functional strategy, and operating strategy) unless diversification into other businesses becomes an active consideration.

Corporate Strategy

Corporate strategy is the overall managerial game plan for a diversified company; it extends companywide—an umbrella over all a diversified company's businesses. Corporate strategy consists of the moves made to establish business positions in different industries and the approaches used to manage the company's group of businesses. Crafting corporate strategy for a diversified company involves four kinds of initiatives:

1. *Making the moves to establish positions in different businesses and achieve diversification*-- In a diversified company, a key piece of corporate strategy is how many and what kinds of businesses the company should be in—specifically, what industries to enter and whether to enter the industries by starting a new business or acquiring another company (an established leader, an up-and-coming company, or a troubled company with turnaround potential). This piece of corporate strategy establishes whether diversification is based narrowly in a few industries or broadly in many industries and whether the different businesses will be related or unrelated.
2. *Initiating actions to boost the combined performance of the businesses the firm has diversified into*-- As positions are created in the chosen industries, corporate strategy making concentrates on ways to strengthen the long-term competitive positions and profitabilities of the businesses the firm has invested in. Corporate parents can help their business subsidiaries be more successful by financing additional capacity and efficiency improvements, by supplying missing skills and managerial know-how, by acquiring another company in the same industry and merging the two operations into a stronger business, or by acquiring new businesses that strongly complement existing businesses. Management's overall strategy for improving companywide performance usually involves pursuing rapid-growth strategies in the most promising businesses, keeping the other core businesses healthy, initiating turnaround efforts in weak-performing businesses with potential, and divesting businesses that are no longer attractive or that don't fit into the organization's long-range plans.

3. *Pursuing ways to capture valuable cross-business strategic fits and turn them into competitive advantage*-When a company diversifies into businesses with related technologies, similar operating characteristics, common distribution channels or customers, or some other synergistic factor, it gains competitive advantage potential not open to a company that diversifies into totally unrelated businesses. When Amazon.com diversified into selling CDs and conducting online auctions, the moves presented opportunities to (a) transfer Amazon's skills and expertise in online book sales to online music sales, (b) use the same distribution facilities and order fulfillment technology to ship both books and CDs (use of shared facilities and resources meant, lower joint costs), (c) leverage Amazon's brand name, and (d) lay the foundation for Amazon.com to later extend its reach into other product lines and become a one-stop shopping site for online buyers. Such cross-business "strategic fits" strengthen a company's competitiveness and provide a basis for greater profitability.

4. *Establishing investment priorities and steering corporate resources into the most attractive business units*-A diversified company's different businesses are usually not equally attractive from the standpoint of investing additional funds. This facet of corporate strategy making involves channeling resources into areas where earnings potentials are higher and away from areas where they are lower. Corporate strategy may include divesting business units that are chronically poor performers or those in an increasingly unattractive industry. Divestiture frees up unproductive investments for redeployment to promising business units or for financing attractive new acquisitions.

Corporate strategy is crafted at the highest levels of management. Senior corporate executives normally have lead responsibility for devising corporate strategy and for choosing among whatever recommended actions bubble up from lower-level managers. Key business-unit heads may also be influential, especially in strategic decisions affecting the businesses they head. Major strategic decisions are usually reviewed and approved by the company's board of directors.

Business Strategy

The term business strategy (or business-level strategy) refers to the managerial game plan for a single business. It is mirrored in the pattern of approaches and moves crafted by management to produce successful performance in one specific line of business. For a single business company, corporate strategy and business strategy are one and the same.

The central thrust of business strategy is *how* to build and strengthen the company's long-term competitive position in the marketplace. Towards this end, business strategy is concerned principally with (1) forming responses to changes under way in the industry, the economy at large, the regulatory and political arena, and other relevant areas; (2) crafting competitive moves and market approaches that can lead to sustainable 'competitive advantage; (3) building competitively valuable competencies and capabilities; (4) uniting the strategic initiatives of functional departments; and (5) addressing specific strategic issues facing the company's business.

Clearly, business strategy involves initiating whatever actions and responses managers deem prudent in light of competitive forces, economic trends, technological developments, buyer needs and demographics, new legislation and regulatory requirements, and other such broad external factors. *A good strategy is well-matched to a company's external and internal situation*; as the company's situation changes in significant ways, then adjustments in strategy typically are needed. Whether a company's response to changing conditions is quick or slow tends to be a function of how long events must unfold before managers can assess their implications and how much longer it then takes to form a strategic response. Some changes in a

company's external and internal environment, of course, require little or no response, while others call for significant strategy alterations. On occasion, situational factors change in ways that pose a formidable strategic hurdle—for example, cigarette and firearms manufacturers face a tough challenge holding their own against the mounting campaigns against smoking and for stricter gun control. Conventional retailers are rushing to establish their own Internet sales capabilities to defend against competition from thousands of enterprising Internet retailers.

What separates a powerful business strategy from a weak one is the strategist's ability to forge a series of moves, both in the marketplace and internally, that are capable of producing *sustainable competitive advantage*. With a competitive advantage, a company has good prospects for above-average profitability and success in the industry. Without competitive advantage, a company risks being locked into mediocre performance. Crafting a business strategy that yields sustainable competitive advantage has three facets: (1) deciding what product/service attributes (lower costs and prices, a better product, a wider product line, superior customer service, emphasis on a particular market niche) offer the best chance to win a competitive edge; (2) developing expertise, resource strengths, and competitive capabilities that set the company apart from rivals; and (3) trying to insulate the business as much as possible from the actions of rivals and other threatening competitive developments.

A company's strategy for competing is typically both offensive and defensive. Some actions are aggressive and amount to direct challenges to competitors' market positions; others aim at countering competitive pressures and the actions of rivals. Three of the most frequently used competitive approaches are (1) striving to be the industry's low-cost provider; (2) pursuing such differentiating features as higher quality, added performance, better service, more attractive styling, technological superiority, or unusually good value; and (3) focusing on a narrow market niche and doing a better job than rivals of serving the special needs and tastes of its buyers.

The most successful business strategies typically aim at building *uniquely strong or distinctive competencies* in one or more areas crucial to strategic success and then using them as a basis for winning a competitive edge over rivals. Distinctive competencies can relate to leading-edge product innovation, better mastery of a technological process, expertise in defect-free manufacturing, specialized marketing and merchandising knowhow, potent global sales and distribution capability, superior e-commerce capabilities, better customer service, or anything else that constitutes a competitively valuable strength in creating, producing, distributing, or marketing the company's product or service.

On a broader internal front, business strategy must also aim at uniting strategic initiatives in the various functional areas of business. Strategic actions are needed in each functional area to support the company's competitive approach and overall business strategy. Strategic unity and coordination across the various functional areas add power to the business strategy.

Business strategy also extends to *action plans* for addressing any special strategy-related issues unique to the company's competitive position and internal situation (such as whether to add new capacity, replace an obsolete plant, increase R&D funding for a promising technology, reduce burdensome interest expenses, form strategic alliances and collaborative partnerships, or build competitively valuable competencies and capabilities via the Internet). Such custom tailoring of strategy to fit a company's specific situation is one of the reasons why companies in the same industry employ different business strategies.

Lead responsibility for business strategy falls in the lap of whoever is in charge of the business. Even if the business head does not personally wield a heavy hand in business strategy making, preferring to delegate many strategy particulars to subordinates, he or she is still accountable for the strategy and the results it produces. The business head, as chief strategist

for the business, has at least two other responsibilities. The first is seeing that supporting strategies in each of the major functional areas of the business are well conceived and consistent with each other. The second is getting major strategic moves approved by higher authority (the board of directors and/or corporate-level officers) and keeping them informed of important new developments, deviations from plan, and potential strategy revisions. In diversified companies, business-unit heads may have the additional obligation of making sure business-level objectives and strategy conform to corporate-level objectives and strategy themes.

Functional Strategy

The term functional strategy refers to the managerial game plan for a particular functional activity, business process, or key department within a business. A company's marketing strategy, for example, represents the managerial game plan for running the marketing part of the business. A company's new product development strategy represents the managerial game plan for keeping the company's product lineup fresh and in tune with what buyers are looking for. A company needs a functional strategy for every major business activity and organizational unit. Functional strategy, while narrower in scope than business strategy, adds relevant detail to the overall business game plan. It aims at establishing or strengthening specific competencies calculated to enhance the company's market position. Like business strategy, functional strategy must *support* the company's overall business strategy and competitive approach. A related role is to create a managerial road map for achieving the functional area's objectives and mission. Thus, functional strategy in the production/manufacturing area represents the game plan for how manufacturing activities will be managed to support business strategy and achieve the manufacturing department's objectives and mission. Functional strategy in the finance area consists of how financial activities will be managed in supporting business strategy and achieving the finance department's objectives and mission.

Lead responsibility for conceiving strategies for each of the various important business functions and processes is normally delegated to the respective functional department heads and process managers unless the business-unit head decides to exert a strong influence. In crafting strategy, the manager of a particular business function or process ideally works closely with key subordinates and touches base often with the managers of other functions/processes and the business head. If functional or process managers plot strategy independent of each other or the business head, they open the door for uncoordinated or conflicting strategies. Compatible, collaborative, mutually reinforcing functional strategies are essential for the overall business strategy to have maximum impact. Plainly, a business's marketing strategy, production strategy, finance strategy, customer service strategy, new product development strategy, and human resources strategy should be sync rather than serving their own narrower purposes. Coordination and consistency among the various functional and process strategies are best accomplished during the deliberation stage. If inconsistent functional strategies are sent up the line for final approval, it is up to the business head to spot the conflicts and get them resolved.

Operating Strategy

Operating strategy concerns the even narrower strategic initiatives and approaches for managing key operating units (plants, sales districts, distribution centers) and for handling daily operating tasks with strategic significance (advertising campaigns, materials purchasing, inventory control, maintenance, shipping). A plant manager needs a strategy for accomplishing the plant's objectives, carrying out the plant's part of the company's overall manufacturing game plan, and dealing with any strategy-related problems that exist at the plant. A district sales manager needs a sales strategy customized to the district's particular situation and sales

objectives. A company's advertising manager needs a strategy for getting maximum audience exposure and sales impact from the ad budget.

Operating strategies, while of limited scope, add further detail and completeness to functional strategies and to the overall business plan. Lead responsibility for operating strategies is usually delegated to front-line managers, subject to review and approval by higher-ranking managers.

Even though operating strategy is at the bottom of the strategy-making pyramid, its importance should not be downplayed. Operating-level strategies provide valuable support to higher-level strategies. Consider the case of a distributor of plumbing equipment whose business strategy emphasizes fast delivery and accurate order filling in an effort to deliver better customer service than rivals. In support of this strategy, the firm's warehouse manager (1) develops an inventory stocking strategy that allows 99.9 percent of all orders to be completely filled without back-ordering any item and (2) institutes a warehouse staffing strategy that allows any order to be shipped within 24 hours. Without such operating strategies in place, the plumbing distributor's strategy would fail.

Another instance of the importance of operating strategy occurs in manufacturing companies. A major plant that fails in its strategy to achieve production volume, unit cost, and quality targets can undercut the achievement of company sales and profit objectives and wreak havoc with the whole company's strategic efforts to build a quality image with customers. One cannot reliably judge the strategic importance of a given action by the organizational or managerial level where it is initiated.

Uniting the Strategy-Making Effort

The previous discussion underscores that a company's strategic plan is a collection of strategies devised by different managers at different levels in the organizational hierarchy. The larger the enterprise, the more points of strategic initiative it has. Management's direction-setting effort is not complete until the separate layers and pieces of strategy are unified into a coherent, supportive pattern. Ideally the pieces and layers of strategy should fit together like a jigsaw puzzle.

To achieve this unity, the strategizing process has to proceed more from the top down than from the bottom up. Direction and guidance have to flow from the corporate level to the business level and from the business level to the functional and operating levels. Lower-level managers cannot do good strategy making without understanding the company's long-term direction and higher-level strategies. The strategic disarray that occurs in an organization when senior managers don't exercise strong top-down direction setting and strategic leadership is akin to what would happen to a football team's offensive performance if the quarterback decided not to call a play for the team but instead let each player pick whatever play he thought would work best at his respective position. In business, as in sports, all the strategy makers in a company are on the same team. They are obligated to perform their strategy-making tasks in a manner that benefits the whole company, not in a manner that suits personal or departmental interests. Indeed, functional and operating-level managers have a duty to set performance targets and invent strategic actions that will help achieve business objectives and make business strategy more effective.

The larger the company and the more geographically scattered its units and subsidiaries, the more tedious and frustrating the task of harmonizing objectives and strategies piece by piece and level by level. Functional managers are sometimes more interested in doing what is best for their own areas, building their own empires, and consolidating their personal power and organizational influence than they are in cooperating with other functional managers to unify

behind the overall business strategy. As a result, it's easy for functional area support strategies to conflict, thereby forcing the business-level general manager to spend time and energy refereeing functional strategy conflicts and building for a more unified approach. Broad consensus is particularly difficult when there is ample room for opposing views and disagreement.

THE FACTORS THAT SHAPE A COMPANY'S STRATEGY

Many situational considerations enter into crafting strategy.

Strategy-Shaping Factors External to the Company

- Economic, societal, political, regulatory and community citizenship considerations
- Competitive conditions and overall industry attractiveness
- Company opportunities

Strategy Shaping Factors Internal to the Company

- Company resource strengths, weaknesses, competencies, and competitive capabilities
- Personal ambitions, business philosophies, and ethical principles of key executives
- Shared values and company culture

The Mix of Considerations that determines a company's strategic situation

- Conclusions concerning how internal and external factors stack up: their implications for strategy
- Identification and evaluation of strategy alternatives
- Crafting a strategy that fits the overall situation

The interplay of these factors and the influence that each has on the strategy-making process vary from situation to situation. Very few strategic choices are made in the same context. Even in the same industry, situational factors differ enough from company to company that the strategies of rivals turn out to be quite distinguishable from one another rather than imitative. This is why carefully sizing up all the various situational factors, both external and internal, is the starting point in crafting strategy.

Societal, Political, Regulatory and Citizenship Considerations

All organizations operate within the broader community of society. What an enterprise can and cannot do strategywise is always constrained by what is legal, by what complies with government policies and regulatory requirements, by what is considered ethical, and by, what is in accord with societal expectations and the standards of good community citizenship. Outside pressures also come from other sources—special-interest groups, the glare of investigative reporting, a fear of unwanted political action, and the stigma of negative opinion. Societal concerns over gun control, health and nutrition, alcohol and drug abuse, smoking, environmental pollution, sexual harassment, and the impact of plant closings on local communities have caused many companies to temper or revise aspects of their strategies. American concerns over jobs lost to foreign manufacturers and political debate over how to cure the chronic U.S. trade deficit are driving forces in the strategic decisions of Japanese and European companies to locate plants in the United States. Heightened consumer awareness about the hazards of saturated fat and cholesterol have driven most food products companies to phase out high-fat ingredients and substitute low-fat ingredients, despite the extra costs.

Factoring in societal values and priorities, business ethics, community concerns, and the potential for onerous legislation and regulatory requirements is a regular part of external situation analysis at more and more companies. Intense public pressure and adverse media coverage make such a practice prudent. The task of making an organization's strategy socially responsible means (1) conducting organizational activities within the bounds of what is considered ethical and in the general public interest, (2) responding positively to emerging societal priorities and expectations, (3) demonstrating a willingness to take action ahead of regulatory confrontation, (4) balancing stockholder interests against the larger interests of society as a whole, and (5) being a good citizen in the community.

Corporate social responsibility is showing up in company mission statements. John Hancock, for example, concludes its mission statement with the following sentence:

In all that we do, we exemplify the highest standards of business ethics and personal integrity, and recognize our corporate obligation to the social and economic well-being of our community.

John Hancock goes on to state its commitment to ethical behavior:

In order to exemplify the highest standards of business ethics, we conduct the Company's affairs in strict compliance with both the letter and the spirit of the law, and will at all times treat policyholders, customers, suppliers, and all others with whom the Company does business fairly and honorably. Recognizing that our reputation of unquestioned integrity and honesty is our most valued asset, under no circumstances will what we achieve be allowed to take precedence over how we achieve it.

At Sempra Energy, a San Diego-based electricity and natural gas company, management has expressed a strong commitment to enhancing the quality of life in the communities where it does business and stated it is not only good business for the company and its employees to be deeply involved in community activities but also "the thing to do":

We have a vested interest in ensuring that businesses thrive, community needs are met, the environment is protected, and our diverse human resources are engaged to their fullest potential.

Our main focus is building and maintaining valuable relationships with communities community leaders in markets where we do business. We also regularly encourage employee leadership and involvement in civic and community affairs, and make charitable contributions to community and civic organizations through both Sempra Energy and its key affairs.

Competitive Conditions and Overall Industry Attractiveness

An industry's competitive conditions and overall attractiveness are big strategy-determining factors. A company's strategy has to be tailored to the nature and mix of competitive factors in play--price, product quality, performance features, service, warranties, and so on. When competitive conditions intensify significantly, a company must respond with strategic actions to protect its position. Competitive weakness on the part of one or more rivals presents opportunities for a strategic offensive. Furthermore, fresh moves on the part of rival companies, changes in the industry's price-cost-profit economics, shifting buyer needs and expectations, and new technological developments often alter the requirements for competitive success and mandate reconsideration of strategy. The industry environment, as it exists now and is exist later, this has a direct bearing on a company's best competitive strategy option and where it should concentrate its efforts. *A company's strategy can't produce real market success unless it fits the industry and competitive situation.* When a firm concludes its industry environment has grown unattractive and it is better off investing company resources elsewhere, it may begin a strategy of disinvestment and eventual abandonment. A strategist, therefore, has to be a student of industry and competitive conditions.

The Company's Market Opportunities and External Threats

The particular business opportunities open to a company and the threatening external developments that it faces are key influences on strategy. Both point to the need for strategic action. A company's strategy needs to be deliberately aimed at capturing its best growth opportunities, especially the ones that hold the most promise for building sustainable competitive advantage and enhancing profitability. Likewise, strategy should provide a defense against external threats to the company's well-being and future performance. This usually means crafting *offensive* moves to capitalize on the company's most promising market opportunities and crafting *defensive* moves to protect the company's competitive position and long-term profitability. Managers have to scrutinize the kinds of opportunities and threats presented by changes in the market place and be prompt and astute in making needed strategic adjustments.

Company Resource Strengths, Competencies, and Competitive Capabilities

One of the most pivotal strategy-shaping internal considerations is whether a company has or can acquire the resources, competencies, and capabilities needed to execute a strategy proficiently. These are the factors that can enable an enterprise to capitalize on a particular opportunity, give the firm a competitive edge in the marketplace, and become a cornerstone of the enterprise's strategy. The best path to competitive advantage is found where a firm has competitively valuable resources and competencies, where rivals do not have matching or offsetting resources and competencies, and where rivals can't develop comparable capabilities except at high cost or over an extended period of time. Intel's long-standing global leadership in microprocessors for PCs, servers, and workstations has much to do with its deep technological expertise, its multibillion dollar R&D program, its state-of-the-art chip-making plants, and its ability to spend \$3-\$5 billion annually on new chip-making plants and the latest chip-making equipment. None of its competitors have such depth of resources and capabilities. As a rule, a company's strategy ought to be grounded in its resource strengths and in what it is good at doing (its competencies and competitive capabilities).

Even if a firm lacks competitively superior competencies and capabilities (as, in, fact, many do), its managers still must tailor a strategy that fits the enterprise's particular resource strengths and weaknesses. It is foolish to craft a strategy that cannot be executed with the resources and capabilities a firm is able to assemble. And it is foolish to craft a strategy whose success depends on activities which a company performs poorly or has no experience in performing at all.

The Personal Ambitions, Business Philosophies, and Ethical Beliefs of Managers

Managers do not dispassionately assess what strategic course to steer. Their choices are typically influenced by their own vision of how to compete and how to position the enterprise and by what image and standing they want the company to have. Both casual observation and formal studies indicate that managers' ambitions, values, business philosophies, attitudes toward risk, and ethical beliefs have important influences on strategy. Sometimes the influence of a manager's personal values, experiences, and emotions is conscious and deliberate; at other times it may be unconscious. As one expert noted in explaining the relevance of personal factors to strategy, "People have to have their hearts in it."

Several examples of how business philosophies and personal values enter into strategy-making are particularly noteworthy. Ben Cohen and Jerry Greenfield, cofounders and major stockholders in Ben & Jerry's Homemade, Inc., have consistently insisted that the company's strategy incorporate a strong social mission and be supportive of social causes of their choosing. The strategy crafted by Starbucks' CEO, Howard Schultz, mirrors Schultz's insistence on customers

having a very positive experience when patronizing a Starbucks store and his desire to "build a company with soul" and make Starbucks a great place to work. Japanese managers are strong proponents of strategies that take a long-term view and that aim at building market share and competitive position.

Attitudes toward risk also have a big influence on strategy. Risk-avoiders are inclined toward "conservative" strategies that minimize downside risk, have a quick payback, and produce sure short-term profits. Risk-takers lean more toward opportunistic strategies where visionary moves can produce a big payoff over the long term. Risk-takers prefer innovation to imitation and bold strategic offensives to defensive moves aimed at protecting the status quo.

Managerial values also shape the ethical quality of a firm's strategy. Managers with strong ethical convictions take pains to see that their companies observe a strict code of ethics in all aspects of the business. They expressly forbid such practices as accepting or giving kickbacks, badmouthing rivals' products, and buying political influence with political contributions. Instances where a company's strategic actions run afoul of high ethical standards include charging excessive interest rates on credit card balances, employing bait-and-switch sales tactics, continuing to market products suspected of having safety problems, and using ingredients that are known health hazards.

The Influence of Shared Values and Company Culture on Strategy

An organization's policies, practices, traditions, philosophical beliefs, and ways of doing things combine to create a distinctive culture. Typically, the stronger a company's culture, the more that culture is likely to shape the company's strategic actions, sometimes even dominating the choice of strategic moves. This is because culture-related values and beliefs are so embedded in management's strategic thinking and actions that they condition how the enterprise does business and responds to external events. Such firms have a culture-driven bias about how to handle strategic issues and what kinds of strategic moves it will consider or reject. Strong cultural influences partly account for why companies gain reputations for such strategic traits as leadership in technology and product innovation, dedication to superior craftsmanship, a proclivity for financial wheeling and dealing, a desire to grow rapidly by acquiring other companies, having a strong people orientation and being an especially good company to work for, or unusual emphasis on customer service and total customer satisfaction.

In recent years, many companies have articulated the core beliefs, principles, and values underlying their business approaches. One company expressed its values as follows:

We are market-driven. We believe that functional excellence, combined with teamwork across functions and profit centers, is essential to achieving superb execution. We believe that people are central to everything we will accomplish. We believe that honesty, integrity, and fairness should be the cornerstone of our relationships with consumers, customers, suppliers, stockholders, and employees.

The commitment of Ritz-Carlton Hotels to providing its guests with the finest personal service and facilities--combined with its principles of trust, respect, honesty, integrity--drive its strategy and operating practices. The company's cultural motto is "We are ladies and gentlemen serving ladies and gentlemen." Wal-Mart's founder, Sam Walton, was a fervent believer in frugality, hard work, constant improvement, dedication to customers, and genuine care for employees. The company's commitment to these values is deeply ingrained in its strategy of low prices, good values, friendly service, productivity through the intelligent use of technology, and hard-nosed bargaining with suppliers. At Hewlett-Packard, the company's basic values, known internally as "the HP Way," include sharing the company's success with employees, showing trust and respect for employees, providing customers with products and services of the greatest

value, being genuinely interested in providing customers with effective solutions to their problems, making profit a high stockholder priority, avoiding the use of long-term debt to finance growth, individual initiative and creativity, teamwork, and being a good corporate citizen. At both Wal-Mart and Hewlett-Packard, the value systems are deeply ingrained and widely shared by managers and employees. Whenever this happens, values and beliefs are more than an expression of nice platitudes; they become a way of life within the company.

LINKING STRATEGY WITH ETHICS AND SOCIAL RESPONSIBILITY

Strategy ought to be ethical. It should involve rightful actions, not wrongful ones; otherwise it won't pass the test of moral scrutiny. This means more than conforming to what is legal. Ethical and moral standards go beyond the law and the language of "thou shalt not." They address the issues of *duty* and the language of "should do and should not do." Ethics concern human *duty* and the principles on which this duty rests.

Every business has an ethical duty to each of five constituencies: owners/shareholders, employees, customers, suppliers, and the community at large. Each of these constituencies affects the organization and is affected by it. Each is a stakeholder in the enterprise, with certain expectations as to what the enterprise should do and how it should do it. A company has a duty to *owners/shareholders*, for instance, who rightly expect a return on their investment. Even though investors may individually differ in their preferences for profits now versus profits later, their tolerances for greater risk, and their enthusiasm for exercising social responsibility, business executives have a moral duty to pursue profitable management of the owners' investment.

A company's *duty to employees* arises out of respect for the worth and dignity of individuals who devote their energies to the business and who depend on the business for their economic well-being. Principled strategy making requires that employee related decisions be made equitably and compassionately, with concern for due process and for the impact that strategic change has on employees' lives. At best, the chosen strategy should promote employee interests as concerns compensation, career opportunities, job security, and overall working conditions. At worst, the chosen strategy should not disadvantage employees. Even in crisis situations, businesses have an ethical duty to minimize whatever hardships have to be imposed in the form of workforce reductions, plant closings, job transfers, relocations, retraining, and loss of income.

The *duty to the customer* arises out of expectations that attend the purchase of a good or service. Inadequate appreciation of this duty led to product liability laws and a host of regulatory agencies to protect consumers. All kinds of strategy-related ethical issues still abound, however. Should a seller voluntarily inform consumers that its product contains ingredients that, though officially approved for use, are suspected of having potentially harmful effects? Is it ethical for the makers of alcoholic beverages to sponsor college events, given that many college students are under 21? Is it ethical for cigarette manufacturers to advertise at all (even though it is legal)? Is it ethical to short-circuit product testing in order to rush new products to market? Is it ethical for manufacturers to stonewall efforts to recall products they suspect have faulty parts or defective designs? Is it ethical for supermarkets and department store retailers to lure customers with highly advertised "loss-leader" prices on a few select items, but then put high markups on popular or essential items?

Recently, a certain company's chief technology officer helped choose an Internet start up company's products over that of rivals; the Internet company showed its gratitude by granting the officer rights to purchase 250 shares when the Internet company subsequently went public.

The officer bought the shares at the initial offering price of \$23; the stock closed at \$84 at the end of the first day's trading, kept rising, then split ultimately giving the officer a profit of about \$58,000 when the officer sold the shares several months later. Is it ethical for a company to give gifts to individuals in customer companies when those individuals have had an influential role in selecting the company's products over those of its rivals? Is it ethical for the makers of athletic apparel and equipment to make substantial payments to college coaches in return for having the school's athletic teams wear their apparel or use their equipment?

A company's *ethical duty to suppliers* arises out of the market relationship that exists between them. They are both partners and adversaries. They are partners in the sense that the quality of suppliers' parts affects the quality of a firm's own product and in the sense that their businesses are connected. They are adversaries in the sense that the supplier wants the highest price and profit it can get while the buyer wants a cheaper price, better quality, and speedier service. A company confronts several ethical issues in its supplier relationships. Is it ethical to purchase goods from foreign suppliers who employ child labor, pay substandard wages, or have sweatshop working conditions in their facilities? Is it ethical for supermarket chains to demand "slotting fees" from food suppliers in return for placing their items in favorable shelf locations? Is it ethical to threaten to cease doing business with a supplier unless the supplier agrees not to do business with key competitors? Is it ethical to reveal one supplier's price quote to rival supplier? Is it ethical to accept an offer to vacation at a supplier's beach house? Is it ethical to pay a supplier in cash? Is it ethical *not* to give present suppliers advance warning of the intent to discontinue using what they have supplied and to switch to components supplied by other enterprises?

A company's *ethical duty to the community at large* stems from its status as a member of the community and as an institution of society. Communities and society are reasonable in expecting businesses to be good citizens—to pay their fair share of taxes for fire and police protection, waste removal, streets and highways, and so on, and to exercise care in the impact their activities have on the environment, on society, and on the communities in which they operate. For example, is it ethical for a brewer of beer to advertise its products on TV at times when these ads are likely to be seen by underage viewers? (Anheuser-Busch responded to such concerns in late 1996, announcing it would no longer run its beer commercials on MTV.) Is it ethical for the manufacturers of firearms to encourage retired policemen and police departments to trade in or return automatic weapons whose manufacture has since been banned by Congress so they can gain access to a supply of resaleable weapons (a loophole in the laws allow them to traffic in such weapons that were manufactured prior to the bans)? Is it ethical for firearms makers to make just enough changes in the designs of their automatic weapons to escape the bans and prohibitions on automatic firearms instituted by Congress? Some years ago, an oil company was found to have spent \$2 million on environmental conservation and \$4 million advertising its virtue and good deeds actions that seem deliberately manipulative and calculated to mislead.

A company's community citizenship is ultimately demonstrated by whether it refrains from acting in a manner contrary to the well-being of society and by the degree to which it supports community activities, encourages employees to participate in community activities, handles the health and safety aspects of its operations, accepts responsibility for overcoming environmental pollution, relates to regulatory bodies and employee unions, and exhibits high ethical standards. European consumer goods company Diageo PLC—the maker of Guinness beers and over 50 brands of liquors and wines sold across Europe and the United States—states that it has a particular responsibility to encourage responsible use of alcohol as part of a healthy lifestyle. [We] 'are proud of the unique part that alcohol plays in the social lives and celebrations of many cultures. We also recognize that alcohol can be misused, and Diageo will be at the forefront of campaigns to promote moderate and sensible consumption.

Living Up to Ethical Responsibilities A management that truly cares about business ethics and corporate social responsibility is proactive rather than reactive in linking strategic action and ethics. It steers away from ethically or morally questionable business opportunities and business practices. And it goes to considerable lengths to ensure that its actions reflect integrity and high ethical standards. If any of a company's constituencies conclude that management is not measuring up to ethical standards, they have recourse. Concerned investors can protest at the annual shareholders' meeting, appeal to the board of directors, or sell their stock. Concerned employees can unionize and bargain collectively, or they can seek employment elsewhere. Customers can switch to competitors. Suppliers can find other buyers. The community and society can do anything from staging protest marches and urging boycotts to stimulating political and governmental action.

TESTS OF A WINNING STRATEGY

What are the criteria for weeding out candidate strategies? How can a manager judge which strategic option is best for the company? What are the standards for determining whether a strategy is successful or not? Three tests can be used to evaluate the merits of one strategy over another:

1. *The Goodness of Fit Test*-A good strategy has to be well matched to industry and competitive conditions, market opportunities and threats, and other aspects of the enterprise's external environment. At the same time, it has to be tailored to the company's resource strengths and weaknesses, competencies, and competitive capabilities. Unless a strategy exhibits tight fit with a company's external situation and internal circumstances, it is suspect and likely to produce less than the best possible business results.
2. *The Competitive Advantage Test*-A good strategy leads to sustainable competitive advantage. The bigger the competitive edge that a strategy helps build, the more powerful and effective it is.
3. *The Performance Test*-A good strategy boosts company performance. Two kinds of performance improvements are the most telling of a strategy's caliber: gains in profitability and gains in the company's competitive strength and long-term market position.

Strategic options that clearly come up short on one or more of these tests should be dropped from further consideration. The strategic option that best meets all three tests can be regarded as the best or most attractive strategic alternative. Once a strategic commitment is made and enough time elapses to see results, these same tests can be used to determine whether the chosen strategy qualifies as a winning strategy.

There are, of course, some additional criteria for judging the merits of a particular strategy: completeness and coverage of all the bases, internal consistency among all the pieces of strategy, clarity, the degree of risk involved, and flexibility. These criteria are useful supplements and certainly ought to be looked at, but they can in no way replace the three tests posed above.

Key points

Management's direction-selling tasks involve (1) charting a company's future strategic path, (2) setting objectives, and (3) crafting a strategy. Early on in the direction-selling process, managers need to address the question "What is our business and what will it be?"

Management's views and conclusions about the organization's future course, the market position it should try to occupy, and the business activities to be pursued constitute a *strategic vision* for the company. A strategic vision indicates management's aspirations for the organization, providing a panoramic view of "what businesses we want to be in, where we are headed, and the kind of company we are trying to create." It spells out a direction and describes the destination. Effective visions are clear, challenging, and inspiring; they prepare 'a firm for the future, and they make sense in the marketplace. A well-conceived, well-worded mission/vision statement helps managers manage-serving as a beacon of the enterprise's long-term direction, helping channel' organizational efforts and strategic initiatives along the path management has committed to following, building a strong sense of organizational identity and purpose, and creating employee buy-in.

The second direction-setting task is to establish *strategic and financial objectives* for the organization to achieve. Objectives convert the mission statement and strategic vision into specific performance targets. The agreed-on objectives need to spell out precisely how much by when, and they need to require a significant amount of organizational stretch. Objectives are needed at all organizational levels.

The third direction-setting step entails *crafting a strategy* to achieve the objectives set in each area of the organization. A corporate strategy is needed to achieve corporate-level objectives; business strategies are needed to achieve business-unit performance objectives; functional strategies are needed to achieve the performance targets set for each functional department; and operating-level strategies are needed to achieve the objectives set in each operating and geographic unit. In effect, an organization's strategic plan is a collection of unified and interlocking strategies. Typically, the strategy-making task is more top-down than bottom-up. Lower-level strategies should contribute to the achievement of higher-level, company wide objectives.

Strategy is shaped by both external and internal considerations. The major external considerations are societal, political, regulatory, and community factors; competitive conditions and overall industry attractiveness; and the company's market opportunities and threats. The primary internal considerations are company strengths, weaknesses, and competitive capabilities; managers' personal ambitions, philosophies, and ethics; and the company's culture and shared values. A good strategy must be well matched to all these situational considerations. In addition, a good strategy must lead to sustainable competitive advantage and improved company performance.

INDUSTRY AND COMPETITIVE ANALYSIS

INTRODUCTION

A great deal must be learned about an organization so that strategy formulation decisions can be based upon appropriate information. It almost goes without saying that strategists must understand all there is to know about the internal operations of an organization before strategy can be effectively formulated and implemented. The external influences acting on the firm also must be analyzed, documented, and understood to manage the strategy process effectively. This chapter focuses on conducting both external and internal analyses for the purpose of generating information for strategy formulation.

The chapter has two major sections--environmental analysis and internal analysis. An organization's environment consists of two parts: The industry within which it operates (for multibusiness firms, the industry is usually considered the activity in which the firm generates the majority of its revenue), and other environmental dimensions--economic, political/legal, social, and technological. The section of this chapter devoted to internal analysis first addresses financial analysis--the process of learning about the financial performance of the firm or organization. Very often financial analysis will bring to light several financial strengths and weaknesses that are indicative of strategic or operating capabilities and problems within the various strategy levels and within functional areas.

Financial analysis is typically followed by internal diagnosis of functional areas. This process identifies strengths and weaknesses within such areas as marketing, personnel, research and development, and others.

Together these four analytical activities--environmental, industry, and financial analysis and internal diagnosis of functional areas--are undertaken to generate a data set consisting of strengths, weaknesses, threats, and opportunities that comprehensively describes the internal and external characteristics of the organization. This information is then used as input to the strategy formulation process. It is factored with data about past strategies, mission, corporate culture, managers' values, and so on to evaluate the success or failure of present strategies. As a result present strategies either can be modified, left as they are, or replaced as necessary in a particular situation.

Crafting strategy is not a task in which managers can get by with opinions, good instincts, and creative thinking. Judgments about what strategy to pursue need to flow directly from *solid analysis* of a company's external environment and external situation. The two most important situational considerations are (1) industry and competitive conditions and (2) a company's own competitive capabilities, resources, internal strengths and weaknesses, and market position.

All organizations operate in *macro environment* consisting broadly of the economy at large, population demographics, societal values and lifestyles, governmental legislation and regulation, technological factors, and the company's immediate industry and competitive environment. The macro environment includes *all relevant forces* outside a company's boundaries--relevant in the sense that they are important enough to have a bearing on the decisions a company ultimately makes about its business model and strategy. While many forces in the macroenvironment are beyond a company's sphere of influence, company managements are nonetheless obliged to monitor them and adapt the company's strategy as may be needed. The forces in a company's macroenvironment having the biggest impact on a company's strategy, however, typically revolve around the company's immediate industry and competitive environment.

The analytical sequence is from strategic appraisal of the company's external and internal situation, to evaluation of alternatives, to choice of strategy. Accurate diagnosis of the company's situation is necessary managerial preparation for deciding on a sound long-term direction, setting appropriate objectives, and crafting a winning strategy. Without perceptive understanding of the strategic aspects of a company's external and internal environments, the chances are greatly increased that managers will concoct a strategic game plan that doesn't fit the situation well, that holds little prospect for building competitive advantage, and that is unlikely to boost company performance.

This chapter examines the techniques of *industry and competitive analysis*, the term commonly used to refer to assessing the most strategically relevant aspects of a single-business company's macroenvironment. In Chapter 5, we'll cover the methods of *company situation analysis* and explore how to appraise the strategy-shaping aspects of a firm's internal environment and current market position.

THE METHODS OF INDUSTRY AND COMPETITIVE ANALYSIS

Industries differ widely in their economic characteristics, competitive situations, and future profit prospects. The economic and competitive character of the trucking industry bears little resemblance to that of discount retailing. The economic and competitive traits of the fast-food business have little in common with those of Internet service providers. The cable TV business is shaped by industry and competitive considerations radically different from those that dominate the soft-drink business.

The economic character of industries varies according to such factors as overall size and market growth rate, the pace of technological change, the geographic boundaries of the market (which can extend from local to worldwide), the number and size of buyers and sellers, whether sellers' products are virtually identical or highly differentiated, the extent to which costs are affected by economies of scale, and the types of distribution channels used to access buyers. Competitive forces can be moderate in one industry and fierce, even cutthroat, in another. Moreover, in some industries competition focuses on who has the best price, while in others competition is centered on quality and reliability (as in monitors for PCs and laptops) or product features and performance (as in digital cameras) or quick service and convenience (as in online shopping and fast foods) or brand reputation (as in laundry detergents, soft drinks, and beer). In other industries, the challenge is for companies to work cooperatively with suppliers, customers, and maybe even select competitors to create the next round of product innovations and open up whole new vistas of market opportunities (as we are witnessing in wireless telecommunications and personal computers).

An industry's economic traits and competitive conditions, and how they are expected to change, determine whether its profit prospects are poor, average, or excellent. Industry and competitive conditions differ so much that leading companies in unattractive industries can find it hard to earn respectable profits, while even weak companies in attractive industries can turn in good performances.

Industry and competitive analysis uses a tool kit of concepts and techniques to get a clear fix on key industry traits, the intensity of competition, the drivers of industry change, the market positions and strategies of rival companies, the keys to competitive success, and the industry's profit outlook. This tool kit provides a way of thinking strategically about any industry's overall situation and drawing conclusions about whether the industry represents an attractive investment for company funds. The analysis entails examining a company's business in the

context of a much wider environment. Industry and competitive analysis aims at developing insightful answers to seven questions:

1. What are the industry's dominant economic features?
2. What is competition like and how strong are each of the competitive forces?
3. What is causing the industry's competitive structure and business environment to change?
4. Which companies are in the strongest/weakest positions?
5. What strategic moves are rivals likely to make next?
6. What are the key factors for competitive success?
7. Is the industry attractive and what are the prospects for above-average profitability?

The answers to these questions build understanding of a firm's surrounding environment and, collectively, form the basis for matching its strategy to changing industry conditions and competitive realities.

QUESTION 1: WHAT ARE THE INDUSTRY'S DOMINANT ECONOMIC FEATURES?

Because industries differ significantly in their basic character and structure, industry and competitive analysis begins with an overview of the industry's dominant economic features. Our working definition of the word *industry* is "a group of firms whose products have so many of the same attributes that they compete for the same buyers." The factors to consider in profiling an industry's economic features are fairly standard:

- Market size.
- Scope of competitive rivalry (local, regional, national, international, or global).
- Market growth rate and position in the business life (early development, rapid growth and takeoff, early maturity, maturity, saturation and stagnation, decline).
- Number of rivals and their relative sizes—is the industry fragmented into many small companies or concentrated and dominated by a few large companies?
- The number of buyers and their relative sizes.
- Whether and to what extent industry rivals have integrated backward and/or forward.
- The types of distribution channels used to access consumers.
- The pace of technological change in both production process innovation and new product introductions.
- Whether the products and services of rival firms are highly differentiated, weakly differentiated, or essentially identical.
- Whether companies can realize economies of scale in purchasing, manufacturing, transportation, marketing, or advertising.
- Whether key industry participants are clustered in a particular location—the world's best-known cluster locations include Silicon Valley, Hollywood, Italy (for the leather fashion industry), the wine-producing regions of California and France, and New York City (for financial services).
- Whether certain industry activities are characterized by strong learning and experience effects ("learning by doing") such that unit costs decline as *cumulative* output grows.
- Whether high rates of capacity utilization are crucial to achieving low-cost production efficiency.
- Capital requirements and the ease of entry and exit.
- Whether industry profitability is above/below par.

An industry's economic features are important because of the implications they have for strategy. For example, in capital-intensive industries where investment in a single plant can run several hundred million dollars, a firm can spread the burden of high fixed costs by pursuing a strategy that promotes high utilization of fixed assets to generate more revenue per dollar of fixed-asset investment. Thus, commercial airlines employ strategies to boost the revenue productivity of their multimillion-dollar jets by cutting ground time at airport gates (to get in more flights per day with the same plane) and by using multitiered price discounts to fill up otherwise empty seats on each flight. In industries characterized by one product advance after another, companies must spend enough time and money on R&D to match their technical prowess and innovative capability with that of competitors. A strategy of continuous product innovation becomes a condition of survival.

In industries like semiconductors, strong *learning/experience* effects in manufacturing cause unit costs to decline about 20 percent each time *cumulative* production volume doubles. In other words, if the first 1 million chips may cost \$100 each to produce, but by the time the company reaches a production volume of 2 million the chips would cost \$80 each to produce (80 percent of \$100), by a production volume of 4 million each chip would cost \$64 to produce (80 percent of \$80), and so on. When an industry is characterized by sizable economies of experience in its manufacturing operations, a company that initiates production of a new-style product and develops a successful strategy to capture the largest market share gains sustainable competitive advantage as the low-cost producer. The bigger the experience curve effect, the bigger the cost advantage of the company with the largest cumulative production volume.

An Industry's Key Economic Variables

- Market Size
- Market growth rate
- Capacity surpluses or shortages
- Industry profitability
- Entry/exit barriers
- Cost and importance of product
- Standardized products
- Rapid technological change
- Capital requirements
- Vertical integration
- Economies of scale
- Rapid product innovation

QUESTION 2: WHAT IS COMPETITION LIKE AND HOW STRONG ARE EACH OF THE COMPETITIVE FORCES?

One important component of industry and competitive analysis involves delving into the industry's competitive process to discover what the main sources of competitive pressure are and how strong each competitive force is. This analytical step is essential because managers cannot devise a successful strategy without in-depth understanding of the industry's competitive character.

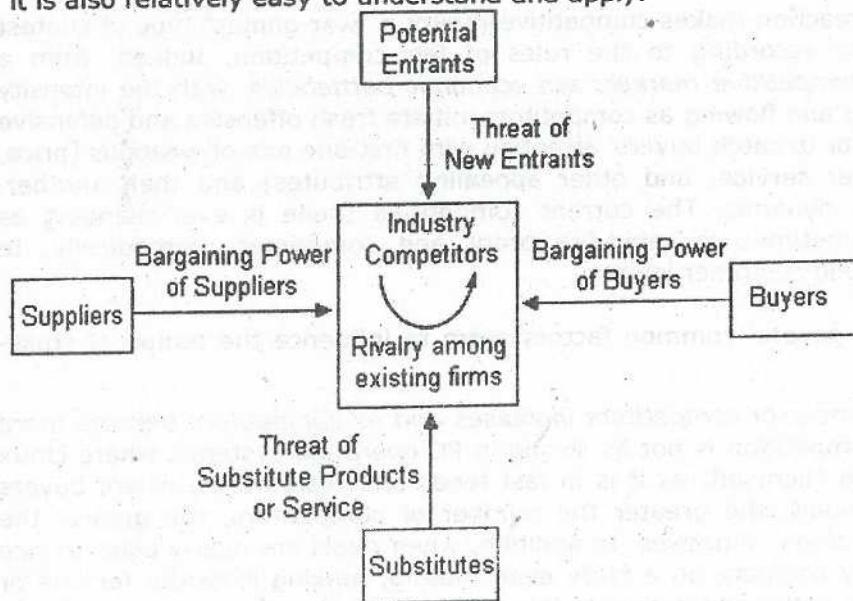
The Five Forces of Competition

Even though competitive pressures in various industries are never precisely the same, the

competitive process works similarly enough to use a common analytical framework in gauging the nature and intensity of competitive forces. As Professor Michael Porter of the Harvard Business School has convincingly demonstrated, the state of competition in an industry is a composite of *five competitive forces*:

1. The rivalry among competing sellers in the industry.
2. The potential entry of new competitors.
3. The market attempts of companies in other industries to win customers over to their own *substitute products*.
4. The competitive pressures stemming from supplier-seller collaboration and bargaining.
5. The competitive pressures stemming from seller-buyer collaboration and bargaining.

Porter's five-forces model, depicted in the following Figure, is a powerful tool for systematically diagnosing the principal competitive pressures in a market and assessing how strong and important each one is. Not only is it the most widely used technique of competition analysis, but it is also relatively easy to understand and apply.



The Rivalry among Competing Sellers The strongest of the five competitive forces *is usually* the jockeying for position and buyer favor that goes on among rival sellers of a product or service. In some industries, cross-company rivalry is centered on price competition—competing to offer buyers the best (lowest) price is typical among Internet retailers and the sellers of such standard commodities as nails, plywood, sugar, printer paper, and gasoline. Occasionally, price competition can be so lively that market prices temporarily fall below unit costs, forcing losses on some or most rivals. In other industries, price competition is minimal to moderate and rivalry is focused on one or more of the following: offering buyers the most attractive combination of performance features (as occurs in digital cameras), being first to market with innovative products, outcompeting rivals with higher-quality or more durable products, offering buyers longer warranties (as in motor vehicles and replacement tires), providing superior after-the-sale service, or creating a stronger brand image (as in beer, cigarettes, bottled water, electronic brokerage, and quick-service restaurants).

Competitive jockeying among cross-company rivals can heat up when a competitor sees an opportunity to better please customers or is under pressure to improve its market share or profitability. *The intensity of rivalry among competing sellers is a function of how vigorously they employ such tactics as lower prices, snazzier features, expanded customer services, longer*

warranties, special promotions, and new product introductions. Rivalry can range from friendly to cutthroat, depending on how frequently and how aggressively companies undertake fresh moves that threaten rivals' profitability. Ordinarily, industry rivals are clever at adding new wrinkles to their product offerings that enhance buyer appeal, and they persist in trying to exploit weaknesses in each other's market approaches.

Irrespective of whether rivalry is lukewarm or heated, every company is challenged to craft a successful strategy for competing-ideally, one that *produces a competitive edge over rivals* and strengthens its position with buyers. The big complication in most industries is that *the success of anyone firm's strategy hinges on what strategies its rivals employ and the resources rivals are willing and able to put behind their strategic efforts*. The "best" strategy for one firm depends, in other words, on the competitive capabilities and strategies of rival companies. Such interdependence means that whenever one firm makes a strategic move, its rivals often retaliate with offensive or defensive countermoves.

This pattern of action and reaction makes competitive rivalry a "war-games" type of contest conducted in a market setting according to the rules of fair competition. Indeed, from a strategy-making perspective, *competitive markets are economic battlefields*, with the intensity of cross-company rivalry ebbing and flowing as competitors initiate fresh offensive and defensive maneuvers and as they endeavor to catch buyers' attention with first one mix of weapons (price, performance features, customer service, and other appealing attributes) and then another. Cross-company rivalry is thus dynamic. The current competitive scene is ever-changing as companies act and react, sometimes in rapid-fire order and sometimes methodically, to outcompete one another and build customer loyalty.

Regardless of the industry, several common factors seem to influence the tempo of cross-company rivalry:

1. *Rivalry intensifies as the number of competitors increases and as competitors become more equal in size and capability.* Competition is not as strong in PC operating systems, where Linux is one of the few challengers to Microsoft, as it is in fast foods and restaurants, where buyers have many choices. Up to a point, the greater the number of competitors, the greater the probability of fresh, creative strategic initiatives. In addition, when rivals are nearly equal in size and capability, they can usually compete on a fairly even footing, making it harder for one or two firms to win the competitive battle and dominate the market.
2. *Rivalry is usually stronger when demand for the product is growing slowly.* In a rapidly expanding market, there tends to be enough business for everybody to grow. Indeed, it may take all of a firm's financial and managerial resources just to keep abreast of the growth in buyer demand, let alone steal rivals' customers. But when growth slows or when market demand drops unexpectedly, expansion-minded firms and/or firms with excess capacity often cut prices and deploy other sales-increasing tactics, thereby igniting a battle for market share that can result in a shake-out of the weak and less efficient firms. The industry then consolidates into a smaller, but individually stronger, number of sellers.
3. *Rivalry is more intense when industry conditions tempt competitors to use price cuts or other competitive weapons to boost unit volume.* When a product is perishable, seasonal, or costly to hold in inventory, or when demand slacks off, competitive pressures build quickly anytime one or more firms decide to cut prices and dump excess supplies on the market. Likewise, whenever fixed costs account for a large fraction of total cost such that unit costs tend to be lowest at or near full capacity, then firms come under significant pressure to cut prices or otherwise try to boost sales. Unused capacity imposes a significant cost-increasing penalty because there are fewer units carrying the fixed-cost burden. In such cases, if market demand weakens or ca-

capacity utilization for some reason falls off, the pressure of rising unit costs can push rival firms into secret price concessions, special discounts, rebates, and other sales increasing tactics, thus heightening competition.

4. *Rivalry is stronger when customers' costs to switch brands are low.* The lower the costs of switching, the easier it is for a rival seller to raid another seller's customers. High buyer switching costs, however, give sellers a more protected customer base and work against the efforts of rivals to promote brand switching among buyers.

5. *Rivalry is stronger when one or more competitors are dissatisfied with their market position and launch moves to bolster their standing at the expense of rivals.* Firms that are losing ground or in financial trouble often react aggressively by acquiring smaller rivals, introducing new products, boosting advertising, discounting prices and so on. Such actions heighten cross-company rivalry and can trigger a hotly contested battle for market share.

6. *Rivalry increases in proportion to the size of the payoff from a successful strategic move.* The greater the benefits of going after a new opportunity, the more likely that one or more rivals will initiate moves to capture it. Competitive pressures nearly always intensify when several rivals start pursuing the same opportunity. For example, competition in online music sales is heating up with the entry of Amazon.com, barnesandnoble.com, Buy.com. Furthermore, the size of the strategic payoff can vary with the speed of retaliation. When competitors respond slowly (or not at all), the initiator of a fresh competitive strategy can reap benefits in the intervening period and perhaps gain a first-mover advantage that is not easily surmounted. The greater the benefits of moving first, the more likely some competitor will accept the risk and try it.

7. *Rivalry tends to be more vigorous when it costs more to get out of a business than to stay in and compete.* The higher the exit barriers (and thus the more costly it is to abandon a market), the stronger the incentive for existing rivals to remain and compete as best they can, even though they may be earning low profits or even incurring losses.

8. *Rivalry becomes more volatile and unpredictable the more diverse competitors are in terms of their visions, strategic intents, objectives, strategies, resources, and countries of origin.* A diverse group of sellers often contains one or more mavericks willing to rock the boat with unconventional moves and "rule-breaking" market approaches, thus generating a livelier and less predictable competitive environment. Globally competitive markets often contain rivals with different views about where the industry is headed and a willingness to employ perhaps radically different competitive approaches. Attempts by cross-border rivals to gain stronger footholds in each other's domestic markets usually boost the intensity of rivalry, especially when the aggressors have lower costs or products with more attractive features. For instance, Motorola has recently faced vigorous competition in cell phones from Europe-based Nokia and Ericsson, largely because these two companies bet on different cell phone technologies than Motorola and because, unlike Motorola, they moved aggressively to make their cell phones work on both analog and digital wireless systems.

9. *Rivalry increases when strong companies outside the industry acquire weak firms in the industry and launch aggressive, well-funded moves to transform their newly acquired competitors into major market contenders.* A concerted effort to turn a weak rival into a market leader nearly always entails launching well-financed strategic initiatives to dramatically improve the competitor's product offering, excite buyer interest, and win a much bigger market share. Actions that, if successful, put added pressure on rivals to counter with fresh strategic moves of their own.

Two facets of rivalry need to be underscored. First, a powerful, successful competitive strategy employed by one rival greatly intensifies the competitive pressures on other rivals. Second, the frequency and vigor with which rivals use any and all competitive weapons at their disposal are major determinants of whether the competitive pressures associated with rivalry are cutthroat, fierce, strong, moderate, or weak. Rivalry can be characterized as *cutthroat* or *brutal* when competitors engage in protracted price wars or habitually employ other aggressive tactics that are mutually destructive to profitability. Rivalry can be considered *fierce* to *strong* when competitors are initiating frequent moves and countermoves in a battle for market share so vigorous that profit margins are being squeezed. Rivalry can be characterized as *moderate* when sellers are active in using the various weapons of competition at their command yet are still usually able to earn acceptable profits. Rivalry is *weak* when most companies in the industry are relatively well satisfied with their sales growth and market shares, rarely make concerted attempts to steal customers away from one another, and have comparatively attractive earnings and returns on investment.

The Potential Entry of New Competitors New entrants to a market bring new production capacity, the desire to establish a secure place in the market, and sometimes substantial resources with which to compete. Just how serious the competitive threat of entry is in a particular market depends on two classes of factors: *barriers to entry* and *the expected reaction of incumbent firms to new entry*. A barrier to entry exists whenever it is hard for a newcomer to break into the market or economic factors put a potential entrant at a disadvantage relative to its competitors. There are several types of entry barriers:

- *Economies of scale*—Scale economies deter entry because they force potential competitors either to enter on a large scale (a costly and perhaps risky move) or to accept a cost disadvantage and consequently lower profitability. Trying to overcome the disadvantages of small size by entering on a large scale at the outset can result in long-term overcapacity problems for the new entrant (until sales volume builds up), and it can so threaten the market shares of existing firms that they retaliate aggressively (with price cuts, increased advertising and sales promotion, and similar blocking actions) to maintain their positions. Either way, a potential entrant is discouraged by the prospect of lower profits. Entrants may encounter scale-related barriers not just in production but in advertising, marketing and distribution, financing, after-sale customer service, raw materials purchasing, and R&D as well.
- *Cost and resource disadvantages independent of size*—Existing firms may have cost and resource advantages not available to potential entrants. These advantages include partnerships with the best and cheapest suppliers of raw materials and components, possession of patents and proprietary technology, existing plants built and equipped years earlier at lower costs, favorable locations, and lower borrowing costs.
- *Learning and experience curve effects*—When lower unit costs are partly or mostly the result of experience in producing the product and other learning curve benefits, new entrants face a potentially significant cost disadvantage competing against existing firms with more accumulated know-how.
- *Inability to match the technology and specialized know-how of firms already in the industry*—Successful entry may require technological capability not readily available to a newcomer or skills and know-how not easily learned by a newcomer. Key patents can effectively bar entry, as can lack of technically skilled personnel and an inability to execute complicated manufacturing techniques. Existing firms often carefully guard the know-how that gives them an edge in technology and manufacturing capability. Unless new entrants can gain access to such proprietary knowledge, they cannot compete on a

level playing field.

- *Brand preferences and customer loyalty*—Buyers are often attached to established brands. Japanese consumers, for example, are fiercely loyal to Japanese brands of motor vehicles, electronics products, cameras and film. European consumers have traditionally been loyal to European brands of major household appliances. High brand loyalty means that a potential entrant must commit to building a network of distributors and dealers, and then be prepared to spend enough money on advertising and sales promotion to overcome customer loyalties and build its own clientele. Establishing brand recognition and building customer loyalty can be a slow and costly process. In addition, if it is difficult or costly for a customer to switch to a new brand, a new entrant must persuade buyers that its brand is worth the switching costs. To overcome the switching-cost barrier, new entrants may have to offer buyers a discounted price or an extra margin of quality or service. All this can mean lower expected profit margins for new entrants—something that increases the risk to start-up companies dependent on sizable early profits to support their new investments.
- *Capital requirements*—The larger the total dollar investment needed to enter the market successfully, the more limited the pool of potential entrants. The most obvious capital requirements are associated with manufacturing plants and equipment, working capital to finance inventories and customer credit, introductory advertising and sales promotion to establish a clientele, and cash reserves to cover start-up losses.
- *Access to distribution channels*—In the case of consumer goods, a potential entrant may face the barrier of gaining adequate access to consumers. Wholesale distributors may be reluctant to take on a product that lacks buyer recognition. A network of retail dealers may have to be set up from scratch. Retailers have to be convinced to give a new brand ample display space and adequate trial period. The more existing producers tie up present distribution channels, the tougher entry will be. To overcome this barrier, potential entrants may have to "buy" distribution access by offering better margins to dealers and distributors or by giving advertising allowances and other promotional incentives. As a consequence, a potential entrant's profits may be squeezed unless and until its product gains enough acceptance that distributors and retailers want to carry it.
- *Regulatory policies*—Government agencies can limit or even bar entry by requiring licenses and permits. Regulated industries like cable TV, telecommunications, electric and gas utilities, radio and television broadcasting, liquor retailing, and railroads entail government-controlled entry. In international markets, host governments commonly limit foreign entry and must approve all foreign investment applications. Stringent government-mandated safety regulations and environmental pollution standards are entry barriers because they raise entry costs.
- *Tariffs and international trade restrictions*—National governments commonly use tariffs and trade restrictions (antidumping rules, local content requirements, and quotas) to raise entry barriers for foreign firms and protect domestic producers from competition. In 1996, due to tariffs imposed by the South Korean government, a Ford Taurus cost South

Korean car buyers over \$40,000. The government of India has required that 90 percent of the parts and components used in Indian truck assembly plants be made in India. And to protect European chip makers from low-cost Asian competition, European governments instituted a rigid formula for calculating floor prices for computer memory chips.

Whether an industry's entry barriers ought to be considered high or low depends on the resources and competencies possessed by the pool of potential entrants. Entry barriers can be formidable for start-up enterprises trying to compete against well-established companies. But interested outsiders may, given their resources, competencies, and brand-name recognition, see the industry's entry barriers as relatively easy to hurdle. Likewise, entry barriers may be low for current industry participants that are looking to enter areas of the overall market where they do not yet have a presence. A company already well-established in one market segment or geographic area may possess the resources, competencies, and competitive capabilities to hurdle the barriers of entering a different market segment or new geographic area. In evaluating the potential threat of entry, management must look at (1) how formidable the entry barriers are for each type of potential entrant-start-up enterprises, candidate companies in other industries, and current industry participants looking to expand their market reach-and (2) how attractive the profit prospects are for new entrants. High profits act as a magnet to firms outside the industry, motivating potential entrants to commit the resources needed to hurdle entry barriers.

Even if a potential entrant has or can acquire the needed competencies and resources to attempt entry, it still faces the issue of how existing firms will react. Will incumbent firms offer only passive resistance, or will they aggressively defend their market positions using price cuts, increased advertising, product improvements, and whatever else they can to give a new entrant (as well as other rivals) a hard time? A potential entrant can have second thoughts when financially strong incumbent firms send clear signals that they will stoutly defend their market positions against newcomers. A potential entrant may also turn away when incumbent firms can leverage distributors and customers to retain their business.

The best test of whether potential entry is a strong or weak competitive force in the marketplace is to ask in the industry's growth and profit prospects are attractive enough to induce additional entry. When the answer is no, potential entry is a weak competitive force. When the answer is yes and there are entry candidates with sufficient expertise and resources, then potential entry adds significantly to competitive pressures in the marketplace. The stronger the threat of entry, the more that incumbent firms are driven to fortify their positions against newcomers, endeavoring not only to protect their market shares but also to make entry more costly or difficult.

One additional point: *the threat of entry changes as the industry's prospects grow brighter or dimmer and as entry barriers rise or fall.* For example, the expiration of a key patent can greatly increase the threat of entry. A technological discovery can create an economy-of-scale advantage where none existed before or, alternatively, make it easier for newcomers to gain a market foothold-the Internet, for example, is making it much easier for new e-commerce retailers to compete against some of the strongest and best-known retail chains. New actions by incumbent firms to greatly bolster their e-commerce capabilities, increase advertising, strengthen distributor-dealer relations, step up R&D, or improve product quality can raise the roadblocks to entry. In international markets, entry barriers for foreign-based firms fall as tariffs are lowered, as host governments open up their domestic markets to outsiders, as domestic wholesalers and dealers seek out lower-cost foreign-made goods, and as domestic buyers become more willing to purchase foreign brands.

Competitive Pressures from Substitute Products Firms in one industry are quite often in close competition with firms in another industry because their respective products are good substitutes. The producers of eyeglasses compete with the makers of contact lenses and with eye specialists who perform laser surgery to correct vision problems. The sugar industry competes with companies that produce artificial sweeteners and high-fructose corn syrup. Cotton and wool producers are in head-on competition with the makers of polyester fabrics. Companies providing electric power are in competition with companies providing natural gas for such purposes as cooking, space heating, and water heating. Aspirin manufacturers compete against the makers of acetaminophen, ibuprofen, and other pain relievers. Newspapers are in competition with television in providing late-breaking news and with Internet sources in providing sports results, stock quotes, and job opportunities. E-mail is a substitute for the overnight document delivery services of FedEx, Airborne Express, and the U.S. Postal Service. Just how strong the competitive pressures are from substitute products depends on three factors: (1) whether attractively priced substitutes are available; (2) whether buyers view the substitutes as being satisfactory in terms of quality, performance, and other relevant attributes; and (3) whether buyers can switch to substitutes easily.

The presence of readily available and attractively priced substitutes creates competitive pressure by placing a ceiling on the prices an industry can charge for its product without giving customers an incentive to switch to substitutes and risking sales erosion. This price ceiling, at the same time, puts a lid on the profits that industry members can earn unless they find ways to cut costs. When substitutes are cheaper than an industry's product, industry members come under heavy competitive pressure to reduce their prices and find ways to absorb the price cuts with cost reductions.

The availability of substitutes inevitably invites customers to compare quality, features, performance, ease of use, and other attributes as well as price. For example, ski boat manufacturers are experiencing strong competition from personal water-ski craft because water sports enthusiasts are finding that personal water-skis have exciting performance features that make them satisfying substitutes. The users of glass bottles and jars constantly weigh the performance trade-offs with plastic containers, paper cartons, and metal cans. Competition from substitute products pushes industry participants to heighten efforts to convince customers their product has attributes that are superior to those of substitutes.

Another determinant of the strength of competition from substitutes is how difficult or costly it is for the industry's customers to switch to a substitute. Typical switching costs include extra price premiums, the costs of additional equipment, the time and cost in testing the quality and reliability of the substitute, the psychic costs of severing old supplier relationships and establishing new ones, payments for technical help in making the changeover, and employee retraining costs. If switching costs are high, sellers of substitutes must offer a major cost or performance benefit in order to entice the industry's customers away. When switching costs are low, it's much easier for sellers of substitutes to convince buyers to change over to their products.

As a rule, then, the lower the price of substitutes, the higher their quality and performance, and the lower the user's switching costs, the more intense the competitive pressures posed by substitute products. Good indicators of the competitive strength of substitute products are the rate at which their sales and profits are growing, the market inroads they are making, and their plans for expanding production capacity.

Competitive Pressures Stemming from Supplier Bargaining Power and Supplier-Seller Collaboration Whether supplier-seller relationships represent a weak or strong competitive force depends on (1) whether suppliers can exercise sufficient bargaining power to influence the

terms and conditions of supply in their favor, and (2) the extent of supplier-seller collaboration in the industry.

How Supplier Bargaining Power Can create Competitive Pressures Suppliers have little or no bargaining power or leverage over rivals whenever the items they provide are commodities available on the open market from numerous suppliers with ample capability to fill orders. In such cases, it is relatively simple for rivals to obtain whatever is needed from any of several capable suppliers, perhaps dividing their purchases among two or more suppliers to promote lively competition for orders. . Commodity product suppliers have market power only when supplies become quite tight and users are so anxious to secure what they need that they agree to terms more favorable to suppliers.

Suppliers are likewise relegated to a weak bargaining position whenever there are good substitutes for the item they provide and buyers find it neither costly nor difficult to switch their purchases to the suppliers of alternative items. For example, soft-drink bottlers can counter the bargaining power of aluminum can suppliers on price or delivery by promoting greater use of plastic containers and introducing more attractive plastic container designs.

Suppliers also tend to have less leverage to bargain over price and other terms of sale when the company they are supplying is a *major customer*. In such cases, the well-being of suppliers is closely tied to the well-being of their major customers. Suppliers then have a big incentive to protect and enhance their customers' competitiveness via reasonable prices, exceptional quality, and ongoing advances in the technology of the items supplied.

In contrast, companies may have little bargaining power with *major suppliers*. 'Consider Intel's position as the world's dominant supplier of microprocessors for PCs. The microprocessor is not only an essential component but also a big part of the cost 'of a PC, as much as 20 percent in the case of chips for high-performance PCs. It thus matters a great deal to PC makers (and to PC buyers) whether Intel's price for its latest microprocessor chip is \$600 or \$300 and whether a chip of comparable quality and performance is available from Advanced Micro Devices (AMD), Intel's leading rival. When suppliers provide an item that accounts for a sizable fraction of the costs of an industry's product, is crucial to the industry's production process, or significantly affects the quality of the industry's product, suppliers have considerable influence on the competitive process. This is particularly true when a few large companies control most of the available supplies and have pricing leverage (as in microprocessors for PCs). Likewise, a supplier (or group of suppliers) possesses more bargaining leverage the more difficult or costly it is for users to switch to alternate suppliers. Big suppliers with good reputations and growing demand for their output are harder to wring concessions from than struggling suppliers striving to broaden their customer base or more fully utilize their production capacity.

Suppliers are also more powerful when they can supply a component more cheaply than industry members can make it themselves. For instance, most producers find it of outdoor power equipment (lawn mowers, rotary tillers, snowblowers, and so on) find it cheaper to source the small engines they need from outside manufacturers rather than make their own because the quantity they need is too little to justify the investment, master the process, and capture scale economies. Specialists in small-engine manufacture by supplying many kinds of engines to the whole power equipment industry, obtain a big enough sales volume to fully realize scale economies, become proficient in all the manufacturing techniques, and keep costs well below what power equipment firms could realize making the items in-house. Small-engine suppliers, then are in a position to price the item below what it would cost the user to self-manufacture but far enough above their own costs to generate an attractive profit margin. In such situations, the bargaining position of suppliers is strong *until* the volume of parts a user needs becomes large enough for the user to justify backward integration *into self-manufacture*

of the component. Then the balance of power shifts from suppliers to users. The more credible the threat of such backward integration into the suppliers: business becomes, the more leverage users have in negotiating favorable terms with suppliers.

Another instance in which the relationship between industry members and suppliers is a notable competitive force is when suppliers, for one reason or another, do not have the capability or the incentive to provide items of high or consistent quality. For example, if a manufacturer's suppliers provide components that have a relatively high defect rate or that fail prematurely, they can so increase the warranty and defective goods costs of the manufacturer that its profits, reputation, and competitive position are seriously impaired.

How Collaborative Partnerships between Sellers and Suppliers Can Create Competitive Pressures In more and more industries, rival sellers are electing to form long-term strategic partnerships and close working relationships with select suppliers in order to (1) promote just-in-time deliveries and reduced inventory and logistics costs, (2) speed the availability of next-generation components, (3) enhance the quality of the parts and components being supplied and reduce defect rates, and (4) reduce the supplier's costs and pave the way for lower prices on the items supplied. Such benefits can translate into competitive advantage for industry members who do the best job of managing supply chain relationships and form effective collaborative partnerships with suppliers.

Dell Computer has used strategic partnering with key suppliers as a major element in its strategy to be the world's low-cost supplier of branded PCs, servers, and workstations. Because Dell has managed its supply chain relationships in ways that contribute to a low-cost/high-quality competitive edge over rivals in components supply, Dell has put enormous competitive pressure on its PC rivals to try to imitate its supply chain management practices or else run the risk of being at a serious competitive disadvantage. Effective supply chain partnerships on the part of one or more industry rivals can thus become a major source of competitive pressure for other rivals.

Competitive Pressures Stemming from Buyer Bargaining Power and Seller-Buyer Collaboration Whether seller-buyer relationships represent a weak or strong competitive force depends on (1) whether buyers have sufficient bargaining power to influence the terms and conditions of sale in their favor and (2) the extent and competitive importance of seller-buyer strategic partnerships in the industry.

How Buyer Bargaining Can Create Competitive Pressures Just as with suppliers, the leverage that buyers have in negotiating favorable terms can range from strong to weak. Buyers have substantial bargaining leverage in a number of situations. The most obvious is when buyers are large and purchase a sizable percentage of the industry's output. Typically, purchasing in large quantities gives a buyer enough leverage to obtain price concessions and other favorable terms.

Large retail chains like Wal-Mart, Circuit City, and The Home Depot typically have considerable negotiating leverage in purchasing products from manufacturers because of manufacturers' need for broad retail exposure and favorable shelf space for their products. Retailers may stock one or even several brands but rarely all available brands, so competition among rival manufacturers for the business of popular or high volume retailers gives such retailers significant bargaining leverage. In the United States and Britain, supermarket chains have sufficient leverage to require food products manufacturers to make lump-sum payments to gain shelf space for new products. Motor vehicle manufacturers have significant bargaining power in negotiating to buy original equipment tires not only because they buy in large quantities but also because tire makers believe they gain an advantage in supplying

replacement tires to vehicle owners if their tire brand is original equipment on the vehicle. "Prestige" buyers have a degree of clout in negotiating with sellers because a seller's reputation is enhanced by having prestige buyers on its customer list.

Even if buyers do not purchase in large quantities or offer a seller important market exposure or prestige, they may still have some degree of bargaining leverage in the following circumstances:

- *If buyers' costs of switching to competing brands or substitutes are relatively low*-Buyers who have the flexibility to fill their needs by switching brands or sourcing from several sellers often have negotiating room with sellers. When the products of rival sellers are virtually identical, it is relatively easy for buyers to switch from seller to seller at little or no cost and anxious sellers may be willing to make concessions to win a buyer's business. However, if the products of rival sellers are strongly differentiated, buyers may be less able to switch without incurring sizable changeover costs; an alert seller may conclude, often correctly, that the customer is locked in to using its product and therefore may not be inclined to make any substantive concessions.
- *If the number of buyers is small or if a customer is particularly important to a seller*-The smaller the number of buyers, the less easy it is for sellers to find alternatives when a customer is lost. The prospect of losing a customer not easily replaced often makes a seller more willing to grant concessions of one kind or another.
- *If buyers are well-informed about sellers' products, prices, and costs*- The more information buyers have, the better bargaining position they are in. The mushrooming availability of information on the Internet is giving added bargaining power to individuals. It is relatively easy for buyers to use the Internet to compare prices and features of motor vehicles, obtain mortgages and loans, and purchase big-ticket items such as digital cameras. Bargaining individuals can shop around for the best deal on the Internet and use that information to negotiate with sellers.
- *If buyers pose a credible threat of integrating backward into the business of sellers*--Companies like Anheuser-Busch, Coors, and Heinz have integrated backward into metal can manufacturing to gain bargaining power in obtaining the balance of their can requirements from otherwise powerful metal can manufacturers. Retailers gain bargaining power by stocking and promoting their own private-label brands alongside manufacturers' name brands. Wal-Mart, for example, has elected to compete against Procter & Gamble, its biggest supplier, by introducing its own brand of laundry detergent called Sam's American Choice, which is priced about 25 to 30 percent lower than P&G's Tide.
- *If buyers have discretion in whether and when they purchase the product*-If consumers are unhappy with the sticker prices of new motor vehicles, they can delay purchase or buy a used vehicle instead. If business customers are not happy with the prices or security features of electronic bill payment software systems, they can either delay purchase until next-generation products become available or attempt to develop their own software in-house. If college students believe that the prices of new textbooks are too high, they can purchase used copies.

Buyers typically have weak bargaining power when they buy infrequently or in small quantities and when they face high costs to switch brands. High switching costs can keep a buyer locked in to the present brand. For example, companies that have bought Compaq or Hewlett-Packard engineering and graphics workstations that use Microsoft's Windows operating

systems are not strong candidates to switch to Sun Microsystems' workstation models that run on a UNIX operating system. Switching from Windows to UNIX entails considerable time and relearning on the part of users and can also entail having to abandon all the Windows-based engineering and graphics application software that the user has accumulated over the years and replace it with software applications written for a UNIX-based operating system.

A final point to keep in mind is that *not all buyers of an industry's product have equal degrees of bargaining power with sellers*, and some may be less sensitive than others to price, quality, or service differences among competing sellers. For example, independent tire retailers have less bargaining power in purchasing tires than do Honda, Ford, and DaimlerChrysler (which buy in much larger quantities), and they are also less quality sensitive. Motor vehicle manufacturers are very particular about tire quality and tire performance because of the effects on vehicle performance, and they drive a hard bargain with tire manufacturers on both price and quality. Apparel manufacturers confront significant bargaining power when selling to retail chains like Kmart or Sears or Macy's, but they can command much better prices selling to small owner-managed apparel boutiques.

How Collaborative Partnerships between Sellers and Buyers Can Create Competitive Pressures Partnerships between sellers and buyers are an increasingly important element of the competitive picture in *business-to-business relationships* as opposed to business-to-consumer relationships. Many sellers that provide items to business customers have found it in their mutual interest to collaborate closely on such matters as just-in-time deliveries, order processing, electronic invoice payments, and online sharing of sales at the cash register. Wal-Mart, for example, provides the manufacturers with whom it does business (like Procter & Gamble) with daily sales data from each of its stores so that they can replenish inventory stocks on time. Dell Computer has partnered with its largest customers to create online systems for over 50,000 corporate customers, providing their employees with information on approved product configurations, global pricing, paperless purchase orders, real-time order tracking, invoicing, purchasing history, and other efficiency tools. Dell also loads a customer's software at the factory and installs asset tags so that customer setup time on the PCs it orders is minimal and helps customers migrate their PC systems to next generation hardware and software. Dell's partnerships with its customers have put significant competitive pressure on other PC makers to develop packages of offerings to corporate customers that will compare favorably with what Dell offers.

Strategic Implications of the Five Competitive Forces

The special contribution of the five-forces model is the thoroughness with which it exposes what competition is like in a given market—the strength of each of the five competitive forces, the nature of the competitive pressures comprising each force, and the overall structure of competition. *As a rule, the stronger the collective impact of competitive forces, the lower the combined profitability of participant firms.* The most brutally competitive situation occurs when the five forces create market conditions tough enough to impose prolonged subpar profitability or even losses on most or all firms. The competitive structure of an industry is dearly "unattractive" from a profit-making standpoint if rivalry among sellers is very strong, low entry barriers are allowing new rivals to gain a market foothold, competition from substitutes is strong, and both suppliers and customers are able to exercise considerable bargaining leverage. These conditions are approximated in tire manufacturing and apparel, where profit margins have historically been thin.

In contrast, when competitive forces are not collectively strong, the competitive structure of the industry is "favorable" or "attractive" from the standpoint of earning superior profits. The "ideal" competitive environment is one in which both suppliers and customers are in weak bargaining positions, there are no good substitutes, entry barriers are relatively high, and rivalry

among present sellers is only moderate. However, even when some of the five competitive forces are strong, an industry can be competitively attractive to those firms whose market position and strategy provide a good enough defense against competitive pressures to preserve their ability to earn above-average profits.

To contend successfully, managers must craft strategies that shield the firm as much as possible from the five competitive forces and that help make the rules, put added pressure on rivals, and perhaps even define the business model for the industry. Managers cannot expect to develop winning competitive strategies without first identifying what competitive pressures exist, gauging the relative strength of each, and gaining a deep understanding of the industry's whole competitive structure. The five-forces model is a powerful tool for giving strategy makers the competitive insights they need to build a successful enterprise—ideally one that enjoys a sustainable competitive advantage.

QUESTION 3: WHAT IS CAUSING THE INDUSTRY'S COMPETITIVE STRUCTURE AND BUSINESS : ENVIRONMENT TO CHANGE?

An industry's economic features and competitive structure say a lot about its fundamental character but very little about the ways in which its environment may be changing. All industries are characterized by trends and new developments that gradually or speedily produce changes important enough to require a strategic response from participating firms. The popular hypothesis about industries going through a life cycle helps explain industry change but is still incomplete. The life-cycle stages are strongly keyed to changes in the overall industry growth rate (which is why such terms as *rapid growth*, *early maturity*, *saturation*, and *decline* are used to describe the stages). Yet there are "more causes of industry change than an industry's position in the life cycle.

The Concept of Driving Forces

While it is important to judge what growth stage an industry is in, there's more analytical value in identifying the specific factors causing fundamental industry and competitive adjustments. Industry and competitive conditions change because forces are in motion that create incentives or pressures for change. The most dominant forces are called driving forces because they have the biggest influence on what kinds of changes will take place in the industry's structure and competitive environment. "Driving forces" analysis has two steps: identifying what the driving forces are and assessing the impact they will have on the industry.

The Most Common Driving Forces Many events can affect an industry powerfully enough to qualify as driving forces. Some are unique and specific to a particular industry situation, but most drivers of change fall into one of the following categories:

The Internet and the new e-commerce opportunities and threats it breeds in the industry—The Internet is unquestionably spawning a sweeping business revolution that alters industry boundaries, opens up all kinds of new business-to-business and business-to-consumer market opportunities and threats, sparks competition from new and entirely different breeds of enterprises, and mandates fundamental changes in business practices. Scarcely any industry or company is unaffected. But the transformation that the Internet is producing varies from industry to industry and company to company, and the industry and competitive implications are continuously evolving as new Internet-related technologies emerge and new Internet-related products hit the market. The challenge here is to assess how growing use of the Internet will alter the industry and competitive landscape. In many industries, the role and impact of the Internet is a critical, if not *the* critical, driver that must be factored into the strategy-making equation.

Increasing globalization of the industry--Industries move toward globalization for any of several reasons. One or more nationally prominent firms may launch aggressive long-term strategies to win a globally dominant market position and precipitate a race for world leadership among the industry's major rivals. Demand for the industry's product may start to blossom in more and more countries. Countries may decide to reduce trade barriers or open up once-closed markets to foreign competitors--as is occurring in many parts of Europe, Latin America, and Asia; tariff reductions, deregulation, and privatization of government-owned enterprises bring local competitors eyeball-to-eyeball with ambitious global companies. The spread of technological know-how may pave the way for lesser-known companies in developing countries to enter the industry arena on an international or global scale. Significant differences in labor costs among countries may create a strong reason to locate global-scale plants for labor-intensive products in low-wage countries and use these plants to supply market demand across the whole world. Wages in China, Taiwan, Singapore, Mexico, and Brazil, for example, are about one fourth those in the United States, Germany, and Japan.

Significant cost economies may accrue to firms with world-scale volumes as opposed to national-scale volumes. Multinational companies with the ability to transfer their production, marketing, and management know-how from country to country at very low cost can sometimes gain a significant competitive advantage over domestic-only competitors. As a consequence, global competition usually shifts the pattern of competition among an industry's key players, favoring some and disadvantaging others.

Globalization is most likely to be a driving force in industries (1) where scale economies are so large that rival companies need to market their product in many country markets to gain enough volume to drive unit costs down; (2) where low-cost production is a critical consideration (making it imperative to locate manufacturing facilities in countries where the lowest costs can be achieved); (3) where one or more globally ambitious companies are pushing hard to gain a significant competitive position in as many attractive country markets as they can; (4) where local governments are privatizing government-owned monopolies (e.g., in telecommunications and energy) and opening up their once-closed local markets to competition; and (5) where critical natural resources and raw material supplies (e.g., crude oil, copper, and cotton) are scattered all over the globe.

Globalization has triggered a frantic, fast-paced race for global market leadership in credit cards, PCs, motor vehicles, telecommunications (long-distance telephone service, Internet access, electronic communications), refined petroleum products, and energy.

- *Changes in the long-term industry growth rate*--Shifts in industry growth up or down are a driving force for industry change, affecting the balance between industry supply and buyer demand, entry and exit, and the character and strength of competition. An upsurge in long-term demand triggers a race for growth among established firms and newcomers attracted by the prospects for higher growth. Competition becomes a contest of who can capture the growth opportunities and win a place among the market leaders. A shrinking market heightens competitive pressures, producing an often-intense battle for market share and inducing mergers and acquisitions that result in industry consolidation to a smaller number of participants. Some companies may exit the industry and those remaining may be forced to close less efficient plants and retrench to a smaller production base.

- *Changes in who buys the product and how they use it*-Shifts in buyer demographics and new ways of using the product can alter the state of competition by forcing adjustments in customer service offerings (credit, technical assistance, maintenance and repair); opening the way to market the industry's product through a different mix of dealers and retail outlets; and prompting producers to broaden or narrow their product lines, bringing different sales and promotion approaches into play. The mushrooming popularity of the Internet at home and at work is creating new opportunities for electronic shopping, online brokerage services, e-mail services, bulletin board services, data services, and Internet-provider services. The changing demographics generated by longer life expectancies are creating growth markets for residential golf resorts, retirement planning services, mutual funds, and health care.
- *Product innovation*-Product innovation can shake up the structure of competition by broadening an industry's customer base, rejuvenating industry growth, and widening the degree of product differentiation among rival sellers. Successful new product introductions strengthen the market position of the innovating companies, usually at the expense of companies that stick with their old products or are slow to follow with their own versions of the new product. Product innovation has been a key driving force for makers of personal computers, PC software, digital cameras, golf clubs, video games, toys, prescription drugs, frozen foods, and mobile phones. *Technological change*-Advances in technology can dramatically alter an industry's landscape, making it possible to produce new and better products at lower cost and opening up whole new industry frontiers. Technological developments can also produce competitively significant changes in capital requirements, minimum efficient plant sizes, distribution channels and distribution logistics, and learning or experience curve effects.
- *Marketing innovation*-When firms are successful in introducing new ways to market their products, they can spark a burst of buyer interest, widen industry demand, increase product differentiation, and lower unit costs-any or all of which can alter the competitive positions of rival firms and force strategy revisions. In today's world, the Internet is the vehicle for all kinds of marketing innovations.
- *Entry or exit of major firms*-The entry of one or more foreign companies into a market once dominated by domestic firms nearly always shakes up competitive conditions. Likewise, when an established domestic firm from another industry attempts entry either by acquisition or by launching its own start-up venture, it usually applies its skills and resources in some innovative fashion that pushes competition in new directions. Entry by a major firm often produces a new ball-game, not only with new key players but also with new rules for competing. Similarly, exit of a major firm changes the competitive structure by reducing the number of market leaders (perhaps increasing the dominance of the leaders who remain) and causing a rush to capture the exiting firm's customers.
- *Diffusion of technical know-how across more companies and more countries*-As knowledge about how to perform a particular activity or execute a particular manufacturing technology spreads, any technically based competitive advantage held by firms originally possessing this know-how erodes. The diffusion of such knowledge can occur through scientific journals, trade publications, on-site plant tours, word-of-mouth among suppliers and customers, and the hiring away of knowledgeable employees. It can also occur when those possessing technological know-how license others to use it for a royalty fee or team up with a company interested in turning the technology into a new business venture. Quite often, technological know-how can be acquired by simply buying a company that has the skills, patents, or manufacturing capabilities.

In recent years technology transfer across national borders emerged as one of the most important driving forces in globalizing markets and competition. As companies worldwide gain access to technical know-how, they upgrade their manufacturing capabilities in a long-term effort to compete head-on against established companies. Examples of where technology transfer has turned a largely domestic industry into an increasingly global one include automobiles, tires, consumer electronics, telecommunications, and computers.

- *Changes in cost and efficiency*-Widening or shrinking differences in the costs and efficiency among key competitors tends to dramatically alter the state of competition. The low cost of e-mail and fax transmission has put mounting competitive pressure on the relatively inefficient and high-cost operations of the U.S. Postal Service-sending a one-page fax is cheaper and far quicker than sending a first-class letter; sending e-mail is faster and cheaper still. In the electric power industry sharply lower costs to generate electricity at newly constructed combined cycle generating plants has put older coal-fired and gas-fired plants under the gun to lower their production costs to remain competitive. E-tailing can have lower-cost economics than brick-and-mortar retailing. In fact, use of wired networks (the Internet and company intranets) is radically transforming the cost structure of doing business in industry after industry.
- *Growing buyer preferences for differentiated products instead of a commodity product instead of strategy differentiated products* -A shift to differentiated products is signaled when sellers are able to win a bigger and more loyal buyer following by offering made-to-order products, introducing new features, making style changes, offering options and accessories, and creating image differences via advertising and packaging. We have seen growing numbers of buyers decide that a customized "made-to-order" PC suits them better than standardized off-the-shelf models: a similar shift may be happening in car buying where several car manufacturers and online sellers are offering made-to-order vehicles. When a shift from standardized to differentiated products occurs, the driver of change is the contest among rivals to cleverly outdifferentiate one another.

On the other hand, buyers sometimes decide that a budget-priced, mostly look-alike product suits their requirements as well as or better than a premium-priced product with lots of snappy features and personalized services. Online brokers, for example, have used the lure of cheap commissions to attract many investors willing to place their own buy-sell orders via the Internet; growing acceptance of online trading has put significant competitive pressures on full-service brokers whose business model has always revolved around convincing clients of the value of asking for personalized advice from professional brokers and paying their sharply higher high commission fees to make trades. Pronounced shifts toward greater product standardization usually spawn lively price competition and force rival sellers to drive down their costs to maintain profitability. The lesson here is that competition is driven partly by whether the market forces in motion are acting to increase or decrease product differentiation.

- *Regulatory influences and government policy changes*-Government regulatory actions can often force significant changes in industry practices and strategic approaches. Deregulation has proved to be a potent procompetitive force in the airline, banking, natural gas, telecommunications, and electric utility industries. Government efforts to reform Medicare and health insurance have become potent driving forces in the health care industry. In international markets, host governments can drive competitive changes by opening up their domestic markets to foreign participation or dosing them off to protect domestic companies.

- *Changing societal concerns, attitudes, and lifestyles*-Emerging social issues and changing attitudes and lifestyles can be powerful instigators of industry change. Growing antismoking sentiment has emerged as the major driver of change in the tobacco industry: initiatives for stricter gun control are having a big impact on gun makers. Consumer concerns about salt, sugar, chemical additives, saturated fat, cholesterol, and nutritional value have forced food producers to revamp food-processing techniques, redirect R&D efforts into the use of healthier ingredients, and compete in coming up with nutritional, good-tasting products. Safety concerns have transformed safety features into a competitive asset in the automobile, toy, and outdoor power equipment industries, to mention a few. Increased interest in physical fitness has spawned whole new industries in exercise equipment, mountain biking, outdoor apparel, sports gyms and recreation centers, vitamin and nutrition supplements, and medically supervised diet programs. Social concerns about air and water pollution have forced industries to incorporate expenditures for controlling environmental pollution into their cost structures. Shifting societal concerns, attitudes, and lifestyles alter the pattern of competition, usually favoring those players that respond quickly and creatively with products targeted to the new trends and conditions.
- *Reduction in uncertainty Gild business risk*-A young, emerging industry is typically characterized by unproven cost structure, much uncertainty over potential market size, how much time and money will be needed to surmount technological problems, and what distribution channels and buyer segments to emphasize. Emerging industries tend to attract only risk-taking entrepreneurial companies. Over time, however, if the business model of industry pioneers proves profitable and market demand for the product appears durable, more conservative firms are usually enticed to enter the market. Often, these later entrants are large, financially strong firms looking to invest in attractive growth industries.

Lower business risks and less industry uncertainty also affect competition in international markets. In the early stages of a company's entry into foreign markets, conservatism prevails and firms limit their downside exposure by using less risky strategies like exporting, licensing, joint marketing agreements, and collaborative partnerships and joint ventures with local companies to accomplish entry. Then, as experience accumulates and perceived risk levels decline, companies move more boldly and more independently, making acquisitions, constructing their own plants, putting in their own sales and marketing capabilities to build strong competitive positions in each country market, and beginning to link the strategies in each country to create a more globalized strategy.

The many different *potential driving forces* explain why it is too simplistic to view industry change only in terms of the life-cycle model and why a full understanding of the *causes* underlying the emergence of new competitive conditions is a fundamental part of industry analysis.

However, while many forces of change may be at work in a given industry, no more than three or four are likely to qualify as driving forces in the sense that they will act as *the major determinants* of why and how the industry is changing. Thus, strategic analysts must resist the temptation to label everything they see changing as a driving force; the analytical task is to evaluate the forces of industry and competitive change carefully enough to separate major factors from minor ones.

The link between Driving Forces and Strategy Sound analysis of an industry's driving forces is a prerequisite to sound strategy making. Without keen awareness of what external factors will produce the biggest potential changes in the company's business over the next one to three years, managers are ill prepared to craft a strategy tightly matched to emerging conditions. Similarly, if managers are uncertain about the implications of each driving force or if their views are incomplete or off-base, it's difficult for them to craft a strategy that is responsive to the driving forces and their consequences for the industry. So driving-forces analysis is not something to take highly it has practical strategy-making value and is basic to the task of thinking strategically about the industry is headed and how to prepare for the changes.

Environmental Scanning Techniques

One way to try to detect future driving forces early on is to systematically scan the environment for new straws in the wind. Environmental scanning involves studying and interpreting the sweep of social, political, economic, ecological, and technological events in an effort to spot budding trends and conditions that could become driving forces. Environmental scanning involves time frames well beyond the next one to three years—for example, it could involve judgments about the demand for electric power in the year 2010, what kinds of appliances and computerized electronic controls will be in the "house of the future," how people will be communicating over long distances 10 years from now, or what will happen to the income levels and purchasing habits of retired people in the 21st century if average life expectancies continue to increase. Environmental scanning thus attempts to spot first-of-a-kind happenings and approaches that are catching on, and to extrapolate their possible implications 5 to 20 years into the future. *The purpose of environmental scanning is to raise the consciousness of managers about potential developments that could have an important impact on industry conditions and pose new opportunities or threats.*

Environmental scanning can be accomplished by systematically monitoring and studying current events, constructing scenarios, and employing the Delphi method (a technique for finding consensus among a group of knowledgeable experts). Environmental scanning methods are highly qualitative and subjective. The appeal of environmental scanning, notwithstanding its speculative nature, is that it helps managers lengthen their planning horizon, translate vague inklings of future opportunities or threats into clearer strategic issues (for which they can begin to develop strategic answers), and think strategically about developments in the surrounding environment. Companies that undertake formal environmental scanning on a fairly continuous and comprehensive level include General Electric, AT&T, Coca-Cola, Ford, General Motors, Du Pont, and Shell Oil.

QUESTION 4: WHICH COMPANIES ARE IN THE STRONGEST/WEAKEST POSITIONS?

The next step in examining the industry's competitive structure is to study the market positions of rival companies. One technique for revealing the competitive positions of industry participants is strategic group mapping. This analytical tool is useful for comparing the market positions of each firm separately or for grouping them into like positions when an industry has so many competitors that it is not practical to examine each one in depth.

Using Strategic Group Maps to Assess the Competitive Positions of Rival Firms

A strategic group consists of those rival firms with similar competitive approaches and positions in the market. Companies in the same strategic group can resemble one another in any of several ways: they may have comparable product-line breadth, sell in the same price/quality range, emphasize the same distribution channels, use essentially the same product attributes to appeal to similar types of buyers, depend on identical technological approaches, or offer buyers similar services and technical assistance. An industry contains only one strategic group when all

sellers pursue essentially identical strategies and have comparable market positions. At the other extreme, there are as many strategic groups as there are competitors when each rival pursues a distinctively different competitive approach and occupies a substantially different competitive position in the marketplace.

The procedure for constructing a *strategic group map* and deciding which firms belong in which strategic group is straightforward:

- Identify the competitive characteristics that differentiate firms in the industry typical variables are price/quality range (high, medium, low); geographic coverage (local, regional, national, global); degree of vertical integration (none, partial, full); product-line breadth (wide, narrow); use of distribution channels (one, some, all); and degree of service offered (no-frills, limited, full).
- Plot the firms on a two-variable map using pairs of these differentiating characteristics.
- Assign firms that fall in about the same strategy space to the same strategic group.
- Draw circles around each strategic group, making the circles proportional to the size of the group's respective share of total industry sales revenues.

Several guidelines need to be observed in mapping the positions of strategic groups in the industry's overall strategy space. First, the two variables selected as axes for the map should *not* be highly correlated: if they are, the circles on the map will fall along a diagonal and strategy makers will learn nothing more about the relative positions of competitors than they would by considering just one of the variables. For instance, if companies with broad product lines use multiple distribution channels while companies with narrow lines use a single distribution channel, then looking at broad versus narrow product lines reveals just as much about who is positioned where as looking at single versus multiple distribution channels; one of the variables is redundant. Second, the variables chosen as axes for the map should expose big differences in how rivals position themselves to compete in the marketplace. This, of course, means analysts must identify the characteristics that differentiate rival firms and use these differences as variables for the axes and as the basis for deciding which firm belongs in which strategic group. Third, the variables used as axes don't have to be either quantitative or continuous; rather, they can be discrete variables or defined in terms of distinct classes and combinations. Fourth, drawing the sizes of the circles on the map proportional to the combined sales of the firms in each strategic group allows the map to reflect the relative sizes of each strategic group. Fifth, if more than two good competitive variables can be used as axes for the map, several maps can be drawn to give different exposures to the competitive positioning relationships present in the industry's structure. Because there is not necessarily one best map for portraying how competing firms are positioned in the market, it is advisable to experiment with different pairs of competitive variables.

What Can Be Learned from Strategic Group Maps

One thing to look for is whether *industry driving forces and competitive pressures favour, with groups and hurt others*. Firms in adversely affected strategic groups may try to shift to a more favorably situated group; how hard such a move proves to be depends on whether entry barriers for the target strategic group are high or low. Attempts by rival firms to enter a new strategic group nearly always increase competitive pressures. If certain firms are known to be trying to change their competitive positions on the map, then attaching arrows to the circles showing the targeted direction helps clarify the picture of competitive jockeying among rivals.

Another consideration is whether *the profit potential of different strategic groups varies due to the strengths and weaknesses in each group's market position*. Differences in profitability can occur because of differing degrees of bargaining leverage or collaboration with suppliers and/or customers, differing degrees of exposure to competition from substitute products outside the

industry, differing degrees of competitive rivalry within strategic groups, and differing growth rates for the principal buyer segments served by each group.

Generally speaking, *the closer strategic groups are to each other on the map. The stronger competitive rivalry among member firms tends to be.* Although firms in the same strategic group are the closest rivals, the next closest rivals are in the immediately adjacent groups. Often, firms in strategic groups that are far apart on the map hardly compete at all. For instance, Tiffany & Co. and Wal-Mart both sell gold and silver jewelry, but their clientele and the prices and quality of their products are much too different to justify calling them competitors. For the same reason, Timex is not a meaningful competitive rival of Rolex, and Subaru is not a close competitor of Lincoln or Mercedes-Benz.

QUESTION 5: WHAT STRATEGIC MOVES ARE RIVALS LIKELY TO MAKE NEXT?

Unless a company pays attention to what competitors are doing, it ends up flying blind into competitive battle. A company can't expect to outmaneuver its rivals without monitoring their actions, understanding their strategies, and anticipating what moves they are likely to make next. As in sports, scouting the opposition is essential. Competitive intelligence about the strategies rivals are deploying, their latest moves, their resource strengths and weaknesses, and the plans they have announced is essential to anticipating the actions they are likely to take next and what bearing their moves might have on a company's own best strategic moves. Competitive intelligence can help a company determine whether it needs to defend against specific moves taken by rivals or whether those moves provide an opening for a new offensive thrust.

Monitoring Competitors' Strategies

The best source of information about a competitor's strategy comes from examining, what it is doing in the marketplace and from what its management is saying about the company's plans. Additional insights into what a competitor is up to and its future strategy can be gotten by considering the competitor's geographic market arena, strategic intent, market share objective, position on the industry's strategic group map, and willingness to take risks; further, it is important to know whether the competitor's recent moves are mostly offensive or defensive. Good sources for such information include the company's annual report and IO-K filings, recent speeches by its managers, the reports of securities analysts, articles in the business media, company press releases, information on the company's website and other websites, its exhibits at international trade shows, and conversations with a rival's customers, suppliers, and former employees. Many companies have a competitive intelligence unit that regularly gathers information on rivals and makes it available on the company's intranet.

Gathering competitive intelligence on rivals, however, can sometimes tread the fine line between honest inquiry and unethical or even illegal behavior. For example, calling rivals to get information about prices, the dates of new product introductions, or wage and salary levels is legal. But misrepresenting one's company affiliation during such calls is unethical. Pumping rivals' representatives at trade shows is ethical only if one wears an accurate name tag like everyone else. In 1991, Avon Products secured information about its biggest rival, Mary Kay Cosmetics (MKC), by having its personnel search through the garbage dumpsters outside MKC's headquarters. When MKC officials learned of the action and sued, Avon claimed it did nothing illegal—a 1988 Supreme Court case had ruled that trash left on public property (in this case, a sidewalk) was anyone's for the taking. Avon even produced a videotape of its removal of the trash at the MKC site. Avon won the lawsuit—but the legality of Avon's action does not mean that what the company did was ethical.

Evaluating Who the Industry's Major Players Are Going to Be

It's usually obvious who the *current* major contenders are, but these same firms are not necessarily positioned most strongly for the future. Some may be ill-equipped to compete on the industry's future battleground and may already be losing strength. Smaller companies may be poising for an offensive against larger but vulnerable rivals. Longstanding contenders for market leadership sometimes slide quickly down the industry's ranks; others end up being acquired. Today's market leaders don't automatically become tomorrow's.

In deciding which competitors are favorably or unfavorably positioned to gain market ground, company strategists need to focus on why there is potential for some rivals to do better or worse than other rivals. Usually, how securely a company holds its present market share is a function of its vulnerability to driving forces and competitive pressures, whether it has a competitive advantage or disadvantage, and whether it is the likely target of offensive attack from other industry participants. Pinpointing which rivals are poised to gain market position and which rivals seem destined to lose market share helps a strategist anticipate what kinds of moves they are likely to make next.

Predicting Competitors' Next Moves

Predicting competitors' next moves is the hardest yet most useful part of competitor analysis. Good clues about what moves a specific company may make next come from studying its strategic intent, monitoring how well it is faring in the marketplace, and determining how much pressure it is under to improve its financial performance. Whether a company will continue its present strategy usually depends on how well it is doing and how satisfied it is with its current performance. Content rivals are likely to continue their present strategy with only minor fine-tuning. Ailing rivals can be performing so poorly that fresh strategic moves, either offensive or defensive, are virtually certain. Aggressive rivals with ambitious strategic intent are strong candidates for pursuing emerging market opportunities and exploiting the vulnerabilities of weaker rivals.

Since managers generally operate from assumptions about the industry's future and beliefs about their own firm's situation, insights into the strategic thinking of rival managements can be gleaned from their public pronouncements about where the industry is headed and what it will take to be successful, what they are saying about their firms situation, information from the grapevine about what they are doing, and their past actions and leadership styles. Another thing to consider is whether a rival has the flexibility to make major strategic changes or whether it is locked in to pursuing its same basic strategy with minor adjustments.

To succeed in predicting a competitor's next moves, company strategists need to have a good feel for the rivals' situation, how its managers think, and what its options are. Doing the necessary detective work can be tedious and time-consuming since the information comes in bits and pieces from many sources. But scouting competitors well enough to anticipate their next moves allows managers to prepare effective countermoves (perhaps even beat a rival to the punch) and to take rivals' probable actions into account in designing the best course of action.

QUESTION 6: WHAT ARE THE KEY FACTORS FOR COMPETITIVE SUCCESS?

An industry's **key success factors (KSFs)** are those things that most affect industry members' ability to prosper in the marketplace—the particular strategy elements, product attributes, resources, competencies, competitive capabilities, and business outcomes that spell the difference between profit and loss and, ultimately, between competitive success or failure. KSFs

by their very nature are so important that *all firms* in the industry must pay close attention to them—they are the prerequisites for industry success or, to put it another way, KSFs are the rules that shape whether a company will be financially and competitively successful. The answers to three questions help identify an industry's key success factors:

- On what basis do customers choose between the competing brands of sellers? What product attributes are crucial?
- What resources and competitive capabilities does a seller need to have to be competitively successful?
- What does it take for sellers to achieve a sustainable competitive advantage?

In the beer industry the KSFs are full utilization of brewing capacity (to keep manufacturing costs low), a strong network of wholesale distributors (to gain access to as many retail outlets as possible), and clever advertising (to induce beer drinkers to buy a particular brand and thereby pull beer sales through the established wholesale/retail channels). In apparel manufacturing the KSFs are appealing designs and color combinations (to create buyer interest) and low-cost manufacturing efficiency (to permit attractive retail pricing and ample profit margins). In tin and aluminum cans, because the cost of shipping empty cans is substantial, one of the keys is having plants located close to end-use customers so that the plant's output can be marketed within economical shipping distances (regional market share is far more crucial than national share).

Determining the industry's key success factors, given prevailing and anticipated industry and competitive conditions, is a top-priority analytical consideration. At the very least, managers need to understand the industry situation well enough to know what is more important to competitive success and what is less important. They need to know what kinds of resources are competitively valuable. Misdiagnosing the industry factors critical to long-term competitive success greatly raises the risk of a misdirected strategy. In contrast, a company with perceptive understanding of industry KSFs can gain sustainable competitive advantage by training its strategy on industry KSFs and devoting its energies to being *distinctively better* than rivals on one or more of these factors indeed. Companies that stand out on a particular KSF enjoy a stronger market position for their efforts—being *distinctively better than rivals on one or more key success factors* presents a golden opportunity for gaining competitive advantage. Hence, using the industry's KSFs as *cornerstones* for the company's strategy and trying to gain sustainable competitive advantage by excelling at one particular KSF is a fruitful competitive strategy approach.

Key success factors vary from industry to industry and even from time to time within the same industry as driving forces and competitive conditions change. Only rarely does an industry have *more than three or four* key success factors at anyone time. And even among these three or four, one or two usually outrank the others in importance. Managers, therefore, have to resist the temptation to include factors that have only minor importance on their list of key success factors—the purpose of identifying KSFs is to make judgments about what things are more important to competitive success and what things are less important. To compile a list of every factor that matters even a little bit defeats the purpose of concentrating management attention on the factors truly critical to long-term competitive success.

QUESTION 7: IS THE INDUSTRY ATTRACTIVE AND WHAT ARE ITS PROSPECTS FOR ABOVE-AVERAGE PROFITABILITY?

The final step of industry and competitive analysis is to use the answers to the previous six questions to draw conclusions about the relative attractiveness or unattractiveness of the

industry, both near-term and long-term. Company strategists are obligated to assess the industry outlook carefully, deciding whether industry and competitive conditions present an attractive business opportunity for the company or whether the company's growth and profit prospects are gloomy. The important factors on which to base such conclusions include:

- The industry's growth potential.
- Whether competition currently permits adequate profitability and whether competitive forces will become stronger or weaker.
- Whether industry profitability will be favorably or unfavorably affected by the prevailing driving forces.
- The company's competitive position in the industry and whether its position is likely to grow stronger or weaker, (Being a well-entrenched leader or strongly positioned, contender in an otherwise lackluster industry can still produce good profitability; however, having to fight an uphill battle against much stronger rivals can make an otherwise attractive industry unattractive.).
- The company's potential to capitalize on the vulnerabilities of weaker rivals (perhaps converting an unattractive industry situation into a potentially rewarding company opportunity).
- Whether the company is able to defend against or counteract the factors that make the industry unattractive.
- The degrees of risk and uncertainty in the industry's future.
- The severity of problems confronting the industry as a whole.
- Whether continued participation in this industry adds importantly to the firm's ability to be successful in other industries in which it may have business interests.

As a general proposition, *if an industry's overall profit prospects are above average, the industry can be considered attractive; If its profit prospects are below average, it is unattractive.* However, it is a mistake to think of industries as being attractive or Unattractive to all industry participants and all potential entrants. Attractiveness is relative not absolute, and conclusions one way or the other are in the eye of the beholder—industry attractiveness always has to be appraised from the standpoint of a particular company. Industry environments unattractive to weak competitors may be unattractive to strong competitors. Despite the obvious problems of the cigarette industry, for example, Philip Morris has managed to grow market share and maintain reasonable profitability. Industries attractive to insiders, like soft drinks, may be unattractive to outsiders (because of high entry barriers and the global competitive capabilities of Coca-Cola and PepsiCo). Companies on the outside may look at an industry's environment and conclude that it is an unattractive business for them to get into, given the prevailing entry barriers, their particular resources and competencies, the difficulty of challenging current market leaders, and the more profitable opportunities they seem to have elsewhere. But a favorably positioned company already in the industry may survey the very same business environment and conclude that the industry is attractive because it has the resources and competitive capabilities to take sales and market share away from weaker rivals, build a strong leadership position, and earn good profits.

An assessment that the industry is fundamentally attractive typically suggests that current industry participants employ strategies calculated to strengthen their long-term competitive positions in the business, expanding sales efforts and investing in additional facilities and equipment as needed. If the industry and competitive situation is judged relatively unattractive, more successful industry participants may choose to in cautiously, look for ways to protect their long-term competitiveness and profitability, and perhaps acquire smaller firms if the price is right; over the longer term, stronger companies may consider diversification into more attractive businesses. Weak companies in unattractive industries may consider merging with a rival to bolster market share and profitability or, alternatively, begin looking outside the industry for attractive diversification opportunities.

EVALUATING COMPANY RESOURCES AND COMPETITIVE CAPABILITIES

In Chapter 4, we described how to use the tools of industry and competitive analysis to strategically assess a company's external environment. In this chapter we discuss the techniques of evaluating company's resource capabilities, relative cost position, and competitive strength versus rivals. Company situation analysis prepares the groundwork for matching the company's strategy both to its external market circumstances and to its internal resources and competitive capabilities. The spotlight of company situation analysis is trained on five questions:

1. How well is the company's present strategy working?
2. What are the company's resource strengths and weaknesses and its external opportunities and threats?
3. Are the company's prices and costs competitive?
4. How Strong is the company's competitive position relative to its rivals?
5. What strategic issues does the company face?

To explore these questions, we'll be using four analytical techniques: SWOT analysis, value chain analysis, strategic cost analysis, and competitive strength assessment. These are basic strategic management tools that serve to illuminate a company's resource strengths and deficiencies, its best market opportunities, the outside threats to its future profitability, and its competitive standing relative to rivals. Insightful company situation analysis is a precondition for identifying the strategic issues that management needs to address and for tailoring strategy to company resources and competitive capabilities as well as to industry and competitive conditions.

QUESTION 1: HOW WELL IS THE PRESENT STRATEGY WORKING?

In evaluating how well a company's present strategy is working, a manager has to start with what the strategy is. The first thing to pin down is the company's competitive approach. Is the company striving to be a low-cost leader or stressing ways to differentiate its product offering from rivals? Is it concentrating its efforts on serving a broad spectrum of customers or a narrow market niche? Another strategy-defining consideration is the firm's competitive scope within the industry-how many stages of the industry's production-distribution chain it operates in (one, several, or all), what its geographic market coverage is, and the size and makeup of its customer base. The company's functional strategies in production, marketing, finance, human resources, information technology, new product innovation, and so on further characterize company strategy. In addition, the company may have initiated some recent strategic moves (for instance, price cuts, design improvements, stepped-up advertising, entry into a new geographic area, or merger with a competitor) that are integral to its strategy and that aim at securing an improved competitive position and, optimally, a competitive advantage. The strategy being pursued can be further nailed down by probing the logic behind each competitive move and functional approach.

While there's merit in evaluating the strategy from a *qualitative* standpoint (its completeness, internal consistency, rationale, and suitability to the situation), the 'best *quantitative* evidence of how well a company's strategy is working comes from studying the company's recent strategic and financial performance and seeing what story the numbers tell about the results the strategy is producing. The two best empirical indicators are (1) whether the company is achieving its stated financial and strategic objectives, and (2) whether the company is an above-average industry performer. Persistent shortfalls in meeting company performance targets and weak performance relative to rivals are reliable warning signs that the company

suffers from poor strategy making, less-than-competent strategy execution, or both. Sometimes company objectives are not explicit enough (especially to company outsiders) to benchmark actual performance against, but it is nearly always feasible to evaluate the performance of a company's strategy by looking at:

- Whether the firm's sales are growing faster, slower, or about the same pace as the market as a whole, thus resulting in a rising, eroding, or stable market share.
- Whether the company is acquiring new customers at an attractive rate as well as retaining existing customers.
- Whether the firm's profit margins are increasing or decreasing and how well its margins compare to rival firms' margins.
- Trends in the firm's net profits, return on investment, and economic value added, and how these compare to the same trends for other companies in the industry.
- Whether the company's overall financial strength and credit rating are improving or on the decline.
- Whether the company can demonstrate continuous improvement in such internal performance measures as unit cost, defect rate, scrap rate, employee motivation and morale, number of stock outs and customer back orders, fewer days of inventory, and so on.
- How shareholders view the company based on trends in the company's stock price and shareholder value (relative to the market value added of other companies in the industry).
- The firm's image and reputation with its customers.
- Whether the company is regarded as a leader in technology, product innovation, e-commerce, product quality, short times from order to delivery, having the best prices, getting newly developed products to market quickly, or other relevant factors on which buyers base their choice of brands.

The stronger a company's current overall performance, the less likely the need for radical changes in strategy. The weaker a company's financial performance and market standing, the more its current strategy must be questioned. Weak performance is almost always a sign of weak strategy, weak execution, or both.

QUESTION 2: WHAT ARE THE COMPANY'S RESOURCE STRENGTHS AND WEAKNESSES AND ITS EXTERNAL OPPORTUNITIES AND THREATS?

Sizing up a firm's resource strengths and weaknesses and its external opportunities and threats, commonly known as *SWOT analysis*, provides a good overview of whether a firm's business position is fundamentally healthy or unhealthy. SWOT analysis is grounded in the basic principle that *strategy-making efforts must aim at producing a good fit between a company's resource capability* (as reflected by its balance of resource strengths and weaknesses) *and its external situation* (as reflected by industry and competitive conditions, the company's own market opportunities, and specific external threats to the company's profitability and market standing). Perceptive understanding of a company's resource capabilities and deficiencies, its market opportunities, and the external threats to its future well-being is essential to good strategy-making. Otherwise, the task of conceiving a strategy that capitalizes on the company's resources, aims squarely at capturing the company's best opportunities, and neutralizes the threats to its well-being becomes a chancy proposition indeed.

Identifying Company Strengths and Resource Capabilities

A *strength* is something a company is good at doing or a characteristic that gives it enhanced competitiveness. A strength can take any of several forms:

- A skill or important expertise—low-cost manufacturing capabilities, strong e-commerce expertise, technological know-how, a proven track record in defect-free manufacture, expertise in providing consistently good customer service, excellent mass merchandising skills, or unique advertising and promotional talents.
- Valuable physical assets—state-of-the-art plants and equipment, attractive real estate locations, worldwide distribution facilities, ownership of valuable natural resource deposits, cutting-edge computer networks and information systems, or sizable amounts of cash and marketable securities.
- *Valuable human assets*—an experienced and capable workforce, talented employees in key areas, motivated and energetic employees, cutting-edge knowledge and intellectual capital, astute entrepreneurship and managerial know-how, or the collective learning embedded in the organization and built up over time.
- *Valuable organizational assets*—proven quality control systems, proprietary technology, key patents, mineral rights, a base of loyal customers, a strong balance sheet and credit rating, cutting-edge supply chain management systems, a well-functioning company intranet, and e-commerce systems for accessing and exchanging information with suppliers and key customers, computer-assisted design and manufacturing systems, systems for conducting business on the Internet, or a comprehensive list of customers' e-mail addresses.
- *Valuable intangible assets*—brand-name image, company reputation, buyer goodwill, or a motivated and energized workforce.
- *Competitive capabilities*—short development times in bringing new products to market, a strong dealer network, strong partnerships with key suppliers, an R&D organization with the ability to keep the company's pipeline full of innovative new products, a high degree of organizational agility in responding to shifting market conditions and emerging opportunities, a cadre of highly trained customer service representatives, or state-of-the-art systems for doing business via the Internet.
- *An achievement or attribute that puts the company in a position of market advantage*—low overall costs, market share leadership, a superior product, a wide product selection, strong name recognition, state-of-the-art e-commerce technologies and practices, or exceptional customer service.
- *Alliances or cooperative ventures*—fruitful collaborative partnerships with suppliers and marketing allies that enhance the company's own competitiveness.

Company strengths thus have diverse origins. Sometimes they relate to fairly specific skills and expertise (like know-how in researching consumer tastes and buying habits or training customer contact employees to be cordial and helpful) and sometimes they flow from different resources teaming together to create a competitive capability (like continuous product innovation—which tends to result from a combination of knowledge of consumer needs, technological know-how, R&D, product design and engineering, cost-effective manufacturing, market testing, and other types of intellectual capital). The regularity with which employees from different parts of the organization pool their knowledge and expertise, their skills in exploiting and building on the organization's physical and intangible assets, and the effectiveness with which they collaborate can create competitive capabilities not otherwise achievable by a single department or organizational unit within the enterprise.

Taken together, a company's skills and expertise, its intellectual capital, its competitive capabilities, its uniquely strong competencies, its collection of strategically valuable assets, and its market achievements determine the complement of *resources* with which it competes. The caliber of its resources and its ability to mobilize them in a manner calculated to result in competitive advantage are the biggest determinants of how well the company will be able to perform in light of the prevailing industry and competitive conditions.

Identifying Company Weaknesses and Resource

A *weakness* is something a company lacks or does poorly (in comparison to others) or a condition that puts it at a disadvantage. A company's internal weaknesses can relate to (1) deficiencies in competitively important skills or expertise or intellectual capital of one kind or another; (2) a lack of competitively important physical, organizational, or intangible assets; or (3) missing or weak competitive capabilities in key areas. *Internal weaknesses are thus shortcomings in a company's complement of resources.* A weakness may or may not make a company competitively vulnerable, depending on how much the weakness matters in the marketplace and whether it can be overcome by the resources and strengths in the company's possession:

Table 4.1 indicates the kinds of factors to be considered in determining a company's resource strengths and weaknesses. Sizing up a company's complement of resource capabilities and deficiencies is akin to constructing a *strategic balance sheet* where resource strengths represent *competitive assets* and resource weaknesses represent *competitive liabilities*. Obviously, the ideal condition is for the company's strengths/competitive assets to outweigh its weaknesses/competitive liabilities by an ample margin—a 50-50 balance is definitely not the desired condition.

Once managers identify a company's resource strengths and weaknesses, the two compilations need to be carefully evaluated for their competitive value and strategy making implications. Some resource strengths and competencies are *competitively* more important than others because they add greater power to the company's strategy or are bigger factors in contributing to a strong market position and higher profitability. Likewise, some weaknesses can prove fatal if not remedied, while others are inconsequential, easily corrected, or offset by company strengths. A company's resource weaknesses suggest a need to review its resource base: What existing resource deficiencies need to be remedied? Does the company have important resource gaps that need to be filled? What needs to be done to augment the company's future resource base?

Identifying Company Competencies and Capabilities

The Related Concepts of Company Competence and Competitive Capability Identifying and evaluating what a company is really good at doing and what capabilities it has for competing is a critical component of assessing a company's situation. A company competence is nearly always the product of experience, representing an accumulation of learning over time and the buildup over time of *real proficiency*. Competencies have to be consciously built and developed—they don't just happen. A company competence originates with deliberate efforts to develop the organizational ability to do something, however imperfectly or inefficiently. Such efforts entail selecting people with the requisite knowledge and skills, upgrading or expanding individual abilities as needed, and then molding the efforts and work products of individuals into a cooperative group effort to create organizational ability. Then as experience builds, such that the company reaches a level of ability to perform the activity consistently well and at an acceptable cost, the ability begins to translate into a true competence.

Examples of competencies include skills in merchandising and product display, the ability to create attractive and easy-to-use websites, expertise in a specific technology, proven ability to select good locations for retail outlets, skills in working with customers on new applications and uses of the product, and expertise in just-in-time inventory management practices. Company competencies are normally bundles of skills, know-how, resources, and technologies-as opposed to a single discrete skill or resource or technology.

A company competence becomes a meaningful competitive capability when customers deem the competence valuable and beneficial, when it helps differentiate a company from its competitors, and when it enhances its competitiveness. However, it is important to understand that competitive capabilities are not all *equal-some merely enable survival* because they are common to most all rivals while *others hold potential for changing the basis of competition* because they are unique, proprietary, and deliver considerable customer value. But it is *useful to think of a company as consisting of a collection of capabilities*, some difficult to disentangle from one another and some stronger and more competitively valuable than others.

Core Competencies: A Valuable Company Resource One of the most valuable resources a company has is the ability to perform a competitively relevant activity very well. A competitively important internal activity that a company performs better than other competitively important internal activities is termed a core competence. While a core competence is something a company does well internally, what makes it a core competence as opposed to just a competence is that it is central to a company's competitiveness and profitability rather than peripheral. A company's core competence can relate to any of several aspects of its business: expertise in building networks and systems that enable e-commerce, speeding new or next-generation products to market, good after-sale service, skills in manufacturing a high-quality product, innovativeness in developing popular product features, speed and agility in responding to new market trends and changing competitive conditions, know-how in creating and operating a system for filling customer orders accurately and swiftly, and expertise in integrating multiple technologies to create families of new products.

A company may have more than one core competence in its resource portfolio but rare is the company that can legitimately claim more than two or three core competencies. Plainly, a core competence gives a company competitive capability and thus qualifies as a genuine company strength and resource.

Most often, a company's core competence resides in its people and in its intellectual capital, not in its assets on the balance sheet. Core competencies tend to be grounded in cross-department and cross-functional combinations of skills, resources, and technologies. Knowledge and intellectual capital, more than physical assets and tangible organizational resources, are the key ingredients of a core competence and a firm's competitive capability.

Distinctive Competencies: A Competitively Superior Company Resource Whether a company's core competence represents a distinctive competence depends on how good the competence is relative to what competitors are capable of-is it a competitively superior competence or just a standout internal company competence? A distinctive competence is something a company does well in comparison to its competitors. Most every company does one competitively important activity enough better than the other things it does internally that it can claim that activity as a core competence. But what a company does best internally doesn't translate into a distinctive competence unless the company performs that activity better than rivals and thus enjoys competitive superiority. For instance, most all retailers believe they have core competencies in product selection and in-store merchandising, but many retailers who build strategies on these competencies run into trouble in the marketplace because they encounter

rivals whose competencies in these areas are better than theirs. Consequently, a core competence becomes a basis for competitive advantage only when it is a distinctive competence.

Sharp Corporation's distinctive competence in flat-panel display technology has enabled it to dominate the worldwide market for liquid crystal displays (LCDs). The distinctive competencies of Toyota and Honda in low-cost, high-quality manufacturing and in short design-to-market cycles for new models have proved to be considerable competitive advantages in the global market for motor vehicles. Intel's distinctive competence in rapidly developing new generations of ever more powerful semiconductor chips for personal computers has helped give the company a dominating presence in the personal computer industry. Starbucks' distinctive competence in store ambience and innovative coffee drinks has propelled it to the forefront among coffee retailers. Motorola's distinctive competence in virtually defect-free manufacture (six sigma quality—an error rate of about 3.4 per million) has contributed significantly to the company's world leadership in cellular telephone equipment. Rubbermaid's distinctive competence in developing innovative rubber and plastics products for house, hold and commercial use has made it the clear leader in its industry.

The importance of a distinctive competence to strategy-making rests with (1) the competitively valuable capability it gives a company, (2) its potential for being a cornerstone of strategy, and (3) the competitive edge it can produce in the marketplace. It is always easier to build competitive advantage when a firm has a distinctive competence in performing activities important to market success, when rival companies do not have offsetting competencies, and when it is costly and time-consuming for rivals to imitate the competence. A distinctive competence is thus potentially the mainspring of a company's success—unless it is trumped by more powerful resources of rivals.

Determining the Competitive Value of a Company Resource No two companies are alike in their resources. They don't have the same skill sets; assets (physical, human, organizational, and intangible); competitive capabilities; or market achievements—a condition that results in different companies having different strengths and weaknesses. *Differences in company resources account for why some companies are more profitable and more competitively successful than others.* A company's success is more certain when it has appropriate and ample resources with which to compete, and especially when it has a valuable strength, asset, capability, or achievement with the potential to produce competitive advantage.

For a particular company resource to qualify as the basis for sustainable competitive advantage, it must pass four tests of competitive value:

Is the resource hard to copy? The more difficult and more expensive it is to imitate a resource, the greater its potential competitive value. Hard-to-copy resources limit competition, making any profit stream they are able to generate more sustainable. Resources can be difficult to copy because of their uniqueness (a fantastic real estate location, patent protection), because they must be built over time in ways that are difficult to imitate (a brand name, mastery of a technology), and because they carry big capital requirements (a new cost-effective plant to manufacture semiconductor chips can cost \$1 to \$2 billion).

How long does the resource last? The longer a resource lasts, the greater its value. Some resources lose their value quickly because of the rapid speeds with which technologies or industry conditions are moving. The value of Eastman Kodak's resources in film and film processing is rapidly being undercut by the growing popularity of digital cameras. The value of 3Com's expertise in PC modem technology is fast being eroded by the onslaught of cable modems and by the efforts of chip manufacturers to incorporate modem functions directly into the microprocessor instruction set. The investments that commercial banks have made in

branch offices is a rapidly depreciating asset because of growing use of direct deposits, ATMs, and telephone and Internet banking options.

Is the resource really competitively superior? Companies have to guard against pridefully believing that their core competences are distinctive competences or that their brand name is more powerful than the brand names of rivals. Who can really say whether Coca-Cola's consumer marketing skills are better than Pepsi-Cola's or whether Mercedes-Benz's brand name is more powerful than BMW's or Lexus's?

Can the resource be trumped by the different resources/capabilities of rivals? Many commercial airlines (American Airlines, Delta Airlines, United Airlines, Singapore Airlines) have succeeded because of their resources and capabilities in offering safe, convenient, reliable air transportation services and in providing an array of amenities to passengers. However, Southwest Airlines has been a more consistently profitable air carrier by building the capabilities to provide safe, reliable, basic services at radically lower fares. The prestigious brand names of Cadillac and Lincoln have faded as dominating factors in choosing what luxury cars to buy—Mercedes, BMW, and Lexus have introduced the most appealing luxury vehicles in recent years. Amazon.com is pulling a big dent in the business prospects of brick-and-mortar bookstore chains like Barnes & Noble and Borders; likewise, online retailers of toys and Wal-Mart (with its lower prices) are putting major competitive pressure on Toys "R" Us, at one time the leading toy retailer.

The vast majority of companies are not well endowed with competitively valuable resources, much less with competitively superior resources capable of passing the above four tests with flying colors. Most businesses have a mixed bag of resources one or two quite valuable, some good, many satisfactory to mediocre. Only a few companies, usually the strongest industry leaders or up-and-coming challengers, possess a competitively superior resource. Furthermore, nearly all companies have competitive liabilities, whether they be labeled internal weaknesses, a lack of assets, missing expertise or capabilities, or resource deficiencies.

Even if a company doesn't possess a competitively superior resource, the potential for competitive advantage is not lost. Sometimes a company derives significant competitive vitality, even competitive advantage, from a collection of good to adequate resources which, in combination, have competitive power in the marketplace. Toshiba's laptop computers were the market share leader throughout most of the 1990s—an indicator that Toshiba was good at something. Yet Toshiba's laptops were not demonstrably faster than rivals' laptops, nor did they have superior performance features (bigger screens, more memory, longer battery power, a better pointing device, and so on), nor did Toshiba provide clearly superior technical support services to buyers of its laptops. And Toshiba laptops were definitely not cheaper, model for model, than the comparable models of its rivals. Toshiba laptops seldom ranked first in the overall performance ratings done by various organizations. Rather, Toshiba's market share leadership stemmed from a combination of good resource strengths and capabilities—its strategic partnerships with suppliers of laptop components, its efficient assembly capability, its design expertise, its skills in choosing quality components, its creation of a wide selection of models, the attractive mix of built-in performance features found in each model when balanced against price, the much-better-than-average reliability of its laptops (based on buyer ratings), and its very good technical support services (based on buyer ratings). The verdict from the marketplace was that PC buyers considered Toshiba laptops as better, all things considered, than competing brands.

Matching Strategy to the Company's Resource Strengths and Weaknesses From a strategy-making perspective, a company's resource strengths are significant because they can form the cornerstones of strategy and the basis for creating competitive advantage. If a company doesn't have the resources and competitive capabilities around which to craft an

attractive strategy, managers need to take decisive remedial action to upgrade existing organizational resources and capabilities and add others as needed. At the same time, managers have to look toward correcting competitive weaknesses that make the company vulnerable, hold down profitability, or disqualify it from pursuing an attractive opportunity. The strategy-making principle here is simple: *a company's strategy should be tailored to fit its resources-taking both strengths and weaknesses into account.* As a rule, managers should build their strategies around exploiting and leveraging company capabilities--its most valuable resources--and avoid strategies that place heavy demands on areas where the company is weakest or has unproven ability. Companies fortunate enough to have a distinctive competence or other competitively superior resource must be wise in realizing that its value will be eroded by time and competition. So attention to building a strong resource base for the future and to maintaining the competitive superiority of an existing distinctive competence are ever-present needs.

Selecting/the Competencies and Capabilities to Concentrate On Enterprises succeed in a competitive marketplace over time because they can do certain things that their customers value better than their rivals. The essence of astute strategy making is selecting the competencies and capabilities to concentrate on and use to underpin the strategy. Sometimes the company already has competitively valuable competencies and capabilities in place and sometimes it has to be proactive in developing and building new competencies and capabilities to complement and strengthen its existing resource base. Sometimes the desired competencies and capabilities need to be developed internally and sometimes it is best to acquire them through partnerships or strategic alliances with firms possessing the needed expertise.

Identifying a Company's Market Opportunities

Market opportunity is a big factor in shaping a company's strategy. Indeed, managers can't properly tailor strategy to the company's situation without first identifying each company opportunity and appraising the growth and profit potential each one holds. Depending on the prevailing circumstances, a company's opportunities can be plentiful or scarce and can range from wildly attractive (an absolute "must" to pursue) to marginally interesting (low on the company's list of strategic priorities).

In evaluating a company's market opportunities and ranking their attractiveness, managers have to guard against viewing every *industry* opportunity as a *company* opportunity. Not every company in an industry is equipped with the resources to successfully pursue each opportunity that exists in the industry. Some companies are more capable of going after particular opportunities than others, and a few companies may be hopelessly outclassed in trying to contend for a piece of the action. Deliberately adapting a company's resource base to put it in position to contend for attractive growth opportunities is something strategists must pay keen attention to. *The market opportunities most relevant to a company are those that offer important avenues for profitable growth, those where a company has the most potential for competitive advantage, and those that match lip well with the company financial and organizational resource capabilities.*

Identifying the Threats to a Company's Future Profitability

Often, certain factors in a company's external environment pose *threats* to its profitability and competitive well-being. Threats can stem from the emergence of cheaper or better technologies, rivals' introduction of new or improved products, the entry of lower-cost foreign competitors into a company's market stronghold, new regulations that are more burdensome to a company than to its competitors, vulnerability to a rise in interest rates, the potential of a hostile takeover, unfavorable demographic shifts, adverse changes in foreign exchange rates, political upheaval in a foreign country where the company has facilities, and the like. External threats may pose no more than a moderate degree of adversity (all companies confront some threatening elements in the course of doing business) or they may be so imposing as to make a company's situation

and outlook quite tenuous. It is management's job to identify the threats to the company's future well-being and to evaluate what strategic actions can be taken to neutralize or lessen their impact.

Table 4.1 presents a list of potential threats to a company's future profitability and market position. Opportunities and threats not only affect the attractiveness of a company's situation but, more important, they point to the need for strategic action. Tailoring strategy to a company's situation entails (1) pursuing market opportunities well suited to the company's resource capabilities and (2) taking actions to defend against , external threats to the company's business.

The Real Value of SWOT Analysis

SWOT analysis is more than an exercise in making four lists. The really valuable part of SWOT analysis is determining what story the four lists tell about the company's situation and thinking about what actions are needed. Understanding the story involves evaluating the strengths, weaknesses, opportunities, and threats and drawing conclusions about (1) how the company's strategy can be matched to both its resource capabilities and its market opportunities, and (2) how urgent it is for the company to correct which particular resource weaknesses and guard against which particular external threats. To have managerial and strategy-making value, SWOT analysis must be a basis for action. It also needs to provoke thinking and answers to several questions about *what future* resource strengths and capabilities the company will need to respond to emerging industry and competitive conditions and to produce successful bottom-line results. Will the current strengths matter as much in the future? Are there resource gaps that need to be filled? Do new types of competitive capabilities need to be put in place? Which resources and capabilities need to be given greater emphasis and which merit lesser emphasis? SWOT analysis has not served its purpose until the lessons about the company's situation have been distilled from the four lists.

QUESTION 3: ARE THE COMPANY'S PRICES AND COSTS COMPETITIVE?

Company managers are often stunned when a competitor cuts price to "unbelievably low" levels or when a new market entrant comes on strong with a very low price. The competitor may not, however, be "dumping" (an economic term for selling large amounts of goods below market price), buying market share, or waging a desperate move to gain sales; it may simply have substantially lower costs. One of the most telling signs of whether a company's business position is strong or precarious is whether its prices and costs are competitive with industry rivals. Price-cost comparisons are especially critical in a commodity-product industry where the value provided to buyers is the same from seller to seller, price competition is typically the ruling market force, and lower-cost companies have the upper hand. But even ill industries where products are differentiated and competition centers on the different attributes of competing brands as much as on price, rival companies have to keep their costs *in line* and make sure that any added costs they incur and price premiums they charge create ample buyer value.

Competitors usually don't incur the same costs in supplying their products to end-users. The cost disparities can range from tiny to competitively significant and can stem from any of several factors:

- Differences in the prices paid for raw materials, components parts, energy, and other items purchased from suppliers.
- Differences in basic technology and the age of plants and equipment. Because rival companies usually invest in plants and key pieces of equipment at different times, their

facilities have somewhat different technological efficiencies and different fixed costs (depreciation, maintenance, property taxes, and insurance). Older facilities are typically less efficient, but if they were less expensive to construct or were acquired at bargain prices, they may still be reasonably cost competitive with modern facilities.

- Differences in production costs from rival to rival due to different plant efficiencies, different learning and experience curve effects, different wage rates, different productivity levels, and the like.
- Differences in marketing costs, sales and promotion expenditures, advertising expenses, warehouse distribution costs, and administrative costs.
- Differences in inbound transportation costs on purchased items and outbound shipping costs on goods sold.
- Differences in forward channel distribution costs (the costs and markups of distributors, wholesalers, and retailers associated with getting the product from the point of manufacture into the hands of end users).
- Differences in rival firms' exposure to the effects of inflation, changes in foreign exchange rates, and tax rates (a frequent occurrence in global industries where competitors have operations in different nations with different economic conditions and governmental taxation policies).

For a company to be competitively successful, its costs must be in line with those of close rivals. While some cost disparity is justified so long as the products or services of closely competing companies are sufficiently differentiated, a high-cost firm's market position becomes increasingly vulnerable the more its costs exceed those of close rivals.

Strategic Cost Analysis and Value Chains

Competitors must be ever alert to how their costs compare with rivals'. While every firm engages in internal cost analysis to stay on top of what its own costs are and how they might be changing, strategic cost analysis goes a step further to explore how costs compare against rivals. Strategic cost analysis focuses on a firm's cost position relative to its rivals'.

Every company's business consists of a collection of activities undertaken in the course of designing, producing, marketing, delivering, and supporting its product or service. Each of these activities give rise to costs. The combined costs of all these various activities define the company's internal cost structure. Further, the cost of each activity contributes to whether the company's overall cost position relative to rivals is favorable or unfavorable. The task of strategic cost analysis is to compare a company's costs activity by activity against the costs of key rivals and to learn which internal activities are a source of cost advantage or disadvantage. A company's relative cost position is a function of how the overall costs of the activities it performs in conducting business compare to the overall costs of the activities performed by rivals.

The Concept of a Company Value Chain The primary analytical tool of strategic cost analysis is a value chain identifying the separate activities, functions, and business processes that are performed in designing, producing, marketing, delivering, and supporting a product or service. The chain of value-creating activities it takes to provide a product or service starts with raw materials supply and continues on through parts and components production, manufacturing and assembly, wholesale distribution, and retailing to the end user of the product or service.

A company's value chain shows the linked set of activities and functions it performs internally (see Figure 4.2). The value chain includes a profit margin because a markup over the cost of performing the firm's value-creating activities is customarily part of the price (or total cost) borne by buyers-creating value that exceeds the cost of doing so is a fundamental

objective of business. Disaggregating a company's operations into strategically relevant activities and business processes exposes the major elements of the company's cost structure. Each activity in the value chain incurs costs and ties up assets; assigning the company's operating costs and assets to each individual activity in the chain provides cost estimates for each activity. Quite often, there are links between activities such that the manner in which one activity is done can affect the costs of performing other activities. For instance, Japanese producers of videocassette recorders were able to reduce VCR prices from around \$1,300 in 1977 to under \$300 in 1984 by spotting the impact of an early step in the value chain (product design) on a later step (production) and deciding to change the product design to drastically reduce the number of parts.

Why the Value Chains of Rival Companies Often Differ A company's value chain and the manner in which it performs each activity reflect the evolution of its own particular business and internal operations, its strategy, the approaches it is using to execute its strategy, and the underlying economics of the activities themselves. Because these factors differ from company to company, the value chains of rival companies sometimes differ substantially—a condition that complicates the task of assessing rivals' relative cost positions. For instance, competing companies may differ in their degrees of vertical integration. Comparing the value chain for a fully integrated rival against a partially integrated rival requires adjusting for differences in scope of activities performed. Clearly the internal costs for a manufacturer that *makes* all of its own parts and components will be greater than the internal costs of a producer that *buys* the needed parts and components from outside suppliers and only performs assembly operations.

Representative Company Value Chain

Primary Activities

- Purchased Supplies and Inbound Logistics—Activities, costs, and assets associated with purchasing fuel, energy, raw materials, parts components, merchandise, and consumable items from vendors; receiving, storing, and disseminating inputs from suppliers; inspection; and inventory management.
- Operations—Activities, costs, and assets associated with converting inputs into final product form (production, assembly, packaging, equipment maintenance, facilities, operations, quality assurance, environmental protection).
- Distribution and Outbound Logistics—Activities, costs, and assets dealing with physically distributing the product to buyers (finished goods warehousing, order processing, order picking and packing, shipping, delivery vehicle operations, establishing and maintaining a network of dealers and distributors).
- Sales and Marketing—Activities, costs, and assets related to sales force efforts, advertising and promotion, market research and planning, and dealer/distributor support.
- Service—Activities, costs, and assets associated with providing assistance to buyers, such as installation, spare parts delivery, maintenance and repair, technical assistance, buyer inquiries, and complaints.

Support Activities

- Research, Technology, and Systems Development—Activities, costs, and assets relating to product R&D, process R&D, process design improvement, equipment design, computer software development, telecommunications systems, computer-assisted design and engineering, new database capabilities, and development of computerized support systems.
- Human Resources Management—Activities, costs, and assets associated with the recruitment, hiring, training, development, and compensation of all types of personnel; labor relations activities; development of knowledge-based skills and core competencies.

- General Administration-Activities, costs, and assets relating to general management, accounting and finance, legal and regulatory affairs, safety and security, management information systems, forming strategic alliances and collaborating with strategic partners, and other "overhead" functions.

Likewise, there is legitimate reason to expect value chain and cost differences between a company that is pursuing a low-cost/low-price strategy and a rival that is positioned on the high end of the market with a product that has prestige quality and a wealth of features. In the case of the low-cost firm, the costs of certain activities along the company's value chain should indeed be relatively low, whereas the high-end firm may understandably be spending relatively more to perform those activities that create the added quality and extra features.

Moreover, cost and price differences among rival companies can have their origins in activities performed by suppliers or by forward channel allies involved in getting the product to end users. Suppliers or forward channel allies may have excessively high cost structures or profit margins that jeopardize a company's cost competitiveness even though its costs for internally performed activities are competitive. For example, when determining Michelin's cost competitiveness vis-à-vis Goodyear and Bridgestone in supplying replacement tires to vehicle owners, we have to look at more than whether Michelin's tire manufacturing costs are above or below Goodyear's and Bridgestone's. Let's say that a buyer has to pay \$400 for a set of Michelin tires and only \$350 for a comparable set of Goodyear or Bridgestone tires; Michelin's \$50 price disadvantage in the replacement tire marketplace can stem not only from higher manufacturing costs (refueling, perhaps, the added costs of Michelin's strategic efforts to build a better-quality tire with more performance features) but also from (1) differences in what the three tire makers pay their suppliers for materials and tire-making components and (2) differences in the operating efficiencies, costs, and markups of Michelin's wholesale-retail dealer outlets versus those of Goodyear and Bridgestone. Thus, determining whether a company's prices and costs are competitive from an end user's standpoint requires looking at the activities and costs of competitively relevant suppliers and forward allies, as well as the costs of internally performed activities.

The Value Chain System for an Entire Industry As the tire industry example makes clear, a company's value chain is embedded in a larger system of activities that includes the value chains of its upstream suppliers and downstream customers or allies engaged in getting its product or service to end users. *13 Accurately assessing a company's competitiveness in end-use markets requires that company managers understand the entire value chain system for delivering a product or service to end users, not just the company's own value chain.* At the very least, this means considering the value chains of suppliers and forward channel allies (if any).

Suppliers' value chains are relevant because suppliers perform activities and incur costs in creating and delivering the purchased inputs used in a company's own value chain; the cost and quality of these inputs influence a company's own cost and/or differentiation capabilities. Anything a company can do to reduce its suppliers' costs or improve suppliers' effectiveness can enhance its own competitiveness—a powerful reason for working collaboratively with suppliers.

Forward channel value chains are relevant because (1) the costs and margins of downstream companies are part of the price the end user pays and (2) the activities forward channel allies perform affect the end user's satisfaction. Thus, a company should work closely with its forward channel allies to revise or reinvent their value chains in ways that enhance their mutual competitiveness. Furthermore, a company may be able to improve its competitiveness by undertaking activities that beneficially impact both its own value chain and its customers' value chains.

For instance, some aluminum can producers constructed plants next to beer breweries and delivered cans on overhead conveyors directly to brewers' can-filling lines. This resulted in significant savings in production scheduling, shipping, and inventory costs for both container producers and breweries. Many automotive parts suppliers have built plants near the auto assembly plants they supply to facilitate just-in-time deliveries, reduce warehousing and shipping costs, and promote close collaboration on parts design and production scheduling. In the California wine country, grape growers, irrigation equipment companies, suppliers of grape-harvesting and wine-making equipment, and firms making barrels, wine bottles, caps and corks, and labels are clustered together to be close to the nearly 700 wine makers they supply. The lesson here is that a company's relative cost position and overall competitiveness are linked to the entire industry value chain and to customers' value chains as well.

Value chains for products differ from value chains for services. The major value chain elements for the pulp and paper industry (timber farming, logging, pulp mills, papermaking, printing, and publishing) differ from the major chain elements for the home appliance industry (parts and components manufacture, assembly, wholesale distribution, retail sales). The value chain for the soft-drink industry (processing of basic ingredients, syrup manufacture, bottling and can filling, wholesale distribution, retailing) differs from that for the computer software industry (programming, disk loading, marketing, distribution). A producer of bathroom and kitchen faucets depends heavily on the activities of wholesale distributors and building supply retailers in winning sales to homebuilders and do-it-yourselfers; a producer of small gasoline engines controls its own market share destiny by selling directly to the makers of lawn and garden equipment. A wholesaler's most important activities and costs deal with purchased goods, inbound logistics, and outbound logistics. A hotel's most important activities and costs are in operations-check-in and check-out, maintenance and housekeeping, dining and room service, conventions and meetings, and accounting. A global public accounting firm's most important activities and costs revolve around customer service and human resources management (recruiting and training a highly competent professional staff). Outbound logistics is a crucial activity at Domino's Pizza but comparatively insignificant at Blockbuster. Sales and marketing are dominant activities at Coca-Cola but only minor activities at interstate gas pipeline companies. Consequently, generic value chains like those in Figures 4.2 and 4.3 are illustrative, not absolute, and may require adaptation to fit a particular company's circumstances.

Developing the Data for Strategic Cost Analysis Once the major elements of the value chain are identified, the next step in strategic cost analysis involves breaking down a firm's departmental cost accounting data into the costs of performing specific activities. The appropriate degree of disaggregation depends on the economics of the activities and how valuable it is to develop cross-company cost comparisons for narrowly defined activities as opposed to broadly defined activities. A good guideline is to develop separate cost estimates for activities having different economics and for activities representing a significant or growing proportion of cost.

Traditional accounting identifies costs according to broad categories of expenses—wages and salaries, employee benefits, supplies, travel, depreciation, R&D, and other fixed charges. *Activity-based costing* entails defining expense categories based on the specific activities being performed and then assigning costs to the appropriate activity responsible for creating the cost. Perhaps 25 percent of the companies that have explored the feasibility of activity-based costing have adopted this accounting approach. To fully understand the costs of activities all along the industry value chain, cost estimates for activities performed in the competitively relevant portions of suppliers' and customers' value chains also have to be developed.

To benchmark the firm's cost position against rivals, costs for the same activities for each rival must be estimated—an advanced art in competitive intelligence. But despite the tediousness of developing cost estimates activity by activity and the imprecision of some of the estimates for rivals, the payoff in exposing the costs of particular internal tasks and functions and the cost competitiveness of a company's position vis-à-vis rivals makes activity-based costing a valuable strategic analysis tool.

The most important application of value chain analysis is to expose how a particular firm's cost position compares with the cost positions of its rivals. What is needed are competitor-versus-competitor cost estimates for supplying a product or service to a well-defined customer group or market segment. The size of a company's cost advantage or disadvantage can vary from item to item in the product line, from customer group to customer group (if different distribution channels are used), and from geographic market to geographic market (if cost factors vary across geographic regions).

Benchmarking the Costs of Key Activities

Many companies today are *benchmarking* their costs of performing a given activity against competitors' costs (and/or against the costs of a noncompetitor in another industry that efficiently and effectively performs much the same activity or business process). Benchmarking is a tool that allows a company to determine whether the manner in which it performs particular functions and activities represents industry "best practices" when both cost and effectiveness are taken into account.

Benchmarking entails doing cross-company comparisons of how basic functions and processes in the value chain are performed—how materials are purchased, how suppliers are paid, how inventories are managed, how products are assembled, how fast the company can get new products to market, how the quality control function is performed, how customer orders are filled and shipped, how employees are trained, how payrolls are processed, and how maintenance is performed—and comparing the costs of these activities. The objectives of benchmarking are to identify the best practices in performing an activity, to learn how other companies have actually achieved lower costs or better results in performing benchmarked activities, and to take action to improve a company's competitiveness whenever benchmarking reveals that its costs and results of performing an activity do not match those of other companies (either competitors or noncompetitors).

In 1979, Xerox became an early pioneer in the use of benchmarking when Japanese manufacturers began selling midsize copiers in the United States for \$9,600 each—less than Xerox's production costs. Although Xerox management suspected its Japanese competitors were dumping, it sent a team of line managers to Japan, including the head of manufacturing, to study competitors' business processes and costs. Fortunately, Xerox's joint venture partner in Japan, Fuji-Xerox, knew the competitors well. The team found that Xerox's costs were excessive due to gross inefficiencies in its manufacturing processes and business practices; the study proved instrumental in Xerox's efforts to become cost-competitive and prompted Xerox to embark on a long term program to benchmark 67 of its key work processes against companies identified as having the "best practices" in performing these processes. Xerox quickly decided not to restrict its benchmarking efforts to its office equipment rivals but to extend them to any company regarded as "world class" in performing *any activity* relevant to Xerox's business.

Thus, benchmarking has quickly come to be a tool not only for comparing a company against rivals on cost but also for comparing itself to others on most any relevant activity or competitively important measure. Toyota managers got their idea for just-in time inventory deliveries by studying how U.S. supermarkets replenished their shelves. Southwest Airlines reduced the turnaround time of its aircraft at each scheduled stop by studying pit crews on the

auto racing circuit. Over 80 percent of *Fortune 500* companies reportedly engage in some form of benchmarking.

The tough part of benchmarking is not whether or how to do it but rather gaining access to information about other companies' practices and costs. Sometimes benchmarking can be accomplished by collecting information from published reports, trade groups, and industry research firms and by talking to knowledgeable industry analysts, customers, and suppliers. On occasion, customers, suppliers, and joint-venture partners often make willing benchmarking allies. Usually, though, benchmarking requires field trips to the facilities of competing or noncompeting companies to observe how things are done, ask questions, compare practices and processes, and perhaps exchange data on productivity, staffing levels, time requirements, and other cost components. The problem is that benchmarking involves competitively sensitive cost information and close rivals can't be expected to be completely open, even if they agree to host facilities tours and answer questions. Making reliable cost comparisons is complicated by the fact that participants often use different cost accounting systems.

However, the explosive interest of companies in benchmarking costs and identifying best practices has prompted consulting organizations (e.g., Andersen Consulting, A. T. Kearney, Best Practices Benchmarking & Consulting, and Towers Perrin) and several newly formed councils and associations (the International Benchmarking Clearinghouse and the Strategic Planning Institute's Council on Benchmarking) to gather benchmarking data, do benchmarking studies, and distribute information about best practices and the costs of performing activities to clients or members without identifying the sources. Having an independent group gather the information and report it in a manner that disguises the names of individual companies permits companies to avoid having to disclose competitively sensitive data to rivals and reduces the risk of ethical problems.

Strategic Options for Achieving Cost Competitiveness

Value chain analysis and benchmarking can reveal a great deal about a firm's cost competitiveness. One of the fundamental insights of strategic cost analysis is that a company's competitiveness depends on how well it manages its value chain relative to how well competitors manage theirs. Examining the makeup of a company's own value chain and comparing it to rivals' indicates who has how much of a cost advantage or disadvantage and which cost components are responsible. Such information is vital in crafting strategies to eliminate a cost disadvantage or create a cost advantage.

Looking again at Figure 4.2, observe that there are three main areas in a company's overall value chain where important differences in the costs of competing firms can occur in the suppliers' part of the industry value chain, in a company's own activity segments, or in the forward channel portion of the industry chain. If a firm's lack of cost competitiveness lies either in the backward (upstream) or forward (downstream) sections of the value chain, then reestablishing cost competitiveness may have to extend beyond the firm's own in-house operations.

Attacking the High Costs of Items Purchased from Suppliers When a firm's cost disadvantage is principally associated with the costs of items purchased from suppliers (the upstream end of the industry chain), company managers can pursue any of several strategic actions to correct the problem:

- Negotiate more favorable prices with suppliers.
- Work with suppliers on the design and specifications for what is being supplied to identify cost savings that will allow them to lower their prices.

- Switch to lower-priced substitute inputs.
- Collaborate closely with suppliers to identify mutual cost-saving opportunities.
- For example, finding ways to expedite just-in-time deliveries can lower a company's inventory and internal logistics costs and may also allow its suppliers to economize on their warehousing, shipping, and production scheduling costs—a win-win outcome for both (instead of a zero-sum game where the company's gains match supplier concessions)
- Integrate backward to gain control over the costs of purchased items—seldom an attractive option.
- Try to make up the difference by cutting costs elsewhere in the chain—usually a last resort.

Attacking Cost Disadvantages in the Forward Portion of the Industry Value Chain A company's strategic options for eliminating cost disadvantages in the forward end of the value chain system include:

- Pushing distributors and other forward channel allies to reduce their markups.
- Working closely with forward channel allies to identify win-win opportunities to reduce costs. A chocolate manufacturer learned that by shipping its bulk chocolate in liquid form in tank cars instead of 10-pound molded bars, it could not only save its candy-bar manufacturing customers the costs associated with unpacking and melting but also eliminate its own costs of molding bars and packing them.
- Changing to a more economical distribution strategy, including switching to cheaper distribution channels (perhaps direct sales via the Internet) or perhaps integrating forward into downstream businesses.
- Trying to make up the difference by cutting costs earlier in the cost chain—usually a last resort.

Attacking the High Costs of Internally Performed Activities When the source of a firm's cost disadvantage is internal, managers can use any of the following eight strategic approaches to restore cost parity:

1. Implement the use of best practices throughout the company, particularly for high cost activities.
2. Try to eliminate some cost-producing activities altogether by revamping the value chain. Examples include cutting out low-value-added activities, shifting to a different business model, bypassing the value chains and associated costs of distribution allies and marketing directly to end users (the approach used by Gateway and Dell in PCs), or using e-commerce retailing. A brokerage firm, for example, could switch to online stock trading systems rather than maintaining an elaborate network of local offices staffed by professional brokers; when investors must call or visit brokers in person to handle their trades, the commissions are sharply higher than for online trading. In retailing, Amazon.com, eMusic, mortgage.com, and others have sliced brick-and-mortar activities out of the value chain.
3. Relocate high-cost activities (such as R&D or manufacturing) to geographic areas where they can be performed more cheaply.
4. Search out activities that can be outsourced from vendors or performed by contractors more cheaply than they can be done internally.
5. Invest in productivity-enhancing, cost-saving technological improvements (robotics, flexible manufacturing techniques, and state-of-the-art electronic networking).
6. Innovate around the troublesome cost components—computer chip makers regularly design around the patents held by others to avoid paying royalties; automakers have substituted lower-cost plastic and rubber for metal at many exterior body locations.

7. Simplify the product design so that it can be manufactured or assembled quickly and more economically.
8. Try to make up the internal cost disadvantage by achieving savings in the backward and forward portions of the value chain system-usually a last resort.

From Value Chain Activities to Competitive Capabilities to Competitive Advantage

How well a company manages its value chain activities relative to competitors can allow it to build valuable competencies and capabilities and leverage them into sustainable competitive advantage. With rare exceptions, a firm's products or services are not a dependable basis for sustained competitive advantage; it is too easy for resourceful competitors to clone, improve on, or find an effective substitute for them. Rather, sustaining a company's competitive edge is best grounded in competencies and capabilities critical to market success and to pleasing customers-competencies and capabilities that rivals don't have or can't quite match.

Merck and Glaxo, two of the world's most competitively capable pharmaceutical companies, built their business positions around expert performance of a few competitively crucial activities: extensive R&D to achieve first discovery of new drugs, a carefully constructed approach to patenting, skill in gaining rapid and thorough clinical clearance through regulatory bodies, and unusually strong distribution and sales force capabilities. FedEx has linked and integrated the performance of its aircraft fleet, truck fleet, support systems, and personnel so tightly and smoothly across the company's different value chain activities that it has created the capability to provide customers with guaranteed overnight delivery services. McDonald's can turn out identical-quality fast-food items at some 25,000-plus outlets around the world-an impressive demonstration of its capability to replicate its operating systems at many locations via an omnibus manual of detailed rules and procedures for each activity and intensive training of franchise operators and outlet managers.

QUESTION 4: HOW STRONG IS THE COMPANY'S COMPETITIVE POSITION?

Using the tools of value chains, strategic cost analysis, and benchmarking to determine a company's cost competitiveness is necessary but not sufficient. A more broad ranging assessment needs to be made of a company's competitive position and competitive strength. Particular issues that merit examination include (1) whether the firm's market position can be expected to improve or deteriorate if the present strategy is continued (allowing for fine-tuning); (2) how the firm ranks relative to rivals on each key success factor and each relevant measure of competitive strength and resource capability; (3) whether the firm enjoys a competitive advantage over rivals or is currently at a disadvantage; and (4) the firm's ability to protect and improve its market position in light of industry driving forces, competitive pressures, and the anticipated moves of rivals.

But company managers need to do more than just identify the areas of competitive strength and weakness. They have to *judge how all the signs of strength and weakness add up*. The answers to two questions are of particular interest: Does the company have a net competitive advantage or disadvantage vis-à-vis major competitors? Can the company's market position and performance be expected to improve or deteriorate under the current strategy?

Competitive Strength Assessments

The most telling way to determine how strongly a company holds its competitive position is to *quantitatively* assess whether the company is stronger or weaker than close rivals on each industry key success factor and each competitively essential resource and capability. Much of

the information for competitive position assessment comes from previous analyses. Industry and competitive analysis reveals the key success factors and competitive capabilities that separate industry winners from losers. Competitor analysis and benchmarking data provide a basis for judging the strengths and capabilities of rivals on such competitively important factors as cost, product quality, customer service, image and reputation, financial strength, technological skills, speed to market, distribution capability, and the possession of competitively important resources and capabilities.

Step 1 is to make a list of the industry's key success factors and most telling measures of competitive strength or weakness (6 to 10 measures usually suffice). Step 2 is to rate the firm and its rivals on each factor. Numerical rating scales (e.g., from 1 to 10) are best to use, although ratings of stronger (+), weaker (-), and about equal (=) may be appropriate when information is scanty and assigning numerical scores conveys false precision. Step 3 is to sum the individual strength ratings to get an overall measure of competitive strength for each competitor. Step 4 is to draw conclusions about the size and extent of the company's net competitive advantage or disadvantage based on the strength assessments and to take specific note of areas where the company's competitive position is strongest and weakest.

However, it is better methodology to use a weighted rating system because the different measures of competitive strength are unlikely to be equally important. In a commodity-product industry, for instance, having low unit costs relative to rivals is nearly always the most important determinant of competitive strength. In an industry with strong product differentiation the most significant measures of competitive strength may be brand awareness, amount of advertising, reputation for quality, and distribution capability. In a *weighted rating system* each measure of competitive strength is assigned a weight based on its perceived importance in shaping competitive success. The largest weight could be as high as 0.75 (maybe even higher) in situations where one particular competitive variable is overwhelmingly decisive or as low as 0.20 when two or three strength measures are more important than the rest. Lesser competitive strength indicators can carry weights of 0.05 or 0.10. No matter whether the differences between the weights are big or little, *the sum of the weights must add up to 1.0.*

Weighted strength ratings are calculated by deciding how a company stacks up on each strength measure (using the 1 to 10 rating scale) and multiplying the assigned rating by the assigned weight (a rating score of 4 times a weight of 0.20 gives a weighted rating of 0.80). Again, the company with the highest rating on a given measure has an implied competitive edge on that measure, with the size of its edge reflected in the difference between its rating and rivals' ratings. The weight attached to the measure indicates how important the edge is. Summing a company's weighted strength ratings for all the measures yields an overall strength rating. Comparisons of the weighted overall strength scores indicate which competitors are in the strongest and weakest competitive positions and who has how big a net competitive advantage over whom.

Note that the unweighted and weighted rating schemes produce a different ordering of the companies. In the weighted system, ABC Company dropped from second to third in strength, and Rival jumped from third into first because of its high strength ratings on the two most important factors. Weighting the importance of the strength measures can thus make a significant difference in the outcome of the assessment.

Competitive strength assessments provide useful conclusions about a company's competitive situation. The ratings show how a company compares against rivals, factor by factor or capability by capability, thus revealing where it is strongest and weakest, and against whom. Moreover, the overall competitive strength scores indicate how all the different factors add up--

whether the company is at a net competitive advantage or disadvantage against each rival. The firm with the largest overall competitive strength rating enjoys the strongest competitive position, with the size of its net competitive advantage reflected by how much its score exceeds the scores of rivals.

Knowing where a company is competitively strong and where it is weak in comparison to specific rivals is valuable in deciding on specific actions to strengthen its long-term competitive position. As a general rule, a company should try to leverage its competitive strengths (areas where it scores higher than rivals) into sustainable competitive advantage and take strategic actions to protect against its competitive weaknesses (areas where it scores are below those of rivals). At the same time, the competitive strength ratings point to which rival companies may be vulnerable to competitive attack and the areas where they are weakest. When a company has important competitive strengths in areas where one or more rivals are weak, it makes sense to consider offensive moves to exploit rivals' competitive weaknesses.

QUESTION 5: WHAT STRATEGIC ISSUES DOES THE COMPANY FACE?

The final analytical task is to zero in on the strategic challenges that stand as obstacles to the company's future success. This involves using the results of both company situation analysis and industry and competitive analysis to identify as sharply and as clearly as possible the strategic issues and problems confronting the company. Pinpointing the things that management needs to worry about most sets the agenda for putting together an effective strategic action plan. The "worry list" of obstacles and issues that have to be wrestled with can include such things as *how* to meet the challenges posed by global competition, *how* to combat the product innovations of rivals, *how* to reduce the company's high costs, *how* to sustain the company's present rate of growth or grow the business at a faster rate, *how* to gain better market visibility for the company's products, or how to capture the e-commerce opportunities. Other issues might be *whether* to expend the company's product offerings, put more emphasis on new product R&D, add more production capacity, cut prices in response to the actions of competitors, add new features that will boost the performance of the company's products, or go forward with investments in foreign markets. Finally, managers may ask what to *do about* proposed new regulations that will significantly raise costs, lagging buyer interest in the company's latest new products, or the aging demographics of the company's customer base.

In determining the issues that merit strategic attention, managers need to draw on all the prior analysis, put the company's overall situation into perspective, and lock in on what challenges have to be overcome and what issues have to be resolved in order for the company to be financially and competitively successful in the years ahead. This step should not be taken lightly. Without a precise fix on the challenges and issues, managers are not prepared to start crafting a strategy. Questions that can help pinpoint the right strategic issues to address include the following:

- Is the present strategy adequate for protecting and improving the company's market position in light of the five competitive forces—particularly those that are expected to intensify in strength?
- Is the company vulnerable to the competitive efforts of one or more rivals?
- Should the present strategy be adjusted to better respond to the *driving forces* at work in the industry?
- Is the present strategy closely matched to the *industry's future* key success factors?
- Does the present strategy adequately capitalize on the company's resource strengths and capabilities?
- Which of the company's opportunities merit top priority? Which should be given low

priority? Which are best suited to the company's resource strengths and capabilities?

- How important is it for the company need to correct its resource weaknesses? Are there things the company can do to lessen the impact of external threats?
- Does the company have competitive advantage, or must it work to offset competitive disadvantage?
- Where are the strong spots and weak spots in the present strategy?

The answers to these questions and the worries management has about "how to . . .," "whether to . . .," and "what to do about, ,," signal whether the company can continue the same basic strategy with minor adjustments or whether major overhaul is called for. If a company's current strategy is well matched to its external environment and to its resource strengths and capabilities, there is little need to contemplate big shifts in strategy. If, however, the present strategy is not well suited for the road ahead, the task of crafting a better strategy has got to go to the top of management's action agenda.

Company situation analysis incorporates the concepts and analytical techniques discussed in this chapter and provides a way of reporting the results of company situation analysis in a systematic, concise manner.

Portfolio analysis

The **business portfolio** is the collection of businesses and products that make up the company. The best business portfolio is one that fits the company's strengths and helps exploit the most attractive opportunities.

The company must:

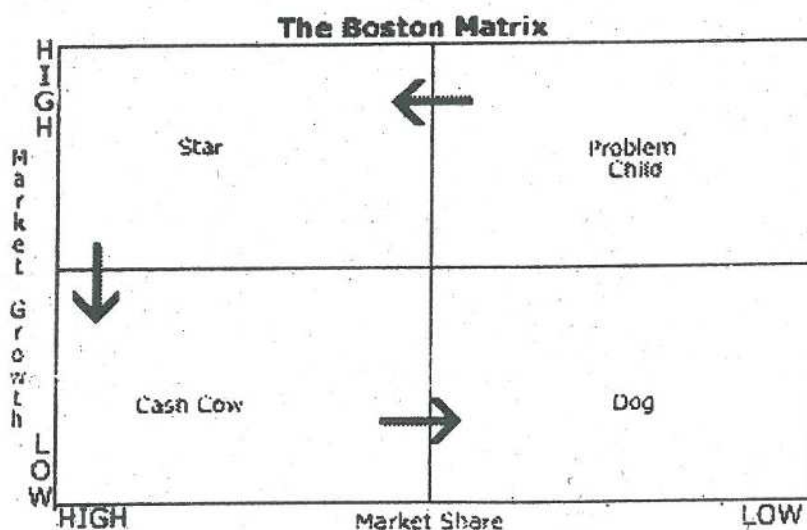
- (1) Analyse its current business portfolio and decide which businesses should receive more or less investment, and
- (2) Develop growth strategies for adding new products and businesses to the portfolio, whilst at the same time deciding when products and businesses should no longer be retained.

The two best-known portfolio planning methods are the Boston Consulting Group Portfolio Matrix and the McKinsey / General Electric Matrix. In both methods, the first step is to identify the various Strategic Business Units ("SBU's") in a company portfolio. An SBU is a unit of the company that has a separate mission and objectives and that can be planned independently from the other businesses. An SBU can be a company division, a product line or even individual brands - it all depends on how the company is organised.

The BCG Matrix- A Description

The Boston Consulting Group Growth-Share Matrix was first introduced to give corporations a ranking system for the value of strategic business units. "BCG developed a simple conceptual framework, named the Growth-Share Matrix, to help corporate managers determine when they should consider using profits from 'cash cow' businesses to fund growth in other businesses. So great was the initial success of BCG's matrix that for the greater part of two decades it became the standard approach to capital allocation in multisector, multisegment companies.

Figure 1- The BCG Growth-Share Matrix



'Stars,' 'dogs,' 'cash cows,' and 'question marks' have become firmly embedded in the language of business. Although the more sophisticated capital markets and competitive landscape of the late 1980s and 1990s make the Growth-Share Matrix less central, it continues to be used as a primer in the principles of portfolio management" *The Experience Curve* (BCG.com, 2004). The BCG model uses market share and market growth to determine where SBU's fall in the matrix. "To ensure long-term value creation, a company should have a portfolio of products that contains both high-growth products in need of cash inputs and low-growth products that generate a lot of cash. The BCG matrix is a tool to determine what priorities should be given in the product portfolio of a business unit. The BCG matrix has two dimensions: market share and market growth. The basic idea behind the BCG matrix is that the bigger the market share a product has or the faster the product's market grows the better it is for the company" *BCG Matrix Explained* (ValueBasedManagement.com, 2004).

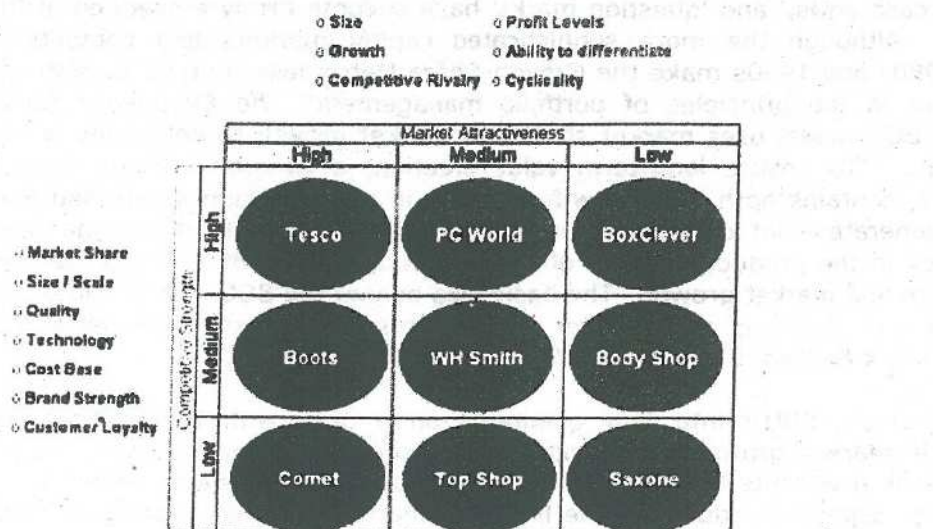
The BCG Model places SBU's into four quadrants on a grid, with the vertical axis representing industry or market growth rate, and the horizontal axis representing relative market share. Each of the quadrants in the grid has been given a specific name based on an SBU's performance in its respective industry. The line of demarcation differentiating between low and high industry growth rate is set at the Gross Domestic Product (GDP). Relative market share of a company is relative to the top three firms in that specific industry. The dividing line between high and low relative market share keeps those firms that are amongst or above the top three firms in the industry to the left of the line, and those below the top three firms to the right.

MarketingTeacher.com (2004) gives the following description of the BCG quadrants, and strategies for dealing with each: "Dogs are products with a low share of a low growth market. These are the canine version of 'real turkeys!' They do not generate cash for the company; they tend to absorb it. Get rid of these products. Cash Cows are products with a high share of a slow growth market. Cash Cows generate more than is invested in them, so keep them in your portfolio of products for the time being. Problem Children are products with a small share of a high growth market. They consume resources and generate little in return. They absorb most money as you attempt to increase market share. Stars are products that are in high growth markets with a relatively high share of that market. Stars tend to generate high amounts of income. Keep and build your stars."

The McKinsey / General Electric Matrix

The McKinsey/GE Matrix overcomes a number of the disadvantages of the BCG Box. Firstly, **market attractiveness** replaces **market growth** as the dimension of industry attractiveness, and includes a broader range of factors other than just the market growth rate. Secondly, **competitive strength** replaces **market share** as the dimension by which the competitive position of each SBU is assessed.

The diagram below illustrates some of the possible elements that determine market attractiveness and competitive strength by applying the McKinsey/GE Matrix to the UK retailing market:



Factors that Affect Market Attractiveness

Whilst any assessment of market attractiveness is necessarily subjective, there are several factors which can help determine attractiveness. These are listed below:

- Market Size
- Market growth
- Market profitability
- Pricing trends
- Competitive intensity / rivalry
- Overall risk of returns in the industry
- Opportunity to differentiate products and services
- Segmentation
- Distribution structure (e.g. retail, direct, wholesale)

Factors that Affect Competitive Strength

Factors to consider include:

- Strength of assets and competencies
- Relative brand strength
- Market share
- Customer loyalty
- Relative cost position (cost structure compared with competitors)
- Distribution strength
- Record of technological or other innovation
- Access to financial and other investment resources

BCG. The Boston Consulting Group matrix is one of the oldest in the market, and the favourite of business schools. The matrix consists of four components – defined by rates of relative

market share and market growth. What is most useful is that it is easy to use, with clear strategic choices derived from it – and of particular value is that the results are all linked to cash flow – of central importance to the SME.

PVA. The PVA or product viability analysis, is a modification of the PLC. Unlike the PLC it does not make assumptions as to what is happening next (the great danger with the PLC is that it creates self-fulfilling prophecies), but rather concentrates on the specific macro and competitive forces that are influencing the product or service over the short, medium and long term. It has in our view specific importance for marketing departments in looking at the range of products/services in their ranges to identify what type of investment priorities should be established. It requires a degree of training to implement, but once commonly used, it is seen as a powerful planning tool.

All of these chosen portfolio systems will add considerable value to the typical planning process. They are easy to use, they provide good information, and are easy to understand.

Scenario Planning

Traditional forecasting techniques often fail to predict significant changes in the firm's external environment, especially when the change is rapid and turbulent or when information is limited. Consequently, important opportunities and serious threats may be overlooked and the very survival of the firm may be at stake. Scenario planning is a tool specifically designed to deal with major, uncertain shifts in the firm's environment.

Scenario planning has its roots in military strategy studies. Herman Kahn was an early founder of scenario-based planning in his work related to the possible scenarios associated with thermonuclear war ("thinking the unthinkable"). Scenario planning was transformed into a business tool in the late 1960's and early 1970's, most notably by Pierre Wack who developed the scenario planning system used by Royal Dutch/Shell. As a result of these efforts, Shell was prepared to deal with the oil shock that occurred in late 1973 and greatly improved its competitive position in the industry during the oil crisis and the oil glut that followed.

Scenario planning is not about predicting the future. Rather, it attempts to describe what is possible. The result of a scenario analysis is a group of distinct futures, all of which are plausible. The challenge then is how to deal with each of the possible scenarios.

Scenario planning often takes place in a workshop setting of high level executives, technical experts, and industry leaders. The idea is to bring together a wide range of perspectives in order to consider scenarios other than the widely accepted forecasts. The scenario development process should include interviews with managers who later will formulate and implement strategies based on the scenario analysis – without their input the scenarios may leave out important details and not lead to action if they do not address issues important to those who will implement the strategy.

Some of the benefits of scenario planning include:

- Managers are forced to break out of their standard world view, exposing blind spots that might otherwise be overlooked in the generally accepted forecast.

- Decision-makers are better able to recognize a scenario in its early stages, should it actually be the one that unfolds.
- Managers are better able to understand the source of disagreements that often occur when they are envisioning different scenarios without realizing it.

The Scenario Planning Process

The following outlines the sequence of actions that may constitute the process of scenario planning.

1. Specify the scope of the planning and its time frame.
2. For the present situation, develop a clear understanding that will serve as the common departure point for each of the scenarios.
3. Identify predetermined elements that are virtually certain to occur and that will be driving forces.
4. Identify the critical uncertainties in the environmental variables. If the scope of the analysis is wide, these may be in the macro-environment, for example, political, economic, social, and technological factors (as in PEST).
5. Identify the more important drivers. One technique for doing so is as follows. Assign each environmental variable two numerical ratings: one rating for its range of variation and another for the strength of its impact on the firm. Multiply these ratings together to arrive at a number that specifies the significance of each environmental factor. For example, consider the extreme case in which a variable had a very large range such that it might be rated a 10 on a scale of 1 to 10 for variation, but in which the variable had very little impact on the firm so that the strength of impact rating would be a 1. Multiplying the two together would yield 10 out of a possible 100, revealing that the variable is not highly critical. After performing this calculation for all of the variables, identify the two having the highest significance.
6. Consider a few possible values for each variable, ranging between extremes while avoiding highly improbable values.
7. To analyze the interaction between the variables, develop a matrix of scenarios using the two most important variables and their possible values. Each cell in the matrix then represents a single scenario. For easy reference in later discussion it is worthwhile to give each scenario a descriptive name. If there are more than two critical factors, a multidimensional matrix can be created to handle them but would be difficult to visualize beyond 2 or 3 dimensions. Alternatively, factors can be taken in pairs to generate several two-dimensional matrices. A scenario matrix might look something like this:

Scenario Matrix

		VARIABLE 1	
		Outcome 1A V	Outcome 1B V
VARIABLE 2	Outcome 2A -->	Scenario 1	Scenario 2
	Outcome 2B -->	Scenario 3	Scenario 4

One of these scenarios most likely will reflect the mainstream views of the future. The other scenarios will shed light on what else is possible.

8. At this point there is not any detail associated with these "first-generation" scenarios. They are simply high level descriptions of a combination of important environmental variables. Specifics can be generated by writing a story to develop each scenario starting from the present. The story should be internally consistent for the selected scenario so that it describes that particular future as realistically as possible. Experts in specific fields may be called upon to develop each story, possibly with the use of computer simulation models. Game theory may be used to gain an understanding of how each actor pursuing its own self interest might respond in the scenario. The goal of the stories is to transform the analysis from a simple matrix of the obvious range of environmental factors into decision scenarios useful for strategic planning.
9. Quantify the impact of each scenario on the firm, and formulate appropriate strategies.

An additional step might be to assign a probability to each scenario. Opinions differ on whether one should attempt to assign probabilities when there may be little basis for determining them.

Business unit managers may not take scenarios seriously if they deviate too much from their preconceived view of the world. Many will prefer to rely on forecasts and their judgement, even if they realize that they may miss important changes in the firm's environment. To overcome this reluctance to broaden their thinking, it is useful to create "phantom" scenarios that show the adverse results if the firm were to base its decisions on the mainstream view while the reality turned out to be one of the other scenarios.

Key Points

There are five key questions to consider in performing company situation analysis:

1. *How well is the present strategy working?* This involves evaluating the strategy from a qualitative standpoint (completeness, internal consistency, rationale, and suitability to the situation) and also from a quantitative standpoint (the strategic and financial results the strategy is producing). The stronger a company's current overall performance, the less likely the need for radical strategy changes. The weaker a company's performance and/or the faster the changes in its external situation (which can be gleaned from industry and competitive analysis), the more its current strategy must be questioned.
2. *What are the company's resource strengths and weaknesses and its external opportunities and threats?* A SWOT analysis provides an overview of a firm's situation and is an essential component of crafting a strategy tightly matched to the company's situation. A company's resource strengths, competencies, and competitive capabilities are important because they are the most logical and appealing building blocks for strategy; resource weaknesses are important because they may represent vulnerabilities that need correction. External opportunities and threats come into play because a good strategy necessarily aims at capturing a company's most attractive opportunities and at defending against threats to its well-being.
3. *Are the company's prices and costs competitive?* One telling sign of whether a company's situation is strong or precarious is whether its prices and costs are competitive with industry rivals. Strategic cost analysis and value chain analysis are essential tools in benchmarking a company's prices and costs against rivals, determining whether the company is performing particular functions and activities cost effectively, learning whether its costs are in line with competitors, and deciding which internal activities and business processes need to be scrutinized for improvement. Value chain analysis teaches that how competently a company manages its value chain activities relative to rivals is a key to building valuable competencies and competitive capabilities and then leveraging them into sustainable competitive advantage.
4. *How strong is the company competitive position?* The key appraisals here involve whether the company's position is likely to improve or deteriorate if the present strategy is continued, how the company matches up against key rivals on industry key success factors and other chief determinants of competitive success, and whether and why the company has a competitive advantage or disadvantage. Quantitative competitive strength assessments, using the methodology presented in Table 4.4, indicate where a company is competitively strong and weak and provide insight into the company's ability to defend or enhance its market position. As a rule a company's competitive strategy should be built around its competitive strengths and should aim at shoring up areas where it is competitively vulnerable. Also, the areas where company strengths match up against competitor weaknesses represent the best potential for new offensive initiatives.
5. *What strategic issues does... the company face?* The purpose of this analytical step is to zero in on the strategic challenges that stand as obstacles to the company's future success. It involves using the results of both company situation analysis and industry and competitive analysis to identify the issues and problems that management needs to address. The objective is to pinpoint the things that management needs to worry about most. Identifying what challenges have to be overcome and what issues have to be resolved in order for the company to be financially and competitively successful in the years ahead frames the strategic agenda that management needs to act on.

Good company situation analysis, like good industry and competitive analysis, is a crucial prerequisite to good strategy-making. A competently done evaluation of a company resources and competencies exposes strong and weak points in the present strategy, company capabilities and vulnerabilities, and the company's ability to protect or improve its competitive position in light of driving forces, competitive pressures, and the competitive strength of rivals. Managers need such understanding to craft a strategy that fits the company's situation well.

STRATEGY FORMULATION AT CORPORATE-LEVEL

As we saw in chapter 1, there are three levels of strategy which are given below:

Levels of strategy

- 1 Corporate level** This involves decisions about the organisation as a whole: they come from the corporate headquarters and cover the overall scope of the organisation.
- 2 Competitive or business level** This is about how to compete in a market: which products / services, the extent to which these meet customer needs as well as to achieve the overall objectives of the organisation, set out on corporate level. So business strategy is likely to be related to a unit within the whole. This is also called as Generic Strategies or Competitive Strategy.
- 3 Operational level** This is concerned with how the different functions of the enterprise - marketing, finance, manufacturing etc. - contribute to the other levels of strategy

In this chapter, we focus on corporate level strategies for enterprises consisting of more than one business. The General Electric Corporation, for instance, comprises several businesses, including consumer electronics, industrial electronics, heavy locomotives, jet engines, and financial services. Firms that operate more than one business are referred to as being *diversified*. In this chapter, we consider the role of diversification in the overall strategic management of the firm, why corporations diversify, and how diversification is best managed.

The chapter has five sections. The first explains the role of diversification, the second reviews the most common forms of diversification, and the third describes the means by which firms diversify. The fourth evaluates the various ways in which diversification benefits stockholders, and the final section explores how managerial behavior can limit these benefits.

This chapter will help you understand:

- The importance of corporate-level strategy
- How corporate diversification creates value for stockholders they could not create for themselves
- The forms diversification takes: vertical, horizontal, and global
- The most common means of diversifying: acquisition, strategic alliances, and internal development
- The importance of taking a strategic approach to divestment
- The most common motives for diversification and their relative impact on increasing stockholders' wealth
- How the benefits managers and stockholders receive from diversification may conflict, and how managers' actions may thereby limit stockholders' wealth

THE ROLE OF DIVERSIFICATION

Corporate diversification is everywhere. Virtually all of the *Fortune* 1,000 (the largest 1,000 corporations in the United States) are diversified, many of them to a great extent. Some corporations, such as Johnson & Johnson or Textron, for example, consist of dozens-even hundreds-of different businesses. Besides such corporate giants, many smaller firms, some with

only a handful of employees, are also diversified. For example, the authors know of one relatively small family business that includes car washes, used-car sales, an auto parts store, and a wrecker service—clearly a diversified corporation. Exhibit 6.1 gives a breakdown of the number and value of business acquisitions by industry in 1993. These industries cover the map, and it is clear that diversification is a pervasive phenomenon of modern business.

What is the strategic role of diversification? The most popular answer, to this question has changed dramatically over the last several decades. During the 1960s, diversification was often used to fuel tremendous corporate growth as corporations bought up dozens of businesses, regardless of what good or service they sold. This diversification into unrelated businesses was based on the assumption that good managers could manage any business, and this assumption resulted in the formation of huge conglomerates of completely unrelated businesses. In the 1970s, managers began to emphasize diversification based on the cash flows individual businesses produced. Corporate managers attempted to diversify in such a way that the resulting portfolio would offer a balance between businesses that produced excess cash flows and those then needed additional cash flows beyond what they could produce themselves. In the 1980s, there was a broad-based effort to restructure corporations, stripping out unrelated businesses and focusing on a narrower range of operations. Restructuring usually also involved downsizing, and the largest corporations shrank in relation to the rest of the economy. In the 1990s, there has been an increasing interest in once again using diversification to grow. But unlike the unrelated diversification that took place in the 1960s, the trend in the 1990s is to diversify into related businesses, or at least into businesses in which the strengths of a particular managerial team fit the needs of the new business being added to the corporation.

So against these continually evolving perspectives, is there any role for diversification so fundamental that it never changes? The answer is yes. The fundamental role of diversification is for corporate managers to create value for stockholders in ways stockholders cannot do better for themselves. To understand this key statement, you must first realize that when corporate managers diversify a corporation, they are essentially investing stockholders' funds in an additional business. "When Coca-Cola bought Columbia Pictures, Coke's stockholders found themselves owning both a soft drink producer and a movie production firm. But stockholders do not require the help of corporate managers to diversify their holdings. Instead, they need only acquire stock in another firm, which is easily done individually. Were the investors better off having Coke make the investment in Columbia than they would have been if they had invested equivalent funds in Columbia themselves? If Coke did not generate a return from this investment greater than what its stockholders could generate for themselves, Coke's corporate managers did not add value to the stockholders' investments.

Imagine, for example, that 10,000 investors had \$400 each that they wished to invest in stock. They have considered investing half in Samson, Inc., a strong, well-managed company, and half in Underdog, Ltd., a weak, poorly managed company. But an alternative would be for the investors to put all their money into Samson and then have Samson's corporate managers buy Underdog. In the first case, in which the investors buy shares in both companies, the managers from Samson cannot contribute their talents to Underdog's problems because the two firms are still separate entities, even though they do happen to be partially owned by the same people. In the second case, the same people again own parts of both companies, but because the companies have been combined into one corporation, Samson's managers can now go to work on Underdog's problems. In other words, Samson's managers can add value in ways the investors cannot.

How should managers such as those at Samson approach their task of adding value by helping Underdog? A corporation's value is ultimately determined by how well its various business units perform. Because, as explained in Chapter 4, superior business-level performance

depends on a sustained competitive advantage, corporate managers should seek diversification moves that add businesses with competitive advantages or that improve the competitive advantages of their existing businesses. Diversification moves that improve core process execution and/or enhance a business unit's structural position, thereby increasing its competitive advantage, are the most likely ways of investing stockholders' funds better than they could do for themselves.

This is the most important role diversification can play, and it is the standard by which we evaluate the benefits of diversification later in this chapter. However, first we need to take a more detailed look at diversification. We do this by first considering its various forms and then the various means by which firms diversify.

We will consider three forms of diversification-vertical, horizontal, and global and three means of achieving that diversification-acquisition, strategic alliances, and internal development. The various forms and means of diversification can be mixed and matched to create a range of options.

THE FORMS OF DIVERSIFICATION

Diversification typically takes one of three forms, each having its own set of issues, benefits, and limitations.

Vertical integration

When a corporation performs more than one step of the process involved in converting raw materials into a product delivered and ready for consumption, it is considered to be *vertically diversified*.

A vertically diversified corporation integrates its businesses so that one efficiently "feeds" the other. Coordinating upstream operations (those closer to the raw materials) with downstream operations (those closer to the customer) is called *vertical integration*.

Benefits of Vertical Integration

The most commonly expected advantage of vertical integration is the elimination, or at least the reduction, of the costs of buying and selling (called transaction costs) that are incurred when separate firms carry out the various steps of converting raw materials to finished goods. Then two such steps are integrated, the marketing and sales efforts formerly carried out in the upstream business can be eliminated, because the downstream customer is now part of the same corporation.

A second benefit of vertical integration is improved coordination. Corporations may also wish to vertically integrate in order to have smoother, better-coordinated operations. For instance, movies have grown increasingly expensive to produce (a big production can easily cost \$60 million or more), but vertically integrated studios are less dependent upon the movie itself as their sole means of recouping the investment. If carefully coordinated, a bundle of downstream products building on the foundation provided by the film can dramatically increase the total returns of a movie venture. Such coordination is probably most easily achieved within a single corporate entity, and Walt Disney, for instance, has long excelled at generating profits from products inspired by successful films.

A firm does not have to be fully vertically integrated in order to realize important benefits. Many corporations pursue a strategy of *tapered*, or *hybrid*, vertical integration. In these strategies, some elements of the corporation may be fully integrated, while others are not. This

allows them to enjoy some of the benefits described above, but involvement with suppliers or customers outside their own corporation also has benefits. One of the greatest benefits of involvement with outsiders is that it keeps the insider counterparts "honest" and "on their toes." For example, we know of one steel mill that uses a tapered integration strategy extensively. The bolt and screw division depends on insider upstream operations for the bulk of its supplies, but it is constantly going outside the corporation to supplement what it buys from insiders. If it finds superior value being offered by outside suppliers, it naturally begins shifting more purchases away from its inside suppliers, placing pressure on them to remain competitive. In some cases this firm has found that its inside operations cannot remain competitive with outside sources and the firm has shut down its own operations and shifted to complete reliance on outside suppliers. This should suggest to you that there are limits to the benefits of vertical integration.

Limits to Vertical Integration

With vertical integration, unbalanced capacities may limit transaction cost savings. The minimum size a plant can be while still remaining reasonably cost efficient is known as its *minimum efficient scale*. If the minimum efficient scale of one part of a vertically integrated corporation is radically different from that of another, some means must be found to profitably use the excess capacity of the larger operation. This usually means that the excess capacity must be sold to other firms. This, unfortunately, incurs the transaction costs vertical integration is designed to avoid. For example, a television tube has a much higher minimum efficient production scale than any other component does. North American Philips (NAP), producer of Magnavox and Sylvania consumer electronics, sells about half of its television picture tubes to firms that produce competing brands. It would be inefficient for NAP to produce just enough tubes for its own consumption, but it avoids marketing and selling costs through vertical integration only on those tubes it sells in house.

By committing to a corporate strategy of vertical integration, firms may reduce their flexibility and anchor themselves to products or technologies that may become outdated and noncompetitive. Firms choosing to integrate vertically accept responsibility for more than just a wider portion of the production process- they also accept responsibility for remaining innovative in all these business segments. For the end product to remain up to date and competitive, the entire chain of vertically integrated subunits must remain innovative. The task of keeping up on so many fronts may be overwhelming, and the corporation may fall behind its more focused competitors.

Vertical integration may make a firm more susceptible to strikes by organized labor. For instance, the United Auto Workers is a powerful union that represents the vast majority of General Motors' assembly workers in all of GM's various vertically integrated plants. This gives the union considerable flexibility to decide where to call a strike. For example, when Saturns were in very short supply, the workers at the plant that supplies the Saturn assembly operation with its automobile frames went on strike. Because Saturn operates on a just-in-time (JIT) production schedule, it had no reserve inventories of car frames, and within hours the entire Saturn operation was shut down by a strike at a single, relatively small feeder operation upstream. The GM workers at Saturn never went on strike, and in fact, because they were out of work due to a parts shortage, they were eligible to collect unemployment compensation. In other words, with minimal cost to itself, the UAW was able to shut down the entire Saturn operation while leaving GM responsible for supporting most of the out-of-work union members.

Finally, difficulties may arise in integrating different specializations. The managerial skills and corporate cultures that best serve upstream operations may be incompatible with those required downstream. For example, the authors are familiar with a vertically integrated high-technology company in which the various specializations make up an informal, but well-defined, caste

system within the firm. Upstream product design engineers rank much higher than production engineers in this caste system, and both groups generally consider themselves to be superior to downstream service technicians. Because of communication difficulties caused by this attitude an entire generation of the firm's new products failed. Production engineers were ignored when they complained to design engineers that the new products were needlessly difficult to manufacture. When poorly assembled parts began to break down in the field, service technicians were not given the documentation and supplies required to make the repairs. In fact, they were sometimes forced to go to a local hardware store to buy parts with which to improvise a repair on a machine. Clearly, if a vertically diversified firm is to become truly integrated, it must overcome anything that segregates the various specialists.

When to Integrate Vertically

The level of integration is best adjusted in light of four questions:

1. *Are our existing suppliers or customers meeting the final consumer's needs?* If the firms in the production and distribution chain are doing an adequate job, it is probably to consider taking over their functions by integrating vertically. In this case, it makes more sense to concentrate managerial resources on problem areas. Some extremely successful firms have followed this strategy, keeping only one or two critical business operations in house and outsourcing the rest." A classic example is Nike, which limits its in-house work to athletic shoe design and marketing strategy.

2. *How volatile is the competitive situation?* Highly volatile situations, in which technologies are changing, customer needs are evolving, and competitors have still not agreed on the "rules of the game," are poor candidates for vertical integration. Such situations require a flexibility that vertically integrated corporations do not have. Once vertically integrated, a company cannot easily move into and out of the businesses.

3. *Is it possible to "own" a business without actually buying it?* Many of the benefits of vertical integration can be obtained by upstream and downstream firms willing to work closely with one another, even though they remain independent businesses. Motorola was one of the first firms to be awarded the Malcolm Baldrige National Quality Award, an award given annually to leaders in total quality management. At one time, Motorola felt so strongly about quality that it decided to require all its hundreds of suppliers to be entered in the Baldrige quality competition and to use the competition as an impetus to upgrade their quality seriously. Because Motorola represented a major account for many of its suppliers, they had little option but to comply. In other words, Motorola was able to influence the behavior of its suppliers significantly without actually owning them.

4. *Will vertical integration enhance the structural position of the business?* Vertical integration may move you into a line of business that has historically held greater market power and is consequently more profitable." For instance, Bose was once just a manufacturer of high-fidelity audio equipment, but in order to capture the attractive margins available downstream, the firm integrated vertically into direct mail order sales. Alternatively, the threat of vertical integration into the type of business now being operated by powerful suppliers or customers may undermine their power and make them more conciliatory in an effort to keep you out of their business. For instance, the threat that a national brewery might integrate backward into can production is usually enough to reduce the bargaining power of its can suppliers.

Horizontal Diversification

Horizontal diversification entails moving into more than one industry. Horizinc, a hypothetical corporation, serves two distinct markets with two very different products. It competes in the seafood industry as a retailer of abalone and in the jewelry business as a retailer of zircons. It is not vertically integrated in either case; although it operates in two industries, it performs only one function (retailing) in the raw-materials-to-finished-goods transformation process of both.

Abalone and zircons represent very different markets, and Horizinc is an example of unrelated diversification. This arrangement is a strategic decision that has a combination of advantages and disadvantages. In fact, the central issue in managing horizontal diversification is to determine how closely related the new business should be to the old business. The relative financial performance of firms pursuing related versus unrelated diversification is perhaps the single most researched topic in strategic management. Much of the research has produced mixed results, but there appears to be some consistent evidence that related diversification is somewhat more profitable. Consequently, most corporations seek out opportunities to diversify into businesses that somehow relate to those they already have, although a few *conglomerates* make no such effort and instead pursue a strategy of unrelated diversification.

The Case for Conglomerates

At one time, building conglomerates of unrelated businesses was widely considered to be an ideal corporate strategy. In the 1960s, firms like Textron, ITT, Gulf & Western, and Teledyne led the way in building vast corporate holdings consisting of every imaginable type of business. For instance, at one time Textron owned Bell Helicopters, Gorham Silver, Homelite Chainsaws, Talon Zippers, and Sheaffer Pens and was also involved in spacecraft propulsion, staplers, chemicals, and air cushion vehicles. Building conglomerates with such diversity was based on the assumption that corporate managers have the expertise to recognize undervalued stocks that many individual investors would miss. Furthermore, the conglomerate builders argued, when it comes to financing acquisitions, corporations have economies of scale that are unavailable to individuals purchasing limited numbers of shares. For example, a corporation may be able to borrow money at a lower rate of interest, or it may be able to lower the per share brokerage commissions on stock purchases by trading very large numbers of shares at once.

The Case Against Conglomerates

Based on a history of the last 30 years of building and managing conglomerates, many managers and researchers today seriously question the wisdom of this corporate strategy. The most important historical arguments against conglomerates are conglomerate discounts and takeover premiums.

Conglomerate Discounts. A *conglomerate discount* exists when the stock of a conglomerate sells for less than the total of the individual stocks would sell for if each business in the corporation sold its stock separately. Conglomerate discounts are evidence that the market perceives "negative synergy," meaning that the sum of the pieces is worth more than the whole. This perception might be based on a fear that managing a corporation as diverse and complex as many conglomerates are entails excessively high overhead. Or it might reflect a concern that association with a large corporation is somehow limiting the flexibility of the individual business units. In either of these cases, investors appear to be unwilling to pay as much for the corporation as a whole than they would be willing to pay for its dismantled parts. Since their initial popularity in the 1960s, conglomerate stocks have typically sold at what is known as a conglomerate discount.

We can measure conglomerate discounts using a *price-earnings ratio (PIE)*, which is simply the price of a share of stock divided by the corporation's annual earnings per share. *P/Es* indicate investor expectations about the future success of a given corporation; a high *PIE* means that investors have high expectations for that corporation and are willing to pay relatively more for its stock. In the 1960s, when *unrebt*¹ diversification was considered to be an ideal corporate strategy, the conglomerate stocks traded at a premium relative to the rest of the market. In fact, at the peak of their popularity, conglomerates often sold for over 50 percent more per dollar of their earnings than the average corporation did. In other words, the average *PIE* ratio of conglomerates was about 50 percent greater than the average *PIE* for other stocks.

This began to change in the 1970s, when conglomerates consistently traded at an average *PIE* lower than the rest of the market's. When conglomerate stocks trade at average *P/Es* that are less than the average *P/Es* of other firms, it is an indication that investors would value the businesses making up the conglomerates more as individual companies than they do bundled together. This is a very volatile situation for corporations and investors alike, a situation that gave rise to the tremendous volume of acquisitions and takeovers seen in the late 1980s

The heavy "deal flow" in the late 1980s occurred because investors realized that, with the conglomerate discounts available then, they could acquire a corporation and then sell off its individual parts for more than they had paid for the original corporation as a whole, without ever having to operate any of the businesses. Those involved in such a takeover could make millions. Firms and individuals specializing in this process came to be called *corporate raiders*. To avoid having their corporations dismantled in such "raids," many corporate managers moved to "deconglomerate" first. For instance, in the early and mid-1980s, Gulf & Western sold off businesses producing cement, cigars, video games, apparel, automotive parts, bedding, heavy industrial equipment, wallpaper, horse racing, and sugar. As a more focused corporation with a simpler mix of businesses, Gulf & Western began trading at a *P/E* very near the average for the market in general, making it an unlikely target for any takeover attempts based on plans to further dismantle the corporation. Reflecting on this metamorphosis, Martin Davis, Gulf & Western's CEO at the time, commented, "Rhyme must follow reason. There must be some kind of fit among diverse operations. A degree of stretching may be acceptable. . . . Stretch too far and the result is greater strain than strength."

After the widespread corporate structuring that took place in the late 1980s, the "deal flow" declined for a while. As it began to pick up in the mid-1990s, observers have noted a more widespread effort to pursue related diversification rather than rebuilding unrelated conglomerates.

Takeover Premiums. The second argument against building huge conglomerates is based on the fact that if one corporation wishes to buy another, it must expect to pay a *takeover premium*. This is the difference in the normal trading price of the takeover target's stock and the price required to entice stockholders to sell enough shares to give the acquiring firm a controlling interest. It is not uncommon to pay a premium of 50 percent or more to acquire controlling interest in a corporation.

For example, before word leaked out that a corporate raider was interested in acquiring United Airlines (UAL) in the late 1980s, stock in the airline was selling for about \$150 per share. In order to be able to buy a controlling interest in UAL quickly, the raider offered to pay about \$240 a share for the stock. The \$90 difference represents the takeover premium that managers in the raiding corporation felt they would need to pay in order to obtain a controlling interest in UAL. If, like most individual investors, the raider had decided to buy only a small number of shares in UAL, it would not have had to pay any takeover premium. The smaller number of shares could have been bought at the going market price, but fewer shares would not offer the raider a

controlling interest. Therefore, in some ways buying stocks in blocks large enough for a takeover is less efficient than individuals' buying stock in smaller amounts. Application 6.2 provides further information on takeover premiums and other costs incurred when corporations try to acquire one another.

Takeover premiums and conglomerate discounts can combine to create tremendous challenges for corporate managers. If they are not careful, managers may pay a takeover premium for a firm that subsequently becomes worth less because of a conglomerate discount. Because this double-edged danger exists, corporate managers considering diversification should be confident that they can create value for stockholders that is sufficient to overcome any takeover premiums and any conglomerate discounts associated with the move.

THE MEANS OF DIVERSIFICATION

Each of the three forms of diversification discussed in the preceding section can be achieved in different ways. We will focus on the three most often employed means of diversifications: (1) acquisitions, (2) strategic alliances, and (3) internal development.

Acquisitions

Acquisition refers to the purchase of a company that is already in operation. Acquisition can quickly diversify a corporation and improve the value of stockholders' investment. However, the sharp decline of acquisition activity in the early 1990s occurred, in part, because managers were encountering significant problems in managing the acquisition process as limitations to this corporate strategy became evident. The track record of success with mergers and acquisitions is not very encouraging. A study conducted by McKinsey & Company found that only 23 percent of the mergers studied over a 14-year period generated returns in excess of the costs incurred by the deal. Yet there are also plenty of examples of acquisitions and mergers that have been tremendously successful, having resulted in much stronger businesses and greatly increased stockholder value. What managerial practices make the difference between success and failure in acquisitions? We can organize our answer around managerial practices in two stages: preacquisition and postacquisition. Application 6.3 provides an example of a merger that benefited from careful consideration of the pre- and post-acquisition issues discussed below, while Application 6.4 provides a counterexample.

Strategic Alliances: Joint Ventures

Diversification by *strategic alliance* refers to arrangements in which corporations join forces to form a cooperative partnership. Typically, neither company owns the other, though often they create a third commercial entity, usually referred to as a *joint venture*, that they co-own. Such arrangements have been growing in number at nearly 30 percent per year since 1985, according to some experts, and some companies treat alliances as the emerging way to carry on business. For instance, IBM is involved in more than 400 joint ventures with firms ranging from Sears to Apple. Strategic alliances make the most sense in cases in which each party has strengths that offset the other's weaknesses. A good example is Dow Corning, a successful joint venture that has regularly seen performance levels higher than those of either of its parents, Dow Chemical and Corning Glass.

Sharing offsetting strengths through such a joint venture has two major benefits. First, neither partner is required to invest in developing the full range of capabilities required by the new venture. Second, financing should be easier to attract because the new business has two backers instead of just one and the partners can share the risks of development. Both these factors help explain why joint ventures are so common between large corporations and small

businesses, especially in the emerging field of biotechnology. Most of the advances in this field are being made by small entrepreneurial firms that lack the financial strength to produce goods in this very capital-intensive industry, as well as the sales forces capable of reaching the broad range of potential customers. Because of this and the risks involved in developing such new products, numerous small biotech firms have teamed up with large corporations. Cetus, one of the leading biotech firms, has had a number of such strategic alliances to produce and market some of the first diagnostic instruments based on the new biotechnology. Cetus provides the bulk of the research, while the larger firms typically provide the financing, marketing, and manufacturing capabilities.

Perhaps the most serious disadvantage of joint ventures is the difficulty of achieving close coordination between two companies that almost certainly have different goals, strategies, procedures, and cultures. Nothing can harm a joint venture's chances of success faster than such incompatibilities. One study revealed that nearly half of all joint ventures that failed experienced conflict between the partners. In order to avoid such conflicts, it is helpful to consider the following guidelines for the strategic management of joint ventures.

Establish a clear understanding between the partners. At a minimum, potential partners in a joint venture should discuss in some detail (1) the mission of the new business, (2) the market(s) it will serve, (3) the product(s) it will offer, (4) the obligations of each partner, and (5) how the joint venture will be dissolved, if necessary.

Do not depend upon a contract to make a joint venture work. Though contracts are essential, if the partners take an adversarial, legalistic approach to managing the joint venture, it will almost surely fail. Joint ventures succeed more often because managers work to make them successful than because of legally binding agreements. For example, Dow Corning was created with a handshake and was already a promising venture before the lawyers eventually finished drawing up the contracts.

Do not try to shortchange your partner. Strategic alliances should be collaborative efforts in which all parties contribute willingly for the good of the partnership. While each partner must look after its own interests, there is no room for greed in such an arrangement.

Internal Development

Diversification through *internal development* refers to building new businesses more or less from the ground up, a process sometimes referred to as *corporate entrepreneurship*. To create new businesses, corporations have developed four types of programs. In the first, the corporation acts simply as a venture capitalist. *Venture capitalists* provide the funds, sometimes called risk capital, required to start a new business. Exxon Enterprises, Exxon's effort throughout the 1980s to develop new businesses, found that this was its most successful type of corporate entrepreneurship program. Over a 10-year period, the company invested in eighteen new ventures. Six of these became attractive enough that the corporation eventually bought them. The remaining twelve were never brought into the corporation, but overall they still represented a sound financial investment. Exxon invested \$12 million in them, and over a 10-year period they returned \$218 million in cash or marketable securities.

A second tactic for fostering corporate entrepreneurship is the *new-venture incubator*. Here the corporation provides funding, low-cost space and equipment, and limited managerial oversight. The ventures supported may have started inside the corporate sponsor, or they may be independent start-ups assisted by the corporation. Corporations often use incubator programs in an effort to take advantage of excess resources such as extra space, idle equipment, and unused managerial talent. But trying to coordinate the new venture's use of these resources with those of the established businesses, corporations often encounter difficulties. Kodak encountered difficulties in integrating mainstream businesses with the "new-

stream" businesses in its incubator program and eventually closed the program, though it had been modes successful in creating profitable new lines of business.

A third option is the *idea generation and transfer program*. This program attempts to birth new business ideas that are then transferred to established operations j further development and ongoing management. Firms have generally had more success with this type of program than with the first two described. Even though the amounts of corporate resources invested in these idea generation and transfer programs are usually much less than the investment in a corporation's venture capital incubator programs, the results have often been much more significant. For example, Raytheon's New Product Development Center, an idea generation and transfer program, has often produced fifty or more patentable innovations per year. Many of these were important new product enhancements, such as ovens that combined conventional and microwave capabilities and laundries that operated using plastic "credit cards," rather than coins. Such accomplishments can generate important new sources of revenue, but idea generation and transfer programs are usually limited in that they seldom foster innovations leading to the development of entirely new businesses. More typically, as at Raytheon, they lead to new products or product refinements for an existing business.

The last category of corporate entrepreneurship programs is called *intrapreneurship*, because it involves entrepreneurial individuals or small teams working within the corporation to develop their ideas into businesses. Perhaps the corporation best known for pursuing this means of diversification is Minnesota Mining and Manufacturing (3M). This corporation consistently beats its goal of having 25 percent of its revenues generated by products no more than 5 years old. This is accomplished by adherence to a number of practices aimed at spreading an entrepreneurial spirit among its employees. For an example, see the story of Post-it Notes in Application 6.6. Such stories have made 3M's culture of entrepreneurship legendary.

Unfortunately, not all attempts at fostering corporate entrepreneurship are nearly as successful as 3M's. Internal development is often risky. Of the eighteen new internal ventures Exxon Enterprises tried in the 1980s, not one produced a business with significant profits. The risks associated with developing new businesses vary widely, depending on whether or not a market for the product already exists whether or not the technology is new. The experiences of numerous companies suggest that almost all new businesses offering familiar product technology to existing markets will be a success, while probably fewer than one in eight new business offering new products to an undeveloped market will succeed. Internal development is also very slow. One study found that it takes about 8 years, on average, for new businesses developed internally to break even, and another 4 years for them to reach levels of profitability that match those of typical mature businesses in the United States.

On the other hand, intrapreneurship may offer benefits other than profits per se. Each of the four types of programs discussed above can be as important for their impact on corporate culture as for their impact on diversification or financial performance. Following deregulation of the telephone industry, Bell's Enter-Prize intrapreneurship program was created to transform the firm's culture from one that was heavily dependent on its monopoly position to an entrepreneurial market leader capable of fending for itself in a highly competitive market. During years of operating in a heavily regulated environment, Ohio Bell had developed a culture in which employees were excellent at carrying out orders but unable to direct themselves, and in which there was widespread resistance to any new ideas or management techniques. Under the Enter-Prize program, employees were paid anywhere from \$50 to \$50,000 for their entrepreneurial ideas on how to make Ohio Bell more competitive. Employ, with ideas for a potential new business were given or loaned resources to test the feasibility of their ideas. While managers estimated that Enter-Prize returned \$5 the corporation for every \$1 invested, they insisted that even greater gains came from fostering the more entrepreneurial culture that now

pervades and impacts businesses throughout the corporation.

Divestments: The Neglected Side of Diversification

Corporate management must not only decide what businesses the corporation will enter it must also decide what businesses the corporation will exit. Although the subject receives much less media attention, divesting businesses is an integral part of corporate management. In fact, research shows that corporations will eventually exit many of the markets they enter through diversification long before the markets disappear. In one study, the corporations examined had divested themselves of approximately one-half of all the business units they had ever owned.

Why do businesses divest? While poor performance is the most obvious reason for selling a business, there are others. Corporations may decide to sell off businesses because their assets have more value in some other application. For instance, Greyhound sold a number of its downtown bus terminals because the real estate had much more value as building sites than as bus stations. Sometimes businesses are sold to help finance a corporation's other acquisitions.

Because divestments represent an important part of corporate management's responsibilities, they should be managed strategically. Unfortunately, this is not always the norm. Divesting corporations have been described as more interested in minimizing trauma than in maximizing profits. Divestments still symbolize failure to many managers, and the result is that they often jump at a chance to get rid of the "loser" and to distance themselves from the whole affair.

Properly managed, divestments should be considered a part of the overall corporate strategy, not just an isolated quick fix for a troubled business. The business in question should be carefully evaluated, not in terms of its potential in the current setting but in an ideal situation. Then a systematic search should be made for potential buyers that could offer this ideal setting. Once they are identified, a sales plan should be created to highlight the fit between the particular business and each of the potential buyers. Selling a business involves the same kind of analysis as buying one, with the focus shifting from how the business fits into your corporation to how it fits into someone else's corporation. Because of the impact divestment can have on employees and the local community in general, corporate managers should also consider their ethical and social responsibility to manage divestments carefully.

Now that we have considered the forms and means of diversification in some detail, we are ready to evaluate the various benefits that have been attributed to diversification.

EVALUATING THE BENEFITS OF DIVERSIFICATION

In this section, we consider the six reasons commonly cited as benefits of diversification. We evaluate these reasons in light of creating value for stockholders that they cannot create for themselves. We begin with the most powerful reasons for diversifying and then move on to those that are least defensible but still commonly cited as motives for diversification.

Capitalizing on Core Competencies

Core competencies are the most significant value-creating skills within a corporation. These skills can often be extended to products or markets beyond those in which they were originally developed. Such extensions represent excellent opportunities for diversification. For example, when considering diversification targets, Philip Morris believed that the core competence it had developed in marketing cigarettes could be applied to other similar markets. Based on this idea, the company purchased M Brewing and then used the Philip Morris marketing skills to move the

Miller hi from seventh place to second in its market.

Any core competence that meets the following three requirements is a viable for the corporation to strengthen a new business unit.

The core competence must translate into a meaningful competitive advantage. In other words, the competence must help the business establish some strength relative to its competition. Every core process and each of the major activities in the value chain is a viable basis for building on a core competence. For instance,

Black & Decker has a core competence in developing products with small electrical motors and rechargeable batteries, and, based on this, the firm has successfully diversified from small power tools for woodworking into higher-margin items such as electrical kitchen appliances, miniaturized vacuum cleaners, and rechargeable flashlights.

The new business must have enough similarity to existing businesses to benefit from the corporation's core competencies. This is one reason why related diversification has been found to be more profitable than unrelated diversification on average. However, this does not necessarily mean that the products themselves must be similar. Rather, at least one element of their value chains must require similar skills in creating competitive advantage in order for the corporation to capitalize on its core competencies. An example is Coca-Cola's move into leisure clothing. At first glance, one might think that soft drinks and sweatshirts have little in common, but in an important strategic sense they are, in fact, closely related; the marketing of both can be based on selling a trademark and an image as much as on selling the product itself. In soft drinks, its core business, Coca Cola emphasizes marketing as a key component of its value chain by building demand through strong customer awareness. Coke used this same expertise in marketing an image to successfully introduce a line of clothing bearing various Coca-Cola trademarks. In its first full year of business, Coca-Cola Clothes generated \$100 million in wholesale revenues-impressive growth in any industry and by far the best in the clothing industry.

The bundle of competencies should be difficult for competition to imitate. If the skills being transferred are widely available or easily replicated, they are unlikely to provide the basis of a sustainable competitive advantage. An individual core competence need not be unique; rather, it is the *collection* of competencies that should be unique, or at least difficult to replicate. For example, Canon, the Japanese diversified manufacturer, has demonstrated an unmatched ability to enter and dominate markets stretching from photocopiers and cameras to laser printers. Its dominance in these varied markets is based on mastery of technologies that are crucial to successful engineering and design of all these products. Canon is a world leader in its core competencies of optics, imaging, and micro processor controls. Other companies are good at each of these technologies, but Canon is arguably the best overall. This provides the company with a basis for diversification that competitors cannot easily match.

A corporation that builds on core competencies utilizes skills that combine to strengthen value chains and build greater competitive advantages. This leads to *synergies* among business units, whereby they become more productive together than independent. The collection of skills used in this situation is largely intangible, but, as we discuss in the next section, corporations can also build synergies by sharing tangible resources.

Increasing Market power

To understand the impact corporate diversification can have on a business unit's market power, you must compare the structural position of an independent business unit against what it would

enjoy as part of a larger corporation. For instance, consider the position of an independent confectioner versus the same business as part of, say, Procter & Gamble on each of the five competitive forces introduced in Chapter 2. Membership in the P&G family can provide the business unit with greater bargaining power vis-a-vis both its suppliers and its customers, as the larger corporation carries more clout. With the resources available from the "deep pockets" of a firm like P&G the individual business unit is also in a much stronger position relative not only to its rivals but also to threats from substitutes and new entrants. Any competing firm evaluating the strength of our hypothetical candy maker is likely to view it as a much more significant rival if it is part of the P&G corporate behemoth than if it is a single, stand-alone business. Association with the larger corporation may also bring the individual business unit increased visibility and an improved image. If so, this could have a favorable impact on any or all of the five forces affecting the business unit's structural position and ultimately on its competitive advantage.

A corporation may also increase its market power by using mergers and acquisitions to consolidate the industry. For instance, Maytag, a leading U.S. manufacturer of domestic appliances, sought to improve its power with suppliers and customers by acquiring a number of business units that both extended and supplemented its core product line. Many of Maytag's acquisitions entailed horizontal diversification in that they moved the firm further into parts of the value chain it had already had a position in; for example, Maytag already manufactured domestic kitchen appliances, but acquisitions gave it a stronger position in manufacturing commercial kitchen appliances. However, a firm can also use diversification to become more vertically integrated thereby increase its power over suppliers and/or customers by making them a "captive" part of the same corporation. In Maytag's case, this entailed purchasing firms that had once been outside suppliers of component parts such as heating elements for stoves and dishwashers.

Finally, membership in a larger corporate enterprise may provide a business with markets or distribution channels it would not be able to access on its own. A number of attempts to enter the U.S. soft drink market failed because the businesses could not overcome the barriers to entry created by that industry's tightly controlled distribution channels. However, the soft drink business unit created inside the Wal-Mart corporation found a ready-made distribution channel provided by the thousands of Wal-Mart retail outlets scattered across the U.S. In this way, that soft drink business enjoyed a much more favorable structural position and greater market power as part of the Wal-Mart Corporation than a similar business would have had as a stand-alone entity.

Government agencies with oversight responsibility for industry competitiveness often place limits on how far a corporation can go in using diversification to gain power, and a move that is believed to place too much power in the hands of a single corporation may be prohibited. For example, government regulators were considering Microsoft's move into on-line services. This diversification move would allow Microsoft to increase its market power by vertically integrating forward; subscribers would be able to download Microsoft software without going through a traditional retailer. Regulators were concerned that this might place too much power in Microsoft's hands, and they were considering stopping the move. However, within such limits, diversifying in ways that improve the market power of the various business units constituting the corporation is clearly one way of meeting our criteria of creating value for stockholders in a way that they cannot replicate themselves.

Sharing Infrastructures

Capitalizing on core competencies requires sharing intangible resources, such as skills, know-how, and talent, across business units. Infrastructures, on the other hand, are tangible

resources, such as production facilities, marketing programs, purchasing procedures, and delivery routes. These are the basic "nuts and bolts" of any business, and the ability to share these resources can be an important benefit of diversification. An example of this is Procter & Gamble's using a common delivery system for various business units. P&G sells a wide range of products that are made in manufacturing facilities spread over an equally wide geographic area. Yet many of these items share two characteristics: they are destined for the same retail outlets, and they are fairly expensive to ship. Because of this, it is more efficient for P&G's various businesses to share delivery systems. Rather than send an entire truckload of cookies to a single retail outlet, P&G mixes its truckloads to provide the product blend each customer desires. In this way, P&G can use one truck with a mix of items to do what otherwise might require a dozen trucks. In addition, because it is inefficient to ship "pure" loads of very light but bulky items (such as potato chips) or very dense goods (such as liquid laundry detergent), P&G also saves on fuel bills and road taxes.

Note the two features that allow P&G to benefit from sharing infrastructures. First, the businesses have similar needs; that is, they use the same retail outlets. This is another benefit of related diversification; without similar needs, businesses have no opportunity for sharing infrastructures. Second, delivery expenses represent a significant part of the value chain for these products, so they help determine the competitiveness of P&G's products. In other words, to be useful, resource sharing must improve competitiveness.

Balancing Financial Resources

Different businesses (even within the same corporation) are capable of generating dramatically different levels of cash. Some businesses produce more cash than is necessary to continue operating, while others need more than they can produce. Historically, much of the emphasis in managing diversified corporations has been placed on efficiently balancing cash flows among a corporation's business units. By combining cash producers and cash users in the same corporation, managers can meet the needs of both.

In such a corporation, the sibling businesses are treated as a portfolio of investments, and cash flows are managed and balanced across the family of businesses rather than merely within each individual business. This approach, called *portfolio management*, first became popular in the 1970s, when a number of leading corporations and consulting firms developed several similar frameworks to guide managers in allocating cash among diverse business units.

Maintaining Growth

Another benefit of diversification is continued growth. Especially among larger firms, diversification is undoubtedly one of the most common sources of corporate growth. Using diversification, BASF, the giant German chemical company, was able to maintain a level of growth through the 1980s that is more typical of rapidly growing startup businesses, even though it was a mature multibillion-dollar multinational corporation. In the last half of that decade, BASF was growing at an average of 36 percent per year, roughly doubling in size every 2 years, from a base that was already huge.

Is growth always desirable? There is considerable argument about the idea that to generate the best return on stockholder investments, corporations should pursue only moderate levels of growth. Beyond that, profitability is likely to decline as the pursuit of high growth levels drives the corporation into more marginal businesses and the cost of operating the increasingly large corporation outstrips the growth in profits that additional businesses might provide. Exhibit 6.15 helps us visualize this relationship.

Reducing Risk

Corporate managers have sometimes tried to justify diversification on the basis of risk reduction. To understand how diversification is related to risk, first note that different businesses respond differently to particular economic cycles: the demand for luxury cruise vacations typically declines during a recession as consumers look for less expensive recreation, while the demand for bus travel typically increases, as this is a relatively inexpensive mode of transportation. We call businesses such as these two *counter cyclical*. In order to reduce the risk associated with volatile earnings, a single corporation might decide to diversify its portfolio by holding both a cruise ship line and a bus line. If such counter cyclical businesses exist within the same diversified corporation, a bad year for one business can be offset by a better year for the other. In this way, the variability of the overall corporation's earnings would be reduced, and stockholder investment would be less risky.

However, investors do not need corporate managers to achieve this risk-reducing effect. They can simply invest their individual funds in the different businesses (cruise ship operators and bus operators in this example) to achieve the same risk-reducing effect: a bad year for one of their investments will be offset by the improved performance of their other investment, and the risk associated with their overall portfolio of investments will be reduced. In fact, individual investors can usually achieve such risk reduction through diversification at a lower cost than corporate managers because they do not have to pay the takeover premium a corporation normally has pay. This being the case, diversification for the sake of risk reduction alone hardly meets the goal of having corporate managers create value for an investor in some way that the investor cannot accomplish alone. As we shall see in the next section, there are forces at play that can limit any of the SLX possible benefits of diversification we have covered.

MANAGERIAL BEHAVIOR THAT LIMITS THE BENEFITS OF DIVERSIFICATION

Creating value for stockholders in ways that they cannot do on their own is complicated by the fact that corporate managers do not always benefit from diversification in the same way stockholders do. To appreciate this important point, it is necessary to understand the relationship between corporate managers and the corporation stockholders. Theoretically, corporate managers are meant to act as the agents for the stockholders, whose interests they are hired to represent. However, an area of research known as agency theory leads us to ask whether managers always act in the stockholders' best interest.

Agency theory suggests that managers will not always place stockholders' in above their own. In fact, stockholders have been dubbed the "least important constituency" by some who have researched the way in which corporate executives manage the diversification process. In managing diversification, corporate managers face a dilemma as they attempt to balance their own interests against those of stockholder. For instance, stockholders often enjoy high profits from the sale of their stock when the firm is taken over. On the other hand, managers of firms that have been taken over often lose their jobs. Critics contend that corporate managers sometimes protect their jobs by using various antitakeover tactics, even though avoiding the takeover often *reduces* the value of stockholders' investments.

Capitalizing on Core Competencies

Managers in newly acquired businesses often resent and oppose transferring skills from the core business. Managers good enough at their work to make their business an attractive acquisition may wonder why the new corporate parent presumes to know better. In the case of Philip Morris and the Miller Brewing acquisition, Philip Morris ended up replacing several key executives at Miller after they resisted the transfer of marketing skills from Philip Morris, even though Philip

Morris was undoubtedly one of the best marketers in the world. Philip Morris was eventually able to overcome this obstacle, but other corporations are less fortunate and face continued resistance from their acquisitions.

Increasing Market Power

Any attempt by a corporation to improve the market power of a business unit by enhancing its structural position entails some loss of autonomy or control on the part of managers in the business unit. To return to our earlier example of a confectioner acquired by Procter & Gamble, to the extent that the candy maker is treated as part of the P&G family, it no longer controls its own destiny. For example, its sales force, may no longer be necessary in order to give the business unit the greatest possible market power, its sales will probably be handled as part of a centralized sales department's responsibilities, with each salesperson handling candy sales along with sales of a variety of other P&G products. This diminished role for managers in the candy business is likely to be met with considerable resistance, and they may try to maintain independence from the larger corporation even though doing so will limit the favorable impact on market power the corporate parent offers.

Sharing Infrastructures

Managers may feel threatened when a corporation attempts to have businesses share resources. A corporation may decide to have one set of managers or one set of facilities serve two businesses; in this case, the other managers or facilities will no longer be needed and some managers will lose their jobs. Clearly, managers have good reason to resist such efforts at making the corporation more efficient.

Balancing Financial Resources

While balancing cash flows across businesses sounds logical, consider how managers might respond to having their businesses labeled "dogs." How often are they advanced by killing off a business efficiently, even if it is done for the good of the corporation? Individual managers often believe that their success depends more on the performance of their particular businesses rather than on the performance of the corporation. In such circumstances, it is difficult for managers to sacrifice their businesses for the good of others in the portfolio, even if the corporation as a whole would benefit.

Maintaining Growth

Corporate growth seems to have at least as much to do with improving the welfare of managers as the welfare of stockholders. Managers may be in favor of growth because they expect personal benefits from increasing the size of the corporation. For example, managers in larger corporations typically get paid more than their counterparts in smaller corporations. One study found that, other things being equal, for every 1 percent increase in company size, U.S. CEOs could expect a 2 percent increase in annual pay. This is true even though larger corporations are not necessarily profitable.

Larger corporations offer managers more prestige and more perquisites, or "perks." Every year the popular business press celebrates corporate size with listings such as the *Fortune* 500, the 500 largest corporations in the United States. For many being a top-ranking executive at a large corporation is considered more prestigious than holding a similar rank in a smaller firm. Corporate jets, executive townhouses, lavish corporate headquarters, and so on, are all expensive executive perks. Larger corporations will more likely be able to afford such perks, because they represent a smaller percentage of overall corporate assets and expenses.

Managers may also feel that larger corporations offer greater job security. Larger corporations were traditionally more difficult to acquire by takeover, so, by increasing the size of their corporations, managers may feel they are reducing the threat of being replaced. With the ever-increasing size of takeover targets, this tactic may no longer be effective, but for most managers, it remains a major consideration for acquisition.

There are ways in which corporations and stockholders can benefit from growth. However, the relationship between corporate size and corporate financial performance is tenuous, and the benefits to growth appear to accrue more directly to managers than to the stockholders they are presumably hired to serve." This suggests that growth alone is not a strong argument for diversifying. It is probably more appropriate to consider growth as a by-product of diversification rather than as a reason for diversifying.

Reducing Risk

As we have seen, because individual investors can diversify their stock portfolios, using countercyclical stocks to reduce their overall risks, corporate diversification for the sake of risk reduction does not meet our standards for good strategy. However, some corporate managers may pursue this tactic because it effectively reduces their own risks. When a corporation is involved in a variety of industries, its total earnings are less volatile, which means that the earnings for which corporate managers are responsible are more assured.

Clearly, managers do not benefit from diversification in the same way owners do, and this difference often limits the benefits owners derive from corporate diversification. In fact, if you return to Exhibit 6.9 and compare the things that benefit stockholders and the things that benefit managers, you may reach the conclusion that the two have precisely opposite rankings for the six reasons we have discussed. While stockholders have much to gain from capitalizing on core competencies, improving market power, and sharing infrastructure, managers have much to lose from the same. On the other hand, managers may benefit from maintaining growth and reducing risk, though, as we have seen, there is little opportunity for stockholders to benefit from corporations diversifying for these reasons alone. (Balancing cash flows appears to offer mixed results for both parties.)

All this suggests that one of the greatest challenges to corporate strategy is overcoming the differences in the motives of owners and managers. One of the most common ways of doing this is tying manager compensation to stock performance. This can be accomplished by granting stock options (options to buy stock at prespecified prices) to managers or by selling stock to all employees on favorable terms. Either option is meant to increase managers' and employees' interest in creating greater value for stockholders, the goal of corporate strategy.

STRATEGY FORMULATION AT THE SBU LEVEL

In Chapter 6, we discussed strategy formulation at the corporate level. Recall that the corporate-level strategist was seen as an investment portfolio manager, deciding upon the overall character and mission of the company, which investments (SBUs) to buy (or develop), and the allocation of resources and management of synergies among them. The steps in the strategy formulation process at the business level are the same as those at the corporate level. Corporate-level strategists often dictate the SBU mission. In a departure from the approach taken in Chapter 6, the *principles* of strategy formulation rather than the *process* will provide the framework for this chapter.

In this chapter, we discuss the kinds of strategies, which help the company to compete in a particular business or in a product or service segment and to contribute to overall organizational success. As we go along, keep in mind that there are many single-SED organizations. *Single-SBU organizations are organizations which either produce only one kind of product or service or treat a multi-product or service operation as a single unit for strategic purposes.* The SBU will first be viewed as an economic entity. Then a marketing view will be taken. Next a number of special purpose strategies will be discussed. In the last section of the chapter, the impact of industry and product or service life cycle upon business-level strategy formulation will be described.

THE SBU AS AN ECONOMIC ENTITY

Whatever view one takes of the business organization—as a social system, as a collection of resources and the people who manage them, as a tool of society through which human needs are satisfied, or as an abstract system devoid of content—it is primarily an economic entity. In general, funds for investments which promise no return cannot be obtained, employees who receive no pay will not keep working, products and services which produce no profit will not long be produced, and customers who have no money cannot obtain those which are.

Profit is the goal of most businesses. Even most nonprofit organizations can be viewed as economic in nature. In general, the missions of organizations like the Red Cross, Save the Children Foundation, and thousands of others is to collect money and use it efficiently to accomplish worthwhile purposes. In business, profit is often taken to be the appropriate measure of how effectively and efficiently corporate resources are used.

What Is the Correct Economic Goal?

Corporations pursue various "profitability" goals. Many SBU strategists find that they really have little choice as to the SBU's mission. It is usually established by corporate level strategists as maximization of profit, ROI, return on equity, or some other economic parameter. In a strict sense, it is the *present value of the managed firm* to the parent corporation which the SBU strategists should try to maximize. But, what is the present value of the firm? Is it the total value of all debt and equity securities?

We will argue that it is only the value of the SBU's common stock or other representation of equity ownership. The obligation to debt security holders is a legally enforceable, fixed obligation and consequently should not be viewed as a goal but as a constraint. Debt obligations must be met before other obligations can be considered. Preferred stock is somewhat like debt in that the dividends typically must be paid before any dividends can be paid on common stock. Preferred stock can be designed to be almost like debt (cumulative preferred with a mandatory

sinking fund provision) or almost like equity (noncumulative, participating preferred). However, it is typically more debtlike than equity like. Therefore, as a general rule, it is the *present value of expected future earnings available to common stock* which should be maximized. If the financial markets are efficient, this should maximize the SBU's contribution to the *current-period common stock price* of the parent corporation.

In general, SBU strategists find maximization of the firm's value a difficult goal to operationalize. Three subordinate purposes, which are easier to apply, are (1) increasing long-term earnings capability, (2) improving current-period profitability, and (3) optimizing cash flow.

Strategies for Improving Long-Term Earning Capacity

The future earning capability of the firm is often enhanced or retarded most significantly by investment decisions involving which assets to buy, divest, improve, or deplete. There are a number of criteria which can be used in making investment choices. The most common approach is ROI. This is roughly how ROI decision making works: When investment or disinvestment opportunities arise, the expected profits which will flow from the investment are estimated. Only those investments, which promise a percentage return above some set minimum level, are considered. Ideally, all the available investments should be compared, and those which offer the highest return should be made until the SBU runs out of investment funds. If retrenchment is necessary, investments are liquidated in reverse order of ROI until the firm's minimum cash needs are met. Since expected profit depends upon who the expector is, what time of day it is, and a number of less concrete variables, many corporations use current-period accounting ROI rather than expected ROI to allocate resources among divisions.

A theoretical fallacy in ROI investment decision making is that ROI is not profit and that it is profit (technically, the present value of future profit) which usually should be maximized. A profitable company which sells portions of its assets and leases them back will almost always increase ROI, although the profits and future earnings capability may not be affected. And a company which borrows money to buy investment assets which earn a little more than the interest charges on the debt will increase profitability, although ROI will normally decline. To some degree, this fallacy is mitigated by the impact of additional debt on the riskiness of investments. It is generally accepted that debt increases risk to the common shareholder and that common shareholders require (or deserve) a higher level of profitability for their more risky investment. Another problem with ROI as an investment criterion is that both return and investment can be computed in a number of different ways-with greatly varying results.

Despite its shortcomings, ROI is perhaps the most widely used criterion for investment decision making, both at the corporate and business levels. ROI is also very popular for allocating resources among SBUs and for evaluating SBU managers.

Another common approach to investment decision making is to accept only those investment projects which promise less than some maximum payback period. *Payback period is the time it takes (or is expected to take) for the net cash flows produced by a capital asset to total the cost of the asset.* For example, if a certain machine costs \$10,000 and is expected to produce \$2000 a year in contribution to net income, ignoring depreciation, the machine has a payback period of five years. Payback period is frequently used as a capital budgeting tool at the business level. Lincoln Electric Company, for example, accepts only those investment projects with payback periods of less than two years. Payback period is seldom used for the allocation of resources among operating divisions or for evaluating managers.

There are a number of more complex approaches to investment decision making, such as internal rate of return (IRR), net present value (NPV), and the capital asset pricing model (CAPM). The *internal rate of return* is the discount rate which equates the present value of the expected net cash flows from an investment asset with the cost of the asset. A firm which uses this method will compare investment alternatives on the basis of the IRR each provides and will usually establish a minimum acceptable IRR. ROI and IRR are essentially identical concepts. However, ROI is normally computed for a SBU (an aggregation of all kinds of assets) on the basis of ex post data, while IRR usually relates to a single capital asset and is often based on ex ante estimates.

Net present value is the present value of the expected net cash flows from an investment asset minus the cost of the asset. Strategists must decide what discount rate to use in the NPV computation. A common approach is to estimate the firm's cost of capital and to use that figure in the NPV computation. This is often the weighted average of (1) the earnings-price ratio for common stock, (2) the dividend-price ratio for preferred stock, and (3) the interest rate on new long-term debt. Some strategists prefer to use the expected cost of funds which will be used to purchase the respective asset as the discount rate for the NPV calculation. Whatever discount factor is used, only those investments providing a positive NPV are acceptable, and alternative investments are preferred according to the NPVs they offer.

The *capital asset pricing model* is a mathematical model which states that the return which capital markets will afford for any asset is the risk-free rate plus a risk premium proportional to the sensitivity of returns on the assets to changes in market returns. The CAPM attempts to explicitly consider and, though its logic is appealing, it has seen limited use in SBU-level decision making. One corporation, Alaska Interstate, Inc., attempted to use the CAPM to evaluate subsidiaries and acquisition candidates. However, in 1982 the company abandoned its diversification effort, along with the CAPM, and returned to more conventional decision-making tools (Harrington, 1983).

Strategies for Improving Profitability

We said earlier that it is expected profit that gives current value to a business. The best indicator of future profitability is present profitability. European and Japanese managers have criticized Americans for sacrificing long-term viability for short-term profits. Some authors have suggested that the problem can be corrected through executive compensation schemes which emphasize the long run. However, few corporate managers believe that the future is significantly predictable beyond about five or ten years, particularly in light of recent price-level volatility. So, perhaps what appears to be a short-term focus on the part of American managers may simply be a recognition of reality.

Profitability strategies

The formula for net profit ($\text{net profit} = \text{revenues} - \text{expenses}$) is well known to every student of finance and to practically every business manager. It is clear from this formula that net profit can be increased only by increasing revenues or by decreasing expenses or by using some combination of both which nets out to the same thing. So, business-level strategies aimed at increasing current profitability should probably either increase revenues or decrease expenses. Among the strategies for increasing revenues are (1) increasing the price for price-inelastic products, (2) decreasing the price for price-elastic products, (3) increasing and/or redirecting promotional efforts, (4) increasing the product quality perceived by potential customers, either through increasing the actual quality or through changing the presentation of the product or service, (5) broadening the product line, and (6) expanding into new territories.

Strategies for reducing expenses include (1) motivational schemes for improving the productivity of labor, (2) improving existing technology through machine repair, rearrangement, and so forth, (3) adopting new technology through machine replacement, redesign, and so forth, (4) redesign of products and services to require fewer or less costly inputs, (5) substituting labor-intensive processes for capital-intensive ones where labor costs per unit are lower than capital costs per unit, and (6) substituting capital-intensive processes for labor-intensive ones where the reverse is true.

Strategies for Producing Cash

Often a business-level strategic manager adopts increased cash flow as a goal. Sometimes, it is a matter of survival. Whatever the basic cause of business failures, they are almost always manifested through what are called cash-flow problems. A business which loses money continuously (an *earnings* problem) will eventually be unable to pay its bills (a *cash-flow* problem).

Even when an SBU is profitable, it may have to serve as a Cash Cow for other SBUs. Maximization of profitability at the corporate level may require withdrawing funds from certain SBUs and investing them in those with a higher earning capability. When this occurs, business-level strategists must shift from a focus on maximizing profitability and concentrate on maximizing cash flow from the business. There are a number of common strategies for doing this.

First, a debt avoidance or delay strategy might be followed. Paying obligations late can produce large quantities of cash. A smaller company with only, say, Rs.1 million in annual sales, and Rs.60,000 in accounts payable can increase its cash balances by \$30,000 by just paying its accounts payable fifteen days late, assuming it previously paid on a thirty-day basis.

Second, a company can increase cash balances through a capital asset depletion policy. In order for most fixed assets to continue to produce income, some reinvestment is required in the form of repairs and maintenance, replacement of machines and parts which wear out, and so forth. A company that requires cash in the short term can forgo these expenditures for a time. If this occurs, of course, the ability of the company to earn profits will slowly decline. In essence, this is a form of disinvestment. Just as investment requires cash, disinvestment produces cash.

Third, cash can be obtained through current-asset management. This too is a form of disinvestment. A company which is in a bind for cash might fail to replenish inventories as they are sold. When the cash need is critical enough, some companies even sell inventories at below cost. Of course, every company should manage its inventories to increase profitability, as discussed in the previous section. But here we are discussing obtaining cash, possibly to the detriment of profitability. Another current asset which can be milked for cash is accounts receivable. The credit terms can be shortened, and discounts for early payment given.

Fourth, any strategy that increases the value of a liability or equity, all else being equal, produces cash. This includes borrowing or issuing more equity securities. If this is done with due regard for the interests of corporate stakeholders, it can be a reasonable and responsible strategy. In fact, rapidly growing companies almost always tend to be cash-hungry. However, when the purpose is simply to obtain cash and avoid more difficult strategic decisions, most would not consider this practice socially responsible.

THE SBU FROM A MARKETING STANDPOINT

In the previous section, we discussed strategic management from an economic perspective. Now our vantage point will be a marketing one. Just as it is true that the corporation is, above everything, an economic entity, it is true that, to be economically effective, an organization must satisfy needs and/or wants in the marketplace. Several decades ago the term *the marketing concept* was coined to designate *the proposition that all of a company's efforts, whether in the area of finance, production, personnel, or sales, should be focused upon the customer*. Rather than being a new view of marketing, however, this is just a different way of looking at the job of strategic management. When the marketing concept is adopted, marketing is not seen simply as one of several functional areas (the others being production, finance, and personnel) which make up the job of management. The marketing concept signifies a market focused approach to managing the total organization.

The strategist who subscribes to this view begins with such questions as: What *needs* is the organization seeking to fill? What are the characteristics of customers with these needs? The answers to these questions lead to adoption of basic marketing strategies like "define a market niche" and "position the firm in the marketplace." From these basics of strategy come derived strategies which can be summarized under "the four P's of marketing." In actuality they could as well be called "the four P's of strategic management," for they provide a powerful way of relating the organization to its environment. By the way, Kenichie Ohmae would add a "T" for timing to the four P's. Timing is, of course, a vital consideration. With this prelude, let's consider the four P's-product, price, promotion, and place-as they relate to strategic management at the business or division level. It is emphasized that it is not *marketing* as a functional area which is being discussed, but *strategic management from a marketing perspective*.

Product

Webster's Third New International Dictionary defines a *product* as "something produced by physical labor or intellectual effort: the result of work or thought." As used in this book, *product* means *the total bundle of goods and services available to the customer*. For most purposes it is unnecessary to distinguish between *goods* and *services*. They are both results of physical labor and/or intellectual activity, and both have value to customers and cost something to produce. In fact, many companies have come to view a physical product more in terms of the services it provides than in terms of its physical nature. For example, oil companies should see themselves as providers of energy, auto companies should offer transportation, and television manufacturers should produce entertainment. So the product should be described from the standpoint of what it will do for the purchaser and how effectively and efficiently it can be produced. The obvious objective is to produce the maximum perceived value for the customer at the lowest cost in terms of resource inputs. The connection between the product aspect of marketing and the production strategy is a well-recognized one. It is perceived value which determines what the customer will pay for a product or how aggressively the customer will seek the product at a given price. This requires an understanding of customer needs as well as efficient and effective production capabilities.

There are essentially two approaches to increasing the value provided to the customer: (1) develop new products, and (2) improve the quality of existing ones. New products may be created through R&D. Atari, in the story at the beginning of this chapter, has chosen to spend a relatively huge amount on R&D for this very purpose. Simply spending money on R&D, however, is not enough. It is as important to discover new needs and to exploit them as it is to make new products to meet known needs. Market research, either formal or casual, rigorous or intuitive, can help determine where the product development opportunities are. Research must be focused upon a need or a potential need in the marketplace. Remember, however, that the

marketing research and the subsequent R&D should be designed to improve the degree to which the product meets customer needs and desires.

The second way to improve value is to improve the quality of existing products. There are a number of strategies for doing this. Quality control standards can be imposed or improved. Edwards Demming, for whom two of Japan's national productivity prizes are named, credits most of his success to what he calls "statistical control" of the production process. Another approach is automation or robotization. Machines are much more consistent in producing goods and services than are humans. Much of Japan's success in the auto and steel industries is credited to reliance on machines. Through the use of computers, banks, retailers, and many other businesses have decreased the number of errors they make in serving customers, improving the speed of service as well as accuracy. Incidentally, an American company, Hewlett-Packard, won the Demming quality control prize in 1982.

Another way to improve quality is to engage employees in quality control efforts. Employees can help both in terms of idea generation and quality-conscious performance. The first strategy is exemplified by the use of quality control circles, or quality circles, made famous in Japan and adopted by many U.S. companies. *Quality circles* are groups of workers, usually consisting of eight to ten persons each, who meet together regularly for the purpose of discovering and recommending or implementing ways to improve the production process, in terms of either efficiency or quality. Lomas and Nettleton, America's largest mortgage banking firm, recently began involving employees in quality circles. They have found the widest use, however, in manufacturing concerns.

Suggestion systems also encourage workers to come up with ways of improving quality. A few companies have included quality considerations as a part of their compensation programs. For example, at Lincoln Electric Company, workers are required to pay for warranty costs traceable to their output. In addition, high marks for quality increase workers' year-end bonuses. Because of Lincoln's extensive statistical control system, warranty costs are traceable to the output of the worker who caused them. At Ford Motor Company, the theme, "Quality is job one," was adopted for the purpose of both promoting the quality of Ford products in the marketplace and developing enthusiasm for quality among Ford employees. Ford's current emphasis on quality was a reaction to a disastrous decline in the popularity of American cars, which many feel could have been avoided by earlier adoption of the marketing concept.

If one accepts traditional economic theory, there is no doubt that price is the primary marketing weapon of the business unit strategist-and one which is too often overlooked. As far as economists have been able to determine, there is no such thing as a "Giffen good," a product for which an increase in price produces an increase in quantity demanded.

There are few tools, perhaps none, other than price, which have such a clearly predictable direction of impact. However, focusing entirely on price would clearly be a mistake. It is price for a given perceived quality of product or service which encourages the purchaser to buy, not price alone. This is not to ignore the fact that price often transmits information about product quality. Most people believe that, at least to some extent, "you get what you pay for." Price should complement the desired product image. When L'eggs pantyhose were sold in different test markets at varying prices, it was found that, when the pantyhose were priced too low, many customers thought they were of inferior quality. This kind of effect, though, usually lasts for only a brief period. Once the customer has tried the product or service, price becomes less important as a source of information. It should also be remembered that proper promotion can overcome any negative information transmitted by price.

So, the direction of the impact of price on the quantity of a given product or service sold is

clear. By decreasing price, volume can normally be increased. However, any significant change in price could severely affect the product image and subsequently decrease the market share. However, the effect on profitability is not always so clear. If a company prices its product below cost, sales may very well increase markedly, but profits will evaporate. The reverse is also true and this is frequently overlooked. If a company increases its prices, unit sales may very well decline while profits increase, particularly if the business has a high percentage of variable costs as compared to fixed costs.

The setting of price for an individual customer or even for an individual product may not be a strategic matter. However, the company's overall approach to pricing its products and services is strategic. There are essentially four approaches to pricing policy, one based upon the cost of producing the product or service, and the other three based upon the market.

First, cost-based pricing is useful when the production costs for various competitors are similar, or at least proportional. In the construction industry most competitors simply calculate what their cost is expected to be for a given job and add a certain percentage to that figure. Many retailers have a certain percentage markup which they apply to the products they sell. For most who practice cost-based pricing, it is really done for simplicity. Such pricing is indirectly based on market forces, with the markup varying from product line to product line depending on what the market will bear. At least one company, Lincoln Electric Company, claims to "at all times, price on the basis of cost and keep downward pressure on costs." In doing this, Lincoln Electric claims to serve its primary constituency, the customers. Lincoln Electric is a rare exception to the general rule, however. For most companies, cost-based pricing is just a convenient way of responding to market forces.

Second, an approach to pricing commonly followed during the early stages of product life cycle is "skim pricing." *Skim pricing is pricing a product or service high while the selling firm has an availability or quality advantage over competitors for the purpose of earning monopolistic-type profits in the short run.* Skimming is really useful as a pricing policy when there is no close substitute for the product in question or when barriers to entry prevent competitors from producing substitutes. For example, when Xerox patented the dry process copier in the 1950s and when IBM patented the Selectric typewriter in the 1960s, it was possible for each company to reap huge profits for an extended period through skim pricing. As each new evolution in home computers is introduced by Apple or IBM or one of the other computer makers, the introducing company can use skim pricing for a brief period until competitors catch up.

As competitors enter the market, however, it becomes necessary to follow the third approach to pricing, a competitive pricing strategy. In general, it is true that innovators are able to profit from skim pricing but that imitators must price more competitively. Innovators, in the sense used here, are companies which concentrate attention upon bringing out new or improved products or services earlier than competitors can. Imitators are companies which look for new or improved products or services in the marketplace and attempt to market similar products or services at a profit. There is a middle ground between imitation and innovation, and the Japanese have found it. In the early 1980s, they copied (imitated) and improved upon (innovated) a number of American developments, with outstanding success. *Competitive pricing is pricing at or slightly below the competitor's prices for a given quality of product.* Competitive pricing should be accompanied by attempts to differentiate the company's product or services, either through promotion or through product design and development. After IBM's patent on the Selectric typewriter ran out, a number of competitors introduced ball-element typewriters. IBM, already very experienced in the technology involved, introduced several improvements, such as an automatic erasing feature, and actually lowered the price at which the typewriter sold.

The fourth approach to pricing is often called *penetration pricing*, *pricing the product or service at well below the existing market price, perhaps even below cost, for the purpose of gaining market share*. It was through penetration pricing from 1972 to 1977 that Texas Instruments came to dominate the hand-held calculator market (Buaron, 1981, pp. 8-9). Strategists know that market share tends to be "sticky downward." Once a company attains a large market share, it often takes years for that market share to decline significantly, even if the price-quality relationship is about the same as that of competitors. Though the technology of Texas Instrument's calculators is no longer remarkable, the company remains the sales leader in the U.S. market for hand-held calculators.

Another good reason for penetration pricing is to elevate sales so that economies of scale can be obtained. For years BIC has used penetration pricing for all its products. BIC's strengths are in the areas of mass production and marketing of low-priced products. Long dominant in the ballpoint pen business, BIC introduced a disposable razor in 1982 at what some considered a ridiculously low price. In fact, the whole razor cost less than a single competitive razor blade. Through this pricing strategy, however, coupled with an efficient mass production system, BIC appears to be headed toward domination of the disposable razor market.

Penetration pricing also has relevance to the experience curve. The *experience curve* is a *graphical representation of the proposition that, for certain industries, the cost of producing a certain quality of product or service declines in a predictable way with the total cumulative volume the company has produced*. Penetration pricing can allow a company to get further out on the experience curve, thereby decreasing its costs and allowing profits to be made. For products and services to which the experience curve applies, pricing below cost for a period of time may be justified as an investment which will return profits in the long run. There is a certain risk involved in this tactic. Any major improvement in the basic product may diminish experience curve advantages.

Promotion

The third P relates to the company's *promotion strategy*. This is the *plan for informing and convincing the customer*. The usual objective of promotion is to improve the price/ quality trade-off from the company's standpoint or to increase the sales volume. Of course, it is conceivable that a company which views the customers as a major constituency might wish to advise them about the product just to increase its usefulness. However, the only way to keep this from being reflected in increased sales or prices is to limit the information to certain customers and to keep others from finding out about the additional usefulness. Otherwise, the product or service will have to be rationed.

Promotion can be accomplished in one of three main ways: through advertising, through personal selling, or through word of mouth. For years Church and Dwight Company's Arm & Hammer baking soda was marketed essentially without advertising. Its sales were relatively stable. The low price, quality, and product identification had driven most competitors from the market. A few years ago an aggressive advertising campaign was begun, which touted the multiple uses of Arm & Hammer baking soda (antacid, cleaner, deodorant, tooth powder). What had been a solid but relatively unprofitable performer became a high flyer.

In some cases, promotion results in an increase in the perceived value of a product relative to its real value to the customer. The oil additive STP is commonly agreed to have no significant value in terms of increasing engine life or improving performance. However, when Andy Granatelli began hawking the product on television, sales skyrocketed. Few customers have the expertise to determine whether oil additives actually improve performance or engine life. Consequently, it was possible through promotional efforts to convince them that STP did, and to

keep them convinced. The STP example flies in the face of conventional marketing wisdom, which suggests that promotion cannot create a successful product but can only increase market acceptance.

In no other aspect of the strategic manager's job are ethical considerations more paramount than in promotion activities. The strategists must determine to what degree promotional efforts are designed to inform the customer about the real attributes of the product or service and to what degree they are designed simply to convince the customer to buy or even to convince the customer that the product or service has attributes it does not possess.

The choice between concentrating on advertising, personal selling, or word of mouth is not usually a clear one. Many companies use a combination of all three. Of course, if word of mouth is the choice, the primary strategy might be to build a better product or offer a better service at a lower price. Often a kind of mystique develops concerning a certain product, making word of mouth a most effective strategy. This has been true at times for Coors beer, L. L. Bean sporting goods, Gravely garden tractors, and a wide range of other products. Through personal selling and advertising, however, it is often possible to improve the customer image for a given quality of product or service. Further, while selling and advertising are artistic-type endeavors, they are not mystical.

The organizational strategist must typically decide not only what type of promotion strategy to follow, but also the amount of money the company is willing to spend on promotion. Often a policy is established through which a certain percentage of company sales is spent on advertising. The typical pattern in the respective industry may be used as a guide. Other companies base their advertising expenditures upon a desire to accomplish certain sales objectives. Whatever the approach, the design of a promotional strategy, including both expenditure and method, is a vitally important function of SBU strategists.

Place

In discussing this functional aspect of marketing, a number of modern marketing texts substitute *physical distribution* for *place*. Whatever term is used, what is referred to are any and all efforts the company undertakes to give its product or service what economists call "place utility." *Place utility is the usefulness a product or service has because it is available at a certain place.*

From a strategic management standpoint, *place* refers not only to where the product or service is to be distributed, but also how. This includes identification of the appropriate distribution channel as well as the means of compensating and controlling the channel members. Among the choices are (1) distributing through the company's own sales outlets, (2) selling through franchised outlets, (3) using the services of manufacturers' agents to market the product through specialized or nonspecialized wholesalers and/or retailers, (4) using the company's own sales force to distribute the product directly to end users or through specialized or nonspecialized wholesalers and/or retailers, (5) distributing through mail or parcel delivery services on the basis of orders from catalogs or coupon ads placed in the mass media.

Distribution should be viewed as part of the production process. The method of distribution—the outlet where the product is sold—should complement the quality, dependability, and value of the product itself. As stated earlier, products are best defined in terms of the services they provide. Distribution is as vital to the creation of value for the customer as is manufacture. Thus, distribution strategy becomes just an extension of production strategy, both being directed at profitably filling needs in the marketplace.

SALES GROWTH AND SPECIAL-PURPOSE STRATEGIES

Given a certain product or products, the sales growth an individual company or SBU experiences is a direct result of four factors: (1) growth of end markets for the firm's products or products incorporating them as components, (2) additional uses for the company's output, either as final or intermediate goods, (3) price increases without decreases in the quantity demanded (requiring discovery of the elusive Giffen good), and (4) increases in the firm's market share. Obviously, a company can also grow by adding products. Growth strategies, to be effective, must affect one or more of these variables.

The Growth, Stabilization, or Retrenchment Decision

Most people believe that growth is not only desirable, but essential. "Grow or die" is an accepted axiom. When a company actively pursues growth, as most do, this is called a *growth strategy*. Only when businesses are forced into it do they commonly plan to allow sales to stabilize. Most organizational strategists view declining sales as a sign of failure. Even when strategists admit to following a retrenchment (cutting-back) strategy, it is usually only seen as a necessity during an unhappy interlude, after which growth will resume.

To the extent that company management is the constituency being served, sales growth is always desirable as long as the company remains profitable. Larger company size usually carries with it both prestige and higher executive salaries. So, growth becomes an objective, and profitability a constraint. However, if the objective is to maximize return for stockholders or for a corporate parent, this concentration upon growth may not be entirely appropriate. If growth is achieved at the expense of future profitability, it may be to the detriment of all concerned. For example, a company may choose to cut product costs by reducing quality and then compete in the marketplace on the basis of price. This may increase sales and profits until the change in product quality becomes apparent to customers. In the long run, sales may decline and the company's reputation for quality could be permanently hurt.

Like decisions about other objectives, those relating to whether and to what extent to seek sales growth should be based on sound business reasoning, not on an emotional aversion to retrenchment. There are cases where companies have followed the most extreme retrenchment policy, liquidation with distribution of the proceeds to stockholders, with excellent results. If a company's liquidation value is above the market value of its securities, liquidation may be a reasonable alternative.

The decision of whether or not to seek sales growth cannot simply be based upon whether the relevant market is growing. A recent *Forbes* magazine article describes how three companies with small market shares in low-growth industries-Dogs, according to BCG devotees-bucked market trends with excellent results.

The most important criterion for the growth, stabilization, or retrenchment decision is probably the company's degree of distinctive competence in the product or service area. IBM was not a major competitor in the typewriter market until the company invented and patented the ball-element, or Selectric, typewriter. IBM chose to grow rapidly in this area and quickly became dominant at the upper end of the office typewriter market, even though the market was growing only moderately. At the same time, Olivetti, a marketer of premium office typewriters, was forced to accept a retrenchment strategy. This ultimately resulted in Olivetti being combined with Underwood, a company which concentrated upon moderately priced typewriters. IBM's patent ran out in the late 1970s, and other manufacturers were then able to market ball-element typewriters. But by that time the entire office typewriter industry was beginning to

decline because of the availability of word processors, and most typewriter manufacturers were forced to retrench. Thus, this one small industry segment illustrates both how an individual company's growth strategy can be somewhat independent of industry trends at various points in time and how that of competitors in the aggregate cannot.

The urgency with which growth should be sought is largely dependent upon the degree and stability of a company's distinctive competences. A *distinctive competence* is any advantage a company has over its competitors because it can do something they cannot or because it can do something better than they can. Distinctive competences can be based upon technical or managerial expertise, legal rights, ownership or control of financial, material, or human resources, or a wide range of other advantages. When IBM patented its ball-element typewriter, the company knew that for seventeen years it would have a significant advantage over its competitors. By the time the seventeen years (the life of a patent) was up, IBM was far out on the experience curve. Although IBM's distinctive competence based on the patent right had run out, the company still had another kind of distinctive competence based on manufacturing experience. The company was thus able to produce its Selectric typewriter with both higher quality and lower costs than any competitor. Because the advantage was relatively permanent, IBM chose to price the typewriter at the upper end of the market (skim pricing), knowing that the company would be able to gain market share for a number of years.

On the other hand, when Coleco developed its Adam computer system in 1983, the decision was made to price it at only \$600, even though it was thought to be a year ahead of anything else on the market. Accepting the idea that market share is sticky downward, companies like Coleco have to reap the benefits of innovation rather quickly in terms of sales growth. After obtaining a high market share, and lowered production costs (as a result of experience curve effects), profits can be made while competitors catch up on the technology. In Coleco's case, the strategy did not work well because the company's apparent competitive edge evaporated with highly publicized problems involving the early demonstration units of Adam, severe production foul-ups which limited availability for the 1983 Christmas season, and the introduction of IBM's PC, Jr.

In summary, the growth decision is a relatively complex one. It is based largely upon (1) a company's strengths and weaknesses compared to those of competitors in the particular product or service field, and (2) the permanency of those strengths and weaknesses.

SBU strategists often must follow the lead of corporate-level strategists who attempt to manage the larger entity made up of a number of SBUs. Even though a particular business unit might have desirable growth prospects and substantial distinctive competencies compared to its competitors, it may not represent a good investment relative to other SBUs in the corporation. When this is true, corporate-level strategists may decide to extract investment funds from the SBU and allocate them to other, even more outstanding, businesses. On the other hand, if corporate-level strategists manage a number of SBUs all of which have low earnings prospects, a particular SBU may be encouraged to grow because it is the most competent SBU within the organization, although not strong relative to its competitors.

This suggests that corporate-level strategists might sometimes take a "closed-systems view" of the organization. They may not consider the whole universe of investment opportunities, but just those within the corporation. These strategists may be committed to growth from within and internal financing only. Sometimes this is due to the personal preferences of strategists. At other times, it may be favored for tax reasons. The closed-systems view is not totally unreasonable. To some extent, taxes and other costs close the boundaries of corporations. Dividends are taxed. New stock issues result in significant transaction costs. Corporate acquisitions and divestitures distract management from business-level competitive efforts and

involve investment of time and money. The corporation remains an open system, but in some respects the openness is far from perfect.

Let us turn now to consideration of the usefulness of various special-purpose strategies, assuming that the company or SBU has decided upon a particular growth objective. The three possibilities we will consider are growth, stabilization, and retrenchment.

Strategies for Growth

Assuming that the SBU strategists have decided that it is desirable to grow, there are a number of ways that this can be accomplished. In this section we will discuss a rather wide range of strategies for growth. Some of them are designed to accomplish growth, and some to simply facilitate it. First, though, let us briefly consider how sales growth can be financed.

Financing Growth

Whenever a company grows, it is necessary to finance the asset increases which both facilitate and result from that growth. When sales increase, investment in accounts receivable typically increases. Additional productive capacity involves not only fixed assets but also raw materials, work-in-process, and finished goods inventories. In general, the asset increases can be financed through internal or external sources. If the business can increase earnings quickly, by either decreasing costs or increasing revenues, this will provide a net increase in cash flows. The cash flows which are available can be more completely retained by eliminating or reducing dividends or by decreasing the company's cost of capital through renegotiating borrowing arrangements, and so forth.

Usually, however, when growth is rapid, funds must be obtained from outside. Another common approach to obtaining additional capital to sustain growth is through an additional (or initial) issue of debt or equity securities. When a closely held company first offers stock for sale to the general public, this is called "going public".

Facilitating Growth through Cost Reduction

An obvious strategy for growth is to produce a product or service at a lower cost than competitors can. This allows controlled growth through price and promotional competition along with expansion of production capacity. Sometimes the best way to obtain a product at a lower cost is to let others produce it. This is why the major U. S. auto companies have recently done more and more *out-purchasing-the buying of component parts which had previously been produced in house*. In many cases, the out-purchasing is done offshore, that is, in foreign countries. Because of out-purchasing, many, perhaps most, small American cars have Japanese engines. Both Texas Instruments and IBM use microprocessor chips purchased from Intel Corporation.

The experience curve

Another strategy for decreasing costs is simply getting out on the experience curve. Through penetration pricing it may be possible for a company to sell large volumes of a certain product or service. In producing a large volume, the company is often able to reduce its costs for two reasons: First, costs may be less because of economies of scale. *Economies of scale are changes in the cost of producing a product or service because of changes in the volume produced during a given time period.* This is a relatively ancient concept. Second, as previously indicated, costs may go down because of *experience curve effects*. This term refers to *the extent to which production costs vary over time with the cumulative volume of product or service produced.* The

experience curve is a modern concept, and it is based upon our ability to learn how to do a job better over time. Experience curve theorists suggest that, for every doubling of cumulative volume in certain industries, unit costs decline by 25 percent or so. The BCG, which developed the concept of the experience curve, tested the theory on the costs of refrigerators, automobiles, beer, and vacuum cleaners, and it worked for all these products.

Growth through Promotion

Given the capability of producing increasing volumes of a product or service, it is often possible to grow simply through promotional efforts. Even if no economies of scale exist, if advertising dollars are more than offset by the gross profit on additional sales produced, the advertising may be justified. For many products, such as detergents, powders, motor oils, insect repellants, beers, and a host of others, there are no significant differences in product quality, or even content, among the several top brands. So other aspects of the marketing mix - price, promotion, and physical distribution-largely determine the volume sold. Soap manufacturers differentiate their products with "blue granules" and so forth. Beer producers show happy people enjoying a "cool one" at the end of a hard day. Moreover, cola manufacturers fight for shelf space in stores while engaging in sporadic price competition.

Growth through Product Development

Another strategy related to growth is product development. This may be accomplished through spending on R&D, as most major companies do. Products may also be improved by enlisting the aid of the entire work force. This can be done through suggestion programs, quality circles, and other participative devices. At Lincoln Electric, for example, the advisory board, made up of employees, meets every two weeks to discuss ways of improving company operations, including product modification. Whatever approach is taken, success in product development requires attention from top management.

Growth through Integration

Product quality may also be improved through vertical integration. Sales growth normally follows this, or any, quality improvement. In addition, integration results in capturing the value added by suppliers or intermediate customers, which can increase profits. Backward vertical integration (i.e., toward the sources of supply of raw materials) can also improve an SBU's control over the quality and quantity of material inputs. Sears, Roebuck, and Company is noted for having purchased many of its suppliers. This was partly to reduce costs and partly to maintain Sears' reputation for quality. Vertical integration forward, toward the final user of the product, can help the company to control its distribution channels. This can result in more complete satisfaction of customer needs and wants. For example, by owning its retail outlets for Radio Shack computers, Tandy Corporation is able to offer point-of-sale advice and service as well as warranty administration. This is equivalent to an improvement in product quality. Forward vertical integration also directly increases sales, as the markup charged by intermediate customers, such as wholesalers and retailers, is captured.

Growth through the Purchase of Technology

Another way to develop new or improved products is to purchase technology. This can be accomplished through the buying of patent rights or even through the purchase of small companies which have made significant product innovations. For example, Phoenix Computer Graphics in Lafayette, Louisiana, has developed a number of improvements in graphics. A number of major computer manufacturers have held confidential discussions with Phoenix relative to purchase of the company to acquire its technology.

Growth through Attacks on Competitors

Another, often ill-advised, strategy for growth is an attack on competitors. During what was called the "great burger war" in 1982 and 1983, Burger King demeaned the tastiness of McDonald's and Wendy's "fried" hamburgers as compared to Burger King's "flame-broiled" ones. While negative comparison is usually considered to be a losing tactic in advertising, Burger King's market share increased significantly. Perhaps this can be explained. Although there may be some negative reaction to efforts to discredit competitors, it is usually the customer's price-quality perceptions of the various products which determine whose product that customer will buy. Consequently, if a company has only one or two major competitors, as does Burger King, any negative effect may be outweighed by a change in the customer's estimation of relative quality. In addition, the media publicity surrounding the great burger war is estimated to have been equivalent to \$20 million in free advertising for Burger King.

Growth through Market Area Expansion

Another approach to growth is through market area expansion. When the Adolph Coors Company decided to grow rapidly during the 1970s, it immediately began to expand outside its traditional eleven state area. Although market shares in the added states never matched those in states bordering Colorado, Coors' home base, sales did increase sharply. Because of high earnings and a very strong balance sheet, Coors was able to finance most of the growth internally, although a public stock offering was made at one point. The company's brewery at Golden, Colorado, was expanded to allow the additional production required. For a time another large brewery was planned for the Shenandoah Valley of Virginia.

Market area expansion is a very common approach to growth. Insurance companies open sales offices in additional states, chain stores open new stores in other areas, and so forth. When markets start to become saturated and growth levels off in the U.S. market, domestic companies often expand to foreign countries. Holiday Inns, McDonald's, IBM, Xerox, and Otis Elevator have offices all over the world. All these companies were dominant in relatively saturated U.S. markets before they expanded internationally.

Growth through Market Intensification

Market intensification is another approach to growth. When a good salesperson is given a new territory, the first calls are made on the larger and more profitable customers. As time goes on, smaller and smaller customers are selected until a point of diminishing returns is reached. The same is true of businesses. Many local companies never branch out beyond the city limits of their home cities. Yet, they open additional stores, employ additional salespersons, or engage in advertising through different media and at different times in order to reach additional customers. Major franchisers have standards for traffic flow which must be met before they will allow a new sales outlet at a certain location. As time goes on and markets become more saturated, standards are lowered. For example, for many years Pamida Stores opened new stores only in towns with populations of 7000 to 10,000 in Pamida's selected market area, the upper midwest. Although Pamida stayed in the same territory, it was possible to continue a relatively rapid rate of growth by changing the acceptable population size to 4000 to 12,000. The same pattern has been followed by Sears, K-Mart, Wendy's, and a host of other companies.

In summary, once a company has chosen to pursue relatively rapid growth, there are a number of strategies which can be followed. Some of them are designed to achieve the growth. These include investment in fixed assets, improved product quality, promotional efforts, market area

expansion, market intensification, and so forth. Others are designed to increase profitability while growth is occurring, thereby facilitating the growth. These include cost reduction, quality improvement, vertical integration, and cost of capital reduction. If the aim of business-level strategies is to serve the interests of stockholders, sales growth should be viewed as a way of capitalizing upon the company's distinctive competences. This way, growth will not result in a reduction in the company's future earnings prospects and a concomitant reduction in share price, the only valid measure of the 'wealth of the common shareholder' as it relates to a particular company.

Strategies for Stabilization

The strategies in this section could be precisely the same as those discussed under strategies for growth. As unusual as it may be, it is conceivable that a company would choose zero sales growth along with high prices and high profits instead of a more rapid rate of sales growth obtained through price competition and consequently low profitability. In fact, a well-administered company will recognize the trade-off between growth and profitability. Since market share is sticky downward, gaining a market share at the expense of current profitability may be justified by the prospect of the future profitability the added market share brings. But, if a company believes it will be unable to capitalize on the added market share, it might be better to stabilize sales and increase profits today. From these comments, it can be seen that a leveling off of sales may be-and should be-a conscious policy. Organizational strategists always have a rather wide range within which they can control sales, or any other single parameter. If the company is profitable but has chosen not to expand, the profits can be used either in the payment of dividends or for the retirement of securities, either debt or equity.

Recall that the decision as to whether to grow should be based on the special competences an SBU has relative to its competitors or relative to other SBUs in the corporate portfolio. If the company does not have any special distinctive competences, an obvious objective should be to try to attain such competences. In this connection, all the strategies discussed above for improving profitability, product attractiveness, and so forth, are available. A company can be better than its competitors (i.e., have distinctive competences) in R&D, marketing, production, possession of patent or other rights, ability to influence the government, management expertise, and/or work-force qualifications and motivation. In short, anything which helps a company win out over competitors is a distinctive competence. In addition to trying to build strengths and eliminate weaknesses, SBUs can select from among certain strategies which are especially applicable to periods of stabilization. Two of these are efficiency improvement and risk management.

Efficiency Improvement as a Stabilization Strategy

A particularly useful strategic focus during periods of stable sales is efficiency improvement. Labor costs can often be cut through various motivational strategies. Donnelly Mirrors, Inc., of Holland, Michigan, has a Scanlon-type group incentive plan which has allowed it to remain profitable when its major customers, the major auto companies, suffered declines. Lincoln Electric Company, of Cleveland, Ohio, has an incentive plan which offers individual piece rates along with large year-end bonuses based upon group and individual performance. Many companies motivate employees through participative approaches such as quality circles, suggestion boxes, open-door policies, and so forth. Periods of level sales offer good opportunities to look into and initiate such plans.

Efficiency improvement can also be obtained through fixed-asset management and reduction. If sales are not increasing, any improvement in fixed-asset efficiency can allow the elimination of some of these assets. For example, Cabot Corporation, a major producer of corrosion-

resistant pipe, located in Kokomo, Indiana, made major improvements in its plant in Arcadia, Louisiana, during a recent recession. Machines were rearranged, and the work flow redesigned to shorten and speed up the production process. Some machines and materials-handling devices were completely eliminated. Unit product costs have declined significantly. Now that the company has a significant advantage over its competitors, a distinctive competence, it might choose to pursue a growth strategy. On the other hand, Cabot may decide to raise prices during periods of economic resurgence, thereby reaping current profits rather than a growth in sales. It is not intended here to dwell much on the details of process improvement, but merely to suggest that a period of planned sales stability offers a good opportunity for improving efficiency.

Risk Management as a Stabilization Strategy

In addition to efforts to improve current and future profitability through more efficient use of people and machines and efforts to develop distinctive competences through product development, quality improvement, and so forth, the SBU strategists must also consider the riskiness of the company's situation. If stock values are in fact determined in risk-return space, as modern portfolio theory suggests, it is as useful to reduce risk as it is to increase return. During periods of stabilized sales, the strategists have a good opportunity to earn high returns and, since investment needs are diminished, to distribute those returns to stockholders in the form of dividends or repurchase of company stock. But, the strategists can also reduce the riskiness of the company by debt reduction, making long-term supply and marketing contracts, negotiating favorable labor agreements, and establishing solid customer relationships.

In summary, strategies for periods of stable sales do not necessarily differ from those applicable during growth periods. The level of sales growth, within a very broad range, should be the result of conscious strategic decisions made by organizational strategists. However, once a company has chosen a stable sales policy, a good opportunity presents itself to focus inward on process improvement, efficiency measures, and so forth. Finally, stockholders are assumed to prefer decreased risk, given a rate of return on their investment. Consequently, organizational strategists might as well focus on risk reduction as upon profit improvement measures during periods of stable sales.

Strategies for Retrenchment

A dictionary definition of *retrenchment* is "reduction, curtailment, excision, cutting down of expenses," or in the military sense, "a defense work . . . constructed within another to prolong the defense when the enemy has gained the outer work" (*Webster's Third New International Dictionary*). The term is used by organizational strategists in both senses. *Retrenchment* means *cutting back-reducing sales or production capacity*.

The second dictionary definition above illustrates the attitude most strategists take toward retrenchment. It is a strategy to be followed only after competitors have "gained the outer work" and defeat is imminent. This suggests that retrenchment is to be pursued as a strategy only when the company has been outdone by its competitors or is threatened by market force. It is true that few companies intentionally cut back on sales. Thus, retrenchment is often viewed as a reactive strategy rather than *proactive*.

The focus here is not upon retrenchment as an objective, but upon strategies which tend to be successful in meeting organizational goals during periods of retrenchment. It is doubtful that retrenchment per se is often adopted as a goal. But, the goals of profitability, risk reduction, enhancement of future earnings capability, and so forth, are as relevant during periods of retrenchment as at any other time.

Retrenching Profitably There are several ways that a company can retrench effectively. First, it is possible to cut back on sales by simply increasing the price. This does not mean that the company has "given up." Sharpco Fabricators, Inc., a manufacturer of land-clearing equipment and heavy equipment repair facility in Monroe, Louisiana, recently retrenched by raising prices. The company had been doing well. Sales and profits had increased every year since the company was founded in 1972. But, the owner/manager, James Sharplin, was becoming more and more burdened by the growing number of customers who had to be serviced, the increasing employee force, and the requirement to continually expand production facilities. Sharpco's primary strength was its good reputation for quality. This resulted, Sharplin felt, from the personal attention he gave every job and every customer. He had no intention of expanding his operation beyond a size which he could personally supervise. With sales at about \$1.3 million per year, Sharplin decided to increase prices by an average of 15 percent. This was accomplished by increasing the hourly rates for repair work, the bid prices for contract jobs, and the list prices for land-clearing equipment. Sales declined significantly, profits increased, and Sharpco was able to sustain its excellent reputation for quality.

Even though the recession which began in 1979 intensified in 1982, causing a further reduction in sales, Sharpco still earned record profits that year. Sharplin feels that the retrenchment has been a good strategy. In addition to the improved profit picture, he now has more free time and is able to do a better job of supervision. An additional benefit accrued from the retrenchment: Sharpeo's land-clearing equipment sales had recently declined because most of the timberland in northern Louisiana had been cleared and Sharpco's customers were trying to sell their land-clearing equipment, not buy more. Because of the decreased demands of the business, Sharplin was able to spend time improving the repair and parts segment of his business to replace the disappearing sales in the land-clearing equipment area. This suggests that rapid retrenchment might often be a good strategy for business segments which are declining. Then attention can be paid to developing replacement products and markets.

Turnaround

Retrenchment is often considered a kind of turnaround strategy. If sales and/or profits have declined because of market forces or internal weaknesses, the organizational strategists may decide upon one of three approaches: (1) increase sales with the expectation of improving profits at some time in the future, (2) increase sales and profits, or (3) increase profits while allowing sales and productive capacity to decline.

If the first approach is taken, sales might be obtained through aggressive price competition, additional marketing expenditures, and so forth. This is particularly useful for companies that have high fixed costs. For such companies, when sales exceed the breakeven point, profits increase rapidly with additional increases. Expending promotional funds or forgoing revenues through price breaks can be viewed as an investment for building company sales to a profitable level over time. This can certainly be overdone, though.

If sales and profits are to be increased together, it is often best to take a dual approach, paying attention to marketing *and* production. Marketing expenditures might be increased and efforts made to spend marketing funds more efficiently. At the same time, unless sales increase rapidly, it may be necessary to decrease production costs. This can be accomplished through more efficient use of capital and/or labor. This kind of dual focus is probably the most common kind of turnaround strategy, except for extreme cases. When Edward Finkelstein took over as CEO of Macy's, Inc. (parent corporation of Bamberger's department stores, Davison's department stores, and four regional divisions of Macy's stores) in 1980, the company's financial performance had been decidedly mediocre. By boosting sales per square foot and cutting costs, Finkelstein made Macy's one of the most profitable chains in its industry (Chakravarty, 1983).

An extensive study by Hambrick and Schecter (1983) showed that business units, successful turnarounds were related to efficiency improvements and market share increases.

Reducing sales and production capacity intentionally is usually reserved for extreme cases. In these situations, turnaround may be accomplished by lopping off poorly performing segments of the business, disposing of related assets, and enhancing the best performing parts of the business. Often a turnaround specialist is employed for such purposes. Sanford Sigoloff was brought into Wickes Corporation to do this. And J. B. Freeman was hired by AM International Corporation. When Manville Corporation decided in 1982 to concentrate upon its forest products SBU, Albert Dunlop was hired to turn that business around. In the classic style of turnaround specialists, Dunlop released hundreds of employees, sold assets, established a new organizational structure, and attempted to increase the profitability of his division. A similar sequence of events occurred at International Harvester under Donald D. Lennox, at Chrysler Corporation under Lee Iacocca, and at Kentucky Fried Chicken under Richard P. Mayer.

Liquidation

The most extreme retrenchment strategy is outright liquidation, either under the provisions of the U.S. Bankruptcy Code or without filing for bankruptcy. In a sense, publicly traded companies are being liquidated continuously through the sale of their stock by the public. When we think of liquidation, however, we normally mean the sale of the company's assets. Since few companies liquidate without being insolvent, proceeds from such sales normally do not cover all creditor claims. Stockholders, common and preferred, usually receive nothing. The assets of the company are simply auctioned off and the proceeds allocated among creditors and other claimants as prescribed by the code.

Liquidation does not have to be the result of bankruptcy. It may logically be chosen as a strategy if corporate strategists believe that the stock market undervalues the company stock. If it is the company's earning power which is undervalued, seeking to be acquired is a reasonable approach. In this way, the whole company is sold as a unit. Sometimes the stockholders receive cash for their shares. At other times they receive a combination of cash and debt or equity securities-or just securities. When Manville Corporation bought Olinkraft in 1978, some Olinkraft stockholders received cash. Others received one Manville Corporation preferred share in exchange for each Olinkraft common share held. Stockholders who received preferred shares were free to sell them on the open market for cash.

If it is the company's assets which are undervalued and not the unique synergy among those assets represented by the company's earning power, it might be desirable to liquidate, sell off the assets, pay the liabilities, and distribute the remainder of the proceeds to the stockholders. This is very rarely done. One reason for this is that the amounts invested in fixed assets (actually a "sunk cost" and, therefore, irrelevant to current decisions) tends to become an "exit barrier" in the minds of organizational strategists.

Retrenchment to Fund Other

SBUs Short of liquidation, many SBUs find it necessary to retrench significantly because corporate-level strategists desire disinvestment in one SBU in order to invest in others. As previously suggested, it may even be best for some single-SBU companies to retrench slowly, allowing equipment and facilities to run down and sales to fall off, but earning high profits in the process. Companies which do this can pay high dividends. This would be particularly appropriate for a business with competence only in a certain market segment which happens to be declining

without a significant chance of revitalization. Just as a company can increase its market share by price competition, perhaps at the expense of current profitability, the opposite is also possible. If the company has a high market share, it can earn profits by increasing prices, even though that may cause the market share to erode. A company which correctly anticipates the demise of an industry before its competitors do can slowly price itself out of the business, leaving its competitors to participate in the death throes of the industry. *Plans for competing in dying industries* are called *endgame strategies*.

In summary, strategic management decisions are always constrained to some extent. Within whatever constraints there are, organizational strategists should be *proactive*, that is, they should decide what specific strategies should be followed and to what extent growth or retrenchment should take place. Retrenchment is seldom a strategic goal in itself. The question is not how a company retrenches but how a company accomplishes its organizational purposes while retrenching or through retrenchment.

THE PRODUCT LIFE CYCLE AND STRATEGY

Perhaps no variable has been so clearly related to appropriate strategies as product life cycle. A great body of research suggests that strategies which are appropriate for products experiencing a rapidly growing demand are inappropriate for those for which demand is declining. This idea is intuitively appealing as well. It seems reasonable that successful companies in, say, the (growing) home computer industry would have different strategic foci than those in the (declining) mechanical calculator industry. There is some disagreement about exactly which strategies are best during the various stages of industry or product life cycle. But, the concept has enough proven validity to warrant consideration.

What is Product, Service, or Industry Life Cycle?

Product, service, or industry life cycle is the process of introduction, growth, maturity, decline, and extinction through which every product or service and every industry must go. There is no doubt that any product or service which attains any degree of market penetration has to begin at some point in time; that is, it must be introduced. After introduction, the product must go through a period of market development during which sales are promoted and new uses may be found for the product. After the development phase, a period of growth normally occurs during which product sales increase at an increasing rate. At some point, however, sales have to level off, resulting in what is called the maturity phase. Since no product can be expected to have the same relative level of usefulness forever, a decline phase must follow. That the product life cycle exists is a truism. Its application to strategic management is a subject of research and conjecture.

SBU Strategies for Different Life-Cycle Stages

As indicated in the previous main section of this chapter, there is no necessary relationship between industry growth and the growth pattern chosen by a particular competitor. However, as demand for a particular product accelerates, levels off, and then declines, organizational strategists must respond. As suggested before, better than even responding is anticipating and developing strategies for the stages of the product life cycle.

Changing the Life-Cycle Curve

Sometimes, it is even possible to change the shape of the life-cycle curve. This was done with Arm & Hammer baking soda, which had undergone a long stable maturity stage and was

declining in the 1970s. Through an extensive promotional effort in the early 1980s, the company convinced homemakers of the multiple uses of the product and a new growth phase occurred. As the only significant producer in the baking soda market, Arm & Hammer benefited greatly from the increased sales.

Collectivist Strategies

Few companies can determine the shape of the product life-cycle curve by themselves. Through collectivist strategies, though, whole industries often attempt to promote the industry's product. When cotton was threatened with replacement by rayon and other synthetic fabrics, the U.S. Cotton Council, with \$1 a bale revenues from cotton producers, developed various kinds of promotional efforts for cotton. The coolness and naturalness of cotton fiber was promoted, and as a result, a number of fashion garment manufacturers began to use more cotton in their products. Similar efforts were made by the Ronda Orange Growers Association and many other trade groups. So, when organizational strategists anticipate a product life-cycle development with which they are not especially prepared to compete, they can collectively try to forestall that development. This is especially true of companies which have huge capital investments in declining product areas.

Bucking the Industry Life Cycle

Assuming that the total demand for a certain product or service is essentially beyond the control of an individual SBU, there are a number of other obvious relationships between the appropriate strategy and the life-cycle stage involved. However, the likelihood is that the truly successful SBU will not be experiencing the same growth pattern as the industry. If a particular competitor has an exceptional distinctive competence, especially one which can be expected to last (e.g., IBM and the Selectric typewriter, Xerox and the dry process copier, both patented), growth beyond the industry rate of growth can be anticipated. If the company has little distinctive competence but a large market share, a more desirable strategy might be to pursue relatively slower growth than more competent competitors would (Harrigan, 1980). As previously described, this would allow the company to reap profits as its market share declines.

The life Cycle and Overcapacity

Companies in declining industries with heavy fixed investments must be prepared for a potential overcapacity condition. This is likely to result in extensive price competition. This occurred in the U.S. auto industry as foreign competitors took a large proportion of what was at the time a declining market. As a result, U.S. auto makers laid off hundreds of thousands of workers and shut down many plants, leaving billions of dollars in machinery and equipment idle.

It is possible to have overcapacity in a rapidly growing industry, like the home computer industry in 1983. Anticipating the rapid growth of that business, dozens of competitors worldwide developed production and marketing capabilities. When Texas Instruments reported a \$100 million loss for the second quarter of 1983, industry analysts laid it to overcapacity in the home computer field. (Texas Instruments later dropped out of the home computer business.) Home computer sales had been growing at more than a 100 percent annual rate, with growth in the same range anticipated for a number of years. Because of this overcapacity, and the anticipation of future profit opportunities, price competition in home computers was rampant. Obviously the home computer industry is not a mature industry. A sort of "dynamic maturity" had set in, resulting in both overcapacity and price competition. Just as competitors in mature industries must innovate, differentiate their products, and concentrate on market segmentation, so must home computer manufacturers which expect to succeed.

The problem of overcapacity may be even more severe when it occurs in growing industries. Competitors in mature or declining industries tend to expect overcapacity and take it into account in their planning (Harrigan, 1982, pp. 707-708, 729-730). The effects of dynamic maturity in the home computer industry seem to have taken competitors by surprise. For several days after Texas Instruments first reported its expected loss on home computers, all the major computer stocks declined significantly. Texas Instruments alone losing more than \$1 billion in market value.

Responding to Corporate-Level Needs

At the corporate level of strategy many strategists believe that a balanced portfolio of companies confronting various stages of the product or service life cycle is appropriate. Accordingly, a given SBU may be assigned an overall strategic approach to life-cycle related strategy by corporate strategists. If this is done, as the BCG analysis in Chapter 3 suggests, SBUs in mature or declining industries will tend to be used as Cash Cows to fund growth for SBUs in rapidly growing industries. So life-cycle strategy may not be a business-level strategic decision. To some degree, SBU managers must conform to the needs of the corporation's portfolio of companies and the corporate-level strategists' preferences.

Porter's Generic Strategies

If the primary determinant of a firm's profitability is the attractiveness of the industry in which it operates, an important secondary determinant is its position within that industry. Even though an industry may have below-average profitability, a firm that is optimally positioned can generate superior returns.

A firm positions itself by leveraging its strengths. Michael Porter has argued that a firm's strengths ultimately fall into one of two headings: cost advantage and differentiation. By applying these strengths in either a broad or narrow scope, three generic strategies result: *cost leadership*, *differentiation*, and *focus*. These strategies are applied at the business unit level. They are called generic strategies because they are not firm or industry dependent. The following table illustrates Porter's generic strategies:

Porter's Generic Strategies

Target Scope	Advantage	
	Low Cost	Product Uniqueness
Broad (Industry Wide)	Cost Leadership Strategy	Differentiation Strategy
Narrow (Market Segment)	Focus Strategy (low cost)	Focus Strategy (differentiation)

Cost Leadership Strategy

This generic strategy calls for being the low cost producer in an industry for a given level of quality. The firm sells its products either at average industry prices to earn a profit higher than that of rivals, or below the average industry prices to gain market share. In the event of a price war, the firm can maintain some profitability while the competition suffers losses. Even without a price war, as the industry matures and prices decline, the firms that can produce more cheaply will remain profitable for a longer period of time. The cost leadership strategy usually targets a broad market.

Some of the ways that firms acquire cost advantages are by improving process efficiencies, gaining unique access to a large source of lower cost materials, making optimal outsourcing and vertical integration decisions, or avoiding some costs altogether. If competing firms are unable to lower their costs by a similar amount, the firm may be able to sustain a competitive advantage based on cost leadership.

Firms that succeed in cost leadership often have the following internal strengths:

- Access to the capital required to make a significant investment in production assets; this investment represents a barrier to entry that many firms may not overcome.
- Skill in designing products for efficient manufacturing, for example, having a small component count to shorten the assembly process.
- High level of expertise in manufacturing process engineering.
- Efficient distribution channels.

Each generic strategy has its risks, including the low-cost strategy. For example, other firms may be able to lower their costs as well. As technology improves, the competition may be able to leapfrog the production capabilities, thus eliminating the competitive advantage. Additionally, several firms following a focus strategy and targeting various narrow markets may be able to achieve an even lower cost within their segments and as a group gain significant market share.

Differentiation Strategy

A differentiation strategy calls for the development of a product or service that offers unique attributes that are valued by customers and that customers perceive to be better than or different from the products of the competition. The value added by the uniqueness of the product may allow the firm to charge a premium price for it. The firm hopes that the higher price will more than cover the extra costs incurred in offering the unique product. Because of the product's unique attributes, if suppliers increase their prices the firm may be able to pass along the costs to its customers who cannot find substitute products easily.

Firms that succeed in a differentiation strategy often have the following internal strengths:

- Access to leading scientific research.
- Highly skilled and creative product development team.
- Strong sales team with the ability to successfully communicate the perceived strengths of the product.
- Corporate reputation for quality and innovation.

The risks associated with a differentiation strategy include imitation by competitors and changes in customer tastes. Additionally, various firms pursuing focus strategies may be able to achieve even greater differentiation in their market segments.

Focus Strategy

The focus strategy concentrates on a narrow segment and within that segment attempts to achieve either a cost advantage or differentiation. The premise is that the needs of the group can be better serviced by focusing entirely on it. A firm using a focus strategy often enjoys a high degree of customer loyalty, and this entrenched loyalty discourages other firms from competing directly.

Because of their narrow market focus, firms pursuing a focus strategy have lower volumes and therefore less bargaining power with their suppliers. However, firms pursuing a differentiation-focused strategy may be able to pass higher costs on to customers since close substitute products do not exist.

Firms that succeed in a focus strategy are able to tailor a broad range of product development strengths to a relatively narrow market segment that they know very well.

Some risks of focus strategies include imitation and changes in the target segments. Furthermore, it may be fairly easy for a broad-market cost leader to adapt its product in order to compete directly. Finally, other focusers may be able to carve out sub-segments that they can serve even better.

A Combination of Generic Strategies - Stuck in the Middle?

These generic strategies are not necessarily compatible with one another. If a firm attempts to achieve an advantage on all fronts, in this attempt it may achieve no advantage at all. For example, if a firm differentiates itself by supplying very high quality products, it risks undermining that quality if it seeks to become a cost leader. Even if the quality did not suffer, the firm would risk projecting a confusing image. For this reason, Michael Porter argued that to be successful over the long-term, a firm must select only one of these three generic strategies. Otherwise, with more than one single generic strategy the firm will be "stuck in the middle" and will not achieve a competitive advantage.

Porter argued that firms that are able to succeed at multiple strategies often do so by creating separate business units for each strategy. By separating the strategies into different units having different policies and even different cultures, a corporation is less likely to become "stuck in the middle."

However, there exists a viewpoint that a single generic strategy is not always best because within the same product customers often seek multi-dimensional satisfactions such as a combination of quality, style, convenience, and price. There have been cases in which high quality producers faithfully followed a single strategy and then suffered greatly when another firm entered the market with a lower-quality product that better met the overall needs of the customers.

Generic Strategies and Industry Forces

These generic strategies each have attributes that can serve to defend against competitive forces. The following table compares some characteristics of the generic strategies in the context of the Porter's five forces.

Generic Strategies and Industry Forces

	Generic Strategies		
	Cost Leadership	Differentiation	Focus
Entry Barriers	Ability to cut price in retaliation deters potential entrants.	Customer loyalty can discourage potential entrants.	Focusing develops core competencies that can act as an entry barrier.
Buyer Power	Ability to offer lower price to powerful buyers.	Large buyers have less power to negotiate because of few close alternatives.	Large buyers have less power to negotiate because of few alternatives.
Supplier Power	Better insulated from powerful suppliers.	Better able to pass on supplier price increases to customers.	Suppliers have power because of low volumes, but a differentiation-focused firm is better able to pass on supplier price increases.
Threat of Substitutes	Can use low price to defend against substitutes.	Customer's become attached to differentiating attributes, reducing threat of substitutes.	Specialized products & core competency protect against substitutes.
Rivalry	Better able to compete on price.	Brand loyalty to keep customers from rivals.	Rivals cannot meet differentiation-focused customer needs.

FUNCTIONAL STRATEGIES

The third level of strategy is the functional strategy. In essence, a business strategy is built on a set of functional strategies, representing the competitive weapons that a company employs to compete in a given industry. The way to identify a business strategy is simply to first go through each of the functional areas and identify what pattern of decisions have been made in each, as follows:

Marketing Strategy. What products or services are being sold by the corporations, to whom are these being sold, and where (in what geographic areas) are they being sold? How does the company's price compare with that of the rest of the industry? Is the company a price leader, or does it tend to match the prices set by others? What are the company's promotion

and distribution strategies? Each of these questions should be pursued in detail. For example, a company may have a marketing strategy of selling any set of problem-solving skills to any client, at any time, at any place. Its pricing strategy was to charge out their consultants' time at a multiple of four times the individual's hourly salary rate. In contrast with this company, most strategy consulting firms price their services at a multiple closer to five times the consultant's hourly salary rate. Therefore, the company would be considered a standard-rate pricer, whereas some of the specialized strategy consultants would be considered premium-rate consulting firms. Whether it is beneficial for a firm to be premium-priced is not an issue under consideration yet. What is important is that, in order to evaluate the quality of one's strategy, it is first necessary to recognize what, precisely, the strategy is and how it compares with the strategies of other firms in similar circumstances.

Operations Strategy. Here, management should consider the question of how it transforms inputs into outputs for the marketplace. For example, what kinds of facilities does the company use? Are they concentrated in one location, or are they dispersed over a broader area? What is the company's capacity strategy—does it build capacity in anticipation of demand, or does it wait until there is a backlog of orders before adding capacity?

Is the firm's product or service made to order, or are inventories expanded to serve demand as it occurs? What is the company's strategy with respect to vertical integration? Does it source most materials in-house by integrating backward, or does it subcontract much of its production? For example, prior to its introduction of the SX-70 instant camera, the Polaroid Corporation managed with a low investment in plant and equipment by subcontracting most of its component manufacturing. In contrast, the Kodak Company was fully integrated; at one point it even owned a stockyard to provide the raw materials for some of its chemicals. What Kodak gained in bringing operating margins in-house, Polaroid gained in flexibility and the ability to change products quickly.

Financial Strategy. Although many firms are fairly explicit about the marketing and production strategies that they follow, some of these same firms are vague when it comes to articulating their financial strategies. Usually, this is because a firm just starting its operations pays attention to cash flow and meeting the payroll, but fails to pay close attention to its balance sheet. The identification of the financial strategy can help to assess how the firm is managing its financial resources.

Here, the company should identify its capital structure, how it uses its cash flow (does it pay dividends?), its strategy toward investment in plant and equipment (owning versus leasing), and how it attempts to enhance its stock price.

Research-and-Development Strategy. Firms vary considerably in the extent to which they include research and development as a salient component of their business strategies. For example, the average percentage of sales spent on research is approximately 10 percent in high-technology companies, whereas it might be as low as 0.6 percent in such basic industries as steel and cement. Nevertheless, each of these companies does have a strategy with respect to its activities that might generate new products or a new means of manufacturing its products.

The company should determine whether its research focus is primarily basic or applied. For example, the Polaroid Company was dedicated to the "perfection of photography," which implied a heavy allocation of its research budget to basic research in optics. In contrast, a company such as Crown Cork and Seal, which manufactures steel and aluminum cans, engaged only in a limited amount of applied research and was positioned as a "fast second" in implementing new developments. Crown Cork and Seal's management has felt that, as one of the smaller firms in

the industry (in 1978 it was number four in sales and held 8.3 percent market share), it could leave the technological innovation to others.

Human Resources Strategy. The types of people hired to operate a company is not only a reflection of the other functional strategies (for example, all manufacturing done in-house implies more production and maintenance people on the payroll), but they also determine what kinds of future strategies can be pursued. Why? Because the human assets represent the capability set of the firm.

The relevant questions for human resources strategy are: How do we hire, train, evaluate, compensate, and promote (or discharge) people? For example, Procter & Gamble's famed brand management system—a competitive advantage—is fueled by a stringent recruiting procedure followed by rigorous training, evaluation, and promotion in a way that standardizes (some say, homogenizes) a high-performance cadre of marketing executives. Other questions include: How do human resource procedures differ for executives and for rank and file employees? How does the firm socialize new members? How does the firm communicate its strategy to employees?

STRATEGY EVALUATION

INTRODUCTION

After several likely strategy choices have been formulated, they can be evaluated by following the approaches described in the first part of this chapter. Five schemes are presented for identifying the most likely strategies from among a set of possible choices.

Confronted with several likely strategies, managers must next select the one(s) they believe optimal. The definition of what is optimal varies from decision maker to decision maker and even for particular decision makers (as they vary the decision approach or model they follow to make the selection). In the second part of this chapter, several strategy selection approaches are explained. Our purpose in doing so is to make students more aware of the decision processes that are followed.

The chapter closes with a description of the criteria the selected strategies should meet. This set of factors would apply regardless of the strategy selection approach followed.

SYSTEMS FOR STRATEGY COMPARISON

Although there are doubtlessly many rule-of-thumb approaches used by managers to compare strategy choices, probably the most often discussed techniques over recent years are growth-share matrix, General Electric's stoplight grid, life cycle theory and the related product/market evolution portfolio matrix, gap analysis, and directional policy matrix.

Some of these models, especially those that attempt to portray the complex strategy comparison or selection decisions as a simple matrix model, have received increasing criticism. Most notably, a 1984 Business Week article entitled "The New Breed of Corporate Planner" referred to their use as "formula planning." This brand implied that they are superficial shortcuts to management decision making. Pioneered in the 1960s by the Boston Consulting Group (BCG), they gained a wide following when stability of market structures and growth trends prevailed. Now, however, they seem to be oversimplifications for several reasons.

First, they caused an overemphasis on market share growth. Strategic planning degenerated into portfolio management problems instead of trying to figure out how to run successful businesses. High-growth businesses are not necessarily high-profit businesses and many managements found themselves overburdened with imbalanced portfolios of SBUs.

Second, a competitor who knows you are using a certain formula can anticipate your strategic moves accurately. Dependence on formulas may even dull management's thinking about its competitive position and moves.

Finally, use of matrices and formulas can cause managers to circumvent much of the environmental, internal, and industry analysis necessary for formulating and effectively implementing strategy. It is too easy to draw incorrect conclusions from incomplete or faulty data with some of these models.

The relationships addressed in the models that follow are important parts, but only parts, of understanding strategy formulation. However, they by no means should be used to replace or shortcut gaining a thorough understanding of where a firm is today or where it should be in the future.

The models are also excellent expository structures. That is, they are handy for explaining a point about portfolio issues or about strategy elements simply because they are oversimplifications. Their strength is in reducing complex variables to easy-to-understand dimensions and portraying them in readily interpretable terms.

I. Growth-Share Matrix (GSM)

The Boston Consulting Group developed the growth-share matrix to analyze the problem of resource deployment among the business units or products of multibusiness firms. The business units or products are analyzed by placing each one in the matrix shown in Chapter 5 according to their (1) expected growth rate (vertical axis), measured by anticipated growth rate in sales, and (2) relative market share (horizontal axis), measured as the unit's share divided by that of its largest competitor. Thus businesses or products in quadrant I with low expected growth rates and low relative market standing are labeled "dogs" or "cash traps." They should be managed to minimize cash flow by retrenchment, divestiture, or even liquidation. These units or products are likely to be characterized by high costs, low quality, less effective marketing procedures, and so on, which would collectively contribute to weak competitive position and low potential for profits.

Those in quadrant II, with high projected growth rates and low market standing, are interpretive problems. The reason is that although they are operating in markets with expected growth potential, they currently are experiencing competitive disadvantage. Management can invest cash to correct the market weakness so as to take advantage of expected market growth or, if not convinced of their ability to improve market share, it can retrench, divest, or liquidate to minimize the cash drain.

Products or business units in quadrant III, the "stars," have both high market standing and high industry growth potential. They should receive heavy cash investment in order to maintain their market share. Successful resource deployment beyond cash requirements could lead to a superior market share when industry growth potential falls off. Such a product or business would then become a cash generator or "cash cow," as depicted by location in quadrant IV.

Cash cows have a strong market position in industries that have matured. These products or businesses can thus be "milked" by investing just enough cash to maintain market standing and applying excess cash inflows to the firm's other activities that are growth industries or products.³

In addition to the above implications of the GSM for cash management, the matrix also suggests how competitors might be expected to behave in each quadrant. To illustrate, a star performer (market leader with high market share in a rapidly growing industry) usually can expect a serious threat only from cash-rich competitors. Only they can afford to embark upon an expensive program to challenge the probable market leader's cost supremacy and market differentiation.

In comparison with the position of the star performers, cash cows can expect little serious competition because of their relatively low expected industry growth rates. Competitors would likely be reluctant to mount a major offensive in the absence of significant industry potential.

Thus a cash cow can enjoy a relatively secure market position, but only as long as sufficient investment in maintaining market share continues.

Quadrant II firms, "question marks," are highly vulnerable by virtue of their low share in high potential growth rate industries. They can expect diverse competitive challenges. Indeed, as small fish in a big sea, question marks can look forward to heavy cash needs to establish themselves as major competitive forces (stars).

Business units that fall in quadrant I are probably only marginally profitable and can anticipate little improvement in present markets. They have two major competitive options: (1) get out of the market by the means suggested or (2) develop a major innovation to redefine the market and their participation in it.

Although the growth-share matrix analysis can help in making strategic decisions about managing a portfolio of businesses or products, it has some **shortcomings**. First, not all businesses or products fit neatly into one of the four quadrants. Many businesses occupy middle positions between high and low market share and industry growth rate.

Second, other factors besides market share and industry growth rate affect strategy selection. These factors include "stage of product/market evolution, strategic fit among the different businesses, the presence of competitive advantages and distinctive competencies, emerging threats and opportunities, vulnerability to recession, market structure, capital requirements, and size of market. The BCG matrix does not give explicit consideration to these factors."

Third, a business's profitability, cash flow, and industry attractiveness may not always be closely related to market share and growth rate. Some firms with low market share outperform their larger counterparts, and not all high-share businesses in low-growth industries generate surplus cash.

Finally, the GSM does not offer guidance for inter-unit comparisons. For example, in a firm with several cash cows, strict adherence to the matrix implies treating each one in the same way when some might be drained of cash ("harvested") and others managed for cash flow. Also, all stars are not necessarily "better" than cash cows.

II. General Electric's Stoplight Grid

General Electric's stoplight grid is a nine-element matrix used by GE to relate (1) its SBUs' environmental opportunities and other factors determining industry attractiveness to (2) various measures of the SBUs' relative business strengths. A business unit is located in the matrix (*Refer Chapter 5*) by first determining whether its relative business strengths are high, medium, or low (vertical axis) through assessment of such factors as sales growth rate, market share, market image, and management capabilities. Its high, medium, or low ranking on the horizontal axis (industry attractiveness) is a function of the size and potential of its market; technological status, financial health, competitive structure, and social and political characteristics of its industry; and economic circumstances. Rankings on both axes for each of GE's forty-three businesses are decided upon during planning review discussions and determine which of the nine cells in the grid it occupies. Business units with high or medium industry attractiveness in which GE has either medium or high strengths call for an "invest and grow" decision--a green-light strategy, as shown in the upper left-hand cells of the Matrix.

Medium or low industry promise coupled with medium or low strength of a GE business unit operating in that industry would indicate a red-light strategy--minimal additional investment by GE with expected continued earnings generation. The company may resort to retrenchment or limited technological support of red units.

Combinations of industry attractiveness and business strength scores that place a GE business in one of the yellow-light cells could be either a borderline case or composed of both red and green elements.

Hofer and Schendel explain that the major shortcoming of GE's scheme is its ineffectiveness in portraying the circumstances of new businesses whose growth in new industries is just beginning. Commenting on GE's use of the grid, Business Week notes, "After three or four critiques at various levels, the final grids--and decisions--are made by the corporate policy committee--the chairman, three vice-chairmen, five senior vice-presidents, and the vice-president for finance." Thus planning discussions, focused on the variables involved in the grid, may prevent costly mistakes and avoid reliance on gut reactions.

III. Life Cycle Analysis

Life cycle analysis relies on the belief that there are predictable relationships among the stages in product or business unit life cycles on one hand, and certain elements of strategy on the other. (*Refer Chapter 7 for a discussion on Product Life Cycle concept*)

The typical product life cycle curve is analogous to the life cycle of biological organisms with introduction, growth, maturity and decline stages. Note the relationship between unit profit margin and sales revenues at the different stages. During pre-introduction and introduction, the firm is investing heavily to build sales growth through product awareness and refinement, with emphasis on the latter. Thus profit margin is negative until growth begins to occur. If sales growth proceeds at a high enough rate, then unit profit margin will swing positive during the growth phase. Typically the firm's emphasis is shifted from product refinement to building market share, thus increasing the length and slope of the curve during this phase.

As more and more competitors enter the market, however, share is whittled away. Consequently, the product's growth rate begins to level off and the product enters the maturity stage. During growth ever-increasing sales volume can drive unit profit margin higher and higher. As competitive pressures mount, though, profit margin is eaten away. Emphasis shifts to production efficiency as management attempts to maintain profit margin during the maturity phase.

Finally, as sales decline sets in, attention is concentrated on maintaining cash flow. Often a policy is in place that makes product discontinuance a function of the magnitude of net cash flow.

In multiproduct firms attention is focused on the net effect on sales, profit margins, and cash generation of the performance of the firm's stable of products. It can be observed that overall sales performance is a function of the balance of separate products' performance.

Multibusiness firms, that is, conglomerates or holding companies, can be viewed as a collection of multiproduct firms. Of course, the life cycle curves of the separate SBUs would not line up as neatly as they do in a diagram, but rather would be superimposed on each other in a complex network of curves. As noted in Chapter 1, however, corporate-level management is concerned

with balancing the performance of a collection of SBUs. Overall conglomerate sales can be influenced by the addition or deletion of SBUs or by altering the performance of them.

IV. GAP ANALYSIS

In this approach attention is first focused on the gaps between the actual or anticipated values that certain variables take on and the values that are most desirable. Once the gaps are identified, attention shifts to devising ways to close them. Gap analysis has been advocated for strategic choice decisions within the following four primary contexts: Environmental analysis, functional-level policy analysis, business-level strategy analysis, and corporate-level strategy analysis.

Environmental Gap Analysis

For purposes of environmental analysis, gap analysis is a way of focusing on differences between the firm's strategy set and resources and the threats and opportunities that make up its environment.³⁹ More specifically it is used to identify gaps between where a firm would be if it continued with its present strategy and was subjected to expected environmental developments, and where the strategist would like the firm to be in terms of strategic goals. Thus this "planning gap" can be filled by implementing new action plans, or strategic goals can be altered.

Gap Analysis at the Function Level

A popular use for gap analysis is to compare actual and potential market variables for marketing strategy purposes. Webber proposes a form of gap analysis for analyzing the differences between industry market potential and the firm's own sales by product line. This overall gap is made up of four segments as follows:

1. Product-line gap: the portion due to each product in the full product line.
2. Distribution gap: the portion caused by an inadequate distribution system.
3. Usage gap: the part caused by less than full usage.
4. Competitive gap: the segment caused by sales that are lost to direct competitors.

Each type of gap may be closed through its own set of strategic or tactical moves. They correspond to what we have defined as business-level goals and action plans or marketing strategy, depending upon the level of their organization.

Accurately determining the type and magnitude of each kind of gap is the difficult part of market gap analysis. However, this technique focuses attention on defining the various elements of a firm's sales shortfall.

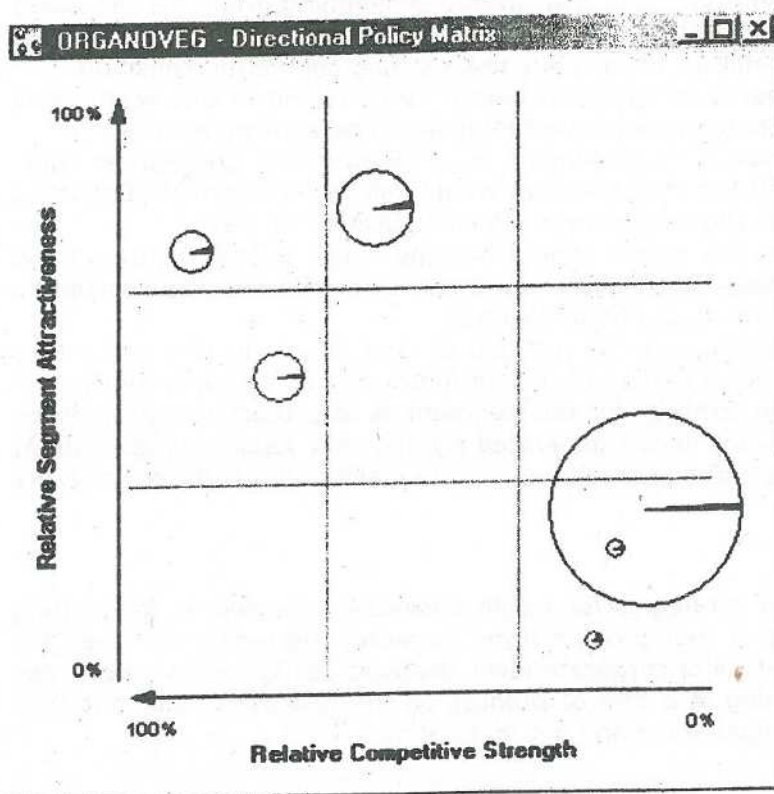
Gap Analysis at the Business Level

There are profound similarities between gap analysis at the business level and gap analysis for environmental audit and functional-level analysis purposes. At the business level, however, the gaps of interest are those related to the performance of the business unit as a whole. The focus is on gaps between actual and planned-for results according to such criteria as various profit measures, cash flow generation, management expertise, company image, and relative product quality. Consequently gap analysis at the business level is very much like analysis of budget variances.

Gap Analysis at the Corporate Level

When applied to the corporate level, gap analysis focuses on the consolidated performance of the portfolio of business units. Differences between desired values of performance variables (gross, operating, or net profit on total assets or equity; growth rate of sales; geographical coverage; and so on) and actual values can trigger portfolio modification decisions (corporate-level strategic decisions).

V. DIRECTIONAL POLICY MATRIX (DPM)



The DPM is a method of business portfolio analysis formulated by Shell International Chemical Company; it is reproduced above. It has nine cells in which businesses are located depending upon their scores on each of the two axes: Expected market profitability and competitive positions. The horizontal axis, labeled "business sector prospects" or "prospects for market sector profitability," is a measure similar to industry attractiveness used in the GE planning grid. A firm is rated on a scale from "unattractive," through "average," to "attractive" depending upon an evaluation of its industry's market growth, market quality, and environmental aspects. Similarly, its location on a scale that runs from a "weak," through "average," to "strong"

competitive position is determined by answering questions about its market share position, production capabilities, and R&D strengths.

The cell labels in the above figure represent possible strategic choices or types of resource deployments most appropriate for the firm, given its score on each of the two axes. More specifically these cell labels have the following implications:

- Disinvest (1,1): Likely already losing money; net cash flow negative over time. Losses may be minimized by divestiture or even liquidation.
- Phased Withdrawal (1,2) and (2,1): Probably not generating sufficient cash to justify continuation; assets can be redeployed.
- Cash Generator (3,1): Equivalent to a "cash cow" in the GE planning grid. This cell would be occupied by a firm or product in later stages of the life cycle that does not warrant heavy investment, but can be "milked" of cash due to its strong competitive position.
- Proceed with Care (2,2): Similar to a "question mark;" firms falling in this sector may require some investment support but heavy investment would be extremely risky.
- Growth (upper - 3,2) and (lower - 2,2): Similar to a GE planning grid "green-light" strategy. A firm, product, or SBU in these sectors would call for investment support to allow growth with the market. It should generate sufficient cash on its own.
- Double or Quit (1,3): Units in this sector should become "high fliers" in the not too distant future. Consequently those in the upper rightmost corner of cell (1,3) should be singled out for full support. Others should be abandoned.
- Try Harder (2,3): External financing may be justified to push a unit in this sector to a leadership position. However, such a move will require judicious application of funds.
- Leader (3,3) (lower - 3,2): The strategy for this segment is to protect this position by external investment (funds beyond those generated by the unit itself - occasionally); earnings should be quite strong and a major focus may be maintaining sufficient capacity to capitalize on strong demand.

The DPM can thus be used to identify strategies for single businesses as well as for plotting combinations of units in multibusiness or multiproduct firms. Locating competitors on the DPM can provide useful insights into the nature of corporate-level strategic configurations. However, there is room for error in the positioning of a firm or product on the two axes, and thus DPM location should be interpreted with an open mind and not in isolation.

Competitive cost dynamics and Experience Curve

T.P. Wright first documented the idea of learning curves and its effect on efficiency in the American aircraft industry in 1936. Wright found that there was a pattern in the way that people learned; he found that per unit production time reduced at an unvarying rate. Researchers took Wright's idea and expounded upon it during World War II, where the emphasis was primarily on cost efficiency.

Since World War II, the term learning curve has been expanded to other business and non-business applications such as management, distribution, team learning, health care, investing, and even exercise. These more general applications of learning curves are more accurately described by the term experience curve or practice curve. A learning curve describes the nonlinear relationship between labor hours per unit and units of output, we assume a single driver units of output for our purposes though more complex formulas exist.

How would a company use learning curves?

The most important question in regards to learning curves is how would a company use learning curves in their business? One practical application of learning curves is in forecasting budgets if companies can accurately estimate the rate of learning they can also estimate product cost. Understanding cost is also paramount to pricing decisions, should the company follow a prestige pricing or price skimming strategy. Determining human resource needs is another application in which learning curves can be used, as companies become more efficient they may eliminate jobs or choose to move them to other functional areas. However as G.J. Steven points out, "It is important to appreciate that the learning curve is not a cost-reduction technique since the rate of future time reduction can be predicted by the learning curve model. Cost reduction only occurs if management action is taken, for example, to increase the rate of time reduction by providing additional training, provision of better tools etc".

Basic Learning Curve Calculations

There are different models for learning curves that have been proposed and used by businesses. None are generally accepted as being superior. For explanatory purposes we will use the Incremental Unit-Time Learning Model. The following mathematical background is borrowed in part from Horngren, Foster, and Datar's Cost Accounting textbook. This model is based on the equation $y = ax^b$ where y = the time to produce the last unit of output, a = the time to produce the first unit of output, X = cumulative number of units produced, and b = the rate of learning. The rate of learning is calculated by taking the natural log of the percentage of learning and dividing by the natural log of 2 ($\ln(\% \text{ of learning}) / \ln 2$). Ultimately what this equation is describing is that the incremental unit time decreases at a constant rate each time the quantity of units produced doubles. The lower your percentage of learning is the faster individual units are produced and thus the faster average time per unit. As a practical matter there is no hard and fast rule for determining the percentage of learning, in Figure 1 a 90% learning curve is assumed.

Figure: 1

Cumulative units	Individual unit time (y): Labor hours	Cumulative total Labor hours	Cumulative average time per unit: Labor hours
1	10	10	10.00
2	9	19	9.50
3	8.46	27.46	9.15
4	8.1	35.56	8.89
5	7.83	43.39	8.68
6	7.62	51.01	8.50
7	7.43	58.44	8.35
8	7.29	65.73	8.22
9	7.16	72.89	8.10
10	7.05	79.94	7.99
11	6.95	86.89	7.90
12	6.85	93.74	7.81
13	6.77	100.51	7.73
14	6.7	107.21	7.66
15	6.63	113.84	7.59
16	6.56	120.4	7.53

Once the percentage of learning is established the numbers can be easily generated using an excel spreadsheet. The individual unit times are based on the equation $y = aX^b$ where a and b will be constant throughout the range of units. Notice how quickly the effects of the learning curve takes place by the time just 16 units are produced the average time per unit has dropped by almost 25%. If the right percentage of learning has been applied a manager could now take this data and produce production schedules, delivery plans, personnel staffing schedules, as well as budget forecasts. The benefits of learning curves were underscored by professor Charles Bailey at the University of Central Florida when he stated, "The potential applications of learning curves far outstrip their current usage".

The learning curve is effected by several outside forces not the least of which is human attributes. As Roark and Briscoe explain, "Just as the areas of standard costing and budgeting have had to incorporate behavioral concepts to increase their effectiveness, so must learning curve applications include behavioral considerations". In other words even the most accurate performance estimates does not insure that our estimates will be accurate. Because we are dealing with human beings planned performance and actual performance can vary for a myriad of reasons.

A discussion of learning curves would not be complete without mentioning that all learning is not created equal. For example, a computer custom manufacturing facility, if an engineer designs a way put an external jumper wire into a board it leads to greater effects on the learning curve than would a single production worker learning to solder on the external jumper wire faster. In fact the engineers breakthrough would negate the learning of the production worker by eliminating the need for the soldering altogether. Learning is influenced in different magnitudes at various points in the production process. Briscoe and Roark define these

points as sources of learning, which they break into three basic categories: preproduction, intratask, and exoteric learning. These sources could easily be termed before, during, and after production. Briscoe and Roark reinforce the manufacturing facility example when they state, "Learning that is achieved from one type will tend to reduce the learning that can be obtained from another".

Real World Application

As previously mentioned, learning curves can be used for a number of applications, perhaps the most basic of these is budgeting. According to G.J. Steven, one company that is utilizing the benefits of learning curves is Above & Beyond Ltd., a manufacturer of high-technology guidance systems. For companies who budget for high-technology projects, knowing the labor costs associated with that project is critical. Labor time and cost tend to be very high because such projects are highly technical and are being performed by very highly paid specialists. Using learning curves helps Above & Beyond determine more realistic task times, which improves pricing decisions and the overall competitiveness of the firm.

THE PROCESS OF STRATEGY SELECTION: STRATEGIC DECISION MAKING

After comparing possible strategies, the manager must decide which will be the future strategies of the organization.* Many different decision models have been proposed to explain how these decisions can be made. The sections that follow discuss strategic decision making within several contexts. These decision-making contexts constitute different frames of reference a decision maker might take. It is important to note which frame of reference--context--surrounds a particular decision model and then to compare it only with other decision models within that context.

**The manager may actually select more than one. In contingency planning systems, an action plan could be selected for the environmental scenario that is most likely to occur and/or the set of goals appropriate to that scenario. Another strategy would be selected for an optimistic scenario - a reasonable but very favorable set of environmental circumstances with a somewhat low probability of occurrence. Then a third strategy would be chosen for the pessimistic scenario, which also has a low probability of occurrence but carries unfavorable implications.*

Cross-context comparisons may be faulty because of the different contexts. For example, arguing about the superiority of, say, Allison's organization process approach to decision analysis or Lindblom's incrementalism model is fruitless without first agreeing on the appropriateness of either the organization or the individual context. This is so because the context of decisions can change with each decision, and the applicability of a decision approach depends on the context.

Five contexts for decisions are described in this section-- individual, group, organization, societal institution, and worldwide societal. Then several decision approaches within each context are discussed.

Context of the Individual Many decision models focus on factors peculiar to the individual decision maker. The major ones are the rationality, bounded rationality, incrementalism, intuitive, and adaptive approaches.

Rational Decision Model. According to Steiner et al., "(A) decision is rational when it effectively and efficiently assures the achievement of aims for which the means are selected." A more general description is that rational decisions maximize net value achievement, where the

sacrifice in one value necessitated by a decision is more than offset by an increase in the achievement of another value. Although many interpretations of rational decision making have been proposed that differ in their details, they tend to have the following common framework of basic steps:

1. Establish a complete set of operational goals with weights.
2. Prepare a complete inventory of values and resources with weights.
3. Generate a complete set of strategy choices or solutions.
4. Prepare a complete set of predicted benefits and costs of each strategy or solution choice.
5. Compute the expected value of each choice.
6. Select the choice that has the highest expected value.

Note the use of the word "complete" in the first four steps. Completeness of these processes is important to ensure that one is behaving rationally. Stated differently, a decision maker could not lay claim to rationality were an incomplete set of strategy choices selected for evaluation.

If the decision maker could perform each of these steps completely, then a decision that maximizes net value achievement would result. For an economist, a rational, optimal decision might be the one that maximizes the value preferences of society as a whole. Behavioral scientists might measure rational decisions in terms of personal need satisfaction. Indeed the definition of rational decision outcomes can change from manager to manager, or even from situation to situation. For business decisions some of the goals that have been used to define rational decisions are return on capital investment, realized positive profits, and profit growth, in addition to maximum profits.

How does rational, maximizing decision making work? Classical economic theory defines an economic (person) as follows:

[One] who in the course of being "economic" is also "rational." This (person) is assumed to have knowledge of the relevant aspects of (the) environment which, if not absolutely complete, is at least impressively clear and voluminous. Such persons are assumed to have a well-organized and stable system of preferences, and a skill in computation that enables (them) to calculate for the alternative courses of action that are available, which of these will permit ... reach(ing) the highest attainable point on (their) preference scale.

Economic (persons) are assumed to make rational, maximizing decisions within closed systems in which minimum weight is given to the decision maker's environment and to the complexity of the decision process itself. Variables that cannot be computed within closed-system rationality requirements are "disregarded by assuming all other things are equal." Then marginal analysis is used to calculate the profit-maximizing solution.

Arguments in favor of striving to make rational, maximizing decisions include the following:

1. Harrison notes that "despite the obvious divergence between theory and practice, ...(it) has some distinct advantages from the standpoint of understanding, prediction, and control."
2. When the model is employed, failure to maximize the selected variable usually indicates economic inefficiency.
3. Acceptance of the model by managers will undoubtedly cause them to select strategic options that will facilitate greater efficiency.

4. When there is goal congruence between the decision maker and the organization, following the model should lead to maximum utility satisfaction as well as efficiency.

However appealing these arguments may seem, there are many detractors from the rational, maximizing model as a basis for business decisions generally, and for strategy choice selection in particular. First, managers are said to maximize their own interests rather than the goals of the firm at best, or to maintain the status quo at worst. Clearly if managers cannot be brought to aspire to corporate goals, their decisions will not approach those that would result from application of the rational, maximizing model to strategy selection.

Second, critics of rational, maximizing behavior argue that because there is a wide divergence of interests, loyalties, and goals in organizations, "it is unlikely that the firm will achieve its objectives with anything resembling maximizing behavior." Thus the tendency is for managers to stop analyzing strategic alternatives when a suitable, but not maximum, choice is found.

Third, objectively weighting organizational goals, even if they can be agreed upon, usually requires more information than most managers have. The most that can be expected is for the implications of alternative strategies to be imperfectly known. The cost of attempting to generate perfect information is usually prohibitive so that maximizing itself becomes nonrational.

Finally, critics argue that the cognitive ability of managers is sufficiently limited so as to prevent rational, maximizing decisions. Managers simply cannot grasp all the information pertinent to complex decisions.

Bounded Rationality. Realization of the practical limitations of the rational model has led to the development of other explanations of how business decisions are made. Miller and Starr quip, "People simply don't have such an irrational passion for dispassionate rationality."⁶⁹ One alternative, "satisficing," is proposed by March and Simon⁷⁰ and rests upon certain assumptions about human behavior described by Simon.⁷¹

Satisficing is a modification of the strictly rational model that recognizes people's tendency toward settling for satisfactory rather than optimum means for achieving goals. March and Simon distinguish between optimal and satisfactory decision alternatives as follows:

- An alternative is optimal if (1) there exists a set of criteria that permits all alternatives to be compared, and (2) the alternative in question is preferred, by these criteria, to all other alternatives.
- An alternative is satisfactory if (1) there exists a set of criteria that describes minimally satisfactory alternatives, and (2) the alternative in question meets or exceeds all these criteria.

Harrison points out that the fundamental difference between these alternatives is that criteria of choice are applied to all the alternatives in the optimal case, but to minimally satisfactory alternatives in the satisfactory situation. Thus in the strategy selection problem, the satisficing manager would identify several reasonable choices and then select the best one. Conversely, rational maximizing managers would have to identify all strategy choices before selecting the best one.

Simon's principle of bounded rationality can be viewed as an explanation of the conditions that lead to satisficing, rather than maximizing, decisions. Accordingly the strategist's quest for

information with which to analyze strategy choices rationally is constrained (bounded) by (1) his/her intellectual limitations in gathering all information, (2) limited amounts of time and money available for information gathering and analysis activities, and (3) "the virtual impossibility of obtaining anything close to perfect information even if one had limitless time and money.

In keeping with the principles of bounded rationality, and recognizing the tendency toward satisficing behavior, we can postulate the following bounded rationality decision model for strategy choice:

1. Establish a reasonably comprehensive set of operational goals.
2. Identify the important values and available resources.
3. Generate a set of action plan choices that fall within the organization's capabilities and interests.
4. Compute the critical costs and benefits of each choice.
5. Select the choice with the greatest net benefit.

Incrementalism. Incrementalism is another approach devised to deal with the impracticalities of the rational maximizing model. Originally presented by Charles Lindblom as a model of public policy formulation, it has since been repeatedly described as a business strategy formulation process as well.

Disjointed incrementalism is explained by Lindblom as follows:

The ... (disjointed incremental model is) continually building out from the current situation, step-by-step by small degrees, ... (in the rational model one) start(s) from fundamentals anew each time, building on the past only as experience is embodied in a theory, and is always prepared to start completely from the ground up.

Disjointed incrementalism views strategy choice as a process of continuing past strategies with only incremental modifications. For example, zero-base budgeting, where the entire amount of a proposed budget is justified and analyzed, is roughly a rational process. Conversely incremental budgeting, in which only the proposed future increase in a budget is justified and analyzed but the present budget is tacitly agreed to, approximates the disjointed approach.

Disjointed incrementalism has generated much interest for about the same reason that Simon proposed the bounded rationality model: Recognition of the practical shortcomings of the rational model. Dye summarized the supporting arguments for disjointed incrementalism, as opposed to rationality, as follows:

1. Decision makers do not have enough time, money or intelligence to behave strictly rationally.
2. They tend to trust established strategies more than untried new ones.
3. Heavy sunk costs in existing strategies make it difficult to accept radical strategy changes.
4. Minor incremental changes in existing strategies are more politically expedient than the "all or nothing" commitment often necessary for new strategy.
5. People naturally tend to "satisfice," not "maximize."

Of course, this kind of incrementalism carries the obvious risk of continuing a bad strategy all the way into bankruptcy. Manufacturing companies that, rather than discard and replace an unsuccessful product, choose instead to continue to change it in minor ways might be following

the incremental approach. On the other hand, the incremental approach to management of a successful strategy might increase the level of success.

In summary, when existing strategy appears reasonable or strategy choices are close to the present strategy, then the incremental approach is probably appropriate. However, when the present strategy is not working or strategy proposals are radically different, then the rational and bounded rationality methods might be superior.

Logical incrementalism shares with disjointed incrementalism the sense of marginal analysis of strategy alternatives. Quinn explains:

(Strategy) involves forces of such great number, strength, and combinatory power that one cannot predict events in a probabilistic sense. Hence it is logical that one proceed flexibly and experimentally from broad concepts toward specific commitments, making the latter concrete as late as possible in order to narrow the bonds of uncertainty and to benefit from the best available information.

Another interpretation of incrementalism is offered by Wu:

Disjointed incrementalism is essentially adaptive. It adapts specifically to: (1) man's limited analytical capacities; (2) the costliness of information; (3) the interdependencies between the past and the present, and between the present and the future; (4) the difficulty of coordination among subunits of organizations; and (5) the difficulty of analyzing and understanding the open system, such as that of a business organization. In applying disjointed incrementalism to planning or decision making, planners start with considering only those alternatives that differ incrementally from the marginal changes for those alternatives being considered, and, finally, rank in order of preference the incremental consequences for making decisions.

In general decision making and problem solving based on the incremental adjustment concept may be described by the following steps:

1. Define problems and (incremental) goals.
2. Appraise the current situation and estimate incremental adjustments to be made to cope with problems.
3. Quantify the consequences of incremental adjustments and determine whether the consequences are satisfactory.
4. If the consequences of incremental adjustments are not satisfactory to the decision maker, return to (2). Otherwise take action to implement incremental adjustments and return to (1).

Wu goes on to integrate this model with a budgeting system, and so provides an implementable model of the incremental decision process.

Intuitive Approach. Another individual-based decision model is the intuitive approach. Called the intuitive-anticipatory approach by Steiner, this decision concept has no explicit set of steps to follow. Instead it recognizes that many managers make "gut-level" decisions about which strategy choice is the right one. Intuitive decisions generally apply within the short-term future and tend to entail little distant forecasting and planning. But this does not imply that managers make intuitive strategy selections in a void. Indeed such decisions typically come out of many years of management experience and a high level of confidence on the part of the decision maker.

Unfortunately good instincts cannot be readily acquired without experience. After stating that "the really effective and experienced people in both management and science typically operate in a largely intuitive manner and view with impatience attempts to make their methods explicit," Morris notes:

It does not appear reasonable ... to suppose ... that one could do very much more than modestly enhance the process of developing intuition ... [by providing decision models as possible targets for imitation when intuition is insufficiently developed]. It may well be that intuition or artistic skill is largely the product of imitation and practice, yet this process of development must have a beginning. Experience suggests that this beginning must include more than simply a familiarity with other people's methods.

The Adaptive Approach. Ansoff proposes this approach as a way to apply probability estimates to the process of selecting strategy. A form of "bounded rationality by elimination," it includes the following steps:

1. Determine minimum threshold values for each goal. These are the minimum acceptable values of variables pertinent to goals. For example, for a firm with a return-on-investment goal, the minimum value of acceptable ROI would be its threshold value.
2. Apply threshold minimums to strategy choices and reject those strategies that are not expected to reach the minimums.
3. Rank strategy choices in terms of their ability to reach specified goal values.
4. Assign probability of reaching each goal to remaining strategies assessed according to the extent to which they can be affected by expected environmental occurrences. The analyst would have already developed a data set. This step involves linking the data set to the strategy choices by use of either subjective (judgmental) or objective (if possible) probabilities.
5. Compute the expected value of each strategy choice that remains in the analysis by finding the products of its feasibility estimate (for each goal) and its payoff.
6. Select the strategy with the greatest expected value. When several strategies produce similar expected values, they can all be referred for subsequent analysis or selection according to other criteria.

This approach results in "adapting or changing one's strategy depending upon the way existing circumstances are perceived." As one proceeds through the adaptive process, certain rankings, payoffs, and probabilities can result in removing strategies from further consideration, modifying remaining strategies, or creating new strategies.

Group Context

Although business decisions ultimately are made by individuals, decision models within the group context focus on collections of people as the major influence in decisions. These approaches are the group and elite models.

Group Model. This model views strategy selection as a process of balancing the interests of groups. Thus the strategy selected from the various strategy choices represents a compromise among the proponents of those strategy choices.

Although group theory, as explained by Truman, applies to public policy, a CEO intent on balancing internal group influences in strategy selection also would utilize such an approach. Balancing the interests of external groups in strategy selection can also be viewed as a group equilibrium problem. When the relative power of groups changes, strategy will change to

establish a new equilibrium. Strategy "will move in the direction desired by the groups gaining in influence, and away from the desires of groups losing influence."

That power is frequently the basis of business decisions is well documented. Cyert and March identified the tendency for groups of people both within and outside organizations to band together into coalitions on the basis of their mutual interests. The strategy selection process then becomes one of balancing the interests of coalitions. Mintzberg *et al.* report that managers often prefer the group/coalition process of decision making over rational analysis, even though it is slower and they do not like to admit using it.

Elite Theory. Dye states that in public policy making the assertion that policy reflects the demands of "the people" is often a myth.

(E)lites actually shape mass opinion on policy questions more than masses shape elite opinion. Thus public policy really turns out to be the preferences of elites. Public officials and administrators merely carry out the policies decided upon by the elite. Policies flow "downward" from elites to masses; they do not arise from mass demands.

Does the elite model of public policy apply to business strategy selection? Mintzberg explains that when the number of people or groups competing for power becomes large and power is widely dispersed, management often emerges as the dominant coalition. The odds are against one individual or group being able to control management, so seldom does such an attempt occur. Thus relative to the perhaps hundreds of thousands of owners of a large, publicly owned corporation, management can constitute an effective elite. Management's decision and strategy selections can be largely implemented unilaterally. The elite group may come to view the mass of owners as passive, apathetic, ill-informed, and subject to manipulation. Preservation of the organization is seen by members of the elite as the way to perpetuate their own positions, autonomy, and wealth. This goal congruence between the elite and the mass of owners can be constructive.

Of course, the elite model can apply more neatly to public organizations than to private. A public university can be dominated by a state legislature, a board of trustees, a union or an administrative group, which allows faculty members to think that they are making strategic decisions when in fact they are not.

Organization Context Within this context attention is focused on the organization itself. Easton explains the systems model as a descriptive model of public policy making. It has been used repeatedly as a conceptualization for business decisions of all sorts as well.

Two models applied by Allison also fit this context.

Systems Model. The systems model portrays decision making as primarily a function of a set of inputs, both organizational and external in origin, which, when processed by the organization, lead to a particular set of outputs. It addresses the organizational context of decisions and can be used to analyze them by comparing inputs and outputs across organizations. Outputs (selected strategy, for example) can be analyzed as a function of organizational inputs. Stated differently, strategy can be viewed as the dependent variable in analysis with organizational inputs treated as independent variables. Thus, in a somewhat oversimplified example, a systems-oriented strategist might look at past environmental scenarios and company circumstances and identify ones similar to the present. Then, the strategy that worked best during past situations that are similar to the present would be selected for implementation. As such, the systems model pays little attention to the internal machinations of the decision process itself, focusing instead on the relationships between inputs and outputs. Like the

intuitive model, the systems approach relies on the strategist's experience and pattern recognition skills.

Some of the benefits of the systems model for strategy selection lie in the questions that it raises:

1. What are the important elements of the environment that place demands on the organization?
2. What characteristics of the organization allow it to transform demands into strategy?
3. How do environmental inputs affect the content of strategy?
4. How does selected strategy affect key actors in the environment through feedback?

The major benefit of this approach is that historical analyses of relationships between inputs of the organization or to the decision-making process and the characteristics of strategies associated with those inputs can be used to spot patterns with normative implications.

Organizational Process Model. Another organizational context model of decision making is Allison's organizational process model (Model II). It is actually a modification of Cyert and March's organizational choice model. Fundamentally strategy would be selected according to this model by (1) inter-organizational bargaining, (2) agreement on goals, (3) informal formulation of expectations, and (4) selection of the first strategy choice that is seen as an acceptable means toward fulfilling expectations.¹⁰¹

Allison's Model III is also an organizational context model in that it views decision making as the result of the political maneuvers of the organization's coalitions. Strategy would be selected according to the political interplay among the various internal and external coalitions of the organization.

Institutional Context Within this context institutions are seen as the primary factors influencing strategy selection. In the public policy area:

Political activities generally center about particular governmental institutions - Congress, the Presidency, courts, states, municipalities, political parties, etc. The interests of individuals and groups, and their activities on behalf of these interests, are generally directed toward governmental institutions. Public policy is authoritatively determined, implemented, and enforced by governmental institutions.

Institutional Model. The institutional model seeks to explain the nature of institutional influence on public policy making. A policy in government is not implemented and enforced until it has been adopted by a governmental institution.

Most institutional studies in government have described the organization structure, duties, and functions of institutions. The point of studying public policy within the institutional model is to analyze the relationships between these institutional variables and the content of public policy.

Can the institutional model be applied to business strategy selection? Certainly Chandler's landmark analysis of the relationship between business structure and strategy can be labeled an institutional study. For example, the Hasbro (B) case describes how concerns and characteristics of the firm's board of directors were ultimately manifested in drastic changes in the company's overall strategy.

With reference to such institutional strategy analyses, patterns of past relationships can shed light on the problem of strategy selection choices.

Global Context

More and more attention is now being given to the question: "How can strategy be selected and implemented to optimize the firm's international competitive position?" Conceivably a strategy selection model will emerge in the near future that casts the selection decision within a global context. At present no such model exists. However, work has been done that describes how to take global factors into consideration in the process of strategy formulation.

Porter explains that global influences enter strategy formulation through the structured analysis of competition in global industries. Global industries are those in which the strategic positions of competitors in major geographical or national markets are fundamentally affected by their overall global positions. Stated differently, companies that have multinational subsidiaries can be non-global if their subsidiaries compete only within, instead of between, countries. Thus IBM is a global firm and Nestle is not.

What distinguishes effective global strategy is that it establishes competitive advantage in terms of four factors:

1. Differences among countries in the cost of production factors.
2. Demographic differences among foreign markets.
3. Different roles of foreign governments in the competitive system.
4. Cross-country "differences in goals, resources and ability to monitor foreign competitors."

The variables addressed in structural analyses of competition (suppliers, potential entrants, buyers, substitutes, and competitors) remain the same for global industry analysis and strategy formulation as for domestic industry analysis. However, the scope of each variable is greater for global than for domestic industries. Consequently "structural analysis in global industries must encompass foreign competitors, a wider pool of potential entrants, a broader array of possible substitutes, and increased possibilities that firms' goals and personalities will differ as well as their perceptions of what is strategically important."¹⁰⁹ These issues are addressed in the chapter on global strategic management.

Decision Model Summary

Decision models were discussed for several decision contexts: the individual (five decision models serve to structure or explain the thought processes of the decision maker); the groups of which the decision maker is a member (two models characterize decisions as a function of group interactions); the organization (the systems model takes the organization's decision process as a converter strategy decision inputs into decision outputs, and Allison's models rely on political processes); the institution (views strategy decisions as functions of business institutional variables); and the global (although no global strategy selection model has been widely acknowledged, criteria for the selection of global strategies were discussed). The context of strategy selection models defines the conceptual level of variables addressed by the decision process; decision models identify the particular decision variables.

Decision Models in Perspective

Around these many different decision models swirls a controversy about how managers actually do make decisions and how they should make them. Understanding of the process of strategy selection ultimately rests upon development of a consensus on the larger issue of how decisions in general are made.

Discussions seem to center first on whether decisions are made rationally or non-rationally. Those who choose the latter then ask, "How are nonrational decisions made?" Attempts to answer this question have generated many of the decision model choices currently available in the literature. What, then, can be said about the selection of decision models?

First of all, when the strategy selection situation is cast primarily in the context of groups, the organization, or institutional variables, then the group, system, or institutional decision approach, respectively, might be applied directly. Within the international context, strategy can be selected by the extent to which it addresses Porter's global strategy factors.

The hardest choices among decision models occur when the strategy selection decision lies securely within the individual context. Here there are no overriding group, organizational, institutional, or global influences on which to rely. Pertinent strategy selection criteria tend, in this case, to be more subtle and more personalized. Steiner advocates using the rational model whenever possible:

It seems apparent that there is no "one best way" for all companies, but there are better decision approaches given the constraints and characteristics of the situation. Even so, to the degree a formal, rational, structured approach can be used, the company will be likely to benefit.

STRATEGY IMPLEMENTATION

In this chapter, we consider what makes strategy implementation difficult and discuss different approaches to strategy implementation. The chapter is organized into five parts. The first explains why strategy implementation and the attendant organizational changes are such difficult managerial challenges. Next, we show you why a common approach to strategy implementation and organizational change, known as activity-centered change programs cannot be recommended. The third part distinguishes between two different levels of change (evolution and revolution) and the appropriate respective approaches to strategy implementation (strategic programming and organizational learning). In part four, we take a detailed look at strategic programming and consider its limitations. In the final part of the chapter, we offer a brief description of what is entailed in organizational learning.

This chapter will help you understand:

- The factors that make strategy implementation so difficult
- Why strategy implementation based on activity centered change programs is discouraged
- How the different levels of organizational change (evolutionary and revolutionary) require different approaches to strategy implementation
- The elements that constitute the strategic programming approach to strategy implementation
- The context in which strategic programming is most likely to be effective
- The limits to strategic programming and the changes that have led to its decreased use as an approach to strategy implementation
- The basic elements of organizational learning and how they fit together to provide a complex, but powerful, alternative approach to strategy implementation

WHY IS STRATEGY IMPLEMENTATION SO DIFFICULT?

Strategy implementation involves a broad range of efforts aimed at transforming strategic intentions into action. The resulting stream of actions constitutes the firm's realized strategy; it reflects what an organization has done and ultimately determines how the organization will fare. Strategies that are not implemented no matter how brilliant they may be, are little more than academic exercises. Consequently, the ability to implement strategies is one of the most valuable of all managerial skills.

Unfortunately, strategy implementation skills are not easily mastered. In fact, virtually all managers find that of the three elements of strategic management discussed in this book (strategic analysis, strategy formulation, and strategy implementations), the most difficult by far is strategy implementation. As one manager explained, "It has been rather easy for us to decide where we wanted to go. The hard part is to get the organization to act on the new priorities. This experience is widespread. U.S. managers are now spending an estimated \$10 billion annually on strategic analysis and strategy formulation. Managers themselves report that less than half the plans resulting from this effort are ever implemented. Outside observers put the success rate even lower: less than 10 percent.

There are several reasons that strategy implementation is so difficult:

The "Organizational Immune System"

A change of strategies usually requires the organization to move in new directions, and strategy implementation is inextricably intertwined with organizational change. Experience shows that all organizations are affected to some degree by inertia—they try to maintain their previous course and resist change. As one researcher put it, "Change theory tells us that human systems seek homeostasis and equilibrium; i.e., we prefer a predictable, stable world." "Research has shown that organizations regularly display commitment to the status quo, sometimes even when it is yielding unsatisfactory results." Because of this natural tendency to resist change and prefer the status quo, organizations have developed a number of immune systems that leaders must overcome if they hope to implement a new strategy successfully. These range from passively rationalizing that change really is not necessary to actively setting out to sabotage change efforts.

Difficult Paradoxes

There are many elements of change that are counterintuitive, and change requires organizations and leaders to face numerous paradoxes. These paradoxes pose what often appear to be irreconcilable problems for leaders, and uncertainty regarding how to address such intractable dilemmas often paralyzes managerial action. The successful leaders of change are those who find creative and practical ways of addressing these problems.

One paradox that managers face is that in order to get everyone in an organization to buy into the proposed changes, most leaders try to give everyone a voice in deciding the organization's future; yet these same leaders see a real need to silence cynics and naysayers. But William Hudson, CEO of AMP, a maker of electronic connectors, addressed this paradox in part by mixing naysayers in the various task forces charged with implementing the numerous changes that were under way in his organization at any one time. Hudson realized that the "can do" members of the task forces should hear the naysayers out, address their concerns as best as possible, and then get on with the job at hand. "Eventually," Hudson feels, "those who won't help raise the sails jump ship."

Another paradox is that change requires the involvement of many people, but, because it means taking risks, change is scary. How can you motivate your people to "risk" implementing changes? Al Dunlap, CEO of Scott Paper, tried to build his organizational change efforts on the fact that people naturally seek out safety in their work lives and volunteer for risky tasks only when they sense there is a safety net. When employees were forced to deal with changes at Scott, his approach was to give them a clear definition of the results that were expected, as well as the responsibility for producing those results. Though they still might dislike the uncertainty associated with change, at least this way they could feel secure about what they were being held accountable for and empowered to control their own success or failure. This provided enough security to allow them to face with confidence the uncertainties inherent in the change process.

To Randy Berggren, general manager of the Eugene (Oregon) Water and Electric Board, the most important paradox in strategy implementation was the need to "instill change through continuity." By this, he meant that there were certain constants that the organization could cling to, and these could actually help bring about important change. For Berggren's organization, the constant was the unchanging need to provide customers with utility services critical to the quality of their lives. This had been the utility's mission since it was founded, but in the newly deregulated environment, meeting this unchanged mission required fundamental changes in operation. As these changes took place, the efforts started to derail several times, primarily due to political infighting triggered by the deregulation. Berggren was successful in keeping the

change effort on track by encouraging the organization to focus on its core mission: "My message was to focus on our work and our customers, not get dragged off in politics. The work itself-and the need to do it better-became the safe place in which trust could grow."

The Number of Variables Involved

Researchers have developed theoretical models of the various elements involved in translating a planned organizational change (called an "intervention activity") into an action that results in desired organizational outcomes

The Interconnectedness of Elements Affecting Change

The interrelatedness of the elements illustrate one characteristic of strategic change that is most difficult to address. A change to one element of this model has a ripple effect that impacts other parts of the model, which in turn have their own ripple effects, and so on. One manager tried to explain her frustration in dealing with the extensive interconnectedness of factors affecting change in her organization by using this pair of analogies: "I used to think that our organization was like a string: tug on one end of it, and the other end simply moves in the direction you pulled. However, it turned out that the string was really just a thread in a complexly woven fabric: pull on the single thread, and you run the danger of unraveling the whole thing."

The Need to Change "Everything" at Once

Because so many factors affecting change are interconnected, changing only one or two things is seldom sufficient to bring about a significant overall organizational change. Managers who hope to change entire organizations by altering only one or two things are said to be searching for a "magic bullet." But research and experience are most convincing on this point: there are no magic bullets. To redirect an organization, it is usually necessary to simultaneously address a number of overlapping and related issues, and the resulting impression of the need to change "everything" at once often overwhelms managers using the 7-S model.

The 7-S model was developed in the late 1970s by consultants at McKinsey & Company who were trying to help managers address several of the difficulties of change we have identified. Specifically, the model shows that change is complex due to organizational immune systems, difficult paradoxes, and the many interconnected variables involved, and that to be effective a change effort must address many of these issues simultaneously. This is often a daunting managerial challenge; consider the following case of the change effort required by an Australian company attempting to change the way it managed research and development.

Heightened competition led this firm to devise a new strategy, one that stressed the importance of developing new, technologically advanced products to reestablish its competitive advantage. The key to this new strategy was the firm's R&D laboratory, a facility that had been created to serve the firm's six operating divisions with cutting-edge technology. It was clear that the firm had fallen far behind its competitors in the technology race, and there was obviously a problem to be fixed before the new strategy, which placed even greater emphasis on technology, could be implemented. However, it was not at all clear to the organization where the problem lay or how to fix it.

The McKinsey 7-S Framework

Strategy.

A set of actions aimed at gaining a sustainable advantage over the competition.

Structure

The organization chart and associated information that *shows* who reports to whom and how tasks are both divided up and integrated.

Systems:

The processes *and* flows that show how an organization operates on a daily basis (e.g. information systems, capital budgeting systems, manufacturing processes, quality control systems, and performance measurement systems),

Style:

What managers consider to be *important* by the way they collectively spend their time and attention and *how* they use symbolic behavior. It is more important how management behaves than what management says.

Staff:

What companies do to foster the *process* of developing managers and shaping the basic values of the management team.

Shared values:

The values that go beyond, but usually include, statement of goals and objectives in determining a firm's destiny. These values are shared by most of the people in the organization.

Skills:

Those dominant attributes or capabilities that are possessed by an organization.

Careful analysis eventually uncovered a whole series of factors that limited the firm's success in commercializing technology. Applying the 7-s framework revealed the following:

Strategy: There was no commonly understood strategy for the lab. For example, the operating division's view of research priorities was in conflict with the lab's view.

Structure: The firm's structure established a clear separation both between the lab and the operating divisions, and between different departments within the lab. There was no interaction between the centralized lab and the six operating divisions: representatives from the divisions visited the lab only once a year, on average. Meanwhile, technology commercialization was a strictly sequential process: first invention, then analysis of market potential, then analysis of production issues. The overall process was slow; even worse, many inventions proved not to be able once they were handed over to the operating divisions. There was also no interaction between departments within the lab, which, removed the opportunity for cross-fertilization of ideas that had originally motivated the creation of a centralized lab.

Systems: The system that had the greatest impact on the laboratory was that which allocated and controlled the use of capital funds. The annual budgets for R&D were developed by the lab and usually rubber-stamped by top management under pressure from the board of directors who felt "research is good." After funding, there was no system for follow-up on the status of R&D investments or payback from the lab.

Staff: The laboratory was hamstrung by several dysfunctional human resource practices. For instance, managers were paid much more than researchers—a practice that encouraged the best researchers to get out of research and into management. Additionally, management pay at

the lab was based on the size of the manager's department-encouraging turf battles and animosity between departments.

Skills: The members of both the laboratory and the operating divisions lacked the skills that were critical to the new strategy's success. The researchers were capable of good basic research but had little experience in developing commercially viable technology. The managers in the operating divisions were unfamiliar with what was required to build or market technologically advanced products.

Shared Values: There was no single organizational culture shared across the company, and the important values varied greatly from one level or function to the next. The board of directors may have felt "research is good," but the firm's general managers saw the laboratory as a "charity." The lab felt the company's failures were due to the operating divisions' inability to utilize the lab's new technology, but the operating divisions thought the failures were due to the lab's inability to develop viable inventions.

Style: There was evidence that the style of leadership found in the laboratory was limiting the lab's success. The head of the lab used a dictatorial leadership style, stressing top-down decisions and tight controls. Any celebrations of success were rare and not visible outside the individual lab departments involved.

To address these many problems, the organization decided to convert its lab from a distant "lab in the woods" operation to a "client service" organization that lived to serve the operating divisions. Such a transformation required that every one of the items listed above had to be rethought and changed in what amounted to a mass assault on the old way of doing things. For example, under the "systems" heading, a process was established in which the lab was funded only when it "sold" R&D services to the operating divisions, and the operating divisions got monthly reports on how the lab was fulfilling its R&D contracts with them. Under "structure," the lab was reorganized around the product lines represented by each of the divisions, rather than around areas of scientific expertise. As part of addressing "skills," 75 percent of the researchers were sent to a marketing course to learn about the issues of developing products with customer appeal. As these and many other changes were implemented, the strategy of using technology to establish a competitive advantage was gradually realized, and the firm began to win awards for its technologically superior products. The lab's \$40 million annual budget was yielding a very attractive return for the business, and it soon became a benchmark operation that other organizations sought to emulate.

While the factors listed earlier in this section make strategy implementation difficult, this example shows that it is not impossible. Both research and experience offer many guidelines that have proven their usefulness in a wide variety of organizations. However, it is just as clear that some things seldom work. Before discussing what works, let us consider the most common mistakes in unsuccessful attempts to implement strategic change.

A PATTERN OF FAILURE: ACTIVITY-CENTERED CHANGE PROGRAMS

Researchers studying why change efforts are so often unsuccessful have observed a common pattern of failure. This pattern has been called the "activity-centered" approach to change because the focus is centered on an activity that is supposed to bring about the change rather than on the desired results of the change. Such an activity is often promoted through a program that becomes the centerpiece of the change effort, and therefore we shall refer to this approach to change as *activity-centered change programs*.

This approach to change is so common and yet so consistently unsuccessful that we need to look at it in some detail. As you read about the various elements of activity-centered change programs, note how each of them is individually rational—they make sense when considered separately. It is only when you see how all the parts fit together that you begin to see why activity-centered change programs so seldom work. The most important elements of this approach to change are identified below and illustrated with a hypothetical example.

1. *Senior management, dissatisfied with past performance, develops new strategic ideas requiring organizational change.* Dissatisfaction with the past is usually the primary reason for attempting to make a strategic change. For our hypothetical example, assume that, in the face of declining sales, senior managers have decided to give renewed emphasis to improving customer satisfaction.

2. *A "program" is established with the intention of producing the desired strategic change.* The intention here is to focus attention on the new idea and generate some excitement about the proposed change. To continue our hypothetical example, a program called "King Customer" is initiated.

3. *Management of the program is delegated to those in staff positions.* Given senior management's wide-ranging responsibilities, the day-to-day oversight for the program is shifted to staff personnel who work in support of line managers. Typically, the staff involved have expertise in an area central to the proposed change. In our example, responsibility for the King Customer program is given to the director of quality.

4. *Senior Management is "handled" by the staff personnel in charge of the program.* The managers who advocated the change remain committed to it, but their personal involvement is structured by their "handlers," a term commonly used to describe the staff who organize and orchestrate the activities of campaigning politicians. In a similar fashion, the director of quality prepares several speeches that the CEO delivers while presiding over the numerous events that constitute the kickoff for the King Customer program.

5. *The staff in charge of the program focus on the range of issues under their direct control.* The majority of staff personnel have no formal authority over most of the organization, and they naturally focus most of their efforts on the limited parts of the organization in which they have the greatest influence. Because they are in staff leadership positions, this often entails direct changes in staff operations that, it is hoped, will have indirect impact on line operations. To continue our example, the director of quality leads in the creation of a new training and development curriculum that is focused on quality management tools and offered to employees in line positions.

6. *Performance is measured by the success of the program.* A widely held management principle is that evaluation of performance should be limited to matters under the control of the person being evaluated. In our example, everyone in the organization recognizes that many of the factors influencing customer satisfaction (such as product design, after-sales service, and product pricing) are far outside the director of quality's control. Therefore, performance improvement is measured in terms of the *programs* success rather than in terms of customer satisfaction per se. For instance, a key metric becomes the number of people who successfully graduate from the new training and development courses. Because there are more hourly workers than managers, and because hourly workers are easier to enroll in the program than their managers are, over time the program becomes focused on the hourly employees rather than the managers. Administering the training activity is relatively straightforward, and the director of quality sees to it that large numbers of hourly employees attend the courses.

7. Even though most of the organization is unchanged, the program is declared a success. With the narrowed performance criteria by which it is judged, the program can be a "success" even if little of the strategic change that was initially desired took place. Given that the director of quality opted to focus on training, a limited activity, it is not surprising that most of the organization was minimally affected by the program-especially because managers, not first-line hourly workers, are the only ones in a position to address many of the factors affecting customer satisfaction. Nonetheless, as performance was assessed in terms of the program's success rather than the overall firm's success, the director of quality has good performance data on the change effort to report back to senior managers.

8. In order to bring about the still elusive desired organizational change, another program is created. Because the first program was "successful" but still fell short of creating the full strategic change desired, it is easy to conclude that it must be supplemented with another change effort. While the senior managers can see from the director of quality's data that the King Customer program was a success in getting many people trained in quality management, many other factors of customer satisfaction still need to be addressed. For instance, cost increases have resulted in rising prices, which customers have complained about. To address this issue, the controller is put in charge of a new program intended to reduce selected costs by 50 percent, called "Have to Halve It."

9. The organization is confused about the relationship between the old program and the new one. Because each of the programs typically addresses only a subset of the total issues involved in the desired change, it is common for the two programs to entail a fair amount of overlap and conflict. When members of the organization learn of the new program, they are unsure of how to balance efforts between the newly acquired quality management tools and the new cost-cutting program. More than one employee is heard to mutter something to the effect that "if they really want to cut costs, they can begin by not pulling us off the line to attend courses like the one I attended last month on quality."

10. The organization becomes cynical about change programs and begins to support the status quo. Frustration develops because it is easy to see that even though the King Customer program was declared a victory, the customer is in fact not treated like royalty in most of what the organization does. And because the Have to Halve It program is only the most recent in what is becoming a steady stream of marginally successful programs, each derisively referred to as "the flavor of the month," employees begin to look at each new program as more of a bother than a solution.⁶ Consequently, they try to avoid personal involvement in all subsequent programs as much as possible, reminding one another that "this, too, shall pass."

In this scenario, not only did customer satisfaction fail to improve, but the organization in fact became more entrenched in the very status quo that senior managers had originally set out to change. Clearly, this is a failed attempt at strategy implementation and organizational change. But if you review each of the ten steps that led to this undesired outcome, it is also clear that there is some rational logic behind every action taken. In other words, there is no single mistake that derailed the change effort; rather, it was the general approach taken, the activity-centered program approach, that was inappropriate.

Such efforts are premised on the assumption that involving an organization in the right set of activities will produce the desired strategic change and improved results. We refer to the use of activity-centered change programs as "managing through inputs," because attention is shifted toward managing inputs and away from output. In our example, the desired output was a

reversal in declining sales to be brought about by an improvement in customer satisfaction. However, very early in the process the *focus* of attention shifted to management of an *input*, in this case the training activity that was the centerpiece of the King Customer program. This emphasis was justified by an assumed relationship between quality management training and customer satisfaction, a link that is plausible but by no means guaranteed.

Though managing through inputs is one of the most commonly observed approaches to implementing strategic change, it very seldom has the desired impact on overall results. We will contrast the activity-centered approach, with its emphasis on managing inputs, against two more promising approaches to strategy implementation: strategic programming and organizational learning. The remainder of the ten is devoted to a detailed treatment of these two approaches. Exhibit 8.3 presents an overview of the differences among the three approaches—mark it for reference as we move through the material ahead.

LEVELS OF ORGANIZATIONAL CHANGE AND ASSOCIATED APPROACHES TO STRATEGY IMPLEMENTATION

In this section we describe two levels of organizational change: evolutionary and revolutionary. We then explain that the most appropriate approaches to strategy implementation (strategic programming and organizational learning) differ according to the level of organizational change involved.

Two Levels of Organizational Change

Research shows that organizations progress through what has been called the punctuated equilibrium model. As shown in Exhibit 8.4, a model similar to the one you first saw in Chapter 5, *punctuated equilibrium* entails two different levels of organizational change, evolutionary and revolutionary.

In this view of the change process, progress occurs through an alternating series, of long evolutionary periods in which incremental changes take place, along with short periods of revolutionary upheaval. The evolutionary changes are incremental and adaptive in nature, somewhat analogous to the concept of "working in the system" (from Chapter 5) in that they are more likely directed toward changes in day-to-day organizational transactions rather than toward broader organizational transformations. This emphasis on transactions implies that administration is an important part of management's work in changes of this limited scope.

On the other hand, revolutionary change more likely entails a quantum break-through, a type of change that is not adaptive but generative; that is, it generates an essentially new organization. We sometimes refer to such changes as "transformational" rather than "transactional," and they require a managerial emphasis on leadership instead of administration. Such changes are roughly analogous to what we called "working on the system".

The revolutionary upheavals are sometimes called "paradigm shifts." A *paradigm* is an accepted view of the world and how it works, or, as one writer put it, "A paradigm, in its business connotation, is the conventional wisdom about how things have always been done and must continue to be done." As this quote suggests and research confirms, shifts in paradigms are typified not by smooth transitions but by disruptive breaks. These breaks provide the "punctuation" within the punctuated equilibrium model. Between paradigm shifts we go through relatively stable periods that are closer to equilibrium, during which incremental changes are made within the context of the current paradigm. The three paradigm shifts that are widely recognized as having the greatest impact on the nature of business are identified as Agrarian-based Economy, manufacturing based economy and knowledge based economy.

Many businesses experienced a particular kind of paradigm shift around the beginning of this century, when industry moved from custom-made products turned out by individual craftsmen for local markets to mass-produced, standardized products made by unskilled labor for national markets. After shifting their paradigm in this way, organizations settled down in a relatively stable period that has lasted nearly a century, in which we worked to continuously improve our mass-production capabilities. But it is important to note that many organizations were unable to make this paradigm shift and went out of business as more effective and efficient rivals adapted to the new competitive arena. Many observers believe we are currently facing a paradigm shift in industry that is every bit as significant as the earlier one entailed in moving from a craft base to an industrial base. The current paradigm shift involves moving from a domestically oriented economy, based on products and manufacturing, to a global economy, based on services and information."

There is some tendency to equate progress with the dramatic disruption that comes with paradigm shifts, but this is not a well-balanced view. To understand why, we can draw an analogy between technological progress and organizational progress. Most people believe that the greatest technological advance in the development of modern lighting was made when Edison invented the electric light bulb. However, Edison's invention is a distant and clearly inferior relative of the lightbulbs we have today. True, Edison's creation represents a paradigm shift that resulted in the worlds moving from gas to electricity, but afterward there were hundreds of smaller changes that gradually made the lightbulb what it is today. In other words, the paradigm shift established a foundation upon which to improve, but the cumulative impact of all these smaller changes has been more significant than the initial improvement from gas to electricity."

This is why a central thesis of the punctuated equilibrium model of organizational progress is that significant advances take place through *both* evolutionary and revolutionary change. Shifting paradigms establishes a new way of seeing the world, a new order of things. But it may take the organization years, even decades, to fully realize the potential gains the new paradigm carries with it. And as we have already said, many organizations will not be successful in shifting their paradigms, much less in realizing the full potential of what they offer. But to maximize their progress, organizations must be capable of both these types of change: as one research team put it, they need to be "dynamically stable. An organization must be dynamic enough to cope with the need for paradigm shifts entailed in the punctuated portion of our model of progress but stable enough to make steady progress through the periods of relative equilibrium.

Many managers see this as asking too much of organizations. Tom Peters reports that many would-be leaders are stymied by what he sees as the ultimate Catch-22: "Success is the product of deep grooves. Deep grooves destroy adaptability that is the key to success." Peters' success through "deep grooves" depends on a commitment to holding things relatively stable while endless evolutionary changes are made, an indication of strong faith in the current paradigm. However, this faith in the paradigm the deep grooves represent also limits an organization's willingness to break out of the groove and make revolutionary changes. In Peters' view too many managers want to focus on making progress through evolutionary changes (digging deeper grooves) or revolutionary changes (jumping out of the groove) when what their organizations need is a combination of both types of progress. Another expert on this subject has put it this way:

The first step in restoring a company's lost vitality is avoiding the false choice between evolution and revolution. . . Effective renewal requires a combination of step-function changes together with an ongoing process of evolutionary "reconditioning," which enhances learning and helps ready people for the next step-function change."

Two Approaches to Strategy Implementation

As you might expect, the evolutionary and revolutionary changes we have been describing require different approaches to strategy implementation. The first approach, which we call *strategic programming*, is best used in relatively simple and stable situations and is most applicable to managing change during the "equilibrium" stage of the punctuated equilibrium model, during which evolutionary change dominates. But organizations seeking to move beyond equilibrium will not be well served by a strategic programming approach to implementing their strategies. Instead, they need an approach that is widely known as *organizational learning*. This approach to change requires leadership that can cope with both generative revolutionary changes and adaptive evolutionary changes.

As we shall explain, few if any organizations can rely entirely on strategic programming or organizational learning, because progress depends on both evolutionary and revolutionary change. Consequently, you will need to be adept at both strategic programming and organizational learning as complementary approaches to strategy implementation. To begin understanding the differences between the two, we must return briefly to a model first introduced in Chapter 1 and reproduced for you here as Exhibit 8.6.

As you study this exhibit, recall from our earlier discussion that there is an important distinction to be maintained between intended strategies and realized strategies. An intended strategy defines what we hope to do—it is a perspective on the future—while the realized strategy defines what actually took place and therefore reflects a historical perspective. The two usually differ because of the added elements of the emergent strategy and the lost elements of the unrealized strategy. In some cases an organization is better off for these changes, but in other cases it is desirable for the intended strategy to play out as originally conceived. In other words, managers often attempt to make the realized strategy as close as possible to the deliberate strategy, which, in turn, is as close as possible to the intended strategy.

It is easy to see the important role played by strategic programming in such cases. Strategic programming involves planning how the deliberate strategy can best match the intended strategy to the realized strategy. In other words, rather than being used to *formulate* the intended strategy, planning here is focused instead on seeing that the intended strategy is *implemented*. This view of planning may be counterintuitive to you at first, because planning is so often equated with producing a strategy. However, as the model in Exhibit 8.6 shows, there are many types of strategy, and strategic programming is aimed at producing a particular kind of realized strategy, namely, one that mirrors the intended strategy. As Henry Mintzberg explains:

Organizations engage in formal planning, not to create strategies, but to program the [intended] strategies they already have. . . . Thus, strategy is not the consequence of planning, but the opposite: its starting point. Planning helps to translate intended strategies into realized ones, by taking the first step that can lead effective implementation.

The success of this approach to implementation is contingent upon an ability to foretell which intended strategy will be most effective. Such prescience (knowledge of events before their occurrence) usually requires a situation that is simple and stable enough that managers can foretell with reasonable accuracy what the future will hold and what strategies will be most effective. Only if it is possible to be reasonably prescient can managers hope to formulate strategies and succeed by careful adherence to their plans during strategy implementation. Note that in this view of management, formulation is a single, discrete step that logically precedes implementation. This clean separation of formulation and implementation is what fundamentally

distinguishes strategic programming from other approaches to organizational change. Referring again to Mintzberg: "Strategic programming makes sense. . . when the world is expected to hold still or change predictably while the intended strategies unfold, so that formulation can logically precede implementation.

We are familiar with a privately held hardwood flooring business that is strikingly successful in using a strategic programming approach. to implementation. The lumber mill that is the heart of the organization is a relatively simple operation *that* has not changed dramatically in the several decades that ha\ve elapsed since it was built. Consumer use of the product has changed little since the business began, and demand has been fairly consistent with home building, which can generally be forecast far enough in advance for management to adjust the firm's purchases and production output. When we spoke to the CEO of this very profitable business about the need to continually adjust his strategic plans as new developments took place, he had difficulty understanding what we were talking about. No, he said, "nothing gees in the way of our plans. That's why we have them, and once we have them, we are going to follow them or die trying." The firm's success showed clearly that in such a simple, stable business, it can be quite appropriate to stress strategic programming for strategy implementation.

But not all organizations benefit from seeing their intended strategies implemented intact. The importance of *not* blindly adhering to an intended strategy but instead letting emergent elements alter it cannot be over-emphasised. Many organizations find it appropriate to blend elements of both emergent and intended strategies. This is especially true for more complex organizations operating in dynamic environments, as well as for situations that are more likely to require revolutionary changes. In such cases, it is very difficult to know in advance what will produce the desired outcomes.

When the world cannot realistically be expected to "hold still" -that is, in times of punctuated change rather than equilibrium-strategic programming is not the best approach to strategy implementation. In such a situation, managers cannot rely on prescient understanding; instead, they need an approach that makes greater allowance for the discovery of new insights and that can adjust an organization's intentions and actions accordingly. Such an adjustment process is captured in the concept of emergent strategy. The central idea behind this concept is that managers cannot possibly hope to foretell the future or what actions will be required by it. Rather, they must learn how to deal with the future as it emerges. In this organizational learning process, it is impossible to separate strategy formulation and implementation because, as intended strategies are implemented, the need for continuous reformulation becomes obvious.

To this point, we have sought to establish the distinctions between strategic programming and organizational learning. Yet, as you will recall from our earlier discussion, most organizations need some blend of both. In other words, it is more useful to think of strategic programming and organizational learning as the extremes of a continuum rather than simply as dichotomous either/or options. Exhibit 8.7 makes the point that between the extremes of emphasis on deliberate strategy and emphasis on emergent strategies there is a continuum of options for strategy implementation. To quote Mintzberg one final time:

. . . few if any strategies can be purely deliberate, and few can be purely emergent. One suggests no learning. the other, no control. All real-world strategies need to mix these in some way-to attempt to control without stopping the learning. . . . Thus, emergent strategies are not necessarily bad, and deliberate ones good; effective strategies mix these characteristics in ways that reflect the conditions at hand.

The most important elements of the "conditions at hand" are the complexity and dynamism

of the situation as shown our Exhibit. Revolutionary change in almost any organization is likely to be complex and dynamic, and in such situations it is difficult for managers to know what will work before the fact. Thus, learning what will work through trial and error becomes more important than enforcing a pre-established plan.

But if there is a lack of complexity or dynamism, an organization may well be more efficient and more effective if it uses strategic programming to implement its plans. There is a tendency to discount the usefulness of strategic programming and to speak of it in pejorative terms, but it would be needlessly slow and expensive to use the more complex organizational learning approach to strategy implementation in situations where strategic programming would do. Having said this, we need to acknowledge that simplicity and stability are increasingly the execution rather than the rule, and you will need to develop an in-depth understanding both approaches.

Having introduced the concepts of strategic planning and organizational learning, we now turn to a more detailed discussion of each.

STRATEGIC PROGRAMMING: CHANGE THROUGH PLANNING

In this section we first describe the elements of the strategic programming process and then consider the limitations to this approach to strategy implementation.

The Elements of Strategic Programming

There is no one model that is *the* strategic programming process. Rather, there are a number of similar processes that share the feature of clearly separating strategy formulation and strategy implementation (that distinguishes strategic programming from organizational learning).

The steps involved in developing and implementing plans take place in a sequential fashion. Based on a preestablished mission and its corresponding objectives, alternative strategies are first identified and then evaluated before the preferred option is selected, completing the strategy formulation part of the process. This strategy is then implemented through a series of increasingly detailed and shorter-range plans and programs. Each level of plans and programs has its corresponding level of budgets by which adherence to the plans is enforced. As the times specified in the plans, programs, and budgets expire, results are evaluated and the evaluation is used as input for the next iteration of the process through a feedback loop.

Note that in this model, implementation is accomplished through a series of plans, programs, and budgets. In fact, the importance of these three has given rise to one of the most common approaches to strategic programming, the so-called planning, programming, and budgeting system (PPBS). This approach to management was first used by Robert McNamara when he served as secretary of defense. Since then, it has been used in a variety of organizations in both industry and government and is still in widespread use today. PPBS has often been singled out for criticism when it has proven ineffective. However, we think dismissing PPBS in particular, or strategic programming in general, is a case of throwing the baby out with the bathwater. Remember the point we have been making throughout this chapter: successful strategy implementation depends on matching one's approach to the conditions at hand. Though there are many cases in which strategic programming would be inappropriate (see discussion below), that does not mean the model is fundamentally flawed or that all organizations should avoid it.

A Generic Model of Strategic Programming

STRATEGY FORMULATION

Establish Master Budget

STRATEGY IMPLEMENTATION

Establish Medium-Run Operating Budgets

Establish Short-Term Tactical Budgets

A Generic Model of Strategic Programming

STRATEGY FORMULATION

Establish Master Budget

Establish Medium Run Operating Budgets

STRATEGY IMPLEMENTATION

Establish Short-Term Tactical Budgets

In fact, many businesses that use strategic programming are among the most consistently successful of all. For example, Emerson Electric has long adhered to a process of formulating strategies and then using detailed plans, coupled with rigorously enforced budgets, to implement them. While this may sound like an "old-fashioned" approach to management, typical of a stodgy dinosaur of a business, in Emerson's case nothing could be further from the truth. The firm is virtually unmatched for its record of earnings growth. At the time of this writing, the firm had not failed to report increased quarterly earnings in nearly 40 years. This period includes some of the most damaging recessions and dramatic economic developments in the history of the US economy—shocks that have represented major setbacks for most firms. Yet through it all, Emerson has consistently enjoyed earnings growth. Application 8.2 describes some of the most important features of strategic programming at Emerson. Based on the success of firms such as Emerson, we must conclude that strategic programming is a logical, well-reasoned approach to implementation when used with a thorough understanding of its limitations.

The Limitations of Strategic Programming

The limitations of strategic programming stem from the fact that it is applicable only under certain conditions and that these conditions are becoming rarer. Additionally, there are problems both with planning and with a command-and-control approach to implementation that limit the use of strategic programming. We consider each of these four types of limitations in turn.

Required Conditions

As we have already mentioned, strategic programming is most appropriate in organizations that face stable and/or simple conditions. In fact, we see these as necessary conditions for its use. However, beyond these two necessary conditions, four other conditions encourage adherence to intended strategies: industry maturity, capital intensity, tightly linked operations, and external control. These six interrelated conditions are shown in Exhibit 8.9 and discussed individually below.

1. *Stability.* Businesses that operate in predictable ongoing ways, free from major unexpected shocks, are said to be stable. Research has revealed that strategic programming is ill suited to dealing with the instability associated with unexpected events, such as the oil crisis that shook a number of businesses in 1973.³⁶ Other research has shown that comprehensive planning is more closely linked to firm performance in stable industries than in unstable industries. Finally, interviews with executives reveal that there is a fairly clear consensus that planning is of limited value when uncertainty is substantial.

2. *Simplicity.* Using programming to implement a deliberate strategy is most appropriate in settings where the business is simple enough that the right strategy can be known before the fact. As one research team put it, "Application of the [programming] model generally depends on being able to see quite clearly which factors we must take into account in solving the problem, and which we can ignore. .. [This] approach is , , , likely to be useful in the planning of simple operations in systems whose inputs and outputs are reasonably clear." In situations that are too complex to allow planners to be prescient about inputs and outputs, adhering strictly to a mechanistic approach to planning can actually be crippling. As managers in complex environments struggle in vain to adequately capture enough information about inputs and outputs to create confidence in the intended strategy, the organization bogs down in what has been called the "paralysis of analysis."

3. *Industry maturity.* As we explained in Chapter 4, mature industries tend to be the most stable, so it is not surprising that planning has found its greatest use in mature industries. An in-depth study of the history of Air Canada revealed this tendency.³⁷ Once the Canadian airline industry became well established, "recipes" for success emerged that established route structures, operating procedures, and relationships among carriers. The resulting *Modus operandi* was maintained for decades with very little change. As one executive from Air Canada put it, during this period, "we could forecast the future very accurately." In this mature market, it was possible for managers to have great confidence in their intended strategies and to work aggressively to see that they were implemented as deliberate strategies. Of course, even in mature markets, shocks can occur that require organizations to rewrite all their recipes. For example, when the mature U.S. airline industry was deregulated, a number of firms realized that what had once worked well at one time worked poorly or not at all in the new environment. The survivors were not necessarily those that had excelled in the previous environment but rather those that could adapt most quickly to the new developments.

4. *Capital intensity.* The extent to which a firm has invested in capital equipment is referred to as *capital intensity*. Most such equipment is limited in its use; an assembly line designed for the production of cars cannot be used for anything else, not even for the production of trucks. This inflexibility provides an incentive for managers to adhere closely to their intended strategy; changing their minds would mean that large investments in capital equipment would be rendered obsolete.

5. *Tightly coupled operations.* Compare the need for planning at two different schools. At one, an elementary school, each teacher is more or less entirely responsible for the students in a single class, allowing the teachers to act more or less independently of one another. At the other, a college, each teacher contributes to a single curriculum, requiring that his or her actions be closely integrated with those of all the other teachers. We consider the college to represent an operation with parts that are more tightly coupled than those of the elementary school. While the teachers at the elementary school are free to adjust their teaching plans as the need arises, the teachers at the university must adhere to their plans more closely because they are collectively linked by the broader curriculum.

Businesses are much the same. Compare the need for adherence to an overall plan for 100 independent trucking contractors versus the need for adherence to a plan for 100 truck drivers constituting a single, centrally controlled network of trucking operations. The independent trucker can adjust plans "on the fly" as events unfold, while the drivers in the tightly linked network must adhere more precisely to prespecified plans in order to avoid mass confusion.

6. *External control.* Organizations that are controlled by outside forces typically have a built-in motivation to adhere more closely to the intended strategies they develop. Thus, a business unit that is held accountable to corporate headquarters is more likely to be motivated to stick to a plan that was approved by headquarters than is a business unit that operates without this external oversight. For example, the corporate management team at the headquarters of Dover Corporation approves annual plans for each of the fifty or so SBUs it oversees, and any deviation from these plans must be explained and justified at follow-up meetings, providing ample motivation for business-level managers to "make plans."

We have observed an even greater emphasis on close adherence to plans among government contractors faced with stringent government oversight. We know of one such contractor whose 20,000 employees know better than to propose any activity that has not been included in the preapproved annual plan. Unless a government agency has signed off on an activity in advance, no budget will be available to support it, and very little can be added to the plan once it is established. On the other hand, actions are seldom deleted from those planned because money that is not spent in one year usually leads to a reduced budget for the next year. Consequently, the management of this organization is focused on careful adherence to the current year's plan.

The conditions that lead to strategic programming are not independent of one another. For example, a mature industry is more likely to be more stable, encouraging greater capital intensity, which in turn tightens coupling across operations. As these various forces tend to move in concert with one another, it is useful to look for an overall label that captures the total picture of the firms that meet these conditions. The label most commonly given to such businesses is *mechanistic organization*. "Mechanistic" is used to connote an organization that is designed to operate reliably in a stable, predictable manner with tightly integrated parts that support one another much as those in a complex machine do. We will use this label to describe firms that meet some or all of the six conditions described above and that adhere to a strategic programming approach to implementation as a result.

The Diminishing Viability of Mechanistic Organizations

The fact that strategic programming is most useful in mechanistic organizations would not be a major limitation if mechanistic organizations were the norm. But not only are they the exception rather than the rule; they are becoming even more rare because of several recent trends and developments both outside and inside organizations. Externally, agile competitors are scrambling to adjust to fragmenting markets that require greater flexibility in adapting to emerging needs, and mechanistic organizations tend to be slow to adapt to such changes. Internally, employees are becoming better educated, and this, coupled with advances in information technology, is encouraging organizations to spread the involvement in planning and decision making, so that planning becomes intertwined with doing. Such trends are causing organizations to conclude that the mechanistic organization that began to develop at the turn of this century is now out of date. The main risk of the mechanistic organization is diminished competitive advantage in terms of differentiation, cost, and response time. For instance, the narrowly defined goals and division of labor common to most mechanistic organizations are ill suited to providing the creativity and initiative required to differentiate products in new ways as necessitated by fragmenting markets. The layers of managers required to enforce adherence to

an intended strategy often represent costs that can leave a firm uncompetitive. Standardized procedures and inflexible plans may slow response times and can prohibit the responsiveness today's competitive environment demands.

As a result of these changes and their negative impacts on firm competitiveness, managers are looking for new models of organization. These new forms of organization are commonly referred to as *organic*, to express the idea that they are lively, dynamic entities that are constantly evolving. Organic organizations differ from mechanistic organizations.

While we know of no single organization that has fully completed the transformation to what this exhibit describes as an organic organization, we know of only a few that are not attempting to make such a change. We see no reason to believe that this trend will be reversed, suggesting that the number of mechanistic organizations that depend on strategic programming for strategy implementation will continue to decrease.

Planning Problems

Planning is the essence of strategic programming. Unfortunately, the very strengths that were attributed to planning earlier in this chapter are also the source of several of its most important weaknesses. Planning works like an organizational gyroscope, constantly exerting righting forces that are useful for keeping an organization on a constant course; however, these same forces must be overcome when a change of course is needed. So an organization that might otherwise wander about can stick to the straight-and-narrow path set forth in the intended strategy, unless the intended strategy was wrong and the path leads in the wrong direction. In such a case, planning will lead the organization astray even worse, it may do so with great efficiency. Regrettably, most managers cannot be sure where their intended strategy will take them until they are well on their way.

Furthermore, once managers discover they are on the wrong path, planning is particularly ill suited to changing course. This is because planning is an inherently conservative process. By this, we mean that planning works to conserve the basic orientation of an organization. It moves an organization more expeditiously down a particular path but seldom leads it to seriously question whether it is the right path and is highly unlikely to suggest that it should be flying instead of walking.

Planning may be useful in bringing about incremental changes within an organization, but it does not promote quantum changes or comprehensive reorientations. These would disrupt all of the paradigms and established thinking on which plans are premised, and therefore such fundamental changes are ignored—or even avoided—in most planning efforts. In effect, planning and plans place blinders on an organization that limit its field of vision. Of course, this focus is appropriate if (1) it is trained on the right target and (2) the target does not move. However, as we have already discussed, trends increasingly require organizations to hit a constantly changing and moving target, a feat not well suited to planning or strategic programming.

Application : General Electric's Salisbury Plant Transforms from a Mechanistic to an Organic Organization

Over the last decade, General Electric has invested heavily in converting many of its business units from fairly mechanistic organizations to more organic ones. It has made this transformation because the corporation is convinced that trends toward greater market instability and complexity will demand that its business units be capable of being more responsive. GE's Salisbury plant, a facility that produces electric circuit breakers, is viewed as

one of the role models for other business units attempting to make this transformation, Jack Welch regularly sends executive teams to the Salisbury plant for what he calls "a peek into the future."

Before the transformation that took place at the Salisbury circuit breaker plant, it was a classic example of a mechanistic, command-and-control, strategic programming organization. Its circuit breakers were relatively simple, low-technology products sold in a mature domestic market. Senior managers established annual plans complete with detailed objectives and budgets they focused on meeting. Workers were confined to narrowly defined, tightly coupled tasks along a capital-intensive assembly line. The plant employed five layers of management to see that its annual plans were carried out precisely, thereby satisfying the requirements of external managers in GE's corporate headquarters. For years, this had been a simple, stable, and profitable business.

However, by the mid-1980s, the situation had changed. GE faced increasing global competition from strong foreign competitors. The company was becoming dependent on foreign markets, where considerable growth potential remained, for any profits. Volatile economies and government regulations made overseas operations a roller-coaster ride of ups and downs. The Salisbury plant was poorly equipped to cope with this complex, unstable environment, and it became so unprofitable that headquarters threatened to shut it down, a crisis that motivated the transformation to a very different-looking organization. The new plant bears very little resemblance to the old one. The dominant strategic objective has shifted from meeting periodic budget targets to continuous improvement and organizational learning. This has shifted the responsibility for setting targets from the top of the organization, where centralized planning had traditionally been done, to throughout the organization. The workforce is organized into self-managing teams, each responsible for a different production unit. Each team's elected facilitators lead the team members in solving problems and planning changes that the teams believe will improve performance. As their ideas prove out, they work across the organization to spread them. Teams work individually to perform traditional managerial functions like planning, hiring, and capital appropriations requests for their own units. Where teams are linked, cross-functional groups of associates meet weekly to address policy issues as they arise, without the need for top-down command and control to enforce top management's plans, the hierarchy has been simplified. It now includes a total of three levels-plant manager, advisors, and associates. Meanwhile, computer-based equipment provides the plant with increased flexibility, so production plans can now shift to reflect the constant changes in demand in the new markets the plant is willing to serve. The plant still makes its quarterly reports to corporate headquarters, but everyone seems to place more emphasis on the data the plant tracks internally and reports on a minute-by-minute basis on an electronic scoreboard that hangs above the factory floor. As teams try new ideas, they are able to track for themselves the impact they are having on factors affecting the business unit's competitive advantage.

Five years after the transformation process began, results were impressive. Customer complaints about poor quality were down tenfold, costs were down 30 percent, and the average delivery cycle had been reduced from 3 weeks to 3 days. Clearly, for its new environment, the new organic, learning-oriented organization has proven to be far superior to the old mechanistic organization the Salisbury plant used to be.

Difficulties with Command and Control

Even when the planning problems identified above can be overcome, problems arise in ensuring adherence to the resulting plan. As we have already explained, adherence to plans has traditionally depended on successful use of a form of management commonly known as command and control. Managers develop commands that reflect their understanding of plans

derived from the intended strategy and then use organizational control systems to enforce compliance with those commands. There are three reasons why command and control has lost its effectiveness as a form of leadership for strategy implementation.

First, it assumes that expertise parallels authority, but, too often, it no longer does. In other words, the managers at the top of the hierarchy may have the formal authority required to issue commands, but they often lack the expertise necessary to do so wisely. For example, the work that takes place on the lowest levels of many organizations can reasonably be directed only by the experts who actually do the work. It makes little sense for an organization to spend large amounts of money to train its workforce to work as a team of experts in operating sophisticated equipment and then leave decision making in the hands of managers who lack such training. Consequently, we have seen the spread of self-directed work teams that are consulted during the planning processes, rather than being told about decisions after the fact. Because of the investment many organizations have made in their employees, they can no longer afford to treat labor as a variable expense. They are committed to retaining as much of the labor pool as possible in order to avoid the cost of training replacements. This attitude has gone far toward removing employee dismissals as a "stick" that was widely used in a command-and-control approach to leadership. Finally, as organizations have removed managerial levels from their hierarchies, they have lost the "lieutenants" necessary to enforce the commands handed down from the "general" above.

In a nutshell, the strategic programming approach to implementation works well only when conditions allow managers to cleanly separate strategy formulation from strategy implementation. As we have seen, these conditions are likely to exist only in simple, stable businesses operating in equilibrium. Businesses that are more complex or that operate in conditions that are more dynamic and disruptive cannot realistically hope to know what strategy will work in advance of efforts made to implement it. In other words, they must continually adjust the strategy, and thus formulation overlaps implementation. According to Mintzberg, it is not even accurate to talk about strategy formulation in most organizations because so little realized strategy is the result of a formulated intended strategy. He prefers to talk about *strategy formation*, a term reflecting the fact that many realized strategies are formed of numerous elements of the emerging strategy rather than formulated whole as intended strategies.

We need not argue over semantics to agree with Mintzberg's basic point: for many organizations, strategic programming is not an appropriate approach to strategy implementation. A more suitable approach integrates formulation and implementation by allowing organizations to discover what works and adjust their plans and methods as they progress toward their strategic targets. We call such an approach organizational learning. In Application 8.4, we provide a description of how Honda depended on this process instead of planning and strategic programming in entering the U.S. motorcycle market.

Because organizational learning combines elements of both formulation and implementation, it is both more difficult to manage and more difficult to explain. Consequently, we will focus on organizational learning in the next four chapters. But before moving on to these chapters, we offer an overview of the future topics to be covered, so you can better assimilate the material as you come to it.

AN OVERVIEW OF LEADERSHIP, LEARNING, AND LEVERAGE

The need for organizational learning has become more apparent as *Knowledge based competition* has emerged. Knowledge-based competition is reflected in the resource-based view

of how firms gain and sustain competitive advantages. One of the key resources an organization can draw upon in establishing a competitive advantage over its rivals is superior knowledge! Consider the importance given to knowledge in the following quote:

The very definition of the firm must change in a subtle yet critical way. Instead of the firm being defined by the products and services it produces at any given time, it must now be defined by the specific process know-how or competence it brings to the competitive market. Therefore, the knowledge [emphasis in original] the firm possesses, develops and enhances, represents the basis for competition.

With this emphasis on knowledge as a competitive weapon, it is appropriate to make organizational learning the centerpiece of our remaining treatment of organizational change. Organizational learning is composed of two major parts, discovery and action. Discovery is finding out what works in moving an organization closer to fulfilling its objectives or strategic intent. We will include a wide range of sources for discovering what works, including history and experience, systematic problem solving, experimentation, and benchmarking the best practices of other organizations. But regardless of its source, learning that entails discovery alone is little more than an academic exercise. Consequently, we argue that to be of practical importance, learning must also include a change in the organization's actions.

In building organizations that are capable of both discovery and action, leaders need to address a wide variety of issues (issues we will take up in Chapters 10, 11, and 12). As we explained earlier in this chapter, organizational change is a complex phenomenon with many interrelated parts. There are no "magic bullets" that will allow leaders to work wonders by addressing only one or two of these parts. For example, charisma has long been seen as critical to organizational leadership. But we see charisma as just one of the many forces that can work for--or against--change. Leaders need to be more than just charismatic; they need to be "organizational architects," capable of creating entirely new organizations by reshaping all of the many forces affecting change. Paul Allaire, CEO of Xerox, makes this point when he urges leaders not to be too enamored with organizational structure, another element of change that is often treated as a "magic bullet." Speaking of successful changes that have taken place at Xerox, Allaire says:

Changing the structure is only part of it. We are also changing the process by which we manage, the rewards and other mechanisms that shape those processes, and the kind of people we place in the key managerial positions. Finally, we are trying to change our informal culture--the ways we do things, the behaviors that drive the business. In fact, the term "reorganization" doesn't really capture what we are trying to do at Xerox. We are redesigning the "organizational architecture" of the entire company.

Managers at AT&T observed a similar need for broad-based change when they attempted to develop greater entrepreneurship in the company after its industry was deregulated. They felt that bringing about the desired organizational changes required them to address the six broad categories of constraining forces identified in Exhibit 8.12. Even in organizations much smaller than AT&T, leaders find that implementing a new strategy usually entails attacking the problem on a wide variety of fronts, as illustrated in Application 8.5.

Finally, researchers studying the dramatic transformation that took place at British Airways, a series of changes that moved it from a second-rate carrier to world class, reached the same conclusion: "The change involved a multifaceted effort that used many leverage points to initiate and support the changes. We find the term 'leverage' to be very appropriate when speaking of the work that faces leaders who would build learning organizations. In thinking of how organizations are moved to implement significant changes, we are reminded of the process used to get a train back onto a track after being derailed. The wreckage often prohibits train-mounted cranes from approaching close enough to be useful. Because this single powerful 'magic bullet' cannot be relied on, the cleanup crews use a very different approach: masses of people attack the problem with levers. These are simple pry poles that individually would be totally

ineffective but collectively can slowly untangle the worst wreck and move the salvageable equipment back onto the track. We believe the work of putting organization "on track" requires the use of three types of levers, as depicted in Exhibit 8.13.

Summary of Managerial Practices to Adopt from This Chapter

- Expect implementation of a strategy to be much more challenging in practice than strategic analysis or strategy formulation is.
- Expect resistance to change from the "organizational immune system" to come in the form of a number of difficult managerial paradoxes that call for creative solutions.
- Remember that strategy implementation and organizational change will require you to address a large number of interconnected factors simultaneously- A framework such as the McKinsey 7-5 model (or the levers model you will study in later chapters) can be useful in helping you to identify all these factors and keep them straight.
- Do not fall prey to the apparent logic of using an activity-centered change program as your primary means of implementing a strategy. Though each step seems rational by itself, the overall impact of this approach is minimal.
- In thinking about the approach to strategy implementation that is appropriate for you, consider (1) the level of change desired and (2) the situation facing the organization.
- Evolutionary changes or strategies being implemented in simple, stable businesses may be successfully implemented by using strategic programming.
- Revolutionary changes, or strategies for organizations facing complex and/or unpredictable situations, will usually require organizational learning.
- Remember the key distinguishing features between strategic programming and organizational learning: In strategic programming, the firm can realistically separate planning and doing, strategy formulation and implementation. In organizational learning, a firm assumes that it cannot realistically tell in advance how the future will unfold or what will work, and it therefore intertwines formulations and implementation, continually adjusting its strategy as it gains new insights through a trial-and-error process of learning by doing.
- Do not assume that either a pure strategic programming approach or a pure organizational learning approach is right for your organization. Most organizations need a blend of the two, and consequently, managers need to understand both.
- You should recognize that while there is nothing inherently wrong with strategic programming, the number of "mechanistic" organizations that can successfully depend on this approach is shrinking. Shifts in the nature of business have made it more important for organizations to become more "organic" and to place greater emphasis on organizational learning.
- While you will find more information about organizational learning later, you should remember that learning entails both discovery and action, that leaders play a key role in developing learning organizations, and that building a learning organization requires managers to use a broad range of "levers" to change traditional organizations.

CONTROL IN STRATEGIC MANAGEMENT

Control of the organization within a strategic management system is concerned with achieving goals by carrying out strategies effectively and efficiently. Thus the strategic management control process addresses two broad issues: (1) the adequacy of performance in fulfilling organizational goals (the effectiveness of the organization) and (2) the efficiency with which strategies are carried out.

The "correctness" of goals and strategies is evaluated during earlier stages of the strategic management process. Therefore, attention during control can be restricted to organizational performance. That is, failure to achieve goals is viewed as a performance problem, not as a matter of faulty goals. We thus are concerned in control with determining the degree to which (1) goals are achieved and (2) resources are conserved.

EFFECTIVENESS AND EFFICIENCY

Effectiveness refers to how well an organization achieves its goals--produces expected results. Similarly Hofer and Schendel define effectiveness as the optimal relationship between a firm and its environment. Thus effectiveness relates to the organization's goals. Efficiency, however, is the amount of output per unit of input and relates more to the nature of internal operations. It is not specifically related to goals. An efficient organization is one that does whatever it does with the minimum consumption of resources.

Ideally organizations carry out their activities both effectively and efficiently; that is, they do the right things in the right way. However, the other three permutations are possible. Indeed a company could be neither effective nor efficient in the conduct of its business. Such a firm would experience competitive disadvantages as well as low productivity. In other words, it would be doing the wrong things wrong.

All this suggests that a number of structural options exist that can be overlaid or used in conjunction with traditional hierarchical relationships. As with other structural matters, however, the equation is underdefined--there is no single best way.

Somewhat better off are firms that do the wrong things right (that is, are efficient but not effective). However, while citing Drucker, Hofer and Schendel note that this is a less advantageous situation than doing the right things wrong (attaining effectiveness without efficiency). Organizations that do the right things wrong will outperform those that do the wrong things right.

It is clearly better to be both effective and efficient at the same time. But when effectiveness and efficiency are in conflict, then positive external relations that lead to effectiveness should be stressed instead of internal efficiency. Although strategic management in its entirety emphasizes organizational effectiveness, the control process is concerned with both effectiveness and efficiency.

In this section we discuss (1) the type of control systems can be used, (2) phases of the control cycle, (3) typical employee responses to control methods, and (4) some suggestions for making a control system work.

TYPES OF CONTROL SYSTEMS

Managers use either steering, yes/no, or postaction control systems, or some combination of the three, for monitoring the organization's progress.

Steering controls generally involve making predictions of expected results in the form of a set of standards and then comparing performance, as it occurs, with standards to detect deviations. The near simultaneity of performance and deviation detection enables timely corrective action.

The process of keeping a moving automobile on the road is an example of steering control. Similarly new employees' fellow workers will push, prod, scale, and instruct them until they begin to conform consistently to work group norms (standards). Another example is high-frequency sampling of items produced on an assembly line for purposes of quality inspection. As soon as samples whose tolerances deviate from the standards are detected, corrections can be made in the way they are manufactured.

Yes/no controls are tests a piece of work must pass to go on to the next process. Examples include automobile inspection systems in some cases, "core" academic programs that must be completed before other courses can be taken, and the preflight tests of an aircraft.

Postaction controls consist of tests conducted on completed processes to determine whether or not results meet a standard. An inspector's evaluation of a long paper, end-line quality control inspection of manufactured products, and the use of review by peers to select articles for publication in journals and magazines are examples of postaction controls.

Of these three steering controls best meet the control needs of strategic management systems. They can be put in place to monitor the performance of an organization while its operations are under way. Information about unmet goals, especially interim targets in the form of key variables, can be fed back to each stage in the strategic management process so that corrective action can be taken.

The frequency of measurements is an important question when using steering controls. When measurements of performance are taken often, deviations from goals can be minimized. However, the cost of such a system can be great when compared with the costs of infrequent measurement. But the costs of too infrequent measurement can also be excessive. Therefore, control system management costs must be evaluated against the costs of such factors as high product failure rates, lost customers, and competitive disadvantage. In these terms even high short-term costs of control can be small when compared with its long-term benefits.

PHASES OF THE CONTROL CYCLE

The control process consists of the following four phases:

1. Select key variables that will become the major evaluative criteria for determining whether goals have been achieved and strategies appropriately carried out.
2. Set standards for key variables that represent levels of satisfactory performance.
3. Measure performance against standards to detect deviations.
4. Take action either to reinforce correct performance or to correct substandard performance.

Next we discuss each of these stages in more detail

Key Variables for Control

Control systems are most often designed to measure profitability because it is a dominant goal in most companies. However, the particular measure of profitability of interest in a particular firm can vary across several interpretations of the various forms of gross profit, operating profit, and net profit. But control systems may focus on other measurements (besides profitability), called key variables [also called 'strategic factors,' 'key success factors,' 'key result areas,' and 'pulse points'] Usually only a few key variables are used for control purposes, "six being the number most commonly used."

Key variables have the following characteristics:

1. They capture the essential elements of success (or failure) of the organization's strategies.
2. They change dramatically with changes in organization performance.
3. Changes in them are not easy to predict.
4. They can be measured directly and objectively.

To arrive at a list of possible key variables for strategic control, the analyst first can ask the following three questions:

1. What management decisions will be critical to successfully carrying out strategies?
2. What factors are important as inputs to these decisions?
3. From what sources of revenue will the firm recover costs associated with these factors?

In answering, a set of variables will emerge that are possible key variables. Then this set can be pared down to a select few by screening them according to the above criteria (success elements, dramatic change, prediction difficulty, and measurability).

The resulting set of key variables that become control variables is peculiar to the firm. These variables reflect its major strategic thrusts and can be as different in various organizations as are people's fingerprints. However, there are some common ones that are peculiar to certain functions. The list that follows is intended merely as an example of the kinds of key variables that may be ultimately selected for purposes of monitoring performance in ways consistent with strategy:

- Marketing variables: Sales, bookings, market share, gross margin, key account orders, lost orders, promotional indicators, new customers
- Production variables: Cost control (output per labor hour, overtime), percentage of capacity utilization, backlogs, quality, yield, raw materials cost, percentage of on-time delivery
- Finance variables: Inventory, accounts receivable, investment return

Within the strategic management process, major objectives and targets established for each level of strategy are also prime candidates for key control variables. For example, a management team striving to increase market share by one percentage point per year for three years can take these interim values as key variables. If, at the close of the first year, implementation of the selected strategy has failed to produce the one percentage point increase in share, then corrective action can be taken. The team might establish six-month criteria, say,

one half a percentage point, if appropriate, and gain even closer control of strategy implementation.

Too often management will set a long-term target and wait until it is not met before taking corrective action. Of course, it is then usually too late to change operations in a constructive way. Timely, feasible, understandable key variables are essential for effective control systems.

Setting Standards

After selecting key variables for monitoring organizational performance, standards have to be set for them. Standards are the levels of key variables that will be accepted as satisfactory.

Anthony and Deardon describe three types of standards: predetermined standards (budgets), historical standards, and external standards. Predetermined standards or budgets are the goals set during the goal formulation process of a strategic management program. A targeted five-year growth in return (operating profit) on sales from, say, 8 to 13 percent, defines a direct key control variable. Annual standards, or interim targets, would probably be set as part of business-level strategy. Whatever annual values were given to expected return on sales goals would be the standards against which subsequent annual performance would be compared for control purposes.

Similarly budgets, another form of predetermined standard, are often established as part of the functional strategy formulation process. Functional managers, along with top-level managers, decide upon the size of budget necessary to carry out strategy when functional strategy goals (and action plans) are established.

Historical standards are set by using past performance as a comparative base. Thus current performance is compared with past performance. Historical standards are often used to evaluate performance. Management may wish to maintain a current ratio of 2 to 1, for example, or a certain inventory turnover ratio.

Use of historical standards is recommended only when it is determined that conditions have not changed so as to invalidate the trend and when prior performance is known to be acceptable.

External standards are those whose values are derived from sources outside the firm or SBU. Examples are other firms' performance characteristics the object firm's management wants to exceed, such as market share, return on assets, to earnings per share. The shortcoming of this type of standard is the possible noncomparability of firms.

Of these three types of standards, the one best suited for strategic management control purposes is predetermined standards.

Comparison of Actual Performance Against Standards

This stage involves measuring actual key variable performance, comparing results against standards, and informing the appropriate people so that deviations can be detected and corrections made or reinforcement given. Financial or management accounting systems are usually relied on for measuring actual performance. There are, however, many other measurement methods available, including product sampling, various predictions, observation by managers, meetings, and conferences. Whatever measurement methods are selected, they should be timely, accurate, and cost effective.

The need to inform people of measurements results necessitates a system of reporting. Anthony and Deardon identify two types of reports for control systems: information reports and control reports. Information reports tell managers what is happening around them and may or may not be intended to precipitate action. Managers study them to determine if it is necessary to take corrective action. Control reports are those directed at actual versus planned performance comparisons and can take many forms.

Reinforcement or Corrective Action

Detection of negative deviations from standards usually leads to analysis of problems, decisions about how to correct them, and adjustments to operations.

Sometimes a control report will precipitate starting a new strategic management cycle. This new cycle may lead to the reformulation of goals or action plans, or both. Usually, however, strategies remain intact while operations are adjusted. The control process should be continuous so that control information is constantly fed back to the goal and action plan formulation stage. Deviations, therefore, should prompt immediate analysis so that a timely decision can be made about whether to change goals or action plans or operational management.

It is important too that performance that exceeds standards be reinforced. Too often management focuses attention only on negative deviations from expectations.

EMPLOYEE RESPONSES TO CONTROL

Control systems themselves can trigger an array of human behaviors, some of which are positive in their impact on the organization and some of which are negative. Positive reactions such as voluntary compliance or even active acceptance can be expected when control criteria demonstrate relevance through operational significance and lead to results that can be (1) affected by employees and (2) directly measured. Further, positive reactions to control can be precipitated by employee participation in the process of setting standards, especially when standards are perceived as achievable but not challenging.

Negative reactions to controls can take several forms. First, employees can resort to fudging records or even sabotage in order to distort performance measurements favorably. This result often stems from lack of participation in the process of developing standards as well as misunderstanding of the importance of control.

A large book printing company installed various types of production-counting devices on its printing and binding machines to determine which tasks represented production bottlenecks. At the end of each work day, the counters would be broken, reset before readings could be recorded, or disconnected altogether. Management was never able to install and use mechanical counters.

Another example of how control systems can be thwarted is a furniture factory in which the canvas bins containing the output of lathes were weighed to estimate the number of turnings produced. Lathe operators stopped discarding defective pieces and instead threw them into the finished goods bin to maximize their respective counts.

Similarly a university administration that measures enrollment in classes according to course registrants rather than enrollment after the drop period usually will receive distorted class-size information.

Trading of favors among organizational units can take place when there is an imbalance between staff people responsible for measuring or reporting results and line people responsible for generating those results. One might find a production manager vehemently supporting the promotion of a cost accounting manager and expecting more lenient treatment in return. This expectation clearly demonstrates the absence of understanding of the purposes of the control system.

A control system that emphasizes short-term results can jeopardize achievement of long-term goals. Failure to replace obsolete machinery may prevent short-term declines in return on assets but may also reduce long-term profitability.

Finally, absenteeism and turnover can be manifestations of tension and pressure caused by an overly strict control system.

SUGGESTIONS FOR CONTROL SYSTEM DEVELOPMENT

These negative results of control can be minimized by following Steiner's suggestions for developing control systems. They are as follows:

1. Enlist top management support. The involvement of top management can enable appropriate assignment of resources to the control effort as well as lend legitimacy to the system.
2. Have a clear organizational structure. A well-defined and well-designed structure will help managers and employees understand their responsibility and authority and their various interrelationships within the control system.
3. Establish clear control responsibility. Someone should be appointed as director of control operations so that accountability for its phases is clearly assigned.
4. Do not permit control to become an end in itself. If the control system is allowed to dominate decisions, then creativity and initiative can be thwarted.
5. Keep accounting "buzzwords" to a minimum. Use of esoteric accounting terminology may alienate those employees who do not understand it. Even a widely understood concept such as profit can evoke negative reactions from employees. A profit goal will often be interpreted by employees as an attempt to get more out of them with nothing given to them in return. For this reason positive reinforcement is important as a control method.
6. Keep it simple. Before very long a control system can evolve into a "can of worms." When this is allowed to happen, frustrations, resentment, and then inaction can result.
7. Communicate the purposes and limitations of control. Fewer negative results will develop the more employees understand and see an opportunity to benefit from the control system.
8. Encourage participation. Especially in the standard-setting process, participation fosters understanding and commitment to the control effort.
9. Keep controls simple and few in number. The easier control variables are to understand, the greater will be chances of acceptance and support by employees. Also, control variables should be kept to as few as possible to prevent unnecessary complexity, confusion, and cost.
10. Make controls meaningful. There must be widespread recognition of the importance and significance of control variables and their standards for the system to be accepted.

SUMMARY

The processes of implementation and control of strategy are critical for successful strategic management. Through implementation responsibility for the various elements of an entire strategy set is assigned to people throughout the organization. Thus the principles of organization design are integral elements in strategy implementation.

The section on organization structure has two parts. First, the influences on structure caused by major strategic thrusts or emphases are discussed. These thrusts normally should be highlighted through organization structure. Also, various environmental factors can influence the nature of organization, as discussed next.

In the second part of the section on organization, the types of structures available to strategists are explained and the lateral linkage options are presented. Most tend to view organization structuring as largely a matter of working out vertical authority and responsibility relationships for a particular strategy. However, lateral relationships also must be thought through and specified so that the appropriate cross-unit integration takes place.

The second section of the chapter addresses the process of controlling strategy implementation. Managers are primarily concerned with two factors in designing control systems. Progress toward achieving goals specified in strategy at all levels is monitored to determine whether or not strategy is effective. Then control systems should be set up to monitor the extent to which resources are conserved. The section explains several types of control systems, the elements of the control cycle, and how employees can be expected to respond to different control configurations. Last, some principles for the development of control systems are enumerated.

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